

Reforming the Charitable Sector to Account for Relative Worthiness?*

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Introduction

Substantial subsidies—administered more or less automatically through the tax systems at federal, state, and local levels—are available for any charitable organization that qualifies as such under section 501(c)(3) of the Internal Revenue Code (the “Code”). But it seems self-evident that not all charities are equally worthy of these subsidies. Some subsidies operate to put nutritious food in the mouth of a hungry child; others seem to operate primarily to lower the price of an opera ticket so that even law firm associates earning less than \$200,000 per year can afford orchestra seats once in a while.

The differences are not merely a matter of the worthiness of each charity’s purpose. Even within any particular category, some organizations perform better, and more admirably, than others. Some soup kitchens are poorly run; some arts organizations focus effectively on education rather than on performances for wealthy audiences. The manifest injustice of failing to differentiate among organizations that seem to deserve different treatment—either because of what they do or how well they do it—raises the question of whether charitable subsidies can’t be better targeted to aid the most deserving elements within that sector.

When first written, the preceding two paragraphs were intended to lead off an article that might have been entitled: “Taking Comparative Worthiness Seriously.” That article would have considered the things that would be needed to assess comparative worthiness across at least two dimensions—worthiness of purpose and effectiveness of performance--and to target tax subsidies in ways that would provide the greatest support to the worthiest charities. But along the way to that article, the obstacles came to seem insurmountable.

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First, while everyone could develop an ordered list of charitable purposes arranged by worthiness, the lists would not be the same. Even apparently uncontroversial assertions—for example, that organizations that primarily serve the poor are entitled to a relatively lofty rank in the worthiness hierarchy—may turn out to have dissenters. One might note, for example, that governments are reasonably good at redistribution, and can accomplish its ends more comprehensively, and with fewer free-rider problems, than private charity ever could. A conservative commentator might therefore observe that if the political will existed for greater redistribution, it should have happened already; and if the political will did not exist, perhaps governmental subsidies for private distribution would be inappropriate. At the other end of the spectrum, a liberal commentator, especially one who fervently believes that greater redistribution would be desirable, would not necessarily support the idea of attacking the problem through private charity. He may believe instead that improving the social safety net is a governmental responsibility—one that should be a national priority; if private philanthropy provides enough amelioration of poverty to diminish the mean voter’s concern about it, legislation creating the optimal governmental social safety net will never be enacted.

Similarly, there are no agreed-upon metrics to measure efficiency or effectiveness of performance. For-profit organizations can always resort to the profits themselves as a general measure of the organization’s success; but there simply is no counterpart to the profit concept available to organizations in the charitable sector. Finally, determining whom the tax rules are subsidizing, and to what degree, can turn out to be surprisingly elusive.

So although the goals of comparative worthiness seem indeed worthy, there is reason to doubt that this concept can be a very effective force in improving the performance of the charitable sector. Determining which purposes serve the most worthy clientele would be incredibly tendentious, and would threaten the pluralism of the charitable sector that is among its most appealing features. And, precisely because assessment of worthiness would be so contentious, a set of rules based on such an assessment at any point in time would be inherently unstable. The subject would become

so politicized that public policies would change with each election, and organizations would have to deal with frequent disruptions as they become more or less favored in each new Congress or opinion poll.

Assessing efficiency and effectiveness of performance seems equally unpromising.² Such assessments would depend on comprehensive and standardized data, and so would inevitably be accompanied by complex definitions and bulky documentation requirements that would in themselves be a drag on effective and efficient performance. And efficiency assessment could lead to all sorts of mischief if applied without nuance, as it likely would be. In an educational context, for example, it might be observed that small classes are less efficient by most measures than larger ones; so the rules might on these grounds to prefer schools that had relatively high student:faculty ratios. Similarly, labor-intensive psychotherapeutic strategies that eschew pharmacologic therapies might well be viewed as less cost-effective than alternative strategies that embrace them, and so would be discouraged. Outcomes such as these are not inevitable, of course, and might even be sound. But effectiveness in many areas of charitable endeavor is very difficult to measure, and ruthless pursuit of efficiency is not likely to lead to uniformly happy outcomes.

But before abandoning the idea of differentiating among charitable organizations according to their worthiness altogether, it would be well to remember that the rules governing this sector already do differentiate among charities along a variety of dimensions. In effect, these differentiations target subsidies to privileged categories of charities, but on grounds that are accidental, opaque, and sometimes even perverse. So, perhaps as a precursor to a serious debate about comparative worthiness, this paper argues that steps should be taken first to uncover the unprincipled differentiations among charities (which might be thought of as faulty *de facto* comparative worth assessments) buried in current tax rules, that may well lead to the misallocation of the charitable subsidies.

² With perhaps the single exception of charitable fund-raising, as will be discussed herein below.

The first section of the paper will attempt to clarify the nature of the subsidies provided to charities by the tax system. While this is in many cases obvious, there are a few aspects of the subsidy issue that have been neglected. After discussion of the nature of the subsidies, the next four sections will outline areas in which subsidies are arguably mistargeted. These include: 1) That the “matching grant” aspect of the charitable contribution deduction provides subsidies to organizations in accordance with the tax status of the donors to those organizations, rather than on any merit that the donee organizations may have. 2) That some subsidies provide differential value based on the type of assets used by the organization—in particular, real estate, though there are others—that have nothing to do with the worthiness of the organization; 3) That the regulations defining “charitable” for purposes of section 501(c)(3) of the Code, and the regulations defining permissible “program-related investments” for private foundations, are unduly narrow, favoring organizations that aim to relieve poverty or racial discrimination, but disfavoring a wide range of purposes that should be regarded as charitable; and 4) That the failure to regulate charitable fund-raising creates sizable moral hazards for managers of charities, and favors those charities whose leaders succumb to those hazards with the most enthusiasm.

In all cases, proposals will be offered to ameliorate the mistargeting identified. The prescriptions suggested may seem radical, and all would face difficulties in the legislative enactment, administrative promulgation, or judicial decision-making (as appropriate) necessary to make them a reality. The argument here, however, insists that they are practicable, and would improve performance in the charitable sector if adopted. The first step in making them attractive to decision-makers is to discuss them in academic settings where ideas are not dismissed if the prospects for immediate adoption seem unpromising.

It should be noted that several of these problems and proposals may require special consideration as they are applied to churches and certain other religious organizations. Most of the discussion of these special considerations would take this paper beyond its intended scope; in general, however, it would usually be the case that an exception could simply be made for churches and other religious organizations from any new rules that

were troublesome in the religious context, much as current law excepts such organizations from certain filing and compliance obligations imposed on other charities.³

1. The Nature of the Subsidy for Charitable Organizations

There are three major categories of tax favoritism shown to charitable enterprises: the exemption from the otherwise applicable income tax (usually, the corporate income tax⁴) itself; the ancillary benefits, of which there are several, that come with tax-exempt status under section 501(c)(3); and the charitable deduction allowed for donations to such organizations.

A. Exemption – The exemption itself might seem to be a benefit of great significance, but in fact that is not the case for most organizations. It is true that, in the most recent year for which good data are available (2005), the total revenue of charitable organizations in the aggregate was about \$1.25 trillion, while total expenses were only \$1.14 trillion.⁵ If the difference—roughly \$115 billion—were subject to an income tax, it might yield \$40 billion or more of tax revenue.⁶ However, a significant part of the “total revenue” of charitable organizations—that received by gift—would not be “gross income” under any reasonable accounting rules. In a corporate setting, gifts would ordinarily be accounted for as contributions to capital, which are not part of a corporation’s income. In 2005, a total of \$276 billion of the gross income of charitable organizations came from “contributions, gifts, and grants.”⁷ While some part of this category might have come in the form of grants for particular services, which might arguably be included in gross

³ See, e.g., IRC § 6033(a)(3)(A)(i), which exempts “churches, their integrated auxiliaries, and conventions or associations of churches” from the obligation to file the Form 990 annual return that most other charities are required to file.

⁴ Section 11 of the Code imposes taxes on corporations and certain other “associations” at rates ranging from 15% to 35%, with most medium and large organizations subject to this tax paying at a more or less flat rate of 34 or 35%. Those charities that are organized as charitable trusts would presumably be exposed to the rates in IRC §1(e), which also have a maximum rate of 35%.

⁵ Paul Ansberger, “Charities, Labor, and Agricultural, and Other Tax-Exempt Organizations, 2005,” *Statistics of Income Bulletin*, Fall, 2008, at 270, 274 (Figure E).

⁶ This rough estimate is derived from applying the 35% maximum corporate rate to the unrounded difference between total revenue and total expense, as reported in Arnsberger, *id.* Of course, since some charities operate at a loss, the total excess of income over expense for those organizations that enjoy such an excess would be larger than \$115 billion.

