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NATIONAL ENDOWMENT FOR THE ARTS

WASHINGTON D.C. 20506

A Federal agency advised by the National Council on the Arts

Statement of

Frank Hodsoll

Chairman,
National Endowment for the Arts

Chairman,
National Council on the Arts

submitted to

Committee on Finance

United States Senate

on the subject of

Available Options for Raising Revenues

July 15 - 17, 1987

On behalf of the National Endowment for the Arts, I am grateful for the opportunity to present the Endowment's views on some of the possible options to increase revenues prepared in June by the staff of the Joint Committee on Taxation in conjunction with the staff of the House Committee on Ways and Means. I should note at the outset that this testimony reflects only the views of the Endowment.

The National Endowment for the Arts was established (P.L. 89-209) in 1965 as the Federal agency to encourage and support "national progress in the arts". The Endowment provides grants and leadership in support of artistic excellence and access to, and appreciation of, the arts. Endowment grants to institutions qualifying as tax exempt under Section 501 (c) (3) of the Tax Code (83 percent of the value of all grants in FY 86) must generally be matched with non-Federal funds at least one to one, and one of the goals of the Endowment is to stimulate increased non-Federal contributions to arts organizations so as to enhance their financial stability.

Based on 21 years of working with the nation's non-profit arts community, we wish to comment on the potential effects on that community, and philanthropy generally, of some of the options before the Committee for increasing Federal revenues. We hope that our perspective will be useful to Members of the Committee as they consider the various revenue raising options before them.

We understand the Ways and Means Committee's wish to consider revenue options in connection with the FY 1988 House Budget Resolution and in that connection to consider reductions in individual and corporate tax preferences. We have no comment on most of the staff-prepared options, but we are very concerned about those that affect the philanthropic sector of which the arts are a part.

In summary, we oppose:

A. The staff prepared option to impose a five percent excise tax on net investment income of tax-exempt organizations (even if sunsetted once the budget deficit has been reduced to a specified level), because we believe it would undermine decades of hard work by arts organizations (and other tax-exempt institutions) to achieve financial stability through the creation of endowments and the like.

Such an excise tax would also undermine the efforts of the Endowment's expenditure since FY 1982 of $65.4 million in Congressionally appropriated Challenge funds explicity to build endowments and cash reserves in arts organizations.

B. The staff prepared options which would limit charitable deductions for taxpayers who itemize: (1) limiting itemized deductions to the lowest (15 percent) tax rate, and (2) placing a floor of 10 percent of a taxpayer's adjusted gross income in excess of $50,000 ($100,000 for a joint return) under the total amount of that taxpayer's itemized deductions. We believe that these options would have a signficant adverse impact on charitable giving which as a matter of public policy is particularly to be encouraged in a time of Federal budget constraints.

Attached to this testimony is a resolution of the National Council on the Arts in support of these positions, unanimously adopted at the Council's meeting on August 1, 1987. (One of the members of the Council is former Secretary of Treasury C. Douglas Dillon.)

We also join the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the House Ways and Means Committee and Deputy Assistant Secretary of the Treasury Chapoton in emphasizing the need for additional information before specific proposals involving business income of tax exempt organizations can be put forward. We specifically include in this last respect consideration of limiting consolidated return pass-throughs and partnership allocations (at least insofar as these provisions apply to subsidiaries of tax exempt organizations) and limitations on equity kickers on loans by tax exempt organizations to business ventures. We agree that thoughtful recommendations in the unrelated business income tax (UBIT) area should not be driven solely by revenue considerations.

Nature of Tax-Exempt Sector in the Arts

Tax exemption for public charities is based on the belief that their activities are in the public interest and not adequately

supplied by market forces alone. Voluntary private efforts on behalf of society have characterized the American experience from the earliest days -- in religion, education, health, culture and social welfare. The Revenue Acts of 1913 and 1917 recognized the desirability of these activities which predated the Revenue Acts, and so exempted them from income tax and provided for deductions from taxable income of contributions to them.

While it is true that these provisions, which have in general been continued to the present day, can be characterized as tax expenditures subject to curtailment (as with any other Federal spending) in order to enhance revenues in a time of Federal budget deficits, it is also true that these provisions represent Congressional recognition that economic activities in the public interest, without net economic benefit to those supporting them, reduce the need for direct government intervention. Voluntary citizen efforts on the people's behalf, without profit to any one of them, can be encouraged through the Federal tax system. In this sense, tax incentives for charitable contributions are different than other tax incentives; the taxpayer who uses them always suffers a net loss in disposable income (but presumably receives non-tangible benefits in return, as such contributions benefit society as a whole).

