2017

The Importance of a Participatory Charitable Giving Incentive

Roger Colinvaux

The Catholic University of America, Columbus School of Law

The Importance of a Participatory Charitable Giving Incentive

by Roger Colinvaux


Roger Colinvaux

Roger Colinvaux is a professor of law at the Catholic University of America Columbus School of Law and was legislation counsel for the Joint Committee on Taxation from 2001 to 2008.

In this report, Colinvaux argues that the charitable deduction relies on widespread taxpayer participation for its integrity and that proposed increases to the standard deduction would intolerably shrink the base for participation. He concludes that in order to prevent that harm, the deduction should be converted into a broad-based credit.

Table of Contents

I. Introduction

The charitable deduction has long been a linchpin of federal tax policy. The deduction for gifts to section 501(c)(3) and other organizations is one of the few federal tax benefits that resonates throughout society, even among those who do not claim it. Indeed, it is difficult to think of another tax benefit that has so completely become part of our national consciousness. Yet the charitable deduction, and the character of the entire nonprofit sector, is in grave peril. The peril is not from the familiar changes to the deduction that have been discussed over the years.[1] Rather, the threat comes from probable reforms to other parts of the income tax system.[2]

Recent leading tax reform plans propose a substantial increase to the standard deduction.[3] The reason to increase the standard deduction is to reduce the number of taxpayers who take itemized deductions, thus simplifying the tax system.[4] Because the charitable deduction is an itemized deduction, far fewer taxpayers would claim it. For example, under the House GOP's "Better Way" tax reform blueprint, the percentage of taxpayers itemizing deductions could be reduced from roughly one-third of taxpayers to one-twentieth, or 5 percent.[5]

What would remain of the charitable deduction raises serious concerns. This report argues that broad-based participation in the giving incentive is central to its integrity and provides a base for a dynamic and worthy charitable sector. A charitable

---

[1]Ideas include putting a cap on the amount of the deduction, allowing the deduction only for contributions above a set amount, converting the deduction to a credit, and expanding the number of taxpayers who may claim the tax benefit. Congressional Budget Office, "Options for Changing the Tax Treatment of Charitable Giving" (May 2011). As discussed later in this report, some of those ideas have merit.

[2]This report is about the integrity of the charitable deduction as a tax benefit. It does not discuss the effect on charitable giving from the proposed repeal of the estate tax. The implications of estate tax repeal for the nonprofit sector are an important but separate topic.

[3]These include the House blueprint, "A Better Way: Our Vision for a Confident America" (June 24, 2016); the Trump campaign's tax plan; and the Tax Reform Act of 2014.

[4]Under the income tax, taxpayers choose between taking the standard deduction and itemizing their deductions.

[5]*See, e.g.*, House blueprint, *supra* note 3 (stating that "the Tax Reform Blueprint aims to reduce the number of taxpayers who itemize their deductions from about one-third under current law to approximately 5 percent under our simpler, fairer, and flatter tax system"). Not all taxpayers who itemize claim the charitable deduction. For example, in 2014 approximately 82 percent of taxpayers who itemized deductions claimed the charitable deduction. Publication 1304, "Returns With Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2014," at Table 2.1 (Aug. 2016).

deduction for only a handful of taxpayers is fatally flawed and would weaken the law of section 501(c)(3), with dreadful results for the nonprofit sector. Accordingly, if tax reform moves toward reducing the number of taxpayers claiming itemized deductions (and for that matter, even if it does not),[6] policymakers should consider converting the charitable deduction to a broad-based credit, which would retain and expand the essential and laudatory participatory features of the charitable deduction while also paving the way for other needed reforms.

II. Best Case for Reducing Itemizers

The best case for folding charitable deductions into the standard deduction lies with the simplification benefits. Instead of using a specific charitable deduction as under current law, for most taxpayers, charitable contributions would be accounted for through the standard deduction. Consistent with current policy, money spent on charitable contributions, in principle, would not be taxed. In that sense, the result is just to swap an itemized deduction for a standard deduction, a major simplification. The IRS would no longer have to be concerned with validating millions of charitable contributions, and millions of taxpayers could give free of substantiation, valuation, or quid pro quo concerns.

Further, despite far fewer itemizers, the amount of deductible charitable contributions would remain high. The 5 percent of taxpayers who would continue to itemize the charitable deduction, though small in number, would claim a substantial percentage of today's charitable deduction (roughly 55 percent in 2014).[7] The simplification gains then would be real: for 2014, about 28 million fewer taxpayers claiming the charitable deduction (or roughly 80 percent of current claimants) and a loss of far less, proportionately, of the total amount of deductions claimed (only about 45 percent).[8]

Still, a shift of 45 percent of charitable contributions from the charitable deduction to a standard deduction could result in reduced charitable giving. Without a direct incentive to give,[9] taxpayers might claim just the standard deduction because they are entitled to it, but not make charitable contributions they otherwise would have made. In other words, with the standard deduction automatic, the cost of giving would increase for taxpayers, and they might decide not to give.