⁷ *Id.*

income, the bulk of the giving came in the form of simple gifts from individuals and estates. The most authoritative source on giving estimates that about \$199 billion of gifts were made to charities by individuals in 2005, and another \$17 billion were made by estates.⁸ If these gifts are not included in gross income, the expenses—most of which would presumably be deductible against income under any reasonable accounting rules—of charitable organizations would have exceeded gross income in the aggregate for the charitable sector by more than \$100 billion.⁹

Of course, aggregate losses do not mean that all types of charities had an excess of expense over income. In particular, two major fields within the charitable sector—private schools and universities, and hospitals—generate a great deal of “program service income” through tuition charges and fees for professional services. Even within those fields, however, disaggregated numbers suggest that sufficient contributions were received to more than eliminate any apparent net excess of revenue over expense.¹⁰

It remains true that aggregate, or even partially disaggregated numbers, cannot prove that every organization within any particular field truly had nothing that could reasonably be called “profits.” Indeed, it seems reasonably certain that some hospitals, in particular, do have profits at least in some years.¹¹ Even in those cases, however, it should be remembered that if charitable organizations were to be subjected to the corporate income tax, they would presumably be allowed to use the full range of methods available to other taxable organizations, including generous rules on loss carrybacks and carryovers.

⁸ The Center on Philanthropy at Indiana University, “Giving USA 2006,” at 11. It should be noted, however, that there are difficulties in combining Giving USA data with SOI data, especially in light of the fact that the former includes contributions to churches, while the latter generally does not, since churches mostly don’t file Form 990.

⁹ This figure is derived by subtracting charitable giving of about \$217 billion from the IRS “total revenue” figure of \$1.25 trillion, and then subtracting the IRS “total expenses” figure of \$1.13 billion from the result.

¹⁰ Ansberger, *supra* at note 5. For the “education” field, the excess of total revenue over total expense was \$41.6 billion, and contributions, gifts, and grants totaled \$70.0 billion; for “health” organizations, the excess of total revenue over total expense was \$38.1 billion, and contributions, gifts, and grants totaled \$52 billion.

¹¹ The treasury estimated the value of the tax exemption to hospitals some time ago as \$1.5 billion per year. See statement of Michael Graetz (then Deputy Assistant Secretary for Tax Policy), Ways and Means Committee Hearings on H.R. 790 and 1374, July 10, 1991, Serial 102-73, at 38. The estimate was for fiscal year 1992, and would presumably be about fifty percent higher if simply adjusted for inflation since that year.

Thus, even among hospitals that sometimes produce profits, only those that do so consistently over time would ultimately have net tax liabilities.

If nonprofit organizations were subject to an income tax, they would also presumably be able to avail themselves of the numerous business credits and more aggressive rules for things like depreciation¹² and research and development costs than are generally used in accounting of revenue and expense of nonprofit corporations. Also, because the Form 990 is for many small and medium-sized organizations the only attested financial statement that may be available, the organization may find it useful in supporting applications for extensions of credit. Thus, the current bias, if any, would be in the direction of enhancing balance sheets and income statements by understating expenses; if exemption were unavailable, this bias would be reversed. Removal of the exemption would expose net income to taxation, and thus create the incentives to make accounting choices that would minimize taxable income.

It might be argued that foundations benefit greatly from exempt status, since they routinely earn substantial sums from investment of foundation assets, but have relatively modest expenses. In 2004, foundations had net investment income of about \$25.2 billion, and operating expenses of only about \$4 billion.¹³ But if it is recognized that foundations are, essentially, in the business of making grants, and under a legal obligation to distribute five percent of their assets annually,¹⁴ then it is reasonable to treat disbursements for grants and related charitable purposes as deductible expenses. In 2004, foundations made \$31.1 billion of such disbursements, which would have generated a net accounting loss if

¹² The instructions to the annual return filed by exempt organizations, the Form 990, tell the organizations that if they “record depreciation, depletion, amortization or similar expenses,” it should report them on line 22 of Part IX, the Statement of Functional Expenses. No guidance on methods is provided, except that it is specifically noted that organizations are not required to use the Modified Accelerated Cost Recovery System that business enterprises must use. The implication appears to be that, if the organization even wants to bother with this, it may use a simple and informal accounting system. Such a system is unlikely to produce the highest possible depreciation deductions.

¹³ Melissa Ludlum, “Domestic Private Foundations and Charitable Trusts: Charitable Distributions and Investment Assets, Tax Year 2004,” Fall, 2007 Statistics of Income Bulletin, at 174, 175. More recent data, running through 2006, is on the IRS webpage, but has not been published in the SOI bulletin. It is, however, consistent with the data in the text.

¹⁴ Technically, there is no obligation to make these distributions; however, an oppressive excise tax under IRC § 4942 applies if they fail to do so.

those expenditures were allowed as deductions.¹⁵ Note also that a good deal of foundation income in any year represents net gains on sales of investment assets—some \$10.7 billion in 2004.¹⁶ If foundations were taxable, they would presumably enjoy the same benefit other taxpayers do of not recognizing unrealized appreciation. They would thus have an incentive to minimize realized gains, confining them largely to the amounts necessary to fund grant programs. Finally, note that some years—including 2008 and probably 2009—are years in which many assets were sold at losses; if foundations were taxable, loss carryovers would presumably be available to offset net gains in other years. Thus, if grants are recognized as expenses, and the usual privileges of deferring unrealized gains and offsetting gains and losses over multi-year periods were accorded to foundations, they would not generally have net taxable income.

A generation ago, Bittker and Rahdert commented critically on the idea that the “income” of charitable organizations could be measured for tax purposes, due to what might be called the mismatch of income-tax accounting concepts with the ways in which charities account for their flows of funds.¹⁷ While they may have exaggerated slightly the difficulty of modifying tax accounting concepts to permit extension of those concepts to charities, their ultimate conclusion was probably correct for the most part, simply because charities don’t have much income to tax. It follows that exemption from such tax is not, *per se*, a feature of our tax rules that conveys much in the way of a subsidy.¹⁸ It is worth noting in passing that neither Congress nor the Executive branch versions of the annual “tax expenditures” include any estimate of the revenue forgone due to the exempt status of nonprofit organizations.¹⁹ And note as well that a great many noncharitable organizations—such as social clubs, labor organizations, and chambers of commerce--that

¹⁵ Melissa Ludlum, *op. cit. supra*, note 13, at 175.

¹⁶ *Id.*

¹⁷ Boris I. Bittker and George K. Rahdert, “The Exemption of Nonprofit Organizations from Federal Income Taxation,” 85 Yale L.J. 299 (1976).

¹⁸ Of course, to the extent that qualification under section 501(c)(3) entitles an organization or its donors to other benefits under the Code or under state or local law, it could be said to involve those subsidies indirectly. This will be considered in the following parts of this section.

¹⁹ See Office of Mgmt. and Budget, Analytical Perspectives: Budget of the United States Government, Fiscal Year 2009, at 287 (2009). Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012,” at 21-22 (2008).

would have at best a very weak claim to federal subsidy nevertheless enjoy tax exemption under other paragraphs of section 501(c),²⁰ or under some other provision of the Code.²¹ In short, the idea that a significant subsidy is conferred by exempt status alone is flatly inconsistent with the current relatively broad exemption.

B. Factor subsidy—There are a number of tax rules that have the effect of lowering the cost of one or more factors of production for charitable organizations. Exemption from state and local property taxes is perhaps the most important example. For most firms, the cost of taxes on real estate is one of the costs of doing business; and to the extent that real estate is taxed more or less heavily than other factors of production, the managers' choice of the optimal mix of factors will reflect that sense of relative costliness. In the charitable setting, however, managers are relieved from the burdens of the tax, and are accordingly free to disregard state and local property tax costs in deciding how best to arrange their production functions.

Charitable organizations are also generally eligible for postal rates that are roughly half as high as individuals or for-profit corporations face. And, finally, charitable organizations have the opportunity to finance capital projects with tax-exempt bonds, giving them an interest subsidy of perhaps as much as 150 to 200 basis points. The value of most of these subsidies cannot easily be estimated, but there are official estimates of the federal revenue loss associated with the issuance of tax-exempt bonds. In Fiscal Year 2009, it is estimated to be about \$5.1 billion.²²

These subsidies raise an issue in the comparative worthiness context largely because charitable organizations differ widely in the degree to which they are able to take advantage of these additional subsidies. Some organizations – universities in particular, but also churches and hospitals to a lesser degree – make quite extensive use of real estate. Duke University, for example, has a campus that consists of 8610 acres, on which some

²⁰ Section 501(c)(3) contains 27 paragraphs, but contributions to organizations described in almost all of those paragraphs are not eligible to receive deductible contributions.

²¹ See, e.g., IRC § 521 (farmers' cooperatives) and 527 (political organizations).

²² Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011," at 31, 33 (2007).

220 buildings sit.²³ In contrast, an affiliate of the Meals-on-Wheels organization may serve hundreds of meals each weekday operating out of a small kitchen (which is as likely to be rented as owned), with no dining or other public facilities. Similarly, a membership organization may make heavy use of the subsidized mailing rates, while a homeless shelter may make little use of the mails at all.

C. Charitable Contribution Deduction—Allowing donors to deduct their charitable contributions is the source of by far the largest subsidies to charitable organizations. It can be and typically is characterized as a matching grant by the federal government, in proportion to the marginal tax rate of the donor, assuming that the donor taxpayer claims itemized deductions.²⁴ For example, a donor who is in the top current marginal rate bracket of 35%, will generally obtain a tax deduction worth 35 cents for every dollar contributed.²⁵ In effect, each 65-cent sacrifice by the donor is matched by a 35-cent federal tax forgiveness—slightly more than a one-to-two match. In some situations, where appreciated property is the subject of the gift, the federal match may be much higher, routinely reaching a proportion in which a 37-cent donor sacrifice is matched by a 63-cent federal tax forgiveness.²⁶ And the federal match is complemented in most cases by an additional match received through the taxpayer’s state income tax return.

