

## THE CHARITABLE CONTRIBUTIONS DEDUCTION (REVISITED)

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In approaching this paper, I decided to explore first whether there is a theoretical case for a charitable contribution deduction (CCD) in an income tax.<sup>2</sup> In so doing, I wanted to stay within the context of accepted income definition and the U.S. income tax system.<sup>3</sup> Part I of the paper presents the results of that exploration. Having concluded that there is a conceptual case for a CCD in the U.S. income tax system, I then outline in Part II the policy and other changes in current law and practice that would be required to implement the model developed in Part I.<sup>4</sup>

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<sup>2</sup> In my previous works on the topic, I accepted that the CCD constituted a tax expenditure in the U.S. income tax and analyzed it accordingly. See Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 *Tax L. Rev.* 377 (1972) (hereafter “Matching Grants”); Paul R. McDaniel “Study of Federal Matching Grants for Charitable Contributions,” in *Commission on Private Philanthropy and Public Needs*, 4 *Research Papers* 2417 (U.S. Dep’t of the Treasury, 1977); Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures* 205, 287-289 (Harvard Univ. Press 1985)

The CCD has been included in U.S. tax expenditure accounts since their formal inception pursuant to the Budget Reform act of 1974.

<sup>3</sup> In his landmark work, Professor Andrews justified a CCD in an “ideal” income tax on the basis that charitable contributions were a type of consumption that provided a public good. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 309 (1972). Andrews’ approach was critiqued in *Tax Expenditures* at 287-288 on the basis that, in his definition of “consumption”, he did not stay within the context of an income tax, and in Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 *Va. L. Rev.* 1393, 1416 (1988), asserting that Andrews’ argument in favor of his analysis really was an argument for a subsidy. Gergen accepts the subsidy classification and argues that the CCD is a desirable form in which to deliver the subsidy.

<sup>4</sup> This paper does not deal with the charitable contributions deduction for wealth transfer tax purposes. IRC §§2055, 2522. For recent analyses of that deduction, see, e.g., David Joulfaian, *Estate Taxes and Charitable Bequests by the Wealthy*, 53 *Nat’l Tax J.* 743 (2000) (arguing that, based on an analysis of 1992 estate tax returns, the overall effects of the estate tax deduction are “modest”; the tax deduction lowers the price of bequests to charity, but the wealth reduction effects pull in the opposite direction); David Joulfaian, *The Pattern of Charitable Bequests and the Influence of Estate Taxation*, 1999 *National Tax Association Proc.* 28 (based on examination of 1995 estate tax returns, found that repeal of the estate tax would reduce charitable bequests by 12%, but if the estate tax were retained and the charitable contribution deduction were

## I.

*The Treatment of Non-Charitable Gifts.* I begin to (re) assess the role of the charitable contributions deduction in the U.S. income tax by examining the treatment of non-charitable gifts, which involve overwhelmingly intra-familial gifts. It seems to me that unless we understand the conceptual bases for the non-charitable gift situation, it is difficult to assess the charitable gift area.

Assume a parent (P) gives \$1,000 to P's child (C). There are four possible income tax treatments of this gift.

1. No deduction for P and \$1,000 income to C.
2. Deduction of \$1,000 for P and \$1,000 income to C.
3. No deduction for P and no income to C.
4. \$1,000 deduction for P and no income to C.

The first approach has some support in the Haig-Simons definition<sup>5</sup>, as formulated by Professor Simons.<sup>6</sup> There are two difficulties with the approach, however. First, in Professor Simons' brief exploration of the term "consumption," he offers as a definition the "destruction of economic goods."<sup>7</sup> Obviously, in the gift situation, there is no

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repealed, charitable bequests would decline by 45%).

