The Charitable Deduction: Tax Expenditure or Tax Base Provision -- Does it Make a Difference?

If there is a body of nonprofit law[1], among its most interesting and important issues are those which argue the justification for relieving public benefit nonprofits[2] from the burden of financing government activities by the payment of taxes[3]. The provisions usually discussed include the exemption from federal, state and local income taxes, the exemption from local real property taxes and the deduction from personal income taxes for contributions made to public benefit nonprofits[4].

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[1] See Swords, "Nonprofits and the Law: a Primer for Managers," New England Journal of Human Services, Volume 9, Issue 2, 27-30 (1989).

[2] The term "public benefit nonprofits" refers to those nonprofits that are exempt from taxation under section 501(c)(3) of the IRC. What distinguishes these groups from other nonprofits, such as social clubs, apartment coops and trade associations, is that they are organized primarily to provide benefits to the public at large whereas other nonprofits are primarily run to provide benefits to their members. This article will refer to section 501(c)(3) nonprofits alternatively as "public benefit nonprofits" and "charities."

[3] In my view, the classics are: Andrews, Personal Deductions in an Ideal Income Tax, 86 Harvard Law Review 309 (1972); Bittker, Charitable Contributions: Tax Deductions or Matching Grants?, 28 Tax Law Review 37, 58-59 (1972); Kelman Personal Deducations Revisited: Why they Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World, 21 Stan. L. Rev. 831 (1979) and Simon, Charity and Dyanasty Under the Federal Tax System, in The Economics of Nonprofit Institutions 253 (S. Rose Ackerman, ed. 1986).

[4] Exemption from state and local sales taxes would also be included, although, as of the time of this writing, there has been very little discussion of the charitable exemption for sales taxes. It should perhaps be noted that the exemptions from federal, state and local taxes are also accorded to many types of non-public benefit nonprofits. An analysis of the

These provisions have been characterized in two ways: as tax expenditures and as means of defining the tax base. Those who argue that these provisions are tax expenditures understand them to have been put into the tax codes not for reasons of tax policy but as a way of providing indirect government support to charities - - they are tax expenditures rather than direct expenditures. Those who argue that these provisions are necessary to properly define the tax base quite obviously understand them to be motivated by tax policy and not by some non-tax social policy. From a practical standpoint it makes no difference at all either to the nonprofit, the government or contributors how these provisions are characterized. Either way the nonprofits have more funds to spend on their exempt purposes, the government has less funds from these sources with which to support its activities, and contributors have more funds to spend on themselves than would have been the case if the deduction was not allowed[5]. What earthly difference does it make then how these provisions are characterized? Are charities sufficiently important to our society to justify treating them differently for tax purpose. This is the real question, not an academic debate that has no practical import. The question this

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local real property laws of all the property taxing jurisdictions in the country would no doubt show that a number of non-public benefit nonprofits also enjoy exemption.

[5] In this last instance, if there was no deduction, it is possible that the contributor would not contribute at the same level as she did with the deduction so as to have the funds with which to pay the tax that would be imposed on her contribution. If this was the case, the nonprofit organization would have less funds than it might otherwise have had.

article addresses is whether the tax expenditure or tax base debate is important and if so why.

Part I discusses the differences between the two approaches and provides a brief history of the evolution of the tax expenditure approach. Part II discusses how the tax advantages accorded to public benefit nonprofits can be described as tax expenditures, and Part III how they can be understood as ways of defining the tax base. Part IV addresses the question this article asks: Does it make a difference how you consider these provisions.

Part I

Provisions that are enacted into the tax code primarily to support government policies that are unrelated to tax policy and that provide relief from taxation are sometimes called tax expenditures. Examples would include accelerated depreciation provisions to support low income housing or business investment. By imposing less of a tax burden than would be the case absent the provisions, they can be viewed as the functional equivalent of direct grants by the government to the organizations that benefit from the provisions. Either the government imposes the full tax and grants back a portion of it - the direct expenditure approach - or it provides a tax exemption and makes no direct grant - the tax expenditure approach. The impact on the government's and organization's budgets are the same. Under this view these provisions are a type of government subsidy, an

incentive to the targeted groups to induce them to invest in low income housing or business, whichever is the case. These provisions are criticized because they, in effect, make government expenditures without going through the regular budgetary process. They originate in tax committees rather than appropriation committees and they do not show up in any budget of direct government expenditures. Further, they are open-ended. Once they have been enacted there is no way of controlling the level of government support. Private decisions as to how much low income or business investment to make set the level for government (indirect) expenditure. Decisions about where and when to invest and the details of what to invest in are also taken out of government hands although, on this view, it is providing some of the funds for these projects.

Stanley S. Surrey[6] pioneered the tax expenditure concept in the mid-1960s. In 1968 the Treasury Department prepared the first federal tax expenditure report. Today, as required by the

[6] An interesting (at least to me) personal history footnote follows for Forum members. Stanley Surrey sat next to my father when they were both freshmen in Class of 1932 at the Columbia Law School. One seat down was the wonderful Edith Spivack. My gentle father, I believe, was somewhat intimidated by Professor Surrey. He always adored Edith. I have interpreted this seating arrangement as apocryphal for me. Edith was a strong opponent on the wrong side of the property tax issue in its early days of our battles and reluctantly came around to our side under the tender persuasion of Fritz Schwarz. Furthermore, I believe it is fair to say that the issues that Surrey raised about characterizing the tax breaks accorded to public benefit nonprofits in the federal income tax system have been one of my major preoccupations for the last 20 years.

Congressional Budget Act of 1974[7], both the executive and legislative branches of the federal government publish annual tax expenditure estimates. The Act defines the term "tax expenditure" as "... those revenue losses attributable to provision of the federal tax laws which allow special exclusion, exemption or deduction from gross income which provide a special credit, a preferential rate of tax or deferral of tax liability.[8]"

On the executive side, tax expenditure reports are prepared by the Office of Management and Budget and published in the "Special Analysis G" section of the annual federal budget. On the legislative side, annual tax expenditure reports are published by the Congressional Budget Office and the Joint Committee on Taxation[9].

In December of 1989, Governor Cuomo signed legislation that requires the executive branch to make annual tax expenditure

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[7] Public law 93-344 (1974).

