
**Compromising the Safety Net:
How Limiting Tax Deductions for High-Income Donors
Could Undermine Charitable Organizations**

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ABSTRACT

With the election behind us, tax reform looms as the hot-button topic of the day. Based on election results, it is likely that the Obama administration will continue to push for the same types of reforms proposed in the 2013 budget. However, inadvertent consequences of the administration's proposals, specifically those impacting charitable donations, may lead to unfortunate results in the rush to do something to break the gridlock on tax reform, especially while federal spending remains reduced or "sequestered" until the budget can be balanced.

President Obama's budget proposals have contemplated reducing the top rate for charitable deductions (and all itemized deductions) to 28%. Because America's largest donors are those in the highest marginal tax brackets, efforts to limit deductibility of charitable donations could have a chilling effect on charitable giving.

In this Article, the author looks at motivations for charitable donations and specifically at the impact of tax deductibility as a motivating factor. He takes a historical look at philanthropic surveys and econometric models and examines empirical data concerning impacts of significant changes to the tax code in the 1980s that could be used as indicators of what effect the proposed limitations on deductibility could have on donations. The author also considers impacts of the recent recession on the nonprofit sector, which has already been burdened by historically high numbers of unemployed individuals and children in poverty.

Because the economic downturn has already stifled charitable giving at a time when the nonprofit sector faces high demands, any further erosion may be the straw that breaks the camel's back. If tax changes dampen enthusiasm for

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charitable giving even further, struggling charities may go under, and prospective new charities may not be able to get off the ground to pick up the slack. At the end of the day, government welfare programs, which are more costly than a tax subsidy for charitable donations, would be needed to meet the needs of citizens slipping through a crumbling safety net.

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“Charity is thus a blessed act that should suffer no discouragement from something so mean as the tax code.”¹

I. INTRODUCTION

More Americans—46 million—are presently living in poverty than at any time in the past fifty years.² Even more disturbing, child-poverty rates have climbed to 22%, up from 16% just ten years ago.³ As demand for social services peaks, many newly unemployed or others who have never before needed social services will turn to charities, specifically their churches, for services because they do not know about public assistance or how to obtain it.⁴

“Superstorm Sandy” reminds us of how vulnerable people are to natural disasters as well as the critical role of nonprofit organizations in providing relief to disaster victims.⁵ Nevertheless, whether our hardships are from natural or economic disasters, what is most evident is the crucial need for the services of the charitable sector to help those who are suffering.

Despite America’s unparalleled modern economic hardship, President Obama has proposed reducing tax relief for wealthy taxpayers who donate to charity.⁶ To the extent these changes could deter charitable giving, the

1. 147 CONG. REC. 2525 (2001) (statement of Rep. Philip M. Crane in support of the Charitable Giving Tax Relief Act). Congressman Crane had the support of 149 members of Congress in an earlier version of the charitable deduction reform bill he was proposing (calling for those taking standard deduction to also receive charitable donation deduction). *See id.* Crane’s remarks explain why many believe that charitable donations are fundamentally different than other personal donations. “Charity benefits both the giver and the receiver in like proportions. The act of giving elevates the heart of the giver. The act of receiving elevates the condition of the recipient.” *Id.*

2. *See* Marisol Bello, *Poverty Affects 46 Million Americans*, USA TODAY, Sept. 28, 2011, <http://www.usatoday.com/news/nation/story/2011-09-28/millions-of-Americans-are-suddenly-poor/50593610/1> (since Census Bureau began tracking poverty data in 1959). “Hispanics and blacks living in poverty remain disproportionate to their population. So do people in families headed by single women, where more than one-third live below the poverty line.” *Id.*; *see also* *How America’s Losing the War on Poverty*, NPR, Aug. 4, 2012, <http://www.npr.org/2012/08/04/158141728/how-americas-losing-the-war-on-poverty> [hereinafter