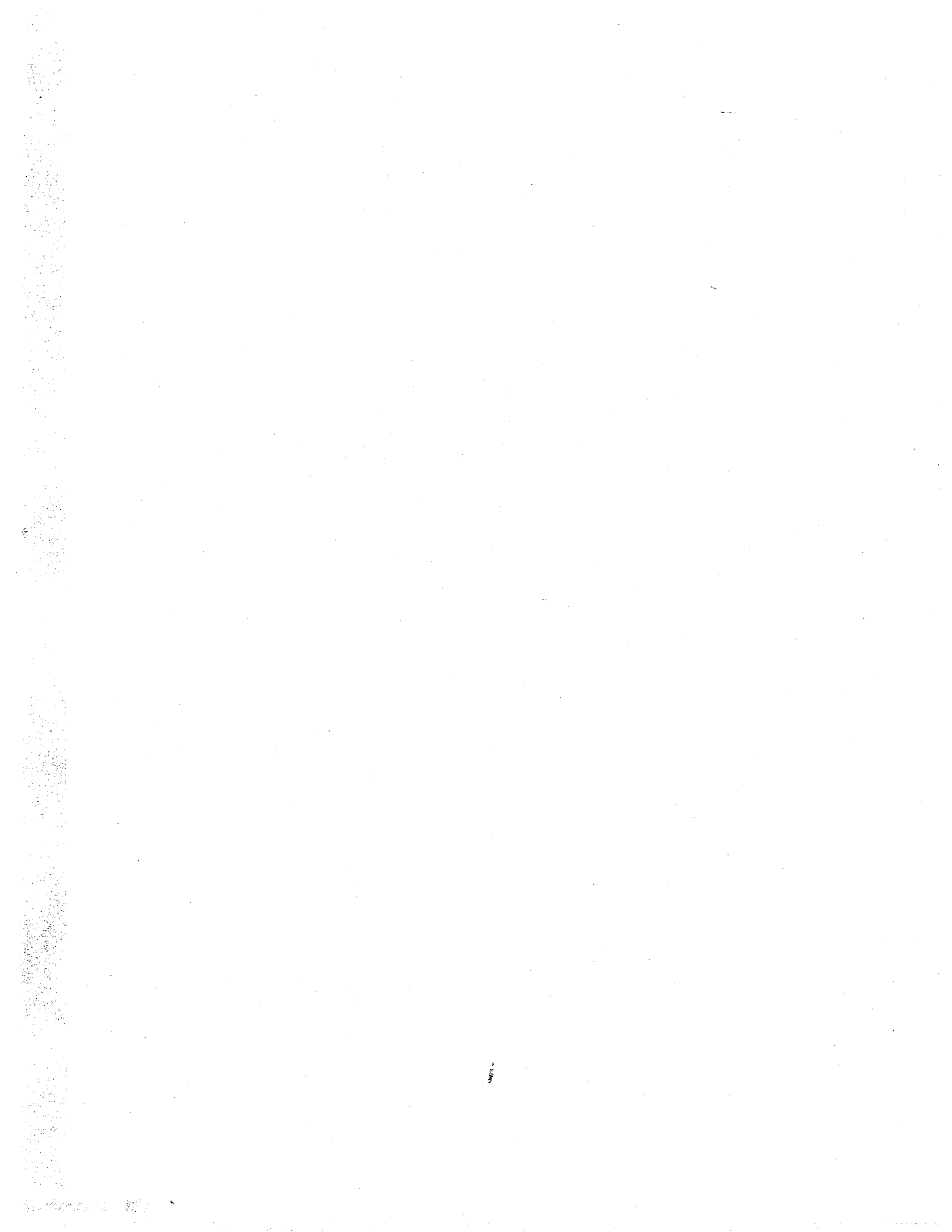


**IS TAX EXEMPTION A SUBSIDY?\***

**by Bill Andrews**

---

\* Copyright © 1992 by Bill Andrews. All rights reserved.



## Is Tax Exemption a Subsidy?

Bill Andrews

### I. Introduction

In Regan v. Taxation With Representation of Wash. (*TWR*),<sup>1</sup> the Supreme Court upheld the age-old prohibition against lobbying by § 501(c)(3) organizations. The prohibition is in the definition of such an organization, and so the sanction for violation is the loss of the tax exemption and deductibility of contributions that goes with that status. A direct prohibition of lobbying, enforced with criminal penalties or by injunction, would be a patent violation of freedom of speech under the First Amendment, but the Court characterized the prohibition in § 501(c)(3) as just a decision not to subsidize lobbying – the petitioner has a constitutional right to lobby but not to have its lobbying paid for by other citizens through a subsidy in the tax code, or elsewhere. That characterization gained support from the fact that petitioner could retain its tax benefits with respect to other activities by returning to the practice of conducting its lobbying activities through a § 501(c)(4) affiliate.<sup>2</sup>

---

1. 461 U.S. 540 (1983).