[8] The Act does not require tax expenditure budgets for other taxes in the Internal Revenue code, such as excise, insurance and estate and gift taxes.

[9] See Appendix A to Office of Tax Policy Analysis of the New York State Department of Taxation and Finance, Issues in State Tax Expenditure Reporting: A Discussion Paper (1988) (hereinafter Discussion Paper). "Recently only the JCT has published tax expenditure reports," Discussion Paper at A-3.

reports.[10] As of this date at least 19 other states have tax expenditure reports[11].

The Congressional Budget Office employs the following definition of tax expenditures: "Tax expenditures are provisions in the tax code that provide incentives for particular kinds of activities or that give special or selective tax relief to certain groups of tax payers.[12]" Professors Surrey and McDaniel in the book Tax Expenditures, after distinguishing between two distinct elements of an income tax - first, those which establish the normal tax structure and second, tax expenditures - state with respect to tax expenditures:

> The second element consists of the special preferences found in every income tax. Those provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity or class of persons.[13]

The New York State laws states: "'Tax expenditure' shall mean any tax incentive authorized by any provision of law that by

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[10] [cite law] In February 1990, the first tax expenditure report was issued. See, Governor, New York State Division of the Budget and New York State Department of Taxation and Finance, Annual Report on New York State Tax Expenditures (1990).

[11] Discussion Paper, supra note 4, at 5.

[12] [cite]

[13] Stanley S. Surrey and Paul R. McDaniel, Tax Expenditures 3 (1985) [hereinafter Tax Expenditures].

exemption, exclusion, deduction, allowance, credit, preferential tax rate or other device, reduces the amount of tax revenues that would otherwise accrue to the state.[14]"

As is implicit in all the definitions of tax expenditures, there are some provisions that supply exemptions and the like that are not designed to provide incentives or "selective tax relief to certain groups of taxpayers." Deductions for business expenses, for example, are clearly not tax expenditures but are put into the code as a way of defining the tax base. We only mean to tax net income. Any other provision whose purpose is to define the tax base or some part of the normal tax structure also would not be a tax expenditure[15].

Some tax provisions are clearly tax expenditures. An example might be a provision designed to provide an incentive to induce a result desired by the government - more low income housing - a provision which is clearly exogenous to any tax

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[14] [cite]

[15] Surrey and McDaniel in making the distinction noted above between the two elements of an income tax - structural provisions and tax expenditures, describe the first element as follows:

> The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transaction. These provisions compose the revenue-raising aspects of the tax.

Id. at 3.

policy consideration. In many cases, however, it will not be self-evident whether a particular provision is a tax expenditure or tax base provision. The confusion will arise primarily because of the many divergent views on what should be in and what should be out of the tax base. There is a continuum as to the comprehensiveness of, for example, the income tax base. At one end all net income would be included and only deductions and exclusions, etc., that were for income producing expenses would be considered tax base provisions and all other deductions, exclusions etc., would be considered tax expenditures. At the other end of the continuum, only earned income would be included and provisions relieving from taxation capital gains, investment income, gifts, etc., would be considered tax base provisions. In between these extremes, we are left with questions of how to treat the medical expense deduction, the deduction for state and local taxes, casualty losses, the charitable contribution deduction and much else.

In the property tax area, there are not as many distinctions, but the basic analytical principle holds. Do we want to include all property in the tax base, only property which is used for private purposes, or all property except for that held by government?

Concentrating for a moment on income taxes, it will be seen that the definition along the continuum you take for the tax

base will push you toward deciding whether a particular provision has been included for tax policy reasons, that is as part of normal tax structure, or for non-tax reasons, i.e., presumably to reach some social goal that has nothing to do with the tax system. If, for example, you choose net income as the tax base, then the medical expense deduction might very well not be understood as being included for tax policy reasons. This suggests a confusion that some of the prior writings on the subject raise. Just because a provision does not go to defining net income, this does not necessarily mean it was included for non-tax reasons. There may be good reasons why as a matter of tax fairness a particular provision may be included in the code even though such reasons have little to do with defining net income; an example would be the charitable contribution deduction. We may decide that we want to measure ability to pay after charitable gifts have been deducted from net income. Questions of tax fairness go beyond defining net income. It is only if you first choose net income as your tax base, that you can then assert that all non-net income defining provisions are included for non-tax reasons. But this presupposition has to be argued first.

Part II

Those who interpret the charitable contribution deduction as a tax expenditure see it as a form of government spending

made to encourage giving to charity. The deduction acts as a kind of matching grant to the contributor's gift. For example, if the tax rate is 30%, then a gift of one hundred dollars can be analyzed as a gift of $70 by the taxpayer matched by a grant of $30 dollars from the government[16]. Stanley Surrey has said this about the charitable contribution deduction:

> First, it clearly is a method of federal assistance. While the end result is often described as 'private support,' and the relevant tax provisions as inducements or incentives to such support, the tax expenditure aspect is clear. The provisions involve federal assistance, in that the contributors are allowed to reduce their tax liabilities through deduction of contributions made to their charitable donees. The amounts involved in tax liabilities forgone are shifted away from the federal government to the charities through the mechanism of the charitable gift and the allowance of that personal gift as a deduction from gross income. The charitable contribution deduction is a special tax provision not required by, and contrary to, widely accepted definitions of income applicable to the determination of the structure of an income tax. It is, in short, a

[16] On this view, the government in effect first collects a tax of $30 from the contributing taxpayer and then gives it back to the organization to whom she made the contribution as a match to her contribution.

tax expenditure as the term is used in the Treasury Tax Expenditure Budget, and the charitable contribution deduction is included therein[17].

One of the strongest criticisms of the charitable contribution deduction assumes that it is a tax expenditure and objects to the fact that the wealthier the taxpayer the greater the matching grant. This criticism had more bite in the days when rates were higher. A taxpayer in the 70% rate bracket who gave $100 was understood as having the government make a $70 match to her $30 gift while a taxpayer in the 20% rate bracket who made a similar gift received only a $20 match to his $80 gift[18].