The extent to which giving levels would change depends on the role the tax incentive plays in facilitating the decision whether and how much to give. A preliminary estimate of one proposal to increase the standard deduction (the Tax Reform Act of 2014) suggests a decrease in charitable giving by individuals in the range of 0.9 to 1.8 percent.[10] This modest estimated decrease in giving might reflect that individuals make charitable contributions for reasons apart from tax policy. For example, many give out of charitable impulse and the personal desire to help others, and would give regularly without a tax incentive, as non-itemizers do today.[11]

On the other hand, it is difficult to predict how donors would respond to a significantly changed legal landscape. Some have argued, for example, that non-itemizers give partly because they believe they *are* getting a charitable deduction (because of the nontransparency of the deduction).[12] If the deduction is changed so that very few taxpayers actually claim it, non-itemizers might soon understand that they receive no benefit and respond by not giving. Also, as discussed below, with 95 percent of taxpayers not claiming the charitable deduction, the meaning of charitable giving would change. Thus, even if giving levels did not decrease substantially, the recipients of giving would change, to the detriment of 501(c)(3) organizations.

In short, seen in its best light, shifting claimants out of itemization offers simplification and the same

[6]This report is written in the context of tax reform proposals to increase the standard deduction. The arguments, however, resonate with tax reform of the charitable deduction generally and so are not limited to that context.

[7]For tax year 2014, according to IRS data, the top 5.35 million returns measured by adjusted gross income (or 3.6 percent of total returns) account for almost 51 percent of the total charitable deduction. It is not possible based on IRS data to allocate the charitable deduction precisely to the remaining 1.4 percent of top returns because the returns are grouped by income, so an approximate amount was derived. All calculations are based on Publication 1304, *supra* note 5, at tables 1.2 and 2.1.

[8]*Id*. Technically, the IRS reports based on tax returns, not taxpayers.

[9]Some taxpayers would continue to have a direct incentive because some states provide a tax incentive for charitable gifts.

[10]Joseph Rosenberg et al., ''Preliminary Estimates of the Impact of the Camp Tax Reform Plan on Charitable Giving,'' Urban-Brookings Tax Policy Center (Aug. 2014). The range is explained in part because of the ''uncertainty in the responsiveness of individuals to the tax incentive provided by the charitable deduction.'' This decrease includes effects of other changes made by former House Ways and Means Committee Chair Dave Camp's plan to other non-itemized-deduction provisions. For the Camp plan as a whole (including changes to the rate structure and other changes), the report estimates a 7 to 14 percent decrease in individual giving.

[11]According to Giving USA, in 2015 approximately 18 percent of total giving was by non-itemizers. Giving USA, ''The Annual Report on Philanthropy for the Year 2015,'' at 22 (2016).

[12]Lillian V. Faulhaber, ''The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience,'' 92 *B.U. L. Rev.* 1307 (2012).

or similar positive tax outcome for most taxpayers, but with an uncertain effect on giving.

III. A Nonparticipatory Charitable Deduction?

Undoubtedly, simplification of the tax system and the effect on giving levels are key considerations for assessing a shift to a standard deduction as the way to account for charitable contributions. But more important for this report is the effect reducing the number of itemizers would have on the charitable deduction that remains. Although the law of the deduction would be the same as before,[13] the ground would have shifted entirely.

Once most itemizers migrated to the standard deduction, the remaining charitable deduction would become an incentive for a small group of itemizers, generally the wealthiest taxpayers. The question becomes the extent to which there is support for that limited incentive.

There have been many explanations for the charitable deduction over the century of its existence. Some of the key rationales are that it promotes altruistic behavior, fosters the private charitable choices of taxpayers, and advances a pluralistic society.[14] All have an element of truth, but as discussed below, for coherence all depend on the deduction being widely participatory. In other words, under these explanations for the charitable deduction, a deduction for a small percentage of taxpayers (wealthy or otherwise) is fundamentally flawed.

First, the rationale that the charitable deduction encourages giving or altruistic behavior generally — that is, giving for giving's sake — provides perhaps its strongest support. The theory is straightforward. As a society we all benefit from being part of a culture of giving. When we are encouraged to, and do, give to others, it is more likely that others will give. Giving becomes a norm and part of the social fabric. By reducing the cost of giving, the charitable deduction in this sense is a policy tool to promote altruism.

A charitable deduction that rewards the altruism of just a small fraction of society, however, would undermine the goal of promoting altruism more broadly. Is the only altruism worth rewarding that of a small slice of the population, which also happens to be the wealthiest? As a social value, the promotion of altruism should extend well beyond this group of taxpayers, and especially to those for whom giving is more of a sacrifice and so more meaningful as a social value. Accordingly, a charitable deduction for the few is not supported by an altruism rationale.