Nor is the deduction for charitable contributions by corporations considered. IRC §170(b). See James R. Boatsman and Sanjay Gupta, *Taxes and Corporate Charity: Empirical Evidence from Microlevel Panel Data*, 49 Nat'l Tax J. 193 (1996) (finding that the income elasticity for corporate charitable giving is very low); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation and the Social Constitution of Charity*, 44 DePaul L. Rev. 1 (1994) (arguing that corporations are motivated solely by profit concerns in making gifts to charitable organizations, i.e., it is the purchase of good will); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. Rev. 579 (1997) (arguing that to protect shareholder interests, corporations should be required by the SEC to disclose charitable contributions).

The special treatment of transfers of appreciated property to charity completes the list of topics not covered in this paper. IRC §170 (c), (e). See, e.g., Cherie J. O'Neil, Richard S. Steinberg, and G. Rodney Thompson, *Reassessing the Tax-Favored Status of the Charitable Deduction for Gifts of Appreciated Assets*, 49 Nat'l Tax J. 215 (1996) (finding that only donors with incomes in excess of \$200,000 are influenced by the special rules; lower income taxpayers are price inelastic with respect to property donations).

<sup>5</sup> Personal income is the algebraic sum of a taxpayer's increase in net worth plus consumption between two points in time. Henry C. Simons, *Personal Income Taxation*, 49-50 (Univ. of Chicago Press 1938) (hereafter "Personal Income").

<sup>6</sup> "The proposition that everyone tries to allocate his consumption expenditure among different goods in such manner as to equalize the utility of dollars-worths may not be highly illuminating; but there is no apparent reason for treating gifts as an exception." *Id.* at 57-58. The thesis of this paper is that there is such a reason. Simons was quite clear that gifts should be included in the income of the donee. *Id.* at 58, 125-147, writing much more extensively on that issue than he did on the treatment of the donor.

<sup>7</sup> *Id.* at 50.

destruction of economic goods by the donor; there is simply a transfer of economic value.<sup>8</sup> More fundamentally to this paper is the fact that, if the donor recognizes income in the gift situation, it is in the form of psychic income derived in a non-market transaction, whether it be altruism, the pleasure in seeing the gift consumed by other family members, the desire for familial control, or the like<sup>9</sup>. We do not seek to reach such income in the U.S. income tax, income from leisure being the overwhelmingly largest example. It is not clear why we should seek to reach it in the family gift context. On the other hand, taxation of the donee fits comfortably within the Haig-Simons definition.

The second approach picks up this last point. The donee has a clear accession to wealth and the amount of the gift should be included in income. Granting a deduction to the donor prevents the donor's psychic income from entering into her tax base. Under this approach, the deduction is not granted because it is necessary to define an "ideal" income tax base. It is solely a mechanism to eliminate this intangible form of income from the tax base and, hence, to treat it consistently with that accorded similar forms of income.<sup>10</sup> The second approach thus has the appeal that it treats the donee properly and treats the donor consistently with others who realize various forms of psychic income in non-market transactions. As such, it has a considerable claim on equity grounds.

There are, however, two significant problems with the second approach. The first is that, in a system using progressive rates, there could be unacceptable opportunities for income shifting within the family unit in transactions which may not change the overall economic position of the family as a whole. These transactions could be difficult for the IRS to monitor and there would be a resulting reduction in the equity gains noted above. Second, the approach could produce insurmountable administrative problems for the IRS. Many gifts of cash could go unreported and there could be an incentive to overvalue gifts of property where the value of the deduction to the donor exceeded the increased tax burden to the donee.

Thus, despite the initial attractiveness of the second approach on equity grounds, the tax avoidance and administrative problems it creates are considerable. These problems in turn lead to the third approach: no deduction for the donor and no income to the donee. This, of course, is the current U.S. approach.<sup>11</sup> This approach accepts taxation of

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<sup>8</sup>I put aside the alleged value destruction games in such situations as the family limited partnership. See James R. Repetti, *It's All About Valuation*, 53 Tax L. Rev. 607 (2000); James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 Tax L.Rev. 415 (1995).