One effect of providing a deduction for charitable contributions is to slightly increase the tax burden of those

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[17] Surrey,Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance, 84 Harv. L. Rev 352 at 384-385 (1970). In comparing the charitable contribution deduction to tax exempt obligations, he goes on to say: "....while the assistance to philanthropy comes from the federal government, its allocation is privately directed -- the government funds are paid to particular institutions at the direction of private persons. Moreover, the assistance is blanket, automatic, no-strings attached, open-ended aid." Id.

[18] See Surrey, supra note 17, at 386-389. After describing the particular way gifts of appreciated property work out, Surrey notes: "It is thus clear that our colleges, insofar as such support through 'gifts' is concerned, are really receiving nearly all of the support from the government with 'donors' providing very little of their own funds and instead 'voting' through the deduction these appropriations of government funds to the colleges." Id.

who do not contribute[19]. Some who view the charitable contribution deduction as a tax expenditure argue that it is justifiable for those who do not contribute to pay a slight increase in taxes because as members of the public they receive the benefits provided by the organization to whom the contribution was made[20].

Part III

In this part, the reasons for characterizing tax provisions that benefit charities as tax base provisions are examined.

Tax bases can only be determined if you begin with a clear idea of what it is you are raising taxes for. For purpose of this article, I am going to assume that taxes are raised to finance general government services, i.e., I am eliminating questions regarding user taxes where taxes are imposed because the government has provided some sort of benefit to the taxpayer. The question then is what do we want to tax to support government services that benefit everyone in the community? Or what do we think it is fair to tax[21]? Questions regarding how to

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[19] See infra note 33.

[20] Gergen, The Case For a Charitable Contribucion Deduction, 74 Virg. L. Rev 1393, 1397-1406 (1988). "A credit will push funding a collective good close to an optimal level by shifting part of the cost of the good from donors to freeriders." Id. at 1400. What is curious about this argument is that a tax policy argument is offered to justify a provision which is otherwise thought of as being provided for public policy reasons exogenous to the tax system.

[21] I assume that in deciding the appropriate tax base, equity reasons take precedence over efficiency reasons. Indeed, it seems likely to me that efficiency concerns have little to do with defining the tax base. If a tax

distribute this burden among members of the community are questions of tax policy[22].

There follows an account of what I believe are the most cogent reasons for viewing the charitable contribution deduction provision, etc., a provision for defining the tax base[23] y. But before doing this, I must first tell a short story which I hope, however abbreviated, suggests, through the means of a hypothesized historical development, the basic structural

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provision is introduced for efficiency reasons, i.e., in the belief that the economy will be more productive on account of this provision, this would seem to me to be done for reasons largely extrinsic to tax policy.

[22] At the start of the analysis of whether nonprofit activity should be taxed, it would seem plausible to argue that there is nothing in the differences between the essential goals of for-profit and nonprofit effort that would lead one to choose to burden one activity with the support of government and not the other. The ultimate goal of for-profit activity is directed primarily towards making money for the persons engaged in the effort - the dominating and insatiable drive to expand capital. See any day's issue of the financial section. For nonprofits, the ultimate goal is to perform a service; in the case of a charitable (i.e., 501(c)(3) nonprofit) a public service. Money is made only to make it possible to carry out the service. See, Baumol & Bowen, On the Performing Arts: The Anatomy of their Economic Problems, The American Economic Review 495, 497-499 (May 1965). It is, of course, possible for nonprofit activity to generate net income (although unlike for-profit activity, that net will be plowed back to support the nonprofit's goal). A tax could be imposed on that net. In other words, much of what can be said about the fascinating and important public policy question of whether it is better to have a particular activity run by the market, the government or the nonprofit sector is beside the point for determining who and what should be taxed. It would be quite possible to have a full blown nonprofit sector and subject its net to tax. The question, as will be expanded on below, is whether society in deciding how to apportion the burden of government services should treat differently the "net" that is allocated to advance one's private interest from the "net" that is devoted to advancing public interests.

[23] The charitable contribution deduction is selected for analysis. Footnote below shows that similar arguments can be made for the tax exemption. the same is true for charitable property tax exemption. See, Peter Swords, Charitable Real Property Tax Exemptions in New York State (1981).

features of a government arrangement such as we have in America today that relies on income taxes to support the provision of general governmental services.

Assuming only five families in our abstracted community, I shall trace the development of their economy through five phases.

Phase 1 - In the first phase there is no exchange and all five families provide themselves with necessary food, clothing shelter and entertainment. Each family decides for itself how much it wants, how hard it wants to work to produce what it wants, and how much leisure time it wants. What it produces and consumes may roughly be thought of as its income[24]. Thus, the more and harder it works, the more income it has; while on the other hand, the more it opts for leisure activities, the less income it has.

Phase 2 - The families discover that by each family specializing in the production of a particular good or service and then exchanging these goods and services, with the same amount of work, they all end up with more (or more and better) food,

[24] In this early phase, it would seem likely that families would use (consume) what they make as they make it. It may be, however, that they would save some of what they produce to be consumed at a later time. In this instance, "income" takes on some of the double-sided aspects noted below in Phase 2. Some might extend "income" to include leisure; as will be seen below, leisure becomes an important factor when considering ability-to-pay ramifications.

clothing, shelter and entertainment. Here also each family can decide how long and hard it wants to work and consequently, generally speaking, what level of goods and services it wants to end up with. The concept of income clouds a bit at this level. Take a particular family. It specializes in the production of one product. When it has produced as much as it wants to trade of that product, it exchanges that output for other things. What the family really wants are the other things; its output of that particular product is far in excess of what it needs for itself. It is the other things that are equivalent to what we suggested was income in Phase 1. On the other hand, if the family chooses not to trade all of its product, the product saved could be traded for other things whenever it wants. The saved output operates like money; it constitutes a potential claim on the resources produced by the other families. When exchange enters the picture the idea of income seems to take on two sides - production and consumption.

Phase 3 - As a result of the five families forming a community, a need arises for certain "public" services, e.g., an adjudicatory system to settle trading disputes, and the five families decide amongst themselves to each devote one day a week to providing these public services. On the day a family works providing public services, they do not produce an output which they can then exchange for something they want for themselves. Their work is of equal benefit to all the community and they

receive nothing back in exchange for it other than their share of the public good. Because they worked one less day producing an output which they could exchange for whatever they wanted, their consumption of private goods is reduced. Note that an important distinction has now been introduced between private goods - those goods and services which families consume on their own, so to speak - and public goods - those goods and services which benefit everyone in the community.