Support of the arts in our system is generally a part of support of education. The arts that make a profit are generally created, produced, presented and distributed by the "entertainment industry" which is "for-profit" and pays taxes in the normal way. But the "for-profit" arts rarely include our cultural heritage and the majority of contemporary expression. They rarely include Shakespeare, Whitman, Beethoven, Copland, George Balanchine and Martha Graham. And, they rarely include the formerly commercial: Cole Porter and Jerome Kern, D.W. Griffiths and much of John Huston. Nor do they generally include the fine institutions which study, preserve and exhibit the art of all ages -- our nation's museums -- or publish much of today's poetry or present the great variety of music, drama, opera, theater, and dance, which lies outside the popular culture of the moment.

It is the activities of these institutions for which tax exemption in the arts is accorded. It is the needs of these institutions and artists, and making what they do accessible to

the American people, that caused the 89th Congress to enact the National Foundation on the Arts and the Humanities Act of 1965 to provide for a direct governmental supplement to the private support that has not been taxable from the beginning of the Federal income tax. The Act specifies that "encouragement and support of national progress in the humanities and the arts, while primarily a matter for private and local initiative, is also an appropriate matter of concern to the Federal Government."

The last 20 years have been years of enormous growth in the not-for-profit arts. Twenty years ago there were only 37 dance companies, primarily located in New York City; today there are 240 throughout the country. Less than two dozen professional not-for-profit theaters have multiplied to more than 400, in every state of the union. There were in 1979 (the most recent survey) over 600 art museums and over 300 museums with substantial art collections, and a more recent survey shows that one third of a national sample of art museums have been founded since 1960. Twenty-seven opera companies have multiplied to nearly a hundred opera companies, and the number of symphonies has tripled from 58 to 165, in the same time period. The number of American artists has also grown enormously -- from 736,960 in 1970 to 1,482,000 in 1985.

This growth in the availability of the arts has meant that many more Americans throughout the country are now able to participate in their cultural heritage and the greater part of contemporary expression which lies outside the popular culture of the moment. Sixty-four million Americans did so in 1982, and 63 percent of adult Americans would like to attend more often. Nearly 15 million people attended non-profit professional theater performances in 1986 as compared with one million in 1965; attendance at orchestral concerts rose from 10.5 million to 22.7 million in the same period. Over six million people attended opera performances during the 1984-85 season as compared with four million during the 1969-70 season. The audience for dance has increased from one million in 1965 to 16 million today. Large museums in major cities are estimated to attract between 500,000 and 2 million visitors each year.

This enormous growth in arts activities and audiences could not have happened without citizen support. While non-profit arts institutions earn substantial amounts through ticket sales, museum memberships and the like (over 50 percent on average),

the price of those tickets and memberships accounts for less than half of the actual cost of attendance, and most arts institutions provide free activities to reach out to audiences that could not afford even the price of a subsidized ticket or membership.

Where does the subsidy come from? It comes principally from private individuals and to a lesser extent from corporations, foundations and government (Federal, state and local). The recent growth in arts activities, which has brought art beyond the popular culture to millions, has been fuelled primarily by extraordinary growth in private contributions -- from $559 million in 1967 to $5.8 billion in 1986. From 1980 to 1986 alone, private contributions have increased from roughly $3 billion to $5.8 billion (nearly doubling in six years).

It is important to note that during the 1980-86 period Federal appropriations for the arts have remained relatively flat in nominal terms (down in real terms), as a contribution to reducing the Federal budget deficit. On the other hand, state appropriations for the arts have over doubled -- from $101.028 million in 1980 to $218.805 million in 1987 -- reflecting the view of state legislatures and governors in the great majority of states that arts funding is very much in the public interest. But the fact remains, and should remain, that private support on a tax deductible basis is the cornerstone of non-profit arts support -- well over 90 percent of total support. The diversity of this private support encourages diversity in the arts and preserves freedom of choice for the citizenry.

Possible Options Prepared by Staff of Joint Committee on Taxation with Staff of Committee on Ways & Means

The Arts Endowment is particularly concerned about the staff prepared options (A) to impose an excise tax on net investment income of tax exempt organizations; and (B) to delete charitable deductions for taxpayers who itemize: either (1) limiting itemized deductions to the lowest (15 percent) rate, or (2) placing a floor of 10% of the taxpayers adjusted gross income in excess of $50,000 ($100,000 if a joint return) under the total amount of that taxpayer's itemized deductions. We believe these provisions could have a serious adverse impact on the stability of non-profit arts organizations and on charitable contributions generally.