The charitable deduction also has been explained as a way to allow private individuals directly to allocate taxpayer (subsidy) dollars.[15] That is, by making a contribution, donors have the power to direct public money (through a government match) as a private appropriation. Under the private choice rationale, it can be said that the charitable deduction facilitates taxpayer participation in setting philanthropic priorities and that it is good civics.

A charitable incentive that is claimed by just 5 percent of taxpayers, however, essentially rejects the private choice rationale as well. Like the altruism rationale, the private choice rationale is credible only to the extent that the deduction is usable by a large swath of taxpayers. Under the charitable deduction that remains once the standard deduction is increased, the power to direct a private allocation of public funds would continue, but only for a few. Why should only one narrow group of taxpayers be allowed to direct public monies in this fashion? And why is it good civics to extend private choice just to this particular group? Ultimately then, the private choice rationale also fails to support a charitable deduction with few participants.

Another related rationale for the charitable deduction is that it fosters pluralism. The pluralism rationale is tied to the generous eligibility criteria for tax-exempt status under section 501(c)(3). Section 501(c)(3) status is granted based on an organization's purposes, which are broadly defined as charitable, educational, religious, scientific, or literary.[16] Thus, section 501(c)(3), through the determination for income tax exemption, sets the standard for most organizations that are eligible to receive deductible

---

[13]Congress could tinker with the remaining deduction, as in TRA 2014 (imposing a floor based on AGI, reducing the amount of the deduction for specific property contributions, changing the percentage limitations, and extending the time to claim the deduction until April 15, among other provisions).

[14]There are others. Perhaps the most common is that the deduction supports charity in the narrow sense of helping the needy. This is true, but only partially because the charitable deduction supports a wide range of organizational purposes. If the charitable deduction was intended only to promote charity in a traditional sense, the deduction would have to be narrowed significantly (which would be another reform option). Another view is that the charitable deduction is best understood as a way to measure (and define) income, that is, a person should not be taxed on money spent for charitable purposes. Under this view, an increase to the standard deduction to account for charitable contributions is no more than a base-defining measure. Consistent with this view, to raise the standard deduction by an amount sufficient to exclude the charitable contributions of the very affluent would be absurd, thus the need to retain a charitable deduction for this group.

[15]*See generally* Roger Colinvaux, Brian Galle, and C. Eugene Steuerle, ''Evaluating the Charitable Deduction and Proposed Reforms,'' Urban Institute (June 2012).

[16]Section 501(c)(3). Public safety organizations also are described in section 501(c)(3) but are ineligible for deductible charitable contributions.

contributions.[17] Because a wide variety of organizations can obtain section 501(c)(3) status, and donors may then donate to (or even form) their favorite charity, a diverse and pluralistic sector emerges — reflecting the varying preferences of donors with differing backgrounds and concerns. Here then the link between section 501(c)(3) and a participatory charitable deduction is especially important.

The pluralism rationale, although appealing, is limited even as applied to the current charitable deduction. By definition, as an itemized deduction, the deduction serves the preferences of itemizers, which under current law generally are the top 30 percent of taxpayers as measured by income.[18] Thus, if itemizers favor giving to their alma mater over providing for basic needs, universities are better served by the deduction than basic needs charities. In other words, the pluralism offered by the charitable deduction already narrowly reflects the pool of itemizers.[19]

By greatly reducing the pool, a charitable deduction for the few would make a mockery of the pluralism rationale. Although the eligibility criteria to become a charitable organization would remain broad, and therefore nominally pluralistic, the effect would be to favor with a tax incentive the charitable choices of a small percentage of taxpayers, in this case the wealthiest, which would not foster societal pluralism. Rather, it could reasonably be expected that the pluralism of the sector would shrink and that the sector would cater to the preferences of this group of taxpayers.

In sum, a charitable deduction that is claimed only by a wealthy few is anathema to how the charitable deduction is often justified. Even if it made sense to provide an incentive to just that group of taxpayers, an incentive that fostered only the giving choices of the group would be, or should be, untenable. The choices of one small group of taxpayers should not be favored over those of any other. This group does not inherently make better charitable choices than other taxpayers do, nor is its altruism more worthy of recognition than others'. Thus, the ironic vision represented by a charitable deduction claimed by the few is to squeeze section 501(c)(3) further to reflect the giving preferences of the most affluent in society — a result very much at odds with historical perceptions of and rationales for the charitable deduction.

IV. Effects on Behavior and the Charitable Sector

There are other reasons to question the wisdom of a charitable deduction for the few. To move from a country where a critical mass of taxpayers have an incentive to use section 501(c)(3) to define their giving choices to a country where section 501(c)(3) matters legally for only 5 percent of taxpayers would be a seismic shift.