Phase 4 - Money is introduced and goods and services are bought and sold and government services are provided by taxing income and paying individuals to furnish the public services with money raised by taxing the income of the members of the community. Note, in very simplified terms, this is what happens in a moneyed economy. 1) People work. 2) They produce output. 3) They exchange their output for money. 4) They take the money and buy (exchange it for) whatever they want. Taxes come in at the end of stage 3. Some money is taken away to provide for public services. As a result, the taxpayer has less money to buy whatever s/he wants. The result is, of course, the same as we saw in Phase 3, namely, the taxpayer has less money to spend on private goods for herself[25].

I believe that the tax base argument can best be understood

[25] Or to save to spend on private goods for herself at a later time or to pass on to her family for them to spend on private goods.

by returning to Phase 3 of our story - that point in the development of the community's political/economic system before the advent of money but after the need for collective goods has been discovered. Imagine our five families conferring in a kind of town meeting called to decide matters regarding collective goods and responsibilities - matters which are public and affect the whole community. They sit as legislators in effect to decide public questions. They might first decide what public goods are needed and then how it is that the burden of providing those public goods should be allocated amongst them. On the latter question, the issue would be how many hours a week, days a month, etc., each family should devote to the provision of public goods. Whatever the general answer to that question, there is the following refinement. If a family voluntarily works for the community, should this be taken into account in deciding how much "coerced" public service work it must provide?

In analyzing this question, it should first be observed that at this stage of the society's development there are four basic kinds of activities that its citizens can engage in. First, leisure, an activity whose benefits are almost entirely private. Second, the production of goods for exchange, an activity that is predominantly private[26]. Third, voluntary

[26] Of course, the production of goods for exchange is beneficial to the community as a whole because the goods are presumably available to anyone for exchange. They are produced, nevertheless, for essentially private purposes, i.e., to exchange for goods that the producing family wants for itself.

public service, an activity which provides predominantly public benefits. And fourth, coerced public service, an activity which also provides predominantly public benefits[27].

A decision about which of two distinctions should be given prominence may be determinative in deciding whether to "credit" voluntary work for the community against coerced public service. The distinctions are:

* time spent to predominantly advance one's own interest versus time spent to advance the public's interest, or
* voluntary activity versus coerced activity[28].

If the first distinction is privileged, then a strong argument can be made that credit should be given to voluntary public service (and this can be extended to show that the charitable contribution deduction is provided to define the tax base). If the second distinction is privileged, the contrary results. This will now be argued.

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[27] These activities produce two kinds of goods: private and public. Private goods are those which predominantly benefit the individual who consumes or uses them for her own benefit. Leisure for these purposes is a private good. Public goods benefit everyone in the community.

[28] The four activities identified above can be divided into two sets of two groups. The first set shows one group with two activities that are for predominantly private ends and one group with two activities that are predominantly for public ends. The second set shows one group of three activities that are voluntarily engaged in and one group of one activity that is coerced.

As the families deliberate in their town meeting and decide to require public services from themselves, it is likely to be widely agreed that coerced public service is a necessary evil[29]. If the first of the two distinctions noted above is predominant, they will be sensitive to the fact that mandated public service cuts into the amount of time they have to engage in activities that predominantly advance their private interests[30]. In these circumstances, might they not decide that time voluntarily spent providing public services should be "credited" to them in determining how much time they should be required to spend providing "coerced" public services? They might believe that since a family that provides voluntary public services has already reduced the amount of time that it has to spend on itself by working for the community as such, that as a matter of equity this should be taken into account in allocating to them their share of coerced public services. In quantitative terms, before the institution of coerced public services, each family had all of its time to spend on itself. With the imposition of coerced public services, this time was reduced. In determining how much time to require from each family, the group meeting as policy makers might decide to look only to the time that a family spends on itself and if a family has already reduced that

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[29] No one likes to pay taxes but everyone does.

[30] If, however, the second distinction is prominent, the focus would more likely fall on the fact that mandated public service cuts into the amount of time they have to engage in voluntary activities. See below.

amount by voluntarily providing public goods, to require less time for coerced public services. In tax base terms, the base is not all the time that a family has, but only that time it has to spend on itself.[31]

If we transfer the principles that have been developed in our analysis of Phase 3 to Phase 4, that point in a community's development when money and an income taxation system are introduced, we see the following. Making a charitable contribution is equivalent to voluntarily providing public services. Just as the "tax base" in Phase 3 was limited to only that time that families spend pursuing interests which predominantly benefit themselves, so here the tax base is limited to only that income which is for predominantly private interests. The charitable contribution deduction on this view is provided then to define the tax base[32]. Money that the taxpayer

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[31] As policy makers deciding about pubic issues, the family-member legislators' concern will be on the supply of services to the community. They will observe themselves by treding with each other and enjoying leisure. It is likely that they will conceive of this self-regarding activity as what the families prefer to do. Consequently, cutting into these activities by requiring coerced public service will be done reluctantly. With this general orientation, however, it would not be illogical to reduce the amount that families must supply to the community if they have already supplied it with public services on a voluntary basis.

[32] The analysis developed so far is similar to that advanced by Andrews (see Andrews, supra note 3) and Bittker (see Bittker, supra note 3). It is an analysis that focuses on the supply side of the economy. Time spent to predominantly advance one's own interest diverts the goods of society to private interests. Time spent to advance the public's interest diverts goods to public interests. When a family provides voluntary public services it contributes its work product to the public and does not use it for its own benefit (except as it is benefitted as a member of the general public). Andrews argues in terms of consumption. He defines income as consumption and

has not used to advance her own interests and has transferred to an organization that will use it to advance public purposes should not be in the tax base. Only money that would otherwise be used for private purposes should be in the tax base. To keep it simple, imagine that there are only two taxpayers in the jurisdiction, A and B, and that each earns $70,000 with no allowable deductions. With a 30% tax rate, both would pay $21,000 to support government services and have $49,000 left

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defines consumption as the "private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others." (Andrews, supra note 3, at). A family in effect exhausts goods and services in satisfaction of its private ends. Elsewhere he says that "the practical purpose of the [income] tax [is] to divert some economic resources to public uses." (Id at) Since money given to charity does not result in the consumption of society's resources by the donors but rather in the consumption of social resources by the public, it should not be in the tax base and the charitable deduction is provided to accomplish just that.