<sup>9</sup>Of course, intrafamilial transfers may constitute compensation for services. For purposes of this analysis, I accept the current somewhat uncertain line between donative and performance-based transfers.

<sup>10</sup> I do not justify the result as necessary to prevent "double counting," i.e., taxing both the donor and the donee on the same income, an approach Simons properly rejected. *Personal Income* at 57-59. Although Simons seemed to think gifts were consumption expenditures by donors, he did not explain why the gift situation differed from the non-taxation of leisure, a result which he approved. *Personal Income* at 52.

<sup>11</sup> IRC §102(a).

the psychic income of the donor and does not tax the donee but, I will argue, only because it reduces the administrative problems involved in the second approach.<sup>12</sup>

The fourth approach — deduction to donor and no income to donee — has no normative claim. That is, neither the administrative difficulties of the second approach nor the conceptual defects of the third approach justify non-taxation of the gift transaction in its entirety.

From the above discussion, I derive the following principles:

1. The taxation of the psychic income of the donor derived from making the gift should be avoided (by granting a deduction) so long as there is reasonable assurance that the value of the gift is included in income on the donee side of the transaction.
2. Taxation of the donor (by disallowing a deduction) is appropriate where the value of the gift is not likely to be included in income on the donee side of the transaction or administrative concerns justify such an approach.

I now turn to assess the applicability of the above principles in the charitable contribution situation.

*The Treatment of Charitable Gifts.* Before beginning the discussion on the treatment of charitable contributions, I want to specify three assumptions that I make in the following discussion. The first is that I accept as a given the tax exemption granted to public charities (which is the only type I consider) by §§ 501(c) and 509(a)(2) and that deductible contributions are appropriately defined. The second is that I assume such organizations to be entities rather than aggregates of individuals.<sup>13</sup> The third is that current law appropriately identifies a “contribution,” for example, compared to a payment for services.<sup>14</sup>

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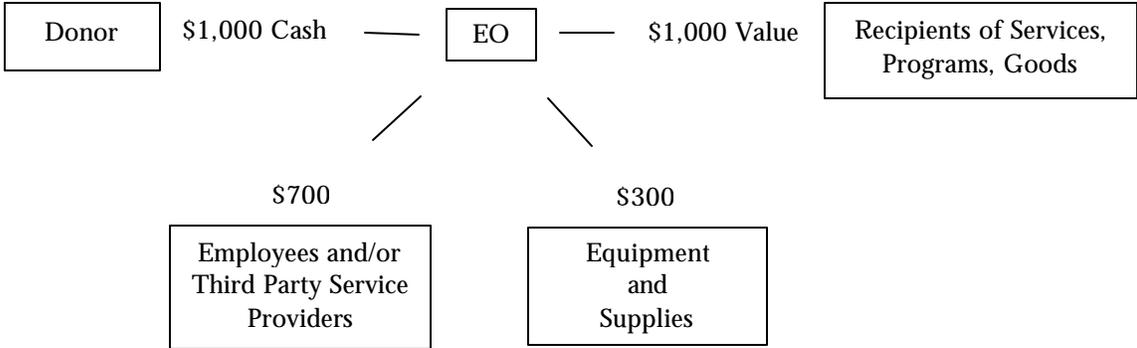
<sup>12</sup> Some justify the current result on the basis that it is the power to consume that should control income inclusion, not how that power is exercised. See Gergen, note 3, at 1417. See also Andrews, note 3, at 355; *Helvering v. Horst*, 311 U.S. 112 (1940). Others argue that current law treatment of the donor is appropriate on the ground that denial of the deduction achieves the right interpersonal results among similarly situated taxpayers. That is, assume A and B each have \$1,000 of income, A spends \$50 on a ski trip and B gives \$50 to charity. Each has made a personal choice as to how to spend \$50 and should therefore pay the same tax, a result reached by current law denying a deduction to A. This approach does not deal with A’s donee side of the transaction and assumes non-market and market transactions should be treated alike. If the donee is taxed, we are driven to ask why is A also taxed in a non-market transaction on psychic income (B being taxed in a market transaction in which B pays what the ski trip costs).