As noted above, charitable giving by the ''95 percent'' would hardly come to an end. But the signaling power of the law over time would become largely irrelevant for most taxpayers in determining their giving choices. The result would be to alter fundamentally the market for charitable gifts and charitable organizations and further dilute the meaning of charity. Moreover, as section 501(c)(3) receded in importance as the defining standard for charitable giving, the validity of using section 501(c)(3) as a base for a wide-ranging system of tax benefits would be weakened. In a nutshell, the questions, discussed next, are how giving, and thus the sector, would be affected by eliminating section 501(c)(3) status for organizations as a condition of giving for so many and by retaining section 501(c)(3) status as an incentive for so few.

A. A Changed Market for Charity

For a century, we have taken for granted that charitable giving (and charitable activity) occurs through the section 501(c)(3) organization. The question is whether that would continue once section 501(c)(3) status is no longer necessary as a condition for charitable gifts for most people. Or put more starkly, once 95 percent of the taxpaying population could ignore the tax code entirely when making charitable gifts, would the section 501(c)(3) organization, and all that it stands for, remain relevant?

Section 501(c)(3) (combined with the common law) sets the standard for a public benefit organization. To qualify the organization must have a charitable or other noble purpose and serve a charitable class. Profits may not benefit organization insiders, nor may there be too much private benefit. Political and substantial lobbying activities are prohibited. The nature of the organization's activities must not be overly commercial, charitable activity must predominate over unrelated activities, and assets must be dedicated to charity upon dissolution of the organization. Combined, these cardinal rules of section 501(c)(3) status have shaped the charitable sector.

The immediate effect of a marginalized section 501(c)(3) might be slight. Out of both habit and

---

[17]Technically, a deductible charitable contribution must be to an organization described in section 170(c). Section 170 largely copies the language of section 501(c)(3). Thus, essentially, section 501(c)(3) exemption standards are the gatekeeper for determining the meaning of charitable for purposes of the charitable deduction.

[18]The percentage of taxpayers who itemize varies from year to year. In 2014, 29.6 percent of returns itemized. Publication 1304, *supra* note 5, at Table 1.2.

[19]This is also generally a fair critique of the other rationales. As an itemized deduction, the charitable deduction directly rewards only the altruism and choices of itemizers.

history, section 501(c)(3) would continue to be a relevant guide for giving by non-itemizers, even though donors could disregard it. Because section 501(c)(3) status has for so long been a required part of charitable giving, and so many organizations have adopted it, donor patterns of giving to long-established and familiar section 501(c)(3) organizations would probably not rapidly change.

But over time the law of section 501(c)(3) and its role in shaping the charitable sector (and so civil society) would be weakened in critical ways. From a donor perspective, without section 501(c)(3) as a necessary magnet, some giving would change direction, regardless of whether it is reduced. Many donors would divert their dollars to individuals; political organizations; non-charitable nonprofits, such as section 501(c)(4) groups; "social enterprise" groups; and even purely for-profit groups with a social mission — all of which cater more to a private benefit than do traditional charities.[20]

Eventually, as donors understood that section 501(c)(3) status was not necessary to their giving choices, the border between charitable and non-charitable organizations would erode. For non-itemizers, personal preference and not the section 501(c)(3) tax classification would determine what makes a contribution charitable.[21] In other words, for most people, charity would be in the eye of the beholder, not the law.

Just as donor behavior would weaken the distinction between traditional charities and other organizations, donee organizations would face a new dynamic. From a donee or organizational perspective, securing or retaining section 501(c)(3) status would matter less. For organizations that elect section 501(c)(3) largely because of the charitable deduction, the essential calculation would be to weigh the costs and limitations of charitable status against the chance of attracting contributions from the 5 percent. Small or neighborhood organizations that do not rely on contributions from the wealthiest taxpayers might opt out of section 501(c)(3) status in favor of "social welfare" status under section 501(c)(4).[22] Many groups, including churches, parent teacher associations, and others, might forgo section 501(c)(3) status to avoid the political activities prohibition or lobbying limits. In other words, just as donors could ignore section 501(c)(3), so too could donee organizations.

The marginalization of section 501(c)(3) would have a profound impact on the types of new groups that form. New mass funding models (for example, crowdfunding) that do not rely on contributions from the wealthiest would make non-section 501(c)(3) status feasible for many organizations. Common law requirements that organizations serve a charitable class would not matter.[23] It would be natural to expect more advocacy organizations to compete for funds. With section 501(c)(3) as the basis for determining charity undermined, it would be harder for consumers to distinguish self-serving from public-serving organizations.

In short, setting aside section 501(c)(3) status as a condition for deductible charitable giving would give rise to various changes in giving behavior and organizational norms and undermine the border between charitable and non-charitable organizations. The charity we are accustomed to (albeit already imperfect) would be diluted considerably. Although, as noted, giving might not decrease by huge margins, non-itemizing donors (the 95 percent) would be free to define charity according to personal preference, thereby changing the market for donee organizations and constraining the power of section 501(c)(3) to set a standard for public benefit.