Tax exemption can also be understood through the analysis developed above. Tax exemption applies to entities. Their net income is exempt. In the pre-money terms of Phase 3, it works out this way. Individuals join together to work for an entity. They produce goods and services which the entity then trades for other goods and services which it distributes in part to those who work for it as compensation for their work. What remains -- the net product -- is, in the case of a non-charitable entity, distributed to the entity's owners while, in the case of a charitable entity, it is applied to furthering the public benefit purposes for which the charitable organization was formed. In the case of the non-charitable entity, the net represents activity performed by the owners (organizing the entity, hiring workers, acquiring the necessary infrastructure, etc.) for their private interests: they appropriate the net to and for themselves. In the case of the charitable entity, any net (which is appropriated to the entity for furthering its charitable purposes) represents activity performed by the entity's organizers for the benefit of the public. A decision to take into account only time spent on activity pursued primarily for personal advantage for purposes of allocating the burden of coerced public services would entail not including in the tax base activity which produced the charitable entity's net. Professor McNulty of Boalt Hall has argued that the charitable contribution deduction "can be defended as the private sector counterpart of the section 501 exemption for charities." McNulty, Public Policy and Private Charity: A Tax Policy Perspective, 3 Virg. Tax Rev. 229 at 233

over to spend on themselves. If A decided to give $10,000 of his $70,000 to a charity, he would have only $60,000 to use for himself. On the view advanced in this part, this is the amount that should be included in the tax base and taxed. If he is accorded a deduction and he is taxed, he will have $40,620 after-tax and after gift and B, who made no gifts, would have $47,380 after-tax or $6,760 more than A to spend on himself[33]. A will have contributed $29,380 to support the provision of public benefits as compared to B's $22,620.

It may be, however, that the families sitting as legislators would view the critical distinction not as that between private and public interests but rather as between coerced and voluntary activity. Coerced activity is to be abjured not just because it means that families will have less time to pursue interests which predominantly benefit themselves

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[33] If the tax base is reduced from $140,000 to $130,000 on account of the deduction provided to A for his gift, the tax rate would have to increase to 32.3% to produce the same amount of revenue as would have been the case if A had not made the deductible gift. Thus, B's tax liability would increase by $1,620, the amount by which A's tax liability decreased after the higher rate is applied to the amount of his income left after his gift. Because A's tax liability decreased by $1,620, even though he gives up the use of $10,000, the after tax amount of money left to him is only $8,380 less than would have been the case if he had not made the gift. Because B's tax liability increase by $1,620, B is only $6,760 better off than A. If the deduction was not allowed, A would have only $39,000 after-tax and after gift, $10,000 less than B. Note, as suggested above, that A also pays the higher rate (32.3%) on the income that is left to him after the gift (viz., $60,000) for his own use.

but more because they will have less time to pursue voluntary activities per se. If one family wants to spend part of its time voluntarily providing public goods while another all of its time pursuing its own self interest, that is their business. The evil is the reduction of voluntary time. In tax base terms, the base is not just the time that the family has to pursue interests which predominantly benefit itself, but all of its time. On this view, voluntary public service work would not give rise to any sort of credit against coerced public service or, translated into tax terms, the charitable deduction would not be provided as a way of defining the tax base[34].

Can anything be said about choosing between these two views[35]? An approach to this question is to suppose that there

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[34] The analysis developed in the above paragraph is similar to that advanced by Kelman (see Kelman, supra note 3). It is an analysis that focuses on the demand side of the economy. Any time spent voluntarily, however spent, is what that family wanted to spend it on. No other activity could have given it more "utility" or the family (being presumed to be rational) would have so spent it on the such other activity. In a footnote Kelman notes: "Thus, any voluntary decision is 'utility-maximizing.' But utility in modern economic thought is not a psychological concept; it is simply the definition of what the voluntary trader 'maximizes.'" Kelman, supra note 3, N.24 at . Kelman defines income and consumption as net receipts, receipts minus the cost of obtaining the receipts. Id. at . Receipts focus on money before it has been spent. Its potential is as yet unrealized. Its holder can spend it on anything she wants. In terms of Phase 3 of our imagined economy, it is similar to the free time that lies ahead of people to spend in any way they want. So long as it is voluntarily spent, it should be considered as within the base that society can look to to exact coerced public services. If one spends her money (exercises demand) as she wishes, it ought to be in the tax base and it does not matter whether she spends it on goods that predominantly advance her own interests or that of society at large.

[35] As noted above, one approach - that most persuasively argued by William Andrews - emphasizes the supply side of the economy (see supra note 32) while the other - advanced able by Mark Kelman emphasizes the demand side

are only a few collective goods that the community needs and that its leader-legislators have agreed they all must be furnished. Let us suppose that to do so each family would have to spend two hours a week on public service. If one family, however, is already spending two hours a week providing one of these goods on a voluntary basis, would fairness require that that family provide additional public services? If so, the remaining families would have the amount of time they are required to spend on providing public services reduced[36] and consequently would have more time to spend on ends that predominantly benefit themselves. (All families, however, would spend the same proportion of coerced versus voluntary time.)

In these circumstances, a credit for the work done on a

(see supra note 34). My argument is closer to Andrew's but may be more comprehensive. Andrews seems to find exhaustion of resources as key. I look to the incursion on time spent on activities pursued to predominantly advance private interests. My view would include in the tax base leisure and activities that do not appropriate time and resources (i.e., lack production costs). It combines elements of both a supply and a demand side focus. On the supply side, it credits time spent supplying society with public goods. On the demand side, it includes in the time that it uses to measure how much coerced time families should be expected to give to the provision of public services (i.e., the tax base) leisure and related activities that do little to reduce social resources but provide those who engage in them clear satisfaction.