2. This procedure would even preserve tax exemption for the lobbying affiliate, but not deduction for contributions to the affiliate. Some of the opinions emphasize that there is no objection to common control and personnel in the § 501(c)(3) organization and its lobbying affiliate; all that is required is sufficient separation of accounts to assure that deductible contributions to the § 501(c)(3) organization are not used to support lobbying.

It has been argued that *TWR* can only be read as resting on the  
(continued...)

2 Andrews

Rust v. Sullivan,<sup>3</sup> involved the Public Health Service Act,<sup>4</sup> which provides federal funding for family-planning services, but also provides, in § 1008, that "none of the funds appropriated under this subchapter shall be used in programs where abortion is a method of family planning." In 1988, the Secretary promulgated new regulations prohibiting, inter alia, "counseling concerning the use of abortion as a method of family planning or . . . referral for abortion as a method of family planning," or engaging in activities that "encourage, promote or advocate abortion as a method of family planning." The regulations further require that Title X projects be organized so that they are "physically and financially separate" from prohibited abortion activities. To be deemed physically and financially separate, "a Title X project must have an objective integrity and independence from prohibited activities. Mere bookkeeping separation of Title X funds from other monies is not sufficient."

Any such prohibitions applied to clinics operating without govern-

---

2. (...continued)  
availability of § 501(c)(4) for lobbying activity, and that the 501(c)(3) restriction on political campaign activities is unconstitutional because there is no such alternate procedure for them. L. Chisholm, *Exempt Organization Advocacy: Matching the Rules to the Rationale*, 63 *small. L.J.* 201 (1988).

3. 111 S.Ct. 1759 (1991).

4. 84 stat. 1506, as amended; 42 U.S.C. §§ 300-300a-41.

ment support would apparently be a rather clear violation of free speech. But the Court reasoned again that the prohibition just represents a government decision not to subsidize abortion advice. Sometimes the Court seems to say the grants were only for pre-pregnancy planning and precautions, not post-conception care or advice. But the regulation prohibiting referrals for abortion also requires that clients who become pregnant be referred for suitable prenatal care and social services (including adoption). The clinics are thus not precluded from giving post-conception advice and referrals, and the regulation is not neutral as between abortion and live childbirth. The opinion in *Rust* says that abortion advocacy and activities can be conducted by a Title X provider in a separate project, somewhat as lobbying activities can be carried out through a § 501(c)(4) affiliate of a § 501(c)(3) organization, but the degree of separation required is apparently more stringent (and costly). Some of the justices in *TWR* said that the presence of an unonerous affiliate procedure was essential to the result there reached.

Does it follow from these decisions that burdens on free speech comparable to those in *Rust* could be applied as a condition to enjoyment of tax exemption and deductibility of contributions? The simple reasoning would be that (1) *Rust* authorizes quite severe restraints as a condition to the receipt of federal subsidies in the form of grants, while

(2) *TWR* establishes that tax exemption and deductibility of contributions are subsidies paid through the tax system. Ergo, (3) restraints akin to those in *Rust* could be imposed as a condition to the enjoyment of § 501(c)(3) status. But it aint necessarily so.

For one thing, the limitation on tax benefits upheld in *TWR* is a very different thing from the limitation in *Rust*. The *TWR* limitation is a quite general prohibition against lobbying, irrespective of cause, adopted for the purpose of achieving neutrality among taxpayers lobbying in support of different, competing objectives. It is closely associated with a prohibition against business expense deductions for lobbying that would otherwise qualify as a business expense. The limitation in *Rust*, on the other hand, is a very specific prohibition against the advocacy of one particular course of action, enacted for the purpose of promoting the alternative. That difference would make it easy to reconcile the holding in *TWR* with a holding prohibiting a *Rust*-type limitation as a condition to enjoyment of general tax benefits provided for charitable and educational institutions. Neither of the opinions, however, makes anything of this difference; indeed the Court in *Rust* argues that the limitation is essentially similar to that in *TWR*.