²³ These data are from the Duke University website, at <http://www.dukenews.duke.edu/resources/quickfacts.html#buildings>. Duke is an extreme case, since it’s “campus” includes the 7000 acre “Duke Forest,” which is largely undeveloped land used lightly for some recreational and research purposes. Even so, the true campus area represents more than two square miles of land, to serve a university with only about 13,000 students.

²⁴ Under section 63(b) of the Code, taxpayers may elect to claim a standard deduction instead of the total of their itemized deductions. The amount of the standard deduction varies by category of return, but the average standard deduction for 2006 was \$7016. Justin Bryan, “Individual Income Tax Returns, 2006,” *Statistics of Income Bulletin*, Fall, 2008, at 7. In 2006 (the most recent year for which official data are available), only a bit more than one-third (35.5%) of all taxpayers itemized their deductions. *Id.*, at 9.

²⁵ This is not invariably true. For example, if the taxpayer in question is subject to the Alternative Minimum Tax of section 55 of the Code, the marginal tax rate under that section—either 26 or 28 percent, depending on the amount of alternative taxable income—will determine the matching grant relationship. Note, however, that the partial disallowance of itemized deductions under section 68 of the Code (temporarily suspended for the 2009 tax year, but programmed to spring back to life thereafter) ordinarily does not affect the match rate, since the disallowance of deductions is in nearly every case a function of the adjusted gross income of the taxpayer, and not the amount of the itemized deductions.

²⁶ For example, if a donor were to give away a painting worth \$100,000, and having a negligible basis, that she would otherwise have sold, she would save \$28,000 of capital gains tax (because the rate on “collectibles” gain is 28%), and would also save the income tax of \$35,000 that she would otherwise pay on

It is clear that not all of the revenue lost due to the charitable contribution deduction can be said to be a subsidy of the organization to which the contribution was directed.²⁷ Perhaps the donor would have made a gift of the same size whether or not a deduction was allowed. In such a case, the deduction would be better viewed as a subsidy delivered to those who make charitable contributions rather than to the institutions that receive them.

In fact, the benefits of the charitable contributions deduction are probably split between the donors and the donees, in some measure that depends on the tax elasticity of charitable donations. The deduction determines the net price of giving, and if donors are highly sensitive to the price of giving—that is, if the elasticity of giving is high—then the amounts of their gifts will be very responsive to the tax incentives, and donees will capture much of the subsidy.²⁸ If the elasticity of giving is low, then gifts will not be much affected by the tax deduction, and the benefit of that tax deduction will be felt primarily as a benefit to the donors rather than to the donees.

Unfortunately, the economics literature on charitable giving is split on the question of the elasticity of giving, with some studies—typically those based on short-term swings in the marginal tax rate, with the amounts of charitable giving as a dependent variable—

the income now sheltered from tax by the \$100,000 charitable contribution. The gross sacrifice of \$100,000 is thus reduced by the two taxes she saves, which total \$63,000.

²⁷ For example, my understanding of the tithing obligation imposed by the doctrine of The Church of Jesus Christ of Latter-Day Saints is that at least some members contribute on the basis of pre-tax income, which means that, for any member who gives exactly ten percent, the amount of the gift would not depend in any way on the tax treatment of the gift.

²⁸ It is even possible that the elasticity could be high enough that the subsidy received by charities could exceed the revenue loss resulting from the contributions deductions. If, for example, a donor would make a gift to a particular charity of \$1000 if there were no deduction, but instead makes a gift of \$2000 because the donation is deductible, the charity will have received an extra \$1000, while the revenue loss of allowing the deduction may be much less. (In the case of a cash contribution by a 35%-bracket taxpayer, for example, the revenue loss associated with a \$2000 deduction would be only \$700.) This behavior should not be thought irrational. If there is no deduction, the taxpayer knows that she can only accomplish a \$1000 increase in charitable work performed by her contribution. If a deduction is available, her charitable leverage is now increased, and she can accomplish a \$2000 increase in charitable work at the bargain price to her of only \$1300 (the gross gift less the tax savings associated with the deduction.) It is entirely plausible that a taxpayer would be willing to increase her sacrifice by 30% to achieve a doubling of the amount of charitable work accomplished.

suggest that elasticity is quite high.²⁹ Other, longer-term studies, suggest that changes in the tax rates (and hence the price of giving) affect the *timing* of charitable giving, but do not much affect the total amounts of giving over the longer term.³⁰ There is no obvious basis on which to conclude that either methodology is superior to the other: the short-term study no doubt does miss longer-term effects, but the longer-term study involves much greater difficulty in filtering out the effects of changes in other, non-tax variables that might affect giving in the long run.³¹ It seems likely that the charitable contributions deduction has a significant and positive effect on giving, and thus operates as a subsidy to charities; but the magnitude of the subsidy is difficult to assess.

2. Matching Grant Program

As the preceding section describes, charitable contributions deductions can be seen as a matching grant program administered through the tax system. Viewed as such, however, its imperfections are immediately evident: the amount of the match is determined not by any assessment of worthiness, of either the category of organization or the operation of the particular organization. Rather, the amount of the match depends on several other factors, including: 1) the status of the donor as an itemizing taxpayer; 2) the donor's marginal tax rate; 3) in the case of gifts of property, the relationship between the value of the property and its tax basis; and 4) the donor's elasticity of demand for charitable giving.

The impact of these factors is obviously not distributed among donee organizations randomly. Rather, it systematically favors donee organizations whose supporters are high-income taxpayers, as well as those organizations that are in a position to receive

²⁹ See, e.g., Martin Feldstein and Charles T. Clotfelter, "Tax Incentives for Charitable Contributions in the United States," 5 J. Pub. Econ. 1,24 (1976), and Charles T. Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, Joel Slemrod, ed. (1990).

³⁰ See, e.g., William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions, 103 J. Pol. Econ. 709, 709-710 (1995).

³¹ See Richard Schmalbeck, "The Death of the Efficiency-Equity Tradeoff?" (A commentary on Martin McMahon's "The Matthew Effect and Federal Taxation"), 45 Boston Col. L.Rev. 1143, 1151-52, ((2004) for a fuller discussion of long-term versus short-term studies of tax elasticity.

appreciated property contributions.³² Thus, universities, and arts organizations, especially museums, tend to be particularly favored by the current tax rules. This effect has been widely criticized as an “upside-down” subsidy,³³ though that characterization seems unnecessarily tendentious. It implies that a “rightside-up” subsidy would allow a greater match for the gifts of low-income taxpayers than for high-income taxpayers, which seems to be just as objectionable as the current system favoring gifts from high-income donors. More desirable, it would seem, would be either a neutral system in which the distribution of tax subsidies would be about the same for all types of organizations, or a system in which subsidies were targeted on the basis of an assessment of the donee’s worthiness, rather than on the basis of factors that depend on characteristics of the donors.³⁴

Can such a system be devised? Probably not, or at least not perfectly. However, the rules can be improved to increase the equity of the distribution of subsidies. Reviewing the four factors governing distribution of subsidies (that are unrelated to meritoriousness of the donee) described above, in reverse order, one notes that accounting for the elasticity of giving would be very difficult to achieve. Elasticity of giving is as mercurial as a sub-atomic particle, varying for each donor, and each potential donee, and even from time-to-time for each pair of donor and donee. It is even possible in many cases that elasticity is not a continuous function. For example, a donor may wish to endow a university chair, and may be willing to sacrifice \$x to achieve that end. If the university policy requires a gift of \$x + y to create a chaired professorship, then a federal match of y will push the donor to create the chair; anything less will not. In any event, because estimates of elasticity are so specific to particular donors, donees, and situations, it would

³² The privilege of deducting the fair market value of a gift of donated property depends on meeting a number of conditions specified in section 170(e) of the Code. Full discussion of those conditions is beyond the scope of this article, but it may be noted that one of the conditions-- that a gift of tangible personal property be made only to an organization that will use the property in pursuit of its exempt function--favors donee organizations that operate museums, since the property in question is likely to be collectible property suitable for such use.

³³ Stanley Surrey originated the term as applied to the tax expenditures associated with charitable giving. See Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures*, 134-36 (1973).

³⁴ It is possible, of course, that those who refer to the present deduction as an “upside-down” subsidy do mean that literally: that the organizations favored by the high-bracket taxpayers both get the biggest subsidies and are the least deserving of any subsidy at all. This possibility will be considered in a bit more detail in the section below on approaches that would relieve the differential subsidy based on varying marginal tax rates of donors.

not be practical to incorporate this factor into the tax rules, even if that were thought desirable. And perhaps one wouldn't even want to; it could be argued that charities that make the most convincing case to their potential donors are the ones that achieve the greatest donor elasticity of giving, and that any additional giving that comes as a consequence of that is fully deserved.