B. Systemic Weakness

Yet another concern arises from a charitable deduction for the few: the credibility of the federal-state system of charitable tax benefits and preferences. At the federal level, section 501(c)(3) status has long been synonymous with the charitable deduction, but other tax benefits also flow from section 501(c)(3) status, such as federal income tax exemption,[24] access to tax-exempt financing,[25] exempt

[20]*See generally* Dana Brakman Reiser, "Theorizing Forms for Social Enterprise," 62 *Emory L. J.* 681 (2013). Indeed, this is already happening to a considerable extent. The initiative by Mark Zuckerberg and Priscilla Chan to fund their philanthropy not using a section 501(c)(3) organization is one example. The GoFundMe social fundraising website is another. In general, project organizers would be able to market themselves to non-itemizers without having to adopt the constraints of section 501(c)(3).

[21]Congress would have to decide whether to modify the gift tax.

[22]Section 501(c)(4) organizations, unlike section 501(c)(3) organizations, may engage in political activity and unlimited lobbying.

[23]Parochial disaster relief organizations and local groups that arise to help a family through a tragedy would attract money that might otherwise have been shaped by traditional charitable forms. For recent discussions of the issue, see Ellen P. Aprill, "Charitable Class, Disaster Relief, and First Responders," *Tax Notes*, Nov. 14, 2016, p. 949.

[24]Federal income tax exemption, unlike the other benefits, is hardly unique to section 501(c)(3) and is provided, in various forms, to at least 28 other organization types. Indeed, as discussed above, the availability of income tax exemption outside section 501(c)(3) would tempt some organizations (existing or forming) to consider non-section 501(c)(3) status.

[25]Section 145.

postal rates, and exemption from various federal regulatory rules.[26] Section 501(c)(3) status also influences state law benefits, including state income and property tax exemptions. Thus, section 501(c)(3) serves as the legal foundation (even symbol) for an entire federal-state system of preferential treatment.[27]

Once section 501(c)(3) is set aside for most taxpayers for charitable deduction purposes, it would be an open question whether section 501(c)(3) should continue its elevated status for other tax and legal purposes. A principal reason for the importance of section 501(c)(3) as a standard stems from the fact that it is linked to the charitable deduction.[28] Although the link between a marginalized section 501(c)(3) and the charitable deduction would remain as a formal matter,[29] the weak rationale for a charitable deduction that serves the preferences of a small minority of (wealthy) taxpayers would cast a shadow on the section 501(c)(3) sector generally. In other words, the fact that the charitable deduction, and by extension section 501(c)(3), would become a vehicle for serving the choices of the wealthiest taxpayers would call into question the suitability of using section 501(c)(3) status, with all it entails, as a basis for other benefits.

The importance of a widely used charitable contribution deduction to the quality of section 501(c)(3) as a basis for deriving other tax benefits has never been tested. Arguably, however, the reliance of many people from a relatively broad spectrum of society on section 501(c)(3) status over time to define giving choices bestows legitimacy on the section 501(c)(3) label, as informed by federal law. The fact that a significant slice of the population at some point in their lives may claim the charitable deduction makes the section 501(c)(3) organization truly public, reflecting public preferences. The section 501(c)(3) label shapes the entire sector, even for non-itemizers who give and rely on the representations inherent in section 501(c)(3) status as a way to segregate or define their charitable activity.

Remove the participatory nature of the charitable deduction and it becomes unclear what type of charitable sector is left behind and who is served. The system of federal-state benefits, already under stress, would be further undermined.

It is easy to take for granted the extent to which section 501(c)(3) and the charitable deduction are part of an organic whole. Together, the two are like a coin with two sides. The coin is the public benefit organization, and the sides of the coin are section 501(c)(3) status (and all it entails) and a charitable deduction, as historically understood. If one side becomes weak, the entire coin is tarnished.

V. A More Participatory Charitable Tax Benefit

If a starting point for tax reform is to increase the standard deduction and substantially reduce the number of itemizers,[30] what should be done with the charitable deduction? As discussed, the idea of a charitable deduction for the wealthiest in society is problematic. Three broad alternatives are worth considering: Expand the tax benefit, eliminate it, or keep the deduction, but make substantial changes to address in part that it would be claimed mostly by a small handful of wealthy taxpayers. As discussed below, the best option is to expand, and reform, the charitable giving incentive.

A. Expand the Tax Benefit to More Taxpayers

One of the long-standing critiques of the charitable deduction is that as an itemized deduction, it already is tilted toward the wealthiest. Thus, most taxpayers, and so society, are denied the participatory benefits.