<sup>13</sup> See *Tax Expenditures* 219-220, for a discussion of alternate ways to treat tax exempt organizations in tax expenditure accounts..

<sup>14</sup> This assumption obviously is challengeable, particularly in the case of organizations such as churches,

The critical phrase in the above principles is “included in income on the donee side of the transaction.” In the charitable context, I believe that what many would assume, if the issue were considered at all, is that the donor’s contribution (or the value of goods or services generated by the contribution) should be included in the income of the beneficiaries of the donee charitable organization’s activities.

Consider the following model:



Under these circumstances, the first principle stated above would hold that Donor should receive a charitable contribution deduction for the \$1,000. This is because the \$1,000 should be taxable to the recipients of the services and goods.

If the donor is denied the CCD in this model, then psychic income is being taxed just as in the case of a nondeductible, non-charitable gift. It does not matter whether the income is derived from altruism, a desire for status in the community, power, or whatever.

But can we tax the beneficiaries of the exempt organization (EO) activities, deemed to be \$1,000 in value in our example? I think it is administratively not possible to do so. Problems of tracing income to beneficiaries of charitable organizations, particularly social welfare agencies and churches, and valuation difficulties make such an approach administratively nearly impossible to implement.

But does this mean, then, that the only policy choice is to deny a CCD to those who make contributions to charitable organizations? The European experience with the Value Added Tax (VAT) suggests one other possibility. Under a VAT, a charitable organization providing goods or services to an ultimate consumer should pay VAT on the goods and services it pays for and should then get a credit for the VAT it has paid against the VAT it charges to its consumers (the program beneficiaries). Such an approach, however, is as problematic as requiring income inclusion in an income tax. Thus, to avoid

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symphony orchestras and museums. See, e.g., Gergen, note 3, at 1394. The current treatment is so well-established, however, that the assumption seems reasonable.

eliminating the consumption entirely from the tax base one of two approaches can be taken: (1) the charitable organization can be denied a credit and thus incur the VAT it has paid to its suppliers; or (2) the charitable organization can pay the VAT on behalf of its consumers-beneficiaries, thus in effect increasing their benefit.<sup>15</sup>

Taken to the income tax context, the second approach would require charitable organizations to pay the income tax that would be estimated to be due if its beneficiaries could be taxed. A single flat rate could be used (or different rates for different categories of charitable organizations). For ease of administration, the tax base could be the costs incurred by a charitable organization in providing its goods or services. This approach permits the donor to take a charitable contribution deduction, insures that the consumption of beneficiaries of charitable organizations remains in the tax base, and is administrable.

Thus, policy makers can be given the choice of:

1. Denying the charitable contribution to donors and not taxing either the charitable organization or its beneficiaries.
2. Granting the charitable contributions deduction to donors and taxing the beneficiaries of charitable organizations through a surrogate tax on the organizations.
3. Granting the charitable contributions deduction to donors and not taxing the beneficiaries of charitable organizations, either directly or through a surrogate tax; in this case, a tax expenditure is involved.

## II.

The following discussion identifies the specific policy approaches that flow if the approach outlined in Part I were adopted. In addition, recent analyses of the CCD will be placed in the context of the model set forth above.

CCD for Non-itemizers: The most obvious policy implication from Part I is that the CCD should be made available to non-itemizers as well as those who itemize their CCDs, assuming that tax is imposed as proposed in option 2, above.<sup>16</sup> If I have analyzed

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<sup>15</sup> See the discussion in McDaniel and Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (Kluwer, 1985) at pp. 72-73 (dealing with the treatment of government subsidies, the government being a tax exempt entity.)