In contrast to incorporating elasticity analysis into the rules, which is impossibly difficult, fixing the inappropriate influence of value to basis relationships is conceptually very easy: deductions for appreciated property should simply be limited to the basis of the property. That this is the correct accounting treatment of appreciated property gifts is not seriously disputed. However, even small steps in this direction have faced fierce opposition from universities and arts organizations, especially museums.³⁵ This item nevertheless needs to be featured prominently on the list of tax amendments that would both raise revenue and improve the fairness of the tax system.

Ridding the system of the discrimination between incentives for itemizers and incentives for non-itemizers is equally simple, though slightly less one-sided as a matter of policy. The simple solution is to allow anyone to deduct charitable contributions by making it a deduction from gross income—a so-called “above-the-line” deduction—rather than an itemized deduction.³⁶ This approach is somewhat at odds with the basic idea of a standard deduction, which is to reduce both the private and public costs of administering the tax system. If (nearly) every taxpayer makes some charitable contributions, the 64.5% of taxpayers who currently do not now have a tax reason to keep track of the amount of their contributions would acquire such a reason by a rule that allowed above-the-line deduction of those contributions. And the deductions would have to be reviewed, on the

³⁵ In 1986, Congress added rules that made the gain portion of appreciated property a tax preference in calculating the Alternative Minimum Tax. Traditional recipients of gifts of appreciated property, such as universities and museums, conducted a campaign against the measure that led to its suspension and final repeal in 1990. See Richard Schmalbeck, “Gifts and the Income Tax—An Enduring Puzzle,” 72 *Law & Contemp. Probs.* (forthcoming Fall 2009).

³⁶ This would require nothing more than adding another paragraph to section 62(a), specifically allowing charitable contributions to be deducted from gross income to determine adjusted gross income, treated such deduction in the way the Code already treats alimony payments, IRA contributions, and a number of other items.

usual ridiculously undersampled basis, by the IRS. Nevertheless, if it is thought to be important to do what is possible to equalize tax subsidies among all charitable organizations, allowing non-itemizers to deduct charitable contributions is an obvious step.³⁷

This leaves the nagging problem presented by the fact that different taxpayers may have different tax rates, in patterns that are conspicuously *not* neutral with respect to categories of donee organizations. This problem too has a simple solution, but it is even more fraught with policy objections than the solution to the non-itemizer problem. The simple-but-fraught solution would be to replace the current deduction for charitable contributions with a credit for some fixed percentage of charitable contributions.³⁸ If every taxpayer were allowed, for example, a tax credit equal to 25% of charitable contributions, every taxpayer would have the same incentive to give, and the implicit match would not vary with the taxpayer's income or marginal tax rate.

The primary problem with this approach has been thought to be that if the credit rate is at the maximum marginal tax rate, it would substantially increase the revenue loss associated with charitable contributions. If, alternatively, the credit rate is set below the maximum marginal tax rate, then high-rate donors will, in effect, continue to be taxed to some degree on money that they have given away. For example, if a 35%-bracket donor gives away \$1000, and is allowed a credit of \$250 for that gift, the credit will not fully offset the \$350 of tax that he has paid on the income that he has given away.

More than a generation ago, William Andrews offered a very compelling analysis of the charitable contributions deduction (among others), emphasizing its income-defining

³⁷ This is not a new idea, having been proposed no later than 1975, when the Filer Commission suggested a version of this proposal. *Giving in America: Toward a Stronger Voluntary Sector*, Report of the Commission on Private Philanthropy and Public Needs 135 (1975). Most recently the proposal was introduced in Congress by Missouri Congressman Roy Blunt in 2005. *See* Charitable Giving Act of 2005 H.R. 3908 109th Cong. § 101 (2005) (allowing to taxpayers who do not itemize a deduction for charitable contributions for the amount in excess of \$250 but less than \$500).

³⁸ This is not a new idea either, to say the least. It originated no later than 1947. *See* William Vickery, *Agenda for Progressive Taxation*, 131 (1947). *See also* Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 *Tax L. Rev.* 377 (1972); William Hochman & James Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, 30 *Nat. Tax. J.* 1 (1977).

properties.³⁹ Funds that are given away for officially sanctioned purposes, such as charity, simply shouldn't be considered as income under the standard definitions of income, in particular the Haig-Simons definition of income as consumption plus wealth increments within the accounting period.⁴⁰ Curiously, Henry Simons himself thought that making gifts *was* a consumption activity. He wrote that “[G]ifts are consumption to the donor, and therefore not properly deductible,”⁴¹ and went on to say: “Broadly, they [gifts] represent merely personal expenditures.”⁴²

While not indefensible, the position that gifts represent consumption by the donor seems extreme. No scarce resources are used up by the act of the gift, and the possibilities for double- or multiple counting of the same income loom large.⁴³ As this author has argued elsewhere, it seems clearly more accurate to think of gifts as a mere transfer of consumption opportunities, not as consumption itself.⁴⁴ Under such a view, it seems reasonable to accord charitable gifts an accounting treatment that reflects the fact that income given away (at least to charity) is not income that should be taxed, which in turn militates in favor of either a full deduction or an equivalent credit.

³⁹ William D. Andrews, “Personal Deductions in an Ideal Income Tax,” 86 *Harvard L.Rev.* 309, 344-48 (1972).

⁴⁰ Henry Simons, Personal Income Taxation, at 50 (1938). The definition has come to be known as the Haig-Simons definition largely because Simons credited the earlier work of another economist, R.M. Haig, as influencing Simons’ own thinking on this subject. It is Simons’ monograph, however, that is viewed as the foundational work in income tax theory, despite its appearance some 25 years after the initial introduction of our modern income tax.

⁴¹ Id., at 139. This quotation is a bit misleading by itself, because a preceding clause has been omitted. Simons began the sentence in which the quotation in the text appears by saying: “One may persevere stubbornly in the contention that, as a matter of principle” He thus signals his own unease with this argument. Also, the context of the discussion was not primarily focused on charitable gifts, but rather upon gifts in general, and whether they should be included in the income of the donee, deducted from the income of the donor, or both. Simons concluded that they should be included in the recipient’s income, but not generally deducted.

⁴² Id., at 139-140. In this case, the sentence is quoted in its entirety.

⁴³ Bittker and Lokken offer a nice example of the multiple counting problem in their monumental treatise, asking if we really think that \$400 of income is generated by a sequence of events in which a taxpayer inherits \$100 from his parents, gives it to his wife, who buys a bicycle for their son, who eventually gives the bicycle to a younger sibling. No, we don’t think that. Q.E.D. See Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, estates, and Gifts*, 3d Ed., v. 1, ¶ 10.1, at 10-3 (1999).

⁴⁴ Richard Schmalbeck, “Race and the Federal Income Tax: Has a Disparate Impact Case Been Made?,” 76 *N.C.L.Rev.* 1817, at 1828 (1998).

The revenue loss involved in allowing a credit at a 35% rate would indeed be considerable. Itemizing taxpayers reported about \$187 billion of charitable gifts in 2006,⁴⁵ which would imply a revenue loss of \$65 billion (if credited at a 35% rate), rather than the \$38 billion revenue loss estimated by the Joint Committee on Taxation for 2006 deductions by individual taxpayers.⁴⁶ A reasonable estimate of the revenue lost due to allowance of the 35% credit for charitable contributions by nonitemizers might be as much as \$28 billion.⁴⁷ The total rough estimate of \$83 billion—more than twice the revenue loss associated with the present rules—would not be easily tolerated.

There is almost always a way to make a particular tax change revenue-neutral, however, and there is an opportunity to do so here that has considerable appeal. It has frequently been suggested that charitable contributions, like deductions for certain other items, such as medical expenses, casualty losses, and miscellaneous itemized deductions, should be allowed only to the extent that they are unusually large. Thus, as in the cases just mentioned, a non-deductible floor could be imposed, so that, for example, only charitable contributions deductions in excess of two percent of adjusted gross income would be allowed.⁴⁸ Since most taxpayers who itemize do make contributions in at least this proportion (the average is about 3.1% of AGI),⁴⁹ such a rule would largely preserve incentives to give at the margin, while reducing the revenue loss dramatically. If itemizers gave \$187 billion in gifts in 2006, and nonitemizers gave \$80 billion (as the above revenue loss estimates presume), with respect to adjusted gross income totals of about \$8 trillion, then only the gifts in excess of \$160 billion (2% of \$8 trillion), or about \$107 billion,

⁴⁵ Justin Bryan, *supra*, note 16, at 8.

⁴⁶ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010* (2006).

⁴⁷ This assumes that nonitemizers would claim deductions for contributions at the same rate as itemizers now do.

⁴⁸ See Congressional Budget Office, *Budget Options Volume 2*, 193 (2009) (listing a 2% floor on charitable contribution deductions as a potential source of revenue); President's Advisory Panel on Tax Reform 2005 Final Report, 75 (November 1, 2005) (proposing a deduction for amount of charitable contributions exceeding 1% of taxpayer's income).