[36] If there were five families, then 10 hours a week of coerced public services would be needed -- 2 hours from each family. If one family (Family A) voluntarily provided 2 of those hours, only 8 hours of coerced public services would be required. If all 5 families were expected to share equally in providing these 8 hours, each family would be required spend 1.6 hours a week on coerced public services. In these circumstances Family A would spend 3.6 hours a week on public services while the other four families would spend only 1.6. (All five families, however, would only spend 1.6 hours a week on coerced public services and all the rest on voluntarily chosen activities.)

voluntary basis may seem eminently fair. The fact that absent the credit our public spirited family would provide a vastly greater portion of time providing goods than the other families[37] might seem more important than the fact that even without a credit all five families would provide the same amount of coerced time on public services. Is there in our notions of fairness a deep commitment to sharing the burden of our collective work more or less equally[38]? If so, does the fact that some may voluntarily choose to shoulder a part of that burden suggest to us they should not have to carry a greater part of the collective load than others?

The case just analyzed, involving the provision of public services on a voluntary basis that would otherwise have been required, will be referred to as the "easy case."

If the line of reasoning developed in connection with the easy case is convincing, the next question that arises is whether it carries over to the case of the voluntary provision of public services that have <u>not</u> been agreed upon by the community as so essential as to mandate their provision. These

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[37] Taking the above example, Family A would spend 36 percent of all the time devoted by the community to public works as compared to 16 percent for each of the four other families.

[38] There are countless work situations throughout the world where it frequently happens that a few workers seem to do more of the work required to be done by the group as a whole than the rest of the workers. This strikes many as unfair. Are they wrong?

are services that would be indisputably public but would not have been selected by the community as part of the package of public services the accomplishment of which is to be brought about by coerced services. If credit is given for these kinds of services, the result would be that the "other " families would have to provide more coerced public services than would have been the case absent the credit. This is a clear and significant difference from the easy case. Does it affect the sense of justice alluded to in the analysis of that case? While the voluntary public services now being considered are not what the community's leaders have selected for coerced public services, they would nevertheless be recognized as public and as providing public benefits[39]. As a result of these voluntary efforts, more benefits, and perhaps a greater range of benefits, are provided to the public than would be the case if public services were limited to coerced public services. The families that decide to engage in the voluntary public services, in effect, identify and define new public needs and benefits. They increase the load of public services but they also concomitantly shoulder that increased load. If the services are understood as providing genuine public benefits, then, perhaps, the same sense of equity that was noticed in the easy case of direct substitution of voluntary for coerced services would apply even though the other families might have to provide a somewhat higher level of

[39] Organizations exempt from federal income taxes under section 501(c)(3) and eligible for the charitable contribution deduction under section 170 are by definition primarily organized to provide public benefits.

coerced public benefits[40].

The argument rests largely on the presupposition that doing something for others - the community as such - is significantly different than doing things for yourself. Those who find it hard to accept that people do things for others, who believe that all behavior is motivated by self-interest, are very likely to find the argument unpersuasive. An appeal has been made to fairness[41]. If, however, it is assumed that doing things for others is essentially the same as doing them for yourself, that "individuals do, in fact, incessantly and uncompromisingly advance only their narrow self interest"[42], then the claim that simple fairness compels us to recognize the contributions voluntarily made to society in apportioning coerced services will ring hollow. In this climate of opinion, the second approach outlined above disregarding the private/public and giving prominence to the voluntary/coerced distinction would

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[40] If the system worked more or less like the existing federal income tax system, the amount of extra work per individual "other" family would be very small. Those families that voluntarily provide public services under the analogy would also be required to provide coerced public services and the total amount of public service contributed by such families would be greater than that contributed by families that provided only coerced public services.

[41] How many Forum members feel more comfortable analyzing these kinds of questions in terms of equity rather than economic efficiency?

[42] A phrase I have borrowed from Amartya Sen in a recent article in the New York Review of Books cited in note 45 below.

seem likely to prevail[43]. Skepticism about altruism is endemic. Middle-class individuality is, after all, the source of many of our dominant values[44]. At this point a recent statement by the economist Amartya Sen may be instructive:

> In many economic and social theories today, human beings are seen as strict maximizers of a narrowly defined self-interest, and given that relentless compulsion, pessimism about social arrangements to reduce inequality will indeed be justified. But not only is that "model" of human beings depressing and dreary, there is very little evidence that it is a good representation of reality. People are influenced not only by perceptions of their interests, but also, as Albert Hirshman puts it, by their passions. Indeed, among the things that seem to move people, whether in Prague or Paris or Warsaw or Beijing or Little Rock or Johannesburg, are concern for others and regard for ideas[45]

If people are perceived to be, in fact, motivated by concern for

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[43] Much of this weather in legal circles may come out of the school of law and economics. Kelman's demand-side thesis resting as it does on notions of utility is an excellent statement of the position. See supra note .

[44] In this connection, I sense in many quarters misunderstanding and distrust of the nonprofit sector. Fairly benign, although infuriating, is the belief that work in the nonprofit sector is easier and less challenging than work in the commercial realm. More poisonous are those views that entertain the belief that nonprofit groups are somehow "ripping off" society through, for example, abuse of the tax and postal systems.

[45] Sen, Individual Freedom as Social Commitment, XXXVII (#10) The New York Review of Books 49, 54 (June 14 1990).

others, then when they spend their time (or money) helping others it may be seen as a genuine public act providing a genuine public benefit and my thesis will ring true.

Part IV

We now come to the question towards which this article has been proceeding: does it make any difference whether the deduction allowed for charitable contribution is characterized as a tax expenditure or as a means of defining the tax base? As noted in the Introduction, it makes no difference to the contributor. She gets her deduction no matter how it is characterized. It also makes no difference to the Treasury. It is out of revenue whatever tax analysts might say about the reasons. Even those who are concerned to support charities may wonder what all the fuss is about. The reason we provide these breaks to charity is because the services they provide are important to our political-economic system. Whether you think of this provision as encouraging contributions or as reflecting our sense of fairness, what it all comes down to is that we think charities are good things. This section examines whether this is right or whether how you view these provisions really does make a difference. I have identified 6 possible reasons why it <u>does</u> make a difference.