If we must be concerned with what the Court says, as well as

what it does, there is still room to wonder. In Bob Jones University v. United States,<sup>5</sup> decided the next day after *TWR*, regulations were upheld imposing requirements of racial nondiscrimination as a condition to § 501(c)(3) classification for schools, even though they were connected with churches whose teaching allegedly dictated such discrimination.<sup>6</sup> Mr. Justice Rehnquist, author of the Court's opinion in *TWR* but dissenting in *Bob Jones*, made no effort to reconcile his position here with the language of his opinion in *TWR*. Even the majority, upholding the limitation, did not describe the tax benefits at issue as subsidies that the government can condition as it wishes.

This case is only one of many involving religious organizations in which the Court has refrained from calling the exemption and deduction subsidies. An obvious reason for refraining is that direct grants to churches might run afoul of the constitutional prohibition against any establishment of religion. State property tax exemptions were upheld against a claim of violation of the establishment clause in Walz v. Tax Comm'n of New York.<sup>7</sup> Subsequent cases have involved tax deductions

---

5. 461 U.S. 574 (1983)

6. *Bob Jones* had admitted some blacks; the issue arose over the permissibility of regulations prohibiting inter-racial dating or marriage or advocacy thereof.

7. 397 U.S. 664 (1970).

for private schooling often in church schools.<sup>8</sup>

## II. Tax Expenditures

The question whether tax exemption and deductibility of contributions are subsidies has arisen in the context of tax policy, as well as constitutionality, and perhaps arguments in that sphere can shed some light on the constitutional issue.

Stanley Surrey coined the phrase "tax expenditure" for provisions in the tax law that represent backdoor government spending carried out through the tax code.<sup>9</sup> A tax expenditure can take a variety of forms: a deduction, or exclusion from gross income, or rate reduction. It is any departure from a normal (income) tax structure adopted for the purpose of promoting some objective that is not integral to the business of collecting taxes. For example, the exemption of municipal bond interest is a departure from the norm of taxing all investment income<sup>10</sup> that can

---

8. Cf. *Committee for Public Education and Religious Liberty v. Nyquist*, 413 U.S. 756 (1973), with *Mueller v. Allen*, 103 S. Ct. 3063 (1983).

9. For subsequent elaboration of Surrey's views, see Surrey, *Pathways to Tax Reform* (Harvard Univ. Press, 1973) and Surrey and McDaniel, *Tax Expenditures* (Harvard Univ. Press, 1985).

10. Especially, as we now know, interest income.



only be understood as a subsidy for state and municipal borrowing and the activities they support. Surrey argued that it would be better, for a variety of reasons, if the revenue code were cleared of these tax expenditure provisions, and their purposes were left to be met by direct government spending. In enumerating tax expenditures, itemized personal deductions have regularly been included.

### Deduction of Contributions

If personal deductions are viewed as tax expenditures, they reflect the graduated rate structure of the income tax in a peculiarly perverse way. The medical expense deduction provides a partial subsidy for extraordinary medical expenses, but higher, proportionally, the *more* income a person has.<sup>11</sup> And the charitable contribution deduction provides a kind of matching grant program for contributing taxpayers, but again one in which the rate of matching varies positively with ones income tax bracket.<sup>12</sup> If one thinks in terms of direct expenditure

---

11. Higher at the margin, that is, for taxpayers whose medical expenses exceed the floor. Use of a percentage of gross income as a floor below which no deduction is allowed operates to keep most high income taxpayers from claiming the deduction at all.

12. With a further increase in rate of matching if the taxpayer's contribution is funded with appreciated property! See Surrey, Federal Income Tax Reform: the Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance, 84 Harv. L. Rev 352, 384-385 (1970).

programs, it is hard to imagine the government giving away so much for such purposes without its own review of priorities; it is almost inconceivable that a matching grant program, conceived as such, would be warped in favor of the well-to-do in quite the way this one is.

But the argument seems to prove too much; the deductions are not as perverse as this makes them seem. Somehow one feels that the reason why the government provides the high bracket taxpayer's charity a bigger matching grant is because the government took more of that taxpayer's money away in taxes in the first place and that that is not an irrelevant consideration, as it would be in the case of grant. Perhaps the deduction *can* usefully be seen as an indirect government expenditure, but it *can* also be seen as a reduction in taxes, in which perspective it makes complete good sense that the relief amounts to more when the taxes to be relieved are more.

The matter of tax expenditures is intimately dependent on the choice of a baseline. A tax expenditure can only be identified and measured as a departure from normal, and normal then has to be specified in terms of some baseline. For purposes of compiling information, it is convenient to take a simple and conventional baseline, like the existing code but without those provisions whose purposes seem to

represent a departure from the business of collecting taxes and the concerns that are inherently connected with that enterprise. For purposes of policy evaluation, on the other hand, it is appropriate to be more probing about the baseline question.