⁴⁹ Calculated from data found IRS, *Statistics of Income 2007*, table 2.1 & table 1.3 (\$194 billion over \$6.188 trillion).

would be creditable. The revenue loss on this amount would approximate the revenue loss under current rules.⁵⁰

Arguably, a disallowed floor is inconsistent with the Andrews' view that contributions have an income-defining quality. Wouldn't the tax rules be taxing the income represented by the disallowed floor, even though it wasn't really the income of the taxpayer who would be taxed on it? Surely this is so, but it is less clear that it is troubling. First, if the floor is reasonably low—beneath the level at which most taxpayers make contributions—then it can be viewed as simply a base-broadening measure that could be replicated, without equity concerns, in a slightly higher set of marginal rates. There is always a trade-off between the size of the tax base and the rates of tax assessed against it, and the disincentive effects of high marginal tax rates make it more attractive in general to adopt a range of measures that expand the base, and hence lower the revenue-neutral set of marginal rates—at least as long as the base-broadening measures do not themselves have unappealing effects on equity or incentives. A floor on charitable contributions deductions passes muster under these standards.

Use of a credit rather than a deduction raises another intriguing possibility: Although this paper argues that trying to assess comparative worthiness is in the end a poor idea, if such an idea were to appeal to Congress, a variable credit mechanism would be a reasonable means to effectuate such a plan. Charitable organizations could be scored on whatever criteria thought desirable—possibly incorporating both the inherent worthiness of the activity and the particular performance of the charity in question—and given grades that entitled their donors to particular percentage credits. A well-run soup kitchen might qualify for a 35% credit; while a badly run opera company might qualify for only a 10% credit, or perhaps no credit at all.

⁵⁰ There is a presumption in this method that biases the revenue estimate on the low side. If all taxpayers gave about 3.1% of income to charity, the estimate in the text would be correct. If, on the other hand, half of taxpayers give nothing, while the other half give 6.2% of income to charity, the revenue loss would be substantially higher. That may well be the case, but if it is, the solution would simply be to tinker with the disallowed floor, perhaps raising it to three percent of adjusted gross income.

A few administrative suggestions, were this idea to be adopted: The grades could be adjusted as frequently as annually, though a longer time horizon would probably be preferable. It would probably be necessary under this approach to ask donors to file a charitable contributions schedule with their returns, and donees should be required to disclose their grades, and the creditable amounts of each donor's contributions, in the receipts that they customarily provide donors under the pressure of the substantiation requirements of section 170(f)(8) of the Code. If this approach would lose revenue compared to existing law (which would depend on how generous the mandated grading system would be), a nondeductible floor could be employed, as described above, to maintain revenue neutrality.

This approach also is subject to the criticism that it ignores the income-defining aspects of charitable giving described by Andrews. But it is less troubling than any general credit less than 35% would be. Andrews' argument, in effect, is that charitable gifts aren't consumption, and so ought not be in the donor's income. But it could be argued that only the purest charitable giving is free of consumption attributes. Giving to one's alma mater, or to a beloved art museum or opera company, may well be less altruistic, and may indeed involve some element of consumption, mixed in some measure with elements of altruism. Getting the sliding scale right would not be easy, but, ideally, it could provide a means to reflect the likely mixed motives a donor might bring to the gift, allowing a credit to erase the tax on part of the gift, while the remainder, which has consumption elements, continues to be taxed to the donor even after he has parted with it. This solution blends elements of the Andrews argument with the views of Henry Simons, and does so on a reasonably principled basis reflecting an official assessment of the worthiness of the gift.

Another criticism of the proposal to use variable credits is that it would significantly complicate the charitable contribution rules. As noted, the proposal would probably require taxpayers to file a new form. It would also obligate charities to inform their donors of the percentage credit available for gifts to that particular charity. In particular, since credits would be available to nonitemizers, including many who now file the simple 1040-EZ or 1040A forms, the charitable contributions schedule might be the most

complicated part of their returns. And with the complexity may come a diminished incentive to give. If donors have difficulty understanding the rules, or in knowing what credit a particular proposed gift would entitle them to, it would provide one more reason not to give.

3. Subsidizing Factors of Production

Charities face a production function that substantially resembles that of for-profit business firms, combining items of specialized labor, general labor, equipment, real estate, and so on, in the mix that optimizes performance. If the items in the production function are differentially subsidized, the optimum as seen by the charity's manager will not be the most socially efficient one. In the case of charities, physical capital, in particular investments in improved real estate, are subsidized by both the availability of tax-exempt bond financing, and the exemption of one of the usual costs associated with use of real estate, namely state and local property taxes.⁵¹

The latter case is complicated by a number of factors, including the fact that state and local governments routinely bargain away their opportunities to collect property taxes as a means of inducing industrial development (which obscures the baseline from which the departure for charitable tax exemption can be measured). Also, in some cases, charitable organizations provide their own quasi-governmental services, so that the implicit *quid pro quo* nature of the property tax is subject to question. For example, if a university provides water, sewage and waste disposal, and police and fire protection to its own campus, when those functions would normally have been provided by the local government, it would be unreasonable to expect the university to bear the tax burdens associated with the provision of those public services.

⁵¹ And because real estate has generally tended to appreciate, gifts of real estate tend to be particularly favored under the rules governing contributions of appreciated property. On the other hand, state and local property taxes may arguably distort choices away from investments in real estate; to the extent that that is true, the advantages to charities of investing in real estate may help neutralize an existing distortion rather than create a new one.

It is more difficult to find good arguments for allowing charitable organizations to finance capital projects with tax-exempt bonds, however. To begin with, tax-exempt bond financing is inherently inefficient, in that it routinely allows deductions that diminish government revenue by a greater amount than the reduction in interest costs obtained by the issuer.⁵² Henry Hansmann has argued that the exemption for charitable organizations can be justified on grounds that such organizations have more difficulty than for-profit organizations in raising capital; allowing them to retain the full amount of their net earnings operates somewhat to offset this in the Hansmann model.⁵³ But it appears that Hansmann's argument is primarily about the inability of a nonprofit to raise equity capital by issuing stock; he is not arguing that nonprofits have any particular difficulty in raising capital to erect buildings. Indeed, because buildings offer one of the more reliable security interests, it is normally easier to borrow money—with or without tax-exempt bonds—for the purpose of erecting buildings than it is for most other purposes.

While the revenue loss associated with section 501(c)(3) bonds is not huge—roughly \$5 billion per year—it is a loss that is worse than unnecessary, in that the revenue loss is compounded by the distortion of decisions by nonprofit managers, resulting in less optimal allocation of resources. It is also—more germane here—an element of the current tax rules that has a differential impact on various categories of charity, offering greater subsidies to those organizations whose services depend on considerable use of improved real estate than to organizations that are not so situated.

4. Qualification for Exemption

Section 501(c)(3) specifies eight categories of organizations that may qualify for exemption under that paragraph, arranged by the purposes that they serve. “Religious, charitable, and educational” purposes account for the bulk of the organizations recognized

⁵² The inherent inefficiency of tax-exempt bonds stems from the fact that such bonds appeal only to those who will save more in taxes than they surrender in rate of return. The foregone rate of return is a good measure of the interest subsidy captured by the user, and it will never be greater, and usually will be much smaller, than the savings obtained by the investor. For a further explanation, see Richard Schmalbeck and Lawrence Zelenak, Federal Income Taxation, at 668-670 (2d ed., 2007).

⁵³ Henry Hansmann, “The Rational for Exempting Nonprofit Organizations From Corporate Income Taxation,” 91 Yale L.J. 54 (1981).

as exempt, but the Code also permits exemption of organizations organized for scientific or literary purposes, and for organizations intended to foster amateur sports competition, prevent cruelty to children or animals, or test products for public safety. Donors to all of these categories except the last are also allowed to deduct their contributions, under the provisions of section 170(c)(2), and subject to various limitations contained in the other provisions of section 170.

Most of these categories have reasonably self-evident meanings, but the “charitable” category suffers from considerable ambiguity, largely due to the fact that there are at least three distinct ways in which that word is used. In its broadest sense, it encompasses all that is described by sections 170(c)(2) and 501(c)(3). One speaks, for example, of the “charitable sector,” or of “charitable contributions,” and the scope of those phrases ordinarily extends to religious, educational, and other types of organizations. But “charitable” is also one of the specific subcategories within the overall category of “charitable” in its larger sense. Disagreement over the use of the word “charitable” in these two senses even reached the Supreme Court on at least one occasion, in *Bob Jones University v. United States*,⁵⁴ when Justice Rehnquist, in dissent, argued that Chief Justice Burger’s attempt to apply common-law conditions that stipulate that “charitable organizations” must not operate in ways contrary to public policy was inapt, because the university was qualified as an educational organization rather than a charitable one.⁵⁵

Adding to the confusion is that even the more narrow understanding of “charitable” is subdivided into two understandings, or perhaps one understanding and one misunderstanding. It may refer narrowly only to activities intended to relieve poverty or distress, a meaning that has sometimes been referred to as the “ordinary and popular” meaning.⁵⁶ Alternatively, it can be used as something of a residual category, encompassing anything that is thought entitled to the special status accorded to charities that is not

⁵⁴ 461 U.S. 574 (1983).

⁵⁵ *Id.* at 614.