1. The clearest reason for finding the difference

significant lies in the argument that it easier to change a tax expenditure provision than one that defines the tax base. For those who want to protect the charitable sector, this, if valid, would be an important difference[46]. A tax base provision is more constitutional in nature. Changing the normative structure of the tax system is a much more radical act than changing a provision that was put into the code for non-tax reasons and therefore should be approached with much more care. If, for example, a provision is added to the code to encourage low cost housing and after a while there is no longer a need for low cost housing, it would seem an unremarkable and sensible thing to eliminate the provision. On the other hand, to overturn an original decision that fairness requires that moneys that are given to charities and benefit the contributors in only a small way, if at all, should not be in tax base would seem a much more difficult thing to justify[47]. Notions of tax fairness are principles of some permanence compared to social policy initiatives that change with changing circumstances. What we think is income or what we think it is fair to tax are decisions that are fairly impervious to changing circumstances. Would we change our view that we only tax <u>net</u> income as easily as we

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[46] For those who would like to limit the advantages that are accorded to charities it would be equally important, since, as will be argued below, understanding the provisions as tax expenditures would make it easier to do so.

[47] For purposes of this part, one has to assume that the arguments in favor of characterizing the charitable contribution deduction as a tax base defining provision are valid. Otherwise the question becomes meaningless.

would our position that there was no longer a need to accord accelerated depreciation to certain investments?[48].

2. Related very closely to this last reason is the one that focuses on an important and often overlooked feature of our charitable system, namely the autonomy it offers to individual members of the community in deciding what public benefits they want to support on a voluntary basis. Private citizens identify needs and opportunities for community-wide goods and services. They define programs and create organizations to deliver them. They decide how these organizations should be structured and at what level of funding they should be supported. All of this is done with only minimal interference by the government[49]. People

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[48] This line of argument has to face the fact that part of the Tax Reform Act of 1986 involved limiting the deduction for expenses incurred for the production of income under section 212. Such deductions are now limited by section 67 which provides that miscellaneous itemized deductions, which include section 212 deductions, "shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." The section 212 deduction would seem to be one that helps define net income and so a tax base defining provision. In commenting on the difference between the business expense deduction under section 162 and the section 212 deduction, Boris Bittker in his treatise on federal taxation, notes (before the Tax Reform Act of 1986) that it does not make much difference which of thee provisions a deduction is taken under "[i]n either case, the individual's tax liability is based on net rather than gross income." Boris Bittker, Federal Taxation of Income, Estates and Gifts, Volume I, 120-98 (1981). I do not recall that objections were made along the lines suggested in the text. This tax base defining provision seems to have been eroded with about as much ease any tax expenditure.

[49] In this connection, an important point in the chain of argument by the court made in McGlotten v. Connaly, 338 F. Supp.448 (D.D.C. 1972) to justify its denial of tax-exempt status and eligibility for the charitable contribution deduction to a fraternal organization that discriminated on racial grounds would seem to be incorrect. The court was constrained to distinguish the charitable contribution deduction from the home mortgage deduction. It did so on the grounds that there was much more governmental

are more likely to volunteer (whether by providing direct services or making financial contributions) for these organizations than they would be for governmental agencies, constrained as most of them are by politics and bureaucracy. A pluralism of approaches to public needs results. If the provision of public goods was limited to the governmental sector, a far narrower range of these goods would be available than is the case under our present system where public goods are furnished both by the government and the private nonprofit sector.

Understanding the charitable contribution deduction as a tax expenditure would mean that the government could pick and choose what public benefits it wanted to support in this manner. Indeed, if a move was made to limit the charitable contribution deduction, it is unlikely that it would be repealed altogether. More probable would be a selective elimination of purposes heretofore considered exempt. In the late 1970s and early 1980s,

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involvement in the charitable contribution deduction case, including defining the purposes which will satisfy the statue. It looked to the "degree of control the Government has retained as to the purposes " which may be benefitted and suggested that the charitable contribution deduction provision "expressly choose fraternal organizations as a vehicle for" favored activity. Id. at 457. At best this is misleading. The tax advantages in question are given to any charitable purpose and the Treasury Regulations make plain that the term charitable is to be understood in its "generally accepted legal sense." Treas. Reg. section 1.501(c)(3) -1(d)(2). This makes reference to the law of trusts which defines a charitable purpose as any purpose which benefits the community as such. See section 368, Restatement (Second) of Trusts. It is individuals that decide what community good to provide, not the government. The government is limited only to assuring that the benefit is a public one.

New York City's Administration did exactly this with respect to its local property tax by considerably limiting the number of purposes that could qualify for the nonprofit exemption[50]. Selective elimination of exempt purposes would be entirely consistent with characterizing the deduction as a tax expenditure, i.e., as a kind of government grant made to support certain efforts thought to be desirable from a social policy viewpoint.[51] Thus, when the government changes its views on social policy, action could be taken to limit the deduction in ways that would reflect its new opinions. For example, the government might decide it no longer wants to support the arts or environmental efforts and amend sections 501 and 170 to remove the fostering of the arts or the protection of the environment from the category of charitable purpose. Viewing the deduction in a way that would permit the limitation of

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[50] See, P. Swords, Charitable Real Property Tax Exemptions in New York State (1981).

[51] Surrey and McDaniel, the organizers and unparalled champions of the tax expenditure concept, have this to say on the subject: The tax expenditure concept informs us that the tax preferences that have been the targets of traditional tax reform efforts were really seeking to reduce or terminate particular spending programs and thereby cut or end government assistance to particular activities or groups. Once this fact is recognized the basic question then becomes whether or not government assistance should be provided. This question must be answered in terms of criteria applied to government spending programs. In seeking to eliminate a particular preference in the interest of horizontal tax equity, tax reformers have rarely faced that issue and have rarely justified adequately - in spending terms - the appropriateness of government assistance for the activity or group. For if such assistance was appropriate, then tax reform had to encompass a wider scope. It had to consider how government could provide that needed assistance through a direct spending program. It also had to consider whether direct spending or tax expenditure was a better framework in which to provide the assistance. Tax Expenditure, supra note 13, at 25-26.

charitable purposes on a selective basis would imperil the autonomy and open-freedom of choice[52] central to our charitable system and as noted above would likely result in a narrower range of public goods than are offered when a healthy charitable sector parallels the efforts of the government in the provision of public benefits.