Rather than narrowing the deduction and making it even more prone to an elitism-based critique, policymakers should expand the giving incentive by making it available to more taxpayers. If all taxpayers were allowed a tax benefit for charitable gifts, the

[26]Bazil Faccina, Evan Showell, and Jan E. Stone, "Privileges & Exemptions Enjoyed by Nonprofit Organizations," 28 *U.S.F. L. Rev*. 85 (1993).

[27]Thus, when the IRS makes a determination that an organization qualifies as a section 501(c)(3), it is doing much more than rendering judgment on qualification for federal income tax exemption. The IRS in effect is certifying that the organization is worthy of the many benefits that flow from the status, including the charitable deduction.

[28]For all but four years of the income tax, the charitable deduction and section 501(c)(3) status have been connected. Although descriptively, the section 501(c)(3) organization's charitable purposes are what distinguish it from other tax-exempt organizations, as a practical matter, it is the fact that these purposes make the section 501(c)(3) organization eligible to receive charitable contributions (just like the government) that sets section 501(c)(3) organizations apart from other nonprofits. Some private non-section 501(c)(3) organizations are eligible to receive deductible contributions, namely veterans' organizations, cemetery companies, and fraternal benefit organizations (only specific contributions). These are outliers and are not generally eligible for multiple other benefits that flow from section 501(c)(3) status.

[29]The tax benefits based on section 501(c)(3) status are severable and, absent a change in law, would continue. For instance, access to tax-exempt financing does not depend on the charitable deduction. State law benefits typically use section 501(c)(3) status as a base, not the charitable deduction. In other words, as a matter of positive law, section 501(c)(3) and the law of exemption are the hub for the federal-state system of charitable tax benefits.

[30]As noted, even if an increased standard deduction is not part of tax reform, the question whether to change the charitable deduction must be addressed and the arguments below remain valid.

pluralism, choice, and altruism rationales for a giving incentive would each be served and strengthened to the benefit of the charitable sector and society.

A truly participatory charitable giving incentive could be accomplished in one of two ways. One would be to extend the charitable deduction to all taxpayers (that is, an above-the-line deduction taken in addition to the standard deduction).[31] The other would be to convert the deduction to a credit. In the context of fundamental tax reform, when major changes to the status quo are feasible, a credit is preferable.

In weighing the choice between a deduction and a credit, three factors stand out: fairness, flexibility, and transparency. First, a credit would be fairer than a deduction. A credit could be set at one rate so that the amount of the tax benefit for each taxpayer claiming the credit would be the same. For example, if the credit rate were 25 percent, for every $100 gift, the credit would be $25. By contrast, if a deduction is used, the tax benefit varies depending on a taxpayer's income: the higher a taxpayer's income, the higher the tax rate and the greater the value of the deduction. For example, for a $100 gift, a taxpayer in a 25 percent bracket would get a tax benefit of $25, whereas a taxpayer in a 30 percent bracket would get a tax benefit of $30.[32] The disparity in tax benefit increases with wealth: If the tax rate is 35 percent, the benefit is $35, and so on.

Tax reform, and converting to a credit, provides an opportunity to remedy that long-standing imbalance. There is no reason to reward the giving of the wealthy more than that of taxpayers who earn less. Altruism should be rewarded equally. The long-standing disparate treatment among taxpayers is simply a consequence of using a deduction for the tax benefit, which was the natural choice in 1917, when the charitable deduction was introduced. One hundred years later, the inequity need not continue.

Second, a credit offers more flexibility than a deduction to respond to changes in society and the charitable sector. With a credit, it would be easier to tailor the giving incentive more toward policy goals. A credit would allow for (but not mandate) multiple credit rates depending on the type of charity. For example, gifts to private foundations could receive a credit but at a lower rate than gifts to other charities.[33] Gifts of noncash contributions could be disfavored relative to cash to account for valuation and other problems commonly associated with contributions of property.[34] In a time of crisis, the credit mechanism could be used to drive deductible dollars to meet critical needs. Setting priorities of this type (which would and should be debated) is more difficult with deductions, which are intended primarily to measure income and which tie the value of the tax benefit to the rate structure and not to any particular charitable end.

Relatedly, a credit would establish the independence of the charitable giving incentive and giving policy. Changes to the broader income tax rate structure would not then have the indirect effect of changing the cost of giving. Congress would set the credit rate independently, but remain free to increase or decrease the rate based on evidence of taxpayer responsiveness and cost. If Congress wanted to provide for a higher credit rate based on taxpayer income (as occurs with the current deduction), there would be no bar. But at least then the differential in tax benefit would be transparent. In short, a credit would enable policymakers to be smarter about charitable giving policy.