⁵⁶ Staff of the Joint Committee on Taxation, “Historical Development and Present Law of the Federal Tax Exemption for Charitable and Other Tax-Exempt Organizations,” JCX-29-05, at 61 (2005).

described elsewhere.⁵⁷ This is sometimes referred to as the “legal sense” of the word, since it can be traced to the Statute of Charitable Uses of 1601,⁵⁸ and is embodied in the well-established doctrines of charitable trust law. The standard treatise on trust law explains the difference between the “ordinary” and the “legal” meaning: “[T]he word “charitable” is obviously not limited to the relief of poverty. It includes as well a great many other purposes generally recognized as charitable”⁵⁹ Lord McNaughten explicitly captured the idea of “charitable” as a residual category when he described the concept of the “legal sense” of “charity” as “compris[ing] four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads.”⁶⁰

The Treasury Regulations promulgated with respect to section 501(c)(3)⁶¹ claim to adopt this “legal” sense of the word: “The term charitable is used in section 501(c)(3) in its generally accepted legal sense”⁶² But the rest of the subparagraph defining “charitable” reflects apparent reluctance to expand very much beyond the idea of relief of poverty or distress. The second sentence—which is more than a little mangled in grammar and punctuation—of the subparagraph indicates what is specifically included, leading off with relief of “the poor and distressed or of the underprivileged.”⁶³ It goes on to include

⁵⁷ It could be debated whether “charitable” in what is called the legal sense is truly a residual category—those purposes for which charitable trusts can be created, but which are not educational, religious, etc.—or rather encompasses the entirety of the charitable sector, including educational, religious, etc. purposes. If the latter, then it would be identical to the “broad” sense of the term, and there would be only two meanings of “charitable.” It seems better to regard it as a residual category for tax purposes, however, since section 170(c)(2) and 501(c)(3) use the word in parallel with educational, religious, etc., which would be entirely redundant if Congress meant “charitable” as used in those sections to encompass the entire sector.

⁵⁸ An Act to Redress the Mis-employment of Lands, Goods, and Stocks of Money Heretofore Given to Certain Charitable Uses, 1601, 43 Eliz. 1, ch. 4 (Eng.).

⁵⁹ Austin Wakeman Scott, William Franklin Fratcher, and Mark L. Ascher, Scott and Ascher on Trusts, 5th Ed., Vol. 5, at 2376 (2008).

⁶⁰ *Comm’r v. Pemsel*, 1891 A.C. 531, xxx (1891).

⁶¹ Oddly, the section 170 regulations are silent on the meaning of “charitable,” apparently deferring to the definitions offered in the section 501 regulations.

⁶² Treas. Regs. § 1.501(c)(3)-1(d)(2).

⁶³ *Id.* Presumably the regulation means “poor *or* distressed,” since it would make no sense otherwise. Perhaps the poor could be said to be constantly distressed by their poverty, but the distressed category presumably includes those who are not poor, but, for example, temporarily homeless due to war or natural disaster.

“advancement of religion,” and “advancement of education or science,” which are unnecessary, since other provisions allow charitable status for organizations pursuing religious, educational, or scientific purposes.⁶⁴ Next in line is “erection or maintenance of public buildings”--which is generally viewed as a governmental obligation rather than a charitable purpose--and “lessening the burdens of government”--which similarly seems to identify things that government rather than private charity should be doing. The next phrase offers at last the promise of greater breadth, of something that could genuinely constitute a residual charitable category: “promotion of social welfare . . . ”⁶⁵ This would be quite useful if it ended at that point. But the regulation goes on to say: “by organizations designed to accomplish any of the above purposes.”⁶⁶ Thus, promotion of social welfare would not appear to be by itself an exempt purpose under this definition; but organizations that fit elsewhere are by this language authorized to promote social welfare as well as whatever it is that qualifies them for exemption.⁶⁷

Finally, almost as an afterthought,⁶⁸ the regulation enumerates four other purposes, in language that unmistakably identifies them as products of the civil rights era⁶⁹: “(i) to

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ A separate paragraph of section 501(c) of the Code--section 501(c)(4)--describes organizations “operated exclusively for the promotion of social welfare,” which may seem the more natural category for the residual charitable basket referred to in the text. However, while an organization may be recognized under this paragraph as exempt from taxation, there is no counterpart provision of section 170(c)(2) of the Code allowing deductions for contributions to such organizations. Thus, such organizations are ineligible for what has been identified earlier as the primary font of tax subsidy. As a practical matter, (c)(4) status is primarily useful for organizations that mean to advance social welfare by a particular method--lobbying--that is subject to severe restrictions under section 501(c)(3). Arguably, the existence of a paragraph, such as 501(c)(4), specifically mentioning “promotion of social welfare” could be taken to preclude qualification of organizations that could be so described under any other provision. That does not appear to be case, however, in a system in which environmental organizations and specialty hospitals treating cancer patients can qualify under section 501(c)(3) even without any special efforts to relieve poverty. See Rev. Rul. 74-587, 1974-2 C.B. 162, and Rev. Rul. 83-157, 1983-2 C.B. 94, respectively. Curiously, the proposed language of the regulations included the following sentence: “A social welfare organization [as defined in section 501(c)(4)-1] will qualify as charitable under section 501(c)(3) if it otherwise meets the requirements of this section and if it is not an “action” organization” This was deleted without explanation when the regulations were finalized. Compare Proposed Regulations issued Feb. 26, 1959, 24 F.R. 1421, 23 with Final Regulations adopted by T.D. 6391, 1959-2 C.B. 139, 144.

⁶⁸ Indeed, this language was tacked on to the proposed regulations by T.D. 6391, *id.*

⁶⁹ The boundaries of the “civil rights era” are unofficial, and hence not entirely clear; but certainly the era could be thought to begin no later than the *Brown v. Board of Education* decision in 1954 347 U.S. 483

lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.” These are no doubt admirable, and appropriately charitable, purposes. But these purposes conclude the list. What is lacking is any indication that “charitable” includes any sense of a residual category of things that are beneficial to the community but not otherwise specifically described. What about, to chose one example, organizations that seek to protect wildlife or the environment?

Such organizations are in fact routinely recognized as exempt under section 501(c)(3).⁷⁰ The IRS has provided guidance from which a more extensive sense of the scope of “charitable purposes” might be inferred, but the guidance has been erratic, especially when considered over time. Often, the guidance seems to reflect something like the residual sense described in Lord McNaughten’s fourth category. But in other rulings one sees more than a hint of the “ordinary and popular” sense of “charitable” described above—the sense that only relief of poverty or distress really counts.

There are many examples, but a brief and mercilessly reductionist history of the treatment of hospitals illustrates, at various times, both sides of this point. In the early 20th century, when our income tax rules were taking shape, hospitals were to a considerable degree residential facilities for the sick and poor—those whose health, combined with their personal and family resources, made it impossible for them to care for themselves. Treating such individuals is quintessentially charitable, and the IRS so regarded it. Hospitals that treated indigent patients were eligible for exempt status under the even the narrower, “popular” charitable rubric noted above.⁷¹

In 1969, however, the IRS ruled that a hospital that did not generally provide care to indigent patients could nevertheless qualify as charitable if it met what came to be called

(1954), and would end no sooner than the passage of the several civil and voting rights acts in the 1960s (or possibly even with the decision in *Bob Jones* cited above). In fact, this regulation was adopted in 1959.

⁷⁰ See, e.g., Rev. Rul. 76-204, 1976-1 C.B. 152, which explains that such organizations are indeed exempt, not under the specific language of Treas. Regs. § 1.501(c)(3)-1(d), but rather under general principles of charitable trust law.

⁷¹ Rev. Rul. 56-185, 1956-1 C.B. 202.

the “community benefit standard.”⁷² The contours of this standard have never been completely clear, but the ruling that first applied it appeared to rely significantly on the operation of a full-time emergency room that was open to all who came in need of care, whether or not they could demonstrate an ability to pay for that care. “By operating an emergency room open to all persons [and by providing more general hospital care to those who could pay for it] Hospital A is promoting the health of a class of persons broad enough to benefit the community.”⁷³ Of course, since all hospitals provide care to those who can pay for it, attention naturally focused on the open emergency room as the *sine qua non* of exempt status for hospitals. But fourteen years later, when faced with the situation of specialty hospitals offering care for such things as cancer or eye diseases, the IRS found that even an emergency room wasn’t necessary as a condition for exemption.⁷⁴

These results do not seem outrageous by any means. In significant part, they are reasonable responses to the changing nature of both hospital care and indigence. Hospitals are no longer in any meaningful sense residential; in general, they house patients only when the most acute care is needed. And, since the Social Security Act of 1965 added the Medicare and Medicaid programs to the social safety net, the elderly and the very poor, who, respectively, have the greatest need for medical care and the greatest need for subsidized insurance, have substantially improved access to governmentally subsidized medical care.

So it is clear that caring for the indigent is no longer a necessary condition for the exemption of a health-care organization. At the same time, mere promotion of health on a nonprofit basis isn’t sufficient for exemption.⁷⁵ What is sufficient? The question has left courts sputtering almost incoherently. In one high-profile recent case involving a large health maintenance organization, the court could do no more than to say, redundantly,

⁷² Rev. Rul. 69-545, 1969-2 C.B. 117.

