

Guidance Needed from Treasury on Donations of Motor Vehicles, Boats and Airplanes

Changes in vehicle donation deductions authorized in the American Jobs Creation Act will become effective December 31, 2004. Without immediate action by the Treasury to issue temporary guidance and regulations there will be significant donor confusion and serious economic damage to charities, the environment, and the automotive industry.

Current Situation

The American Jobs Creation Act, in Section 884, requires the Treasury to issue guidance and regulations on the amount donors can deduct for motor vehicles, boats and airplanes. Most of Section 884 is in clear language and will go into effect after December 31, 2004 without specific guidance from the Treasury. However, sales which are in "direct furtherance" of the donee organization's charitable purpose will be treated differently when the Treasury promulgates guidance or regulations. Specifically, "direct furtherance" sales will be exempted from the requirement that donor deductions "shall not exceed the gross proceeds received from" the sale of the donated vehicle. Donors of vehicles to qualifying charities will continue to be permitted deductions based on a value identical to all other general non-cash donations.

Intent of Congress

Section 884 is classified as a revenue provision in the American Jobs Creation Act. However, Congress clearly intended and estimated that vehicle donations would not be eliminated and would continue at a substantial pace. Congress estimated that this law would increase individual taxpayer taxes \$2.4 billion over 10 years, a reduction of only 36% in the \$6.54 billion tax saving that taxpayers currently get from vehicle donations (based on the unadjusted GAO annual savings of \$654 million in 2000 in GAO Report: 04-73.) The estimated revenue generation appears to arise from an attempt to achieve three, somewhat conflicting, objectives:

1. Capture revenue lost to overvaluations by donors¹
2. Eliminate programs which are uninterested in maximizing the selling price of donated vehicles^{2 3}
3. Avoid harm to programs that use vehicle donations to further their exempt purpose and attempt to maximize revenue from vehicle sales.⁴

The structure of the Conference Agreement shows that exemptions are the most important aspect of proper implementation of the Section. The Conference Agreement is three paragraphs, the first being a summary of the law and the final two being distinct discussions on implementation of the exemptions.

Legislative Mechanism

Congress achieves these objectives, first, by eliminating the ability of most charities to attract vehicle donations. The charities that will cease to operate are ones for which vehicle donations are unrelated to their charitable purpose. Secondly, Congress imposes control mechanisms on charities that will continue to operate, as detailed below:

Unrelated Business Restrictions Where the sale of vehicles is unrelated to and not in direct furtherance of the purpose of the donee charity, the Act creates a strong disincentive for donors to choose that charity. If they do donate to it, they will only receive a tax deduction equal to the "gross proceeds" that the charity sells the vehicle for. The Act, therefore, will effectively end vehicle donations to programs that are not substantially and directly related to the charity's purpose as tax benefits will no longer approximate trade-in values.⁵

¹"The proposal attempts to address the overvaluation problem..." Joint Committee On Taxation, Description Of Revenue Provisions Contained In The President's Fiscal Year 2005 Budget Proposal, JCS-3-04 (February 2004), p. 277

²"From the perspective of the charitable donee, there arguably is little incentive to maximize the selling price of a donated vehicle, because the charity frequently receives net cash proceeds it would not otherwise receive, with little effort expended by it." *ID.* at p. 277

³"such a rule would provide an incentive for a donor to attempt to determine both the value of the vehicle and the methods used by the donee to maximize net proceeds it derives from vehicle sales fundraisers." *ID.* at p. 278

⁴"To the extent that charities do not use the vehicles in their exempt purposes, ... (a) rule that discourages large numbers of automobile donations is a worthy goal." *ID.* at p. 278, paragraph 2, sentence 7

⁵Most donors are reluctant to sell a vehicle on their own so they evaluate the relative benefits of trading in vs. donation. In practical terms, fair market values are usually 2 to 3 times higher than the auto auction sales prices on vehicles worth

There are three specific exceptions that allow continued use of the current "fair market value" rules, all of which are variations on furthering of charitable purpose. There are two exceptions that became effective when the act was passed: Usage of a vehicle by the charity and when a vehicle had "significant improvement" prior to sale (AKA: The high school auto-shop exception.) A third exception, specifically for sales which are in "direct furtherance," is activated when the Treasury passes appropriate guidance and regulations.

Control Mechanisms: Congress provided two control mechanisms:

1. *Information:* Charities will be required by the Act to provide the same information they provide to donors to the Treasury. New information collected includes *Vehicle Identification Numbers* (VIN) and *Taxpayer Identification Numbers* (TIN) which would permit automated verification of deduction claims. As previously presented to the IRS, a VIN Verification System allows the Service to establish condition/price integration and electronically identify over-valuing tax cheaters. Note: the Treasury already has the legal authority and ability to ask for financial details of fund-raising activities such as vehicle donations.⁶
2. *Regulations/Guidance:* The Treasury can issue regulations and guidance on all aspects of this law that are "necessary to carry out the purposes of this paragraph". Specific regulations and guidance are needed to activate the "direct furtherance" exception. Furthermore, the Treasury has the responsibility to minimize donor confusion by clearly directing them how to value vehicles when the gross proceeds rule is not in place. It is within the authority of Treasury to require charities to inform donors, thoroughly and accurately, of the resources and standards for setting correct fair market values. This can be included in the future permission to hold tax exempt, 501 (c)(3), status. And this status can be revoked for a failure to fulfil this information requirement. Communication of the proper valuation methods, combined with the increased information gathering, will eliminate the majority of overvaluations by donors.