Henry Simons taught us that ideally income for personal income tax purposes means the sum of consumption and accumulation,<sup>13</sup> and so that is at least a plausible baseline. The primary purpose of that definition was to make clear that differences in *sources* of funds available for consumption and accumulation are irrelevant to the purposes of a personal income tax. Hence the municipal bond interest exclusion is clearly a departure from normal and should be eliminated. But the other side of Henry Simons' coin is that differences in *uses* of funds are potentially very relevant.<sup>14</sup> If funds are spent for something that does not represent consumption or accumulation, then Simons' definition indicates that the expenditure should be deducted, not as a matter of subsidy but just as a matter of conforming the income tax to its natural

---

13. "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." H. Simons, *Personal Income Taxation* 50 (Chicago, 1938).

14. See Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 809 (1972).

baseline. One could say that whatever one spends his money for is consumption, but that makes the whole argument circular. Simons had a very practically oriented disposition to treat anything one spent money for as consumption, in the amount of the money spent, but he clearly recognized that his definition opened the question.<sup>15</sup>

Consumption, as an element of taxable income, is not self-defining. Should it include, for example, the benefits of good health? Or the pleasure one takes from doing good for others? And should it be measured on a discounted basis so that \$100 of entertainment today is worth more than the same amount of entertainment (after correcting for inflation) in the future? If one answers any of these questions in the negative, then that provides a reason why the baseline itself should have a deduction for expenditures that produce these effects. Extraordinary medical expenses may be made deductible because they represent the cost of restoring (often quite imperfectly) a state of health that would not itself have been taxed and is not taken into taxable income for those who never lost it. Personal interest may be made deductible because the person who pays it is seen not as enjoying a higher level of consumption than one who does not, but rather a lower level of wealth. And expenditures for activities that largely benefit others (taxes and contributions)

---

15. E.g., *id.* at 119-120.

may be made deductible because of an implicit judgment that taxable consumption is best defined (refined) to mean private, preclusive consumption of scarce resources whose consumption by the taxpayer makes them unavailable to others.

The point of this analysis is not that Simons' formulation demands a deduction for charitable contributions (or medical expenses), but that it makes room for an explanation of such deductions as sensible refinements of the Simons' ideal rather than departures from it that can only be understood as tax expenditures. In particular, viewing them this way provides an explanation of why the application of graduated rates to the deductions is not quite so indefensible as the tax expenditure analysis seems to suggest.

### Exemption

How does this sort of view apply to the exemption of organizations from tax, as compared with the deductibility of contributions? It has been pointed out that the exemption for charitable organizations is the same in effect as an unlimited charitable contribution deduction (provided the deduction is understood to extend to funds set aside for

future charitable use).<sup>16</sup> But it is not clear what follows from that observation because it is not clear what should be taken as a baseline or ideal for corporate income taxes.<sup>17</sup> Henry Simons' ideal is not directly applicable since it deals only with personal income taxation.

Would a tax on the windfall profits of petroleum companies entail a subsidy to all other corporate recipients of windfalls? If not, then why must a tax on the profits of business corporations be seen as a subsidy to nonprofit corporations?<sup>18</sup>

In one sense the argument against subsidy characterization is weaker, too, since we do not have revered authority for the proposition that the corporate income tax ought to tax the sum of consumption and accumulation; but on the other hand the argument *for* subsidy characterization is weaker, too, since there is no clear ideal or baseline from which to measure departures.

---

16. Steuerle, *The Issue of Unfair Competition*, Working Paper, Center for the Study of Philanthropy and Voluntarism, Institute of Policy Sciences and Public Affairs, Duke University (February 1988). See also Steuerle, *Taxing Charities*, 45 *Tax Notes* 1623 (Dec. 25, 1989); Steuerle, *Competitive Advantages for Charities*, 46 *Tax Notes* 123 (Jan. 1, 1990)

17. Steuerle was apparently mainly concerned to evaluate the argument, commonly made in defense of the unrelated business income tax, that the charitable exemption would otherwise give an unfair competitive advantage to charities over taxable business competitors.

18. Even government lists of tax expenditures have omitted tax exemption, to the considerable annoyance of true believers in tax expenditure analysis. See Surrey and McDaniel, *Tax Expenditures* 219-220 (1985).

The corporate income tax can be seen as support for the individual income tax: so long as we do not tax shareholders on their shares of undistributed corporate earnings it is essential to have some other present tax, and the corporate income tax serves that function. If that is its primary rationale, then perhaps the argument from the Simons definition as baseline will carry over.