⁷³ *Id.* at

⁷⁴ Rev. Rul. 83-157, 1983-2 C.B. 94

⁷⁵ *See, e.g.,* Federated Pharmacy, Rev. Rul 98-15.

that “the organization must provide some additional ‘plus’.”⁷⁶ But it clearly needn’t be relief of poverty or distress. As to hospitals, at least, the IRS ruling position seems to be more in line with Lord McNaughton’s view that the residual category of charitable organizations did not need to be focused on relief of poverty. “[Such trusts] are not less charitable in the eye of the law because incidentally they benefit the rich as well as the poor”⁷⁷

In certain other areas, however, the IRS ruling orientation continues to emphasize relief of poverty. Thus, in Revenue Ruling 70-585,⁷⁸ the IRS said that an organization formed to provide housing to moderate income households was not pursuing a purpose that would qualify it for exemption. Similarly, the IRS position with respect to collection of client fees by public interest law firms—at first, that no such fees were permissible,⁷⁹ later, that such fees, together with court-awarded fees, could not exceed fifty percent of the firm’s operational budget⁸⁰ effectively precludes operation of a firm to meet the legal needs of moderate-income families on a non-profit, but non-subsidized basis.

This narrower view of “charitable” can also be detected in the regulations regarding “program-related investments” (“PRIs”) that private foundations can make to advance their charitable purposes. Because they are not intended to be part of the foundation’s income-producing portfolio, but are rather intended to advance some programmatic interest of the foundation, these investments are exempted from the usual rules that effectively forbid foundations from making high-risk investments under Code section 4944.⁸¹ PRIs may also be counted against the five-percent mandatory distribution requirements of section 4942.⁸² The regulations defining PRIs include nine affirmative examples of investments that will qualify as such. Two of these do not include full

⁷⁶ IHC Health Plans, Inc. V. Comm’r, 325 F.3d 1188, xxxx (10th Cir. 2003). One might offer an equally redundant alternative: that subtracting a “minus” might do it, if what is subtracted is a profit motive, and what is advanced is public health.

⁷⁷ Comm’r v. Pemsel, note 51, at xxx.

⁷⁸ 1970-2 C.B. 115.

⁷⁹ Rev. Rul. 75-75, 1975-1 C.B. 154, revoked, Rev. Proc. 92-59, 1992-2 C. B. 411..

⁸⁰ Rev. Proc. 92-59, 1992-2 C.B. 411.

⁸¹ IRC § 4944(c), and Treas. Regs. §53.4944-3.

⁸² Treas. Regs. §53.4942(a)-3(a)(2)(i).

statements of facts,⁸³ but the seven that do contain statements of facts all involve situations in which the recipients of the investment funds are located in deteriorating geographical areas, or are members of a “disadvantaged minority group,” or both.⁸⁴ This echoes the notion that “charitable” refers only to relief of the poor or distressed, with a nod toward the language appended at the end of the list of “charitable” purposes in regulations section 1.501(c)(3)-1(d)(2).⁸⁵ Fortunately, neither the IRS nor the larger and more sophisticated foundations appear to be paying much attention to the implicit narrowness of the regulations in this area.⁸⁶ But that narrowness may well have a chilling effect on the PRI practices of smaller foundations.

Defining the parameters of exemption by sporadic announcement of ruling positions is not the best way to secure sound and consistent tax administration. It would surely be preferable to promulgate, and update as necessary, comprehensive and specific regulations. Quite simply, section 1.501(c)(3)-1(d)(2) of the regulations needs to be rewritten to clarify precisely what the scope of “charitable” is, as the word is used in the sequence of purposes specified in section 501(c)(3). The current regulation is now fifty years old, and reflects concerns that in some cases seem almost quaint.⁸⁷ Repairs to the other subparagraphs of this regulation are probably in order as well.⁸⁸

⁸³ Examples (2) and (8) involve the consequences of changed circumstances following qualification as a PRI, and hence do not focus directly on the initial qualification question.

⁸⁴ The ABA Tax Section made a submission to the IRS and Treasury in 2002 suggesting a broader range of examples, numbering 18 in all. A revised list is under consideration as this draft of this article is being completed.

⁸⁵ The reference here is to the numbered items consisting of lessening neighborhood tensions, eliminating prejudice and discrimination, etc. See text and notes at notes 60-69, *supra*.

⁸⁶ This is the author’s sense from attendance at meetings of the Foundations Subcommittee of the Exempt Organizations Committee of the ABA Tax Section, the most recent of which was in Chicago on September 25, 2009.

⁸⁷ Regs. §1.501(c)(3)-1(d) was adopted by Treasury Decision 6391, 1959-2 C.B. 139. As an example, a modern (youngish) reader might well wonder what “neighborhood tensions” refers to. In the first couple of decades following World War II, African-American neighborhoods were expanding virtually from week-to-week, as migrants from the rural south came to the industrial cities of the north to take manufacturing jobs. What “neighborhood tensions” probably referred to were anxieties about whether the expanding African-American populations would breach the historic boundaries of neighborhoods like Chicago’s Bridgeport, a traditionally Irish-American neighborhood on the South Side.

⁸⁸ While this article is focused on the meaning of “charitable,” the regulation in question seems quite defective in other ways as well. Of the eight categories mentioned in the statute, four are not mentioned in the regulations at all, (there is no explanation of the meaning of “religious,” “literary,” “prevention of

Full detail on what the suggested new regulations should say is beyond the scope of this article, but the general idea is to incorporate a residual notion of “charity” conforming to Lord McNaughton’s explanation. It would rest on several principles, including the notion of public benefit, broadly conceived. Such a benefit would plausibly include, for example, historic preservation of property; housing finance for moderate-income families, especially in high-cost areas where affordable housing is not generally available; public broadcasting; publication of general interest newspapers or magazines; recycling centers; carbon-emission-reduction programs; nature preservation, including urban green space and rural land.⁸⁹ Many of these functions can be performed by government, but familiar narratives of government failure explain why there may still be a need for private, charitable solutions.

One would also look for an element of altruism, but this would normally be inherent in the allowance of the contributions deduction. As noted in section 1 above, the primary locus of the tax subsidies available in this area is in the contributions deduction, and there is ordinarily a presumption of altruism that attaches when a donor voluntarily transfers money or property to an organization that is, by the terms of section 501(c)(3), barred from distribution of either the corpus or the income of the gift back to the donor. Established doctrines relating to *quid pro quo* contributions seem adequate to assure that the altruism will be real and not merely facial.

5. Fund-Raising Efficiency

While efficiency measures seem unpromising as applied to the overall operations of a charity, there is one area in which a metric seems reasonably obvious. In the case of fund-raising, it is plausible that the cost of the raising the funds can be compared with the

cruelty to children or animals,” or “promotion of amateur sports competition”). A fifth is described only in brief, largely tautological, language. (“Testing for public safety” is defined as “testing of consumer products . . . to determine whether they are safe”) The definition of “educational” organizations in §1.501(c)(3)-1(d)(3) is scanty, and focused on precluding “action organizations” from qualifying. More helpful would be elaboration of the rules for exemption of the many cultural organizations—orchestras, museums, and even movie theaters—that claim exemption under this heading.

⁸⁹ A similar example of Lord McNaughton’s from the Pemsel opinion cited at note 51, was provision of a “gratuitous supply of pure water for the benefit of a crowded [but not necessarily deteriorated] neighbourhood.” *Id.* at xxx.

amount of the funds raised. An important element of the stewardship that charities owe to their donors is that the organization be reasonably efficient in fund-raising.⁹⁰ Charities that incur unreasonable fund-raising costs, relative to the amounts raised, induce thereby a misallocation of charitable subsidies, rewarding those organizations that abuse fund-raising with a larger share of the charitable subsidies than otherwise similar organizations that behave reasonably.

This is essentially a problem of moral hazard: while the social cost of fund-raising depends on the relationship of the gross contributions to the net resources made available for charitable work, what matters directly to the charity itself is the net amount raised, without regard to the gross contribution number. If the manager of a small charity is approached by a professional fund-raiser who offers an opportunity to conduct a campaign, at no risk to the charity, that might reasonably increase the charity's resources by, say, \$100,000, the manager may find it difficult to refuse. She will tell herself that it is, after all, for a good cause. If the manager were aware that the campaign might cost \$900,000 to raise the \$1,000,000 of gifts necessary to yield a net charitable benefit of \$100,000 it might give her pause. But too often it appears not to. There are some reputational risks to charities that engage in such fund-raising, especially if the campaign is conducted in the immediate location of the charity. But if the charity is engaged in inherently difficult-to-measure charitable work—relief of hunger or disease in a distant land, cancer research, etc.—and if the campaign is geographically broad, based perhaps on a national mailing or telephone list, the risks of embarrassment that would threaten the charity's reputation probably do not loom large.

The problem is not confined to outside professional fund-raisers. Those engaged in legal education have seen the size of each law school's staff devoted to "alumni relations," or "development" grow from one or two people a generation ago to a cadre numbering in the dozens today. However, when the fund-raising is done internally, by employees or volunteers, assessment of the costs of the fund-raising can be difficult. A law school might

⁹⁰ A New Yorker cartoon some years ago captured this nicely. The cartoon showed a woman reading a note which read: "Your generous contribution helps funds these solicitations." New Yorker, at XX December 23, 2002.

plausibly host receptions or reunions for its alumni without regard to the likely effects of those events on the long-term success of the school's fund-raising efforts. Similarly, the time of deans and others with multiple responsibilities is not typically documented in ways that permit definitive segregation of the amount of time and energy that are devoted to fund-raising.