Finally, a credit might well lead to more charitable giving than a deduction. As a general matter, a credit is much more transparent than a deduction precisely because the value of the credit is fixed. Simply as a matter of marketing, for many taxpayers, knowing the amount of the discount on a charitable gift — for example, "for every $100 you give, you get $25 back" — may be more effective than "your gift is tax deductible." This could be true even when, depending on the credit rate, the deduction actually would generate a larger benefit. The fact that come tax time a taxpayer is in the 30 percent bracket and so receives a tax benefit of $30 might not create as much of an incentive to give as being told ahead of time that the benefit is $25. In other words, seeing the dollar sign at the time of giving likely makes the tax benefit more tangible, and giving more attractive, than an abstract reference to a deduction whose value cannot be determined until long after the gift is made.

---

[31]Calls for an above-the-line charitable deduction are not new. For recent discussion, see Rosenberg et al., "The New Debate Over a Charitable Deduction for Nonitemizers," Urban Institute (Oct. 2016).

[32]This effect is sometimes called the "upside-down" subsidy effect. The tax rates used are hypothetical.

[33]In general, providing for different tax benefits is possible with a deduction, but it is awkward. *See* section 170(l) (limiting the deduction to 80 percent of the amount given when the right to purchase tickets at a major sporting event is received in return). Yet even this rule is framed as an effort to capture the actual amount of the gift, and so appropriately measure income, by simply providing by rule a proxy for the value of the benefit received.

[34]*See* Colinvaux, "Charitable Contributions of Property: A Broken System Reimagined," 50 *Harv. J. on Legis.* 263 (2013).

All that said, it is beyond the scope of this report to discuss all the features of an expanded charitable tax benefit. One important issue that would arise, whether any expansion is by a credit or a non-itemizer deduction, is whether to pair the benefit with a floor, that is, a contribution amount below which no tax benefit is allowed.[35] In general, a floor would preserve the incentive effect for contributions above the floor amount, help prevent fraud, and reduce the administrative and revenue costs associated with extending the incentive to all taxpayers.[36] Also, any expansion should retain many of the central features of the charitable deduction, for example, a cap on the credit equal to a percentage of a taxpayer's income, a ban on gifts of partial interests, and the requirement that gifts be to a qualified organization. These and other details are important and would have to be determined by policymakers.

B. Eliminate the Charitable Giving Incentive?

Tax reform presents an opportunity to rethink long-standing initiatives and often is a once-in-a-generation chance to make historic changes to tax policy. As the arguments above indicate, there are good reasons to expand the giving incentive that are consistent with its rationale. But there are also reasons to hesitate and at least to consider whether to continue with a charitable giving incentive at all.

One argument for eliminating the incentive might be that it is not necessary. As a threshold matter, the degree to which the charitable deduction affects behavior is not known. People give to charity for a host of reasons, tax savings being but one. If the charitable giving incentive were eliminated, giving would decrease but would not stop. Moreover, charitable giving is but one source of support for the charitable sector. Other key sources of support are direct government spending and fees charged by nonprofits for services (for example, tuition and healthcare payments).[37] Accordingly, although eliminating a charitable giving incentive would harm the charitable sector — some organizations more than others — it would not mean the end of funding.

Even so, assessing the charitable giving incentive in purely economic terms does not do it justice. At bottom, the incentive is about more than affecting giving levels; it is also about culture and the promotion of a pluralistic civil society. Further, for the parts of the charitable sector that rely most heavily on charitable contributions and do not charge for services (for example, human services organizations), a giving incentive helps legitimize their activities as inherently public and provides a bulwark of support in times when government may reduce its spending. Also, as noted earlier, but even more extreme in the context of elimination, the intangible effects of not having a giving incentive would be to divorce giving behavior from any legal standard, rendering section 501(c)(3) status irrelevant.

Another argument for eliminating the incentive might be to recognize that despite its aspirational purposes, the charitable deduction entails costs. One of its main effects is to require federal oversight of the charitable sector. Because significant federal tax dollars are involved, the federal government has a stake in making sure that donated funds are used as intended. Accordingly, there are many federal rules and legal doctrines directed to the organization and operation of section 501(c)(3) organizations that do not apply to other nonprofits.[38] Moreover, because of the importance of the section 501(c)(3) classification, organizations seeking the status must apply to the IRS for a determination, involving the tax agency in the affairs of private organizations in their formative stages.

It is well beyond the scope of this report to discuss the many issues involved in oversight of charitable organizations. As a general matter, the IRS, as a revenue-collecting agency, is not well equipped to monitor and judge the more than 1 million section 501(c)(3) organizations. Even so, the necessity for oversight of charities, and the difficulty of the task, does not augur for elimination of the deduction. However, it does support investing more resources into oversight and enforcement, a better understanding by policymakers of the IRS's role, and consideration of an alternative to the IRS

---

[35]For a discussion of options, including a credit with and without a floor, see CBO, *supra* note 1; and Rosenberg, *supra* note 31.