<sup>16</sup> In 2001, 70% of taxpayers are expected to claim the standard deduction and only 30% will itemize their deductions. Joint Committee on Taxation, *Description and Analysis of Present Law and Proposals to Expand The Federal Tax Incentives for Charitable Giving* 10 (JCX-13-01), March 13, 2001) (hereafter "2001 JCT Analysis"). In 1998, only 29% of returns itemized deductions. Internal Revenue Service, Statistics of Income Bulletin, Table 1 (Fall 2001) at [http://www.irs.gov/tax\\_stats/soi/ind\\_gss.html](http://www.irs.gov/tax_stats/soi/ind_gss.html).

correctly the role of the CCD in our income tax, there is no policy justification for restricting the CCD only to those who itemize their deductions.<sup>17</sup> This conclusion is reinforced by studies that continue to show that those who are in the lower income brackets (and therefore tend not to itemize deductions under current law) give a higher percentage of their income to charity than do higher income taxpayers.<sup>18</sup>

H.R. 7, the Community Solutions Act of 2001, as passed by the House of Representatives, took a very small step in the suggested policy direction. Under that bill, non-itemizers filing joint returns would be allowed a CCD of \$50 (\$25 for single persons) in 2002 and 2003, \$100 (\$50 for single persons) for 2004-2006, \$150 (\$75 for single persons) for 2007-2009, and \$200 (\$100 for single persons) for 2010 and thereafter.<sup>19</sup> Even this small step is estimated to generate a revenue loss of \$6.37 billion over a ten-year period.<sup>20</sup> If Congress extended the full CCD to non-itemizers, as proposed by the Bush Administration, the revenue cost over a ten-year period would escalate to \$84.4 billion.<sup>21</sup> Presumably, it was this revenue concern that primarily motivated the low limits adopted in H.R. 7.

Additionally, however, the Joint Committee Staff, in its 2001 analysis of various proposals regarding the CCD, pointed to the problem of overstatement of the CCD by non-itemizers if the CCD were extended to them. Some studies have shown that overstatement of CCDs is a problem among itemizers.<sup>22</sup> Administrative concerns can justify a deviation from a normative approach, as I discussed in Part I. But it is difficult to justify denying or radically limiting a CCD for all lower income donors just because some higher income donors abuse the system. I therefore conclude that neither revenue considerations nor administrative concerns justify limiting or denying the CCD to non-itemizers.

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<sup>17</sup> Matching Grants at 383, viewing the CCD as a tax expenditure program, noted that program (not tax) equity would seem to require extension of the program to non-itemizers.

<sup>18</sup>Chronicle of Philanthropy, Aug. 10, 2000 at 12. But, in a different study, Independent Sector found that, in 1998-1999, itemizers gave 2.7% of income to charity while non-itemizers gave 1.7%. See Independent Sector, *Giving and Volunteering in the United States: Executive Summary* (1999) at [http://www.independentsector.org/GrandV/S\\_hous.html](http://www.independentsector.org/GrandV/S_hous.html). One problem with comparing such surveys is that the definition of "income" often is not specified. Obviously, however, higher income taxpayers give larger dollar amounts to charity than do lower income taxpayers. See 2001 JCT Analysis at pp. 13-14, Table 1.

<sup>19</sup> H.R. 7, 107th Cong. (2001).

<sup>20</sup> Joint Committee on Taxation *Estimated Revenue Effects of a Chairman's Amendment in the Nature of a Substitute to H.R. 7, The "Community Solutions Act of 2001"* (JCX-59-01), July 10, 2001.

<sup>21</sup> Joint Committee on Taxation, *Estimated Revenue Effects of the President's Fiscal Year 2002 Budget Proposals* (JCX-31-01) May 4, 2001. The revenue estimate is based on a phase-in of the unlimited deduction over a 10-year period.

<sup>22</sup> See 2001 JCT Analysis; Joel Slemrod, Are Estimated Elasticities Really Just Tax Evasion Elasticities? The Case of Charitable Contributions, 71 *Rev. of Econ. and Statistics* 517 (1989).