A. Excise Tax on Net Investment Income of Tax Exempt Organizations.

The staff prepared option to impose a 5% excise tax on net investment income of all tax exempt organizations would undermine decades of hard work by arts organizations (and other tax exempt institutions) to achieve financial stability through the creation of endowments and the like. Tax exempt organizations in general, and arts organizations in particular, have to raise each year enormous sums to maintain their operations and serve the public interest. The development of endowments and investment income provides a measure of financial stability and cushion from the vagaries of annual contributions. These efforts allow such organizations to ride out a bad year.

In the arts, these considerations are particularly important. It is generally conceded that arts institutions are under-capitalized, generally lacking the endowments that are normal in institutions of higher education.

To help alleviate this lack of capital base of arts institutions, the National Endowment for the Arts changed its Challenge Program in 1983 specifically to stimulate the establishment and enhancement of arts institution endowments and cash reserves. With the support of the Endowment's Appropriations Committees and the Congress, the Endowment has obligated $65.4 million to create and enlarge such endowments and cash reserves. This federally directed stimulus has catalyzed nearly $200 million in new private endowment and cash reserve funds. It is unlikely that the private donors of these funds would have been as willing to provide endowment and cash reserve gifts (normally harder to raise than project and building support) had there been an excise tax of 5% placed on the income therefrom.

The staff prepared option states that in time of large Federal budget deficits all organizations benefiting from Federal expenditures should be called upon to contribute to reducing the budget deficit. This may be true in the for-profit sector, but

not-for-profit organizations undertake tasks in the public interest (for which tax exemption existed from the beginning of the Federal income tax); their existence, activities and help provide an alternative to, and reduce the need for, government intervention -- thus reducing the pressure on the Federal budget. They should not be penalized for seeking financial stability in doing this.

While it may be true that an excise tax on investment income would have a limited impact on the totality of exempt organizations, we believe it would adversely impact just the source of income which most provides for long term stability and therefore long term capacity to carry out activities in the public interest. Those activities that are most in the public interest surely involve long term engagement on society's behalf; this is as true for arts institutions as education institutions; it is in the national interest that their long term stability be enhanced with minimal direct federal appropriations.

Finally, no one is arguing that tax exemption of net investment income to tax exempt organizations creates unfair competition with the for-profit sector. We completely agree with Deputy Assistant Secretary of Treasury Chapton that "an exempt organization's investment of capital in a taxable business should not generally raise concerns over unfair competition". We also agree with him that "exemption for passive investment income may appropriately encourage exempt organizations to avoid deeper commercial involvements and the potential distractions and conflicts they present".

B. Limitation on Charitable Deductions for Taxpayers Who Itemize

1. Limitation of Itemized Deductions to the Lowest (15% Percent) Tax Rate

Limiting the highest rate of deduction to the lowest (15 percent) tax rate, when under current law the highest tax rate is 38.5 percent, would significantly reduce current incentives for charitable contributions and would likely have an important adverse effect on philanthropy itself.

The argument that this option would eliminate the greater proportionate benefits that higher income taxpayers receive under present law ignores the fact that these higher income taxpayers are paying taxes at higher rates than lower income taxpayers to begin with, and that therefore deductibility at the higher rate is equitable since the tax exempt purposes of charitable deductions are in the public interest. The higher income taxpayer should be, and is, taxed at a higher rate to provide revenues for direct government expenditures in the public interest; such a taxpayer should not be taxed on income which he or she contributes directly to support activities in the public interest, particularly when, even at this year's highest rate, 61.5 percent of the contribution represents his or her own resources.

The option also has the effect of applying a limitation on deductions for state and local taxes and mortgage interest. One of the great debates prior to passage of the Tax Reform Act of 1986 (TRA) involved the question of deductibility of state and local taxes; that debate was resolved in favor of continuing their deductibility, and the issue would not usefully be reopened within one year. Most would also agree that the traditional interest in encouraging home ownership militates against a limitation on deductibility of mortgage interest.

Further, since state and local tax payments are not optional expenditures and home ownership normally requires payment of mortgage interest, the only truly discretionary expenditure affected by this option involves charitable giving. At a time when federal budget constraints argue for greater private activity in the public interest, it makes no sense to establish additional burdens to charitable giving. We agree with the Joint Committee staff that the proposal would also add further complexity or tax complications for tax itemizers.