[36]For example, in TRA 2014, only charitable contributions above a set percentage of a taxpayer's income would get the benefit. For discussion of the reasons to impose a floor as well as the possible revenue savings from a floor, see Colinvaux, Galle, and Steuerle, *supra* note 15.

[37]Some organizations rely on charitable giving for support more than others.

[38]These include rules against private inurement, private benefit, commercialism, lobbying, and political activity. The prohibition on private inurement applies to many non-charitable nonprofits. Also, a special excise tax on acts of self-dealing applies to section 501(c)(3) and (4) organizations. Section 4958. Further, there is a complex classification system within section 501(c)(3) that arguably would not exist (or would look much different) were it not for the charitable deduction, including the distinction between public charities and private foundations and special rules for donor-advised funds and supporting organizations.

as the agency charged with guiding the charitable sector and enforcing the law.[39]

A final consideration is that the charitable deduction itself is remarkably complex and a challenge to administer. For those unfamiliar with the ins and outs of the charitable deduction, it consumes roughly 13,700 words in the IRC and more than 80,000 words of regulations. This complexity undermines transparency and can frustrate taxpayers and the IRS. A significant portion of the complexity, however, is attributable to charitable contributions of property, and not to cash contributions, which are relatively straightforward. Thus, elimination of the incentive to address complexity and administrative challenges would be an overbroad response. Instead, whether the incentive is in the form of a deduction or a credit, it could be reformed to reduce the problems associated with property contributions.[40]

The charitable giving incentive should be allowed to continue only after deliberate and informed consideration. Despite imperfections, a federal tax incentive for charitable giving is longstanding, has widespread public and political support, and to a large degree is now a matter of culture. The charitable deduction is a key part of civil society. It promotes a culture of giving and of helping others. The public purposes inherently served by promoting pluralism and civic participation can all be tied to federal support for giving through a tax incentive. Without a giving incentive and the special status conveyed by section 501(c)(3) of the tax code, the quality of societal giving and the integrity of the sector would be undermined.

C. Retain but Curtail the Charitable Deduction

A charitable deduction for the few should be rejected. However, if Congress chooses to expand the standard deduction and keep but not expand the charitable giving incentive, some changes should be considered to make the deduction for the few somewhat more tenable. The focus should be on fairness and ensuring that donated monies are used for public purposes.

Perhaps most fundamentally, a deduction for contributions to private foundations should be reconsidered. If only the wealthiest in society deduct charitable contributions — and at the same time are allowed to create and control their own foundations — a federal tax incentive to do so seems inappropriate at best. The focus of the remaining incentive should be on active public charities at arm's length from donors.

In addition, it would become even more important to require distributions from private foundation substitutes such as donor-advised funds. Donor-advised funds allow donors a current tax deduction but delayed distribution pending advice of the donor, which is not subject to any time limit. Thus, amounts donated to donor-advised funds could accumulate indefinitely. Donor-advised funds should be subject to a mandatory distribution rule that would ensure that any deductible contribution is paid out to an active charity within a reasonable time.[41]

Also, the charitable deduction is already overly generous by allowing taxpayers to deduct untaxed appreciation in contributed property. This entrenched feature feeds perceptions of the charitable deduction as benefiting the most privileged in society and would be exacerbated by a deduction for the few. Again, even under current law, there are reasons to revisit many aspects of the deduction for property contributions. But with a deduction allowed for only the few, at a minimum Congress should deny deductions for unrealized appreciation.[42]

VI. Conclusion

There is a danger that tax reform could harm the charitable giving incentive in unintended ways. If the standard deduction is increased, and as few as 5 percent of taxpayers claim the charitable deduction, the remaining deduction would gut the aspirational idea of a giving incentive that encourages an altruistic and pluralistic society with broad-based participation. Further, the entire charitable sector would be undermined as the section 501(c)(3) tax status recedes in importance.

A charitable deduction for the few should be rejected. Instead, Congress should consider expanding the charitable giving incentive, extending it to all taxpayers in the form of a credit. A credit would remove long-standing inequities, allow for smarter charitable giving policy in the future, and improve

[39]Evelyn Brody and Marcus Owens, "Exile to Main Street: The IRS's Diminished Role in Overseeing Tax-Exempt Organizations," 91 *Chi.-Kent. L. Rev*. 859 (2016).

[40]Charitable contributions of property should be viewed as a distinct tax expenditure and considered separately for tax reform purposes. *See* Colinvaux, *supra* note 34.

[41]There is already a strong case for that type of rule regarding funds sponsored by organizations with commercial affiliates. *See* Colinvaux, "Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy," 92 *Wash. L. Rev*. __ (coming 2017). The case becomes stronger when the charitable deduction becomes the province of the wealthiest.

[42]Daniel Halperin, "A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains," 56 *Tax L. Rev*. 1 (2002).

transparency. But if a charitable deduction for the few becomes part of tax reform, changes should be made to ensure that deductible contributions are not abused and go to active public charities. ■