One case<sup>19</sup> held that the exemption of social clubs from tax on their income from club activities was not a tax subsidy sufficient to make such clubs subject to nondiscrimination requirements then emerging as a condition on tax exemption pursuant to § 501(c)(3). The reasoning was that this exemption was not a tax subsidy but rather a structural decision not to tax organizations through which persons essentially carry out their consumption spending, as compared with their productive investment, on an incorporated or associated basis. We do not tax individuals on gains or losses or savings realized in the process of buying or consuming more efficiently than others; the exemption just extends that practice to efficiencies realized by banding together. Congress subsequently enacted § 501(i) denying the benefit of this exemption to

---

19. *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972). See also *Paralyzed Veterans of America v. Civil Aeronautics Board*, 752 F. 2d 694, 710 et seq. (D.C. Cir. 1985).

clubs that discriminate; the constitutional holding apparently still stands.<sup>20</sup>

### III. Relevance to the Constitutional Issues

What is the relevance, if any, of this tax policy debate about tax expenditures to constitutional issues concerning limitations on tax exemption and deductibility of contributions?

First, neither *TWR* nor the other cases has cited that debate. On the other hand, *TWR* and *Bob Jones* and various other constitutional cases have been cited and extensively discussed in the tax expenditure literature. In particular, Surrey and McDaniel have a whole chapter entitled "The Tax Expenditure Concept in the Courts," in which *TWR* is exhibit A in sound judicial reasoning, because it announces, without qualification, that tax exemption and deductibility of contributions are tax subsidies. Everything is there except use of the precise words "*tax expenditures*." That part of the tax expenditure literature could be cited in support of an argument that tax exemption and deduction are to be treated exactly like grants.

---

20. See Surrey and McDaniel, *Tax Expenditures*, 124-126, 138-154 (1985).



What then of the part of the tax expenditure literature raising questions about the utility of such rigid characterization? What use can be made of the argument that personal deductions can rationally be seen as refinements in the baseline notion of personal consumption as a component of personal income? This part of the tax policy debate may not carry over very clearly with respect to the constitutionality of limitations, because the argument against tax expenditure classification is essentially an enabling not a limiting argument. It basically says tax exemption and deduction do not have to be seen as subsidies; or that they may be seen as subsidies but they are also part of the tax code sharing in its purposes and aspirations and that some of their characteristics can be best understood in the latter light. This argument might be helpful in justifying what the courts have done in not holding tax exemptions for churches unconstitutional under the establishment clause, but it is unlikely to help in setting limits on Congressional discretion. It does not say that tax exemption and the charitable deduction *are not* subsidies, or *cannot* be treated as subsidies for purposes of upholding government regulation.

Perhaps the most important lesson to be derived from the tax expenditure literature is that a rigid assertion of identity between tax

benefits and direct grants is ultimately unhelpful.<sup>21</sup> We have a very complicated pattern of governmental burdens and benefits in which a narrow exception to a broad and general burden may function as a special benefit or subsidy; but within which a narrow exception to a general benefit may sometimes similarly be best understood as a special burden or penalty,<sup>22</sup> and in which it is hopeless to try to specify in any general, inelastic terms which are which. Indeed no intelligent response to any of these matters is likely until it is understood that limitations on tax exemption are likely to share some of the characteristics of penalties with some of the characteristics of mere nonsubsidies and that which should control in any particular case is likely to be a matter of judgment transcending these simple categories.<sup>23</sup>

Tax exemption and deductibility of contributions (*TWR*) is like a government subsidy by grants (*Rust*), but it is also different. Grants often involve some discretionary choice among grantees and activities, which will necessarily leave many applicants out for a wide variety of

---

21. . See, e.g., Wolfman, *Tax Expenditures: From idea to Ideology* (review of Surrey and McDaniel, *Tax Expenditures*), 99 *Harv. L. Rev.* 491 (1985).

22. Unconstitutional conditions generally fall in this category.

23. "The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." F. S. Fitzgerald, *The Crack Up* 69 (1956).

reasons. Promotion of diversity in a program of direct grants may require that the government be able to take account of virtues that it would be unconstitutional (and wholly impractical) to try to require. Our system of tax exemption and deductible contributions creates a much more general sort of entitlement, against whose backdrop a denial of benefit may well have many of the aspects of an affirmative burden or penalty. Diversity is also an objective of tax exemption, but it is to be achieved by a different route--through the diversity of people likely to take advantage of a general entitlement. In this context there is more force to the position that the denial of a government benefit should be viewed as a form of penalty, and it might be reasonable to conclude, therefore, that some limitations on first amendment freedoms should not be allowed as a condition to enjoyment of general tax exemption even though they would be allowed as a condition to enjoyment of a grant.