2. <u>A Floor of 10 Percent of A Taxpayers Adjusted Gross Income in Excess of $50,000 ($100,000 for A Joint Return) Under the Total Amount of That Taxpayer's Itemized Deductions</u>

The 10 percent floor option similarly would reduce the incentive for charitable giving by those who can afford to be generous. The argument that personal consumption should not be subsidized through the tax system does not apply to charitable deductions which subsidize activities in the public interest, not consumption. As in the case of the option to limit the rate for charitable deductions, this option's potential impact on state and local tax deductions and home mortgage deductions goes contrary to the resolution of the Congress in enacting the TRA.

Existing tax law reflects appropriate tax policy regarding floors to deductions, in that different floors are placed on different deductions: 7.5 percent for medical expense; 10 percent for casualty and theft losses greater than $100; 2 percent for miscellaneous itemized deductions. It is current tax policy that there should be no limit on state and local income and real property tax deductions as a matter of comity with state and local governments, that policies in favor of home ownership militate against restricting mortgage deductions, and that general deductibility of charitable gifts (from 1913 and 1917 on) should not be restricted (except as a cap).

Growth of Tax Exempt Sector and Problems

Although tax exemption and deductibility for charitable and other societally desirable activities have been a part of our tax laws since 1913 and 1917, it is also true, as Deputy Assistant Secretary of Treasury Chapton has noted, that growth in the exempt sector has both increased the importance of tax exemption and deductibility and has tended to blur the historical differences in activities and funding between exempt and taxable organizations. There is no question that there have been abuses, and in 1950 Congress enacted the Unrelated Business Income Tax (UBIT), largely in response to concerns about unfair competition between exempt organizations and taxable businesses. The application of UBIT was expanded in 1969, and in 1984 the Congress provided that tax exempt organizations would no longer be entitled to the investment tax credit and accelerated depreciation.

Under current law, tax exempt organizations can earn a profit but not distribute it to their owners or members; they can also earn income (without taxability) that is related to their tax exempt purpose. For example, performing arts institutions can without tax on the revenues sell tickets to an audience, and museums can similarly sell reproductions of the works of art in their collections. In addition, tax exempt organizations benefit from the availability of federally subsidized mail rates, numerous state and local tax exemptions, and exemption and special treatment under other federal and state requirements (e.g., social security, unemployment, and minimum wage provisions). But these tax exempt organizations which are public charities all have to raise money from contributions to make up the losses they sustain in achieving public purposes.

The Office of Advocacy of the Small Business Administration believes there has been an increase in commercial activities engaged in by tax exempt institutions, particularly by hospitals and higher education institutions (which together account for almost 70% of the non profit sector). The General Accounting Office (GAO) in its February 1987 report in response to a request of the Joint Committee on Taxation states that "representatives of the taxable business community question the appropriateness of tax exempt organizations competing with taxable businesses and question the justification for tax exempt status in these situations".

On the other hand, the GAO report notes that the tax exempt community, while recognizing that some tax exempt organizations are expanding their income producing or commercial activities, believes this expansion is important to furthering tax exempt purposes. The tax exempt community also believes that some competition has always existed as between the tax exempt and for-profit sectors and that the increase in this competition is largely due to taxable businesses expanding their activities into areas traditionally regarded as tax exempt (e.g., day care and physical fitness activities). Representatives of the tax exempt community have also pointed out that the for-profit small business community has a number of advantages not available to the tax exempt community: e.g., government contracts designated solely for small businesses (set-asides), tax credits, loan guarantees, and access to capital through stock issuance.

While the Endowment cannot comment on problems stated to involve unfair competition between tax exempt and for-profit organizations in non-profit sectors other than the Arts, we do believe the American Arts Alliance's survey of arts institutions reporting unrelated business income shows that arts organizations are likely complying with current law and regulations. In their testimony of June 5, 1987, the Alliance noted that most respondents have never been audited by the Internal Revenue Service regarding unrelated business income. Of the 35 institutions that reported such audits, 25 were found by the IRS to be in compliance with the law, and nine were awaiting a final ruling. The Survey indicated that only one institution responded that the final audit was unfavorable.