But data problems do not seem insurmountable in the case of outside professional fund-raisers. It would normally be possible to determine over any given accounting period the gross amount raised by the fund-raiser--the donors, after all, will want a receipt from the charity, to substantiate their charitable deductions.⁹¹ The charity will know, as well, how much it has been required to pay to the professional fund-raiser over the same time period. There may be some timing mismatches, as when a campaign begins toward the end of one accounting period, but produces most of its fruits in the next one. But these accounting details do not seem more difficult than the counterpart need for capitalization of inventory accounts in the for-profit business setting.

The possibility of regulating charitable fund-raising by reference to some measure of its efficiency has of course occurred to both federal and state authorities. The most prominent federal attempt consisted of the IRS' attempt to withdraw recognition of exemption from the United Cancer Council in 1990,⁹² which initiated litigation that was to last most of the following decade. More than 90% of the gross value contributed to United Cancer Council went to its professional fund-raiser, over the period under which the two parties had a contract that gave the fund raiser exclusive rights to operate in that capacity.⁹³ Although the Tax Court decided that the Council was guilty of engaging in private inurement, on the theory that the fund-raiser had become an "insider" within the organization as a result of its dominant role in the organization's operations,⁹⁴ this finding was overturned on appeal.⁹⁵ While Judge Posner's opinion on appeal left open the

⁹¹ IRC § 170(f)(8) requires this for gifts of \$250 or larger.

⁹² *United Cancer Council v. Comm'r*, 165 F.3d 1173, 1173 (7th Cir. 1999).

⁹³ *United Cancer Council v. Comm'r*, 109 T.C. 326, 331-32 (1997).

⁹⁴ *Id.* at 389.

⁹⁵ *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999).

possibility that a “private benefit” analysis might have sustained the IRS’ revocation of exempt status, his opinion does not leave much room for belief that such an approach would have been any more successful than the one adopted by the Tax Court. The facts of the case made clear that the fund-raising contract was entered into at arm’s length, and was not flatly unreasonable at the time, and perhaps not even in the light of subsequent events. The Council did receive some \$2.3 million as a result of its dealings with its professional fund-raiser,⁹⁶ and there was no indication that it had any hope of raising as much money over this period by its own devices.⁹⁷ The fact that donors gave some \$28.8 million⁹⁸ over the relevant period in order to produce the \$2.3 million that was spent in the fight against cancer, while abhorrent from a tax policy perspective, does not directly violate any federal statute or regulation. Absent evidence that the fund-raiser had undertaken actions to create the charitable organization, in order to have a vessel in whose name fund-raising pleas could be made, it seems unlikely that either the private inurement or the private benefit claims would be successful.

The inefficiency involved in a case like this is self-evident, but it seems worthwhile to estimate just how inefficient. If two-thirds of the \$28.8 million donated to this charity had been given by taxpayers who itemized their returns,⁹⁹ and if the average marginal tax rate of those donors was 20%,¹⁰⁰ then nearly \$4 million in revenue loss was sustained in order to provide the Council with a little over \$2 million of programmatic funds. And since the Council did not itself do any research or patient treatment, the \$2 million was doubtless further diminished by the internal operating costs of the Council before any funds reached those whose efforts were directly focused on cancer research and treatment.

State (and local) regulators have also tried to control charitable fund-raising, but with no greater success. The story is a familiar one, especially to followers of NCPL

⁹⁶ *Id.* at 1175.

⁹⁷ The evidence in the case indicated that the Council was, at the time of the contract, a “tiny organization” with an “annual operating budget of only \$35,000.” *Id.*

⁹⁸ *Id.*

⁹⁹ *See* note 38 and accompanying text.

¹⁰⁰ *Id.*

annual conferences,¹⁰¹ and it will not be rehearsed in detail here. It will suffice to say that the Supreme Court has found even moderate and reasonable efforts to regulate charitable fund-raising to be constitutionally defective on first amendment grounds. In the most recent of several of these cases, *Riley v. National Federation of the Blind*,¹⁰² the Court invalidated a North Carolina statute that prohibited excessive fund-raising fees, defining that term in a flexible manner that included a rebuttable presumption that fees in excess of 35% of the funds collected was excessive. By itself, that outcome might not have crippled the effort to regulate fund-raising; but the Court went on to invalidate as “compelled speech” certain disclosure requirements of the law,¹⁰³ and a requirement that professional fund-raisers be licensed prior to any solicitations.¹⁰⁴

But the Supreme Court jurisprudence regarding charitable regulations that touch on first amendment rights also includes a case that might offer an alternative that the Court might approve. In *Regan v. Taxation with Representation*,¹⁰⁵ the Court held that Congress could condition exempt status under section 501(c)(3) on the organization’s forbearance from more than insubstantial lobbying, despite the first amendment guarantee of a right to petition Congress. At least some of the justices thought that the condition *would* violate that right, were it not possible for a section 501(c)(3) organization to create an affiliate organization that could be exempt under section 501(c)(4), a subparagraph that does not contain language prohibiting more than insubstantial lobbying. This analysis was quite explicitly the critical point for the three justices who signed Justice Blackmun’s concurring opinion.¹⁰⁶

The reasoning of the majority opinion, while not resting explicitly on the (c)(4) alternative, nevertheless reflects an awareness of that option. Its core holding is that access to the subsidy involved in deductible contributions can indeed be conditioned on an

¹⁰¹ In 1990, the annual conference of the NCPL was devoted to this general topic. See www.law.nyu.edu/ncpl, and particularly Susan Wells, “State Regulation of Charitable Solicitation,” (1990).

¹⁰² 487 U.S. 781 (1988).

¹⁰³ *Id.*, at 798.

¹⁰⁴ *Id.* at 802.

¹⁰⁵ 461 U.S. 540 (1983).

¹⁰⁶ *Id.* at 552. (The two other justices were Brennan and Marshall.)

agreement by the organization to refrain from certain activities that might otherwise be permitted. That holding would seem to violate the Court's earlier opinion in *Speiser v. Randall*,¹⁰⁷ which held that government benefits could not generally be conditioned on forbearance from exercising constitutional rights. But no such forbearance is required, if the constitutional right to petition Congress can be performed by a (c)(4) affiliate. As the Court concluded: "It is not irrational [and also not impermissible] for Congress to decide that tax exempt charities such as TWR should not further benefit at the expense of taxpayers at large by obtaining a further subsidy for lobbying."¹⁰⁸

It would seem that if Congress could, in effect if not in explicit language, condition the deductible contribution subsidy on forbearance from substantial lobbying, so too could it condition that subsidy on forbearance from the use of outside professional fundraisers. And if it could do that, it could presumably take some lesser step of imposing a requirement that a charity could only use outside professional fund-raisers that met certain standards that Congress might wish to impose.

There is even some precedent for Congressional attempts to regulate fund-raising in much this way: the provisions Congress added in 2006 to deal with abuses among credit counseling organizations include a ban on certain types of solicitations for contributions: section 501(q)(2)(A)(i) forbids solicitation of "contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization." This provision has not been tested in court to date, but should obviously not be presumed unconstitutional until it is so found.

Regulating (or even forbidding) the use of outside professional fund-raisers will obviously not end excessive investments in fund-raising. The moral hazard persists, and organizations that fall prey to it can hire employees to avoid the restrictions if they choose to do so. It does attack an area in which abuses have been widespread, and famously resistant to prior attempts at regulation. Forcing the internalization of the fund-raising offers some hope that organizations will be more aware of the relationship between its

¹⁰⁷ 357 U.S. 513 (1958).

¹⁰⁸ *Id.*, at 550.

fund-raising and its programmatic efforts. Finally, if the response to regulation of abuse of outside fundraising proves to be simply that organizations bring similar abuses in-house, Congress could consider extension of the mechanism to a more general limitation on fund-raising excesses. This would involve imposition of rules requiring organizations to account for the amount of resources devoted to fund-raising, and possibly imposing a maximum, or perhaps a sliding scale of maxima based on organization size (and type?), rather like the limitations on lobbying currently contained in section 501(h).

Conclusions

Current tax rules provide substantial subsidies to charitable organizations, but in ways that are neither neutral nor reflective of the worthiness of the donee organization. Changing the rules to target the most worthy organizations is likely to fail due to the difficulties of achieving durable agreement on how to measure worthiness. But changing the rules so that the subsidies are distributed in a manner that is more neutral is a reasonable goal. This paper has outlined a number of features of present law that result in distributions of subsidy that are based, unwisely, on characteristics of donors, or on the mix of the charity's factors of production, and has suggested ways in which those legal features could be changed to improve the neutrality of the distribution of subsidies. It has also suggested that a crisper, and generally broader definition of "charitable," especially in the residual category embracing organizations that serve ends that are not primarily educational, religious, or redistributive would benefit both the charitable sector and the public at large. Finally, it has suggested that distortions induced by fund-raising abuses can and should be addressed by amendments to section 501(c)(3). And so, a call to action: To the barricades, good people! (Catchy slogans are still being developed.)

DRAFT

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