On the other hand, if the charitable contribution deduction is taken to be a tax base defining provision, the autonomy celebrated above would more likely be protected. Changes to the tax system would only be made for tax policy reasons. A decision would have to be made that we no longer believe that as a matter of equity voluntary efforts conducted to advance the public interest should not be taxed -- a decision that presumably would apply to all such efforts and not just a few selectively chosen ones. As argued above, this kind of change would seem likely to be taken only after the most fundamental alterations in our notions of fairness had occurred. That is to say, it would seem a much harder change to effect than to modify a tax expenditure.

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[52] Autonomy and freedom of choice are ingredients of the voluntary character of charitable efforts. As argued in Part III, a decision to view the charitable contribution deduction as a tax expenditure would likely turn on the voluntary nature of charitable efforts. It would be assumed that because the work was done on a voluntary basis it is what the volunteer did at that time to maximize her utility and therefor should be in the tax base. Thus the very features believed by many to especially justify support for the charitable sector -- its autonomy in choosing public purposes -- on this view provide the basis for treating the charitable contribution deduction as a tax expenditure.

3. Another major argument for finding significance in the difference looks to the perversion of the legislative process that tax expenditures are said to cause. Sums of money are forgone every year by the government without any legislative oversight. Indeed, as we saw in Part I, it is likely that it was just this aspect of tax expenditures that provoked Stanley Surrey into his crusade on behalf of the concept of tax expenditures and tax expenditure budgets. At the start of his article, Andrews after noting that some have described the charitable contribution deduction provision as a tax expenditure, notes: "...if we were to have programs of direct support for other charities, it seems likely that we would insist upon much more rigorous evaluation of priorities than the tax expenditure mechanism provides."[53] Indeed, it seems that it was because he recognized that the complaints against the charitable deduction when seen as a tax expenditure were "devastating criticisms[54]" that he wrote his article. If the charitable contribution deduction is afforded because we never expected such contributions to be in the tax base in the first place, then all the problems with back door spending that are thrown against tax expenditure would not apply to it.

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[53] Andrews, supra note 3, at 311.

[54] Id at 311. "If they are correct, it seems to me the provisions in question are indefensible." Id.

4. Part of the "devastating criticisms"[55] that Andrews referred to involves the objection noted in part II that, if the charitable contribution deduction is understood as a tax expenditure, then, under a progressive income tax, the wealthier the taxpayer, the larger the government's matching grant.[56] If, on the other hand, the charitable contribution deduction is viewed as a tax base defining provision, this objection no longer holds.

5. The U. S. Constitution prohibits spending government funds in a manner that promotes or supports racial or sexual discrimination or in ways that promote the establishment of religion. Furthermore, suits lie against private parties for the deprivation of constitutional rights if they have received a government assistance. Questions then are raised as to whether the charitable contribution deduction or the tax exemption provisions constitute a form of government assistance. Plainly those who believe that these provisions are tax expenditures have a good argument that they are. This argument, however, would not be available to those who understand these provisions, as ways of defining the tax base. Among other places, the issue

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[55] Id.

[56] See supra note 18 and accompanying text.

comes up in racial discrimination cases[57], establishment and free exercise cases[58] and state action cases[59]. So far as constitutional litigation goes, the high point has perhaps been reached in Regan v. Taxation With Representation of Washington[60] upholding the denial of eligibility for the charitable contribution deduction to a lobbying group on the grounds that the deduction is the equivalent of a grant and that it is improper for the government to pay for lobbying. If the deduction had been seen as a tax base defining provision the case may well have come out the other way. We have then a difference of clear significance.

6. Finally, the distinction may be important for thinking about the many issues raised by unrelated business income tax considerations. If the tax exemption is thought of as a tax expenditure[61], there would be no disturbing inconsistency in deciding to make grants in support of charity by some means

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[57] See, Green v. Kennedy, 309 F. SUPP. 1127 (D.D.C. 1970), McGlotten v. Connally, 338 F. SUPP. 4487 (D.D.C. 1972); and Bob Jones University v. Simon, U.S. (1983).

[58] See, Walz v. Tax Commission of the City of New York, 397 U. S. 664 (1970); Committee for Public Education and Religious Liberty v. Nyquist, 413 U. S. 756 (1973); and Mueller v. Allen, U.S. ,(1983).

[59] These areas and others are admirably discussed in Stanley Surrey and Paul McDaniel, Tax Expenditures (Harvard Press 1985) at chapter 5.

[60] 461 U.S. 540 (1983).

[61] Although this article is concerned primarily with the charitable contribution deduction, as shown above at footnote , the ground reasons for understanding the charitable contribution deduction as a tax base provision are the same for understanding the tax exemption the same way.

(say, through the charitable contribution deduction and the exemption related to passive income) and not by others (say, through the exemption of unrelated income). This might be a sensible way of setting limits on the amount of the indirect grant. If, however, the tax exemption is understood as a tax base defining provision, then it might sensibly be argued that all income earned by a charity, related, passive or unrelated, should be exempt. On the view advanced in Part III of this paper, all of the income devoted to advance public and not private purposes should not be in the tax base to begin with[62].

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[62] In terms of Phase 3, if an entity's employees produced goods and services unrelated to the entity's charitable purposes which it trades for other goods and services which are then dedicated to advancing the public benefit objectives of the charity, time spent in such production should not be in the tax base. This argument maintains that for tax policy reasons unrelated business income should not be taxed. This is perhaps an extreme position and, if central to the subject of this paper, would require to be further elaborated. It seems, however, entirely consistent with the underlying rationale developed here.

Unfair competition was a major, if not the major, reason for adding the unrelated business income tax provisions to the code. I believe that the better view today is that these concerns were unfounded. See, Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 Stan. L. Rev. 1017 (1982). (I argued to the same effect (although on different grounds) in the October 1987 issue of Philanthropic Monthly.) If, however, concerns of unfair competition are given weight, it would then have to be argued that they would be more likely to carry the day if the exemption was characterized as a tax expenditure than if it was characterized as a tax base defining provision. I am not sure such an argument would work.