There is no question that there are major issues posed by the intersection of the tax exempt and for-profit sectors. The issues are not new; they have been present since enactment of a general income tax; and, as noted, new provisions have been added to the tax laws to deal with these issues. What is not clear is whether the current situation requires additional legislation or whether current law, perhaps with additional enforcement, is adequate to deal with the issues.

Essentially all parties at interest appear to agree that there is a need for better information, research and analysis in this area. This is as true of the Office of Advocacy of the Small Business Administration as it is of the non profit sector. And, both the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the House Committee on Ways & Means agree that there is only limited data available and that additional data and information are needed to measure the nature and magnitude of the competition between taxable and tax exempt organizations. The Subcommittee on Oversight and the Treasury Department believe such information must be developed before specific proposals regarding UBIT can be put forward.

The Arts Endowment agrees with this conclusion. The GAO February 1987 report did not verify whether the unfair competition cited by representatives of the taxable business community actually existed; nor could the GAO determine whether tax exempt organizations offered goods and services for more or less than taxable businesses nor whether tax exempt

organizations realized a surplus from their competitive activity. We believe that such evidence must be in hand across-the-board before across-the-board legislation should be enacted to tighten current tax laws regarding the tax exempt sector.

The staff prepared option to limit consolidated return pass-throughs makes a great deal of sense in principle, and Deputy Assistant Secretary of Treasury Chapoton has suggested changes in the definition of controlled organizations and in the ownership attribution rules as they relate to controlled subsidiaries of non-profit organizations. We, nonetheless, believe that consideration of this matter in the tax exempt sector should be part of an overall analysis of the issues. There are also, as the staff paper notes, administrative difficulties with such limitations.

Similarly, we believe the staff prepared options on partnership allocations and equity kickers on loans to business ventures should await further study. While we agree that partnership allocations that are actually sales of tax benefits can cause economically inefficient investment decisions and can be unfair, we also note that there are a number of limitations already in place to control this situation. We believe tax exempt entities should not be held to stricter standards of distinguishing debt from equity than other investors. Deputy Assistant Secretary of Treasury Chapoton has noted the difficulty of structuring partnership restrictions (e.g., regarding debt financed property rules). Again, we believe consideration of this matter should be part of overall analysis of the issues involving non-profits engaged in business ventures.

The unrelated business income of tax exempt organizations should be taxed, and it is taxed now. The only question involves what is "related" or "unrelated"; this is now determined from the facts of individual cases in relation to the tax exempt purposes of the organizations involved. As in any system of case by case determinations, the administrative and judicial process produces inconsistencies of interpretation; but so can enactment of new legislation; and the question remains whether there is an across-the-board problem that can be equitably resolved by across-the-board solutions. Thus, we would urge development of a better information base on the basis of which the various parties at interest can rationally argue the merits of their respective positions.

* * * * * * * * *

In conclusion, the Endowment believes that the compromises contained in the Tax Reform Act of 1986 regarding individual deductions should not at this time be significantly altered. Given the basic balance of interests achieved in that Act, the country would be better off if the TRA were left largely alone until the results of those balances can be measured. This is particularly so with regard to charitable deductions. The reduction in marginal rates, the elimination of charitable contribution deductibility for non-itemizers, and the inclusion of gifts of appreciated property in the minimum tax base all impact the tax exempt sector. While the results of those changes cannot yet be estimated, the Endowment urges that analysis of those results be undertaken before new burdens are placed on the not-for-profit sector. We also believe that the staff prepared options to limit deductibility are counter to long standing tax policy.

With regard to the issues involving the intersection of the tax exempt and for profit sectors, the Endowment concurs with the Chairman and Ranking Minority Member of the Subcommittee on Oversight of the Ways and Means Committee that revenue options with regard to UBIT should not be considered until better information and analysis is available. The Endowment is prepared to cooperate in developing such information and anaylsis with respect to not-for-profit arts organizations.

Finally, we believe that consideration of revenue raising options that impact the tax exempt sector should carefully weigh the public purposes that this sector achieves in the public interest. In a time of Federal budget deficits, it is of great importance that we do not through tax revenue options increase the pressures for larger Federal appropriations.

Tax incentives for charitable contributions encourage some portion of the taxpayers' disposable income to be spent to advance the public interest. Such tax incentives are cost beneficial to the Federal Government in comparison to direct appropriations. They also permit decision-making with regard to the public interest to be made at the local level. As the National Endowment for the Arts and the Humanities Act stipulates, this is the primary consideration in support of the arts. As in education, governance of our nation's artistic effort has been, and should remain, in the hands of the people.