Limitations on the CCD. Is the limit imposed by § 170(b)(1)(A) (a taxpayer's CCD may not exceed 50% of the taxpayer's contribution base) justified on theoretical grounds? The answer again is negative under the approach developed in Part I. If a taxpayer expends all of her income through charitable contributions and all of that income is taxed on the EO side of the transaction, there is no reason to limit her deduction to some arbitrary percentage of her income.<sup>23</sup>

Tax Expenditure Analysis. If it is accepted, as argued in Part I, that a CCD is an appropriate deduction in the U.S. income tax, it follows that tax expenditure analysis generally does not apply to the deduction.<sup>24</sup> It would continue to apply to those situations in which a deduction by the donor is not accompanied by income inclusion on the donee side. In this situation, the interesting question is whether the tax expenditure is created in the allowance of the CCD or in the nontaxation on the charitable organization's side of these transactions. If the analysis in Part I for granting the CCD is accepted, then the tax expenditure would seem to arise in the nontaxation of the beneficiaries of the charitable organizations, again either directly or through a surrogate tax on the charitable organization.

Changing the identification of the tax expenditure program would have several effects. First, of course, it is unlikely that the revenue loss would be the same as under the current treatment. The revenue loss could be smaller given the low incomes of many charitable beneficiaries. On the other hand, there would be many more persons to take into account and this could cause the revenue loss to be larger.

Second, the "upside down" argument that I and others have used in analyzing the CCD,<sup>25</sup> would be generally inapplicable on the donors' side. The argument is of no more relevance than to observe that the value of deductions for income producing activities rises with income. On the other hand the upside down analysis would be applicable on the charitable beneficiaries' side.

Third, it is also not appropriate to analyze the CCD as a federal subsidy in the form of a matching grant program.<sup>26</sup> The result follows because the CCD is a deduction

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<sup>23</sup> While I do not deal here with gifts of appreciated property, I believe that if the gain were fully taxable to the donor, there would be no objection in principle to allowing an unlimited CCD. But if that gain is not taxable, then the limits would be required in the case of gifts of such property. In large part, the imposition of the limit in 1969 occurred because Congress did not adopt a proposal to tax the gain. Staff of the Joint Committee on Taxation, 91<sup>st</sup> Cong., Summary of H.R. 13270, Tax Reform Act of 1969 (Comm. Print 1969) at 27-29.

<sup>24</sup> Matching Grants was predicated entirely on the proposition that the CCD constitutes a tax expenditure in its entirety.

<sup>25</sup> The deduction increases in value with income.

<sup>26</sup> See Matching Grants at 379-395.

necessary to define the tax base correctly. Again though, a federal subsidy to untaxed charitable beneficiaries is involved and is equivalent to a direct grant program.

Fourth, analysis of the economic efficiency of the CCD (based on the premise that the CCD is a tax expenditure would have to be redirected to the nontaxable charitable beneficiary side. That is, is the exemption the most efficient way to provide a federal subsidy to those persons?

Fifth, option 1 (no deduction to donor, no income to beneficiaries) can be justified on administrative grounds. In such a case, neither a tax penalty nor a tax expenditure would be created. The rule for both charitable and non-charitable gifts would be the same.

## CONCLUSION

The analysis in Part I of this paper supports the proposition that a CCD is an appropriate provision in an income tax system that does not tax psychic income derived in non-market transactions. That is to say that, in general, the CCD should not be classified as a tax expenditure. That proposition is subject to the condition that the amount of a CCD be included in income on the donee side of the transaction, either by taxing charitable beneficiaries directly or, more practically by imposing a surrogate tax on charitable organizations that receive contributions. I suggest that there is sufficient power in this model to warrant its further exploration. But denial of a CCD on administrative grounds coupled with nontaxation of beneficiaries also remains an option that is appropriate in the income tax context.