Effect on Taxpayers and Fundraising if Guidance Not Issued for "Direct Furtherance" Exemption

Without promulgated guidance from the Treasury, revenue to charities from vehicle donations will decline 90% or more. This is based on the fact that the most valuable 20% of vehicles donated yield 92% to 96% of revenue to charities. These vehicles will no longer be donated because the tax incentive will no longer be greater than trade-in values. This 90% decline will be a far cry from the 36% decrease in deductions intended by stopping tax cheaters. In fact, this will result in many vehicle donations programs that directly further charitable purposes being discontinued because they will not be able cover the necessary and reasonable expenses of running their programs.

Further, if Treasury does not provide the called for guidance for the "direct furtherance" exception, deductions by taxpayers will decrease at least 76%, and probably 94% (based on the retail value of the actual mix of donated vehicles and the projected decline in donations of higher value vehicles.) Based on the unadjusted GAO annual savings of \$654 million in 2000, this decline will generate between \$4.97 and \$6.14 billion in tax revenue over 10 years, well in excess of the \$2.379 billion projected by, and intended by, Congress.

Congress clearly intended and estimated that vehicle donations would continue; hence the low estimated reduction in tax benefits and corresponding revenue generation. The Conference Agreement calls for the specific continuance, under the old valuation rules, of sales that are in "direct furtherance" of an organization's charitable purpose to allow continuation of viable, responsible, efficient vehicle donations programs.

Economic Consequences if Guidance Not Issued for "Direct Furtherance" Exemption

Failure to maintain a viable vehicle donation system will result in serious economic dislocation for the automotive industry and negatively impacted the environment as detailed below:

between \$2000 and \$5000 (the vehicles that charities make money on.) Auto dealers sell trade-in cars at auto auctions and will pay cash for trade-ins no higher than these sales prices. Therefore, for the potential upper income donor (35% bracket), the tax benefit of fair market value deductions is currently equivalent to the trade-in cash value and donations are made based on marginal differences. If the deduction is equal to the auto auction sale price, then the tax benefit will be approximately one-third of auction values and will never exceed trade-in values so donations will not occur.

⁶ The Attorney General of California has achieved a doubling of the percent of gross proceeds to charities, from under 20 percent to over 40 percent, by requiring the publication of such data for vehicle donation programs provided by third party operators. Reports available at <http://caag.state.ca.us/charities/publications.htm>.

Economic Dislocation Vehicle donations that are valued at fair market value act as a floor on used car trade-in values. Removing this floor will result in lower values for all used vehicles at trade-in, broadly reducing the pool of money available for new car purchasers who trade-in vehicles on a regular basis resulting in a direct reduction in new car sales. In addition, at least 733,000 and probably more than 1.8 million vehicles (when growth and non itemized donations are included) are donated each year. There are approximately 40 million used car sales each year. Elimination of vehicle donation programs will result in up to 4.5 percent of total used car sales moving from dealers to private parties and will significantly reduce prices.

Environmental Damage The environment will suffer because older vehicles that are near the end of their life are efficiently routed into junkyards by vehicle donation programs. Up to 60 percent of donated vehicles are donated by people who do not itemize simply to get rid of an unwanted vehicle. Charities make little or no money on these vehicles but take them as a service to their supporters and the environment. Without a robust vehicle donation program between 200,000 and 400,000 vehicles per year will remain on America's streets unless their owners take extraordinary efforts to dispose of them. The likely alternative is that owners will simply selling them at very low prices to people who will run them in their polluting state and ultimately abandoned them. Abandon vehicles are already a serious problem in our cities and this will make it much worse.

Congress clearly intends neither of these consequences.

Type of Guidance Required by Conference Agreement

The Conference Agreement records that Conferees specifically intended the Treasury to issue “appropriate” guidance for charities that use vehicle sales to further their charitable purpose, which contrasts with its instruction that the two narrow exemptions be “strictly construed.” This broad exemption is further expanded by the example of this type of guidance given by conferees. They would even allow an organization whose purpose was aiding the poor to be “directly” furthering its charitable purpose “by selling automobiles to needy persons at a price significantly below fair market value.” Any number of charitable purposes might qualify under this guidance, including helping needy people secure work or handicapped individuals get their care. "Strictly construed" guidance for this example would require that the act of selling a vehicle was directly specified in the charitable purpose, for example, when a charity's articles of organization stated their purpose was to provide affordable vehicle transportation to needy individuals.

Language and guidance called for from Treasury by the Conference Agreement is well established and litigated under the Unrelated Business Income Tax (UBIT) laws and regulations. The following quote from IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, is self explanatory:

“A business activity is not substantially related to an organization's exempt purpose **if it does not contribute importantly** (IRS emphasis) to accomplishing that purpose (other than through the production of funds).”

Similarly, for the donee/charity, in order for the sale of a donated vehicle to be “in direct furtherance”, it must **contribute importantly** to the donee/charity's charitable purpose. The conferees direct Treasury that “appropriate guidance” be extended to the “direct furtherance” exception. By using the experience and litigated definitions from UBIT, Treasury's appropriate guidance will allow charities and donors to quickly and easily understand the application of this “direct furtherance” exception.

Recommended Guidance

Immediate temporary Guidance should establish that the “direct furtherance” exception applies to vehicle sale business activities that “contribute importantly” to accomplishing an organization's exempt purpose and that examples and ruling from UBIT would apply. This guidance should clarify that none of the regulatory exceptions from UBIT applies for the “direct furtherance” exception, including the exemption of the sale of donated goods and the requirement that a business be “regularly carried on.” Subsequent Guidance should give more details on unique situations where the "direct furtherance" would apply.

Recognizing the current burden imposed on Treasury by the Act, Temporary Regulations and/or those in a Question-and-Answer format would be sufficient to give guidance and reliability to confused charities and donors prior to the effective date of December 31, 2004. Issuance of guidance after this date will result in confusion and incorrect claims by donors and significant economic damage to charities, the environment, and the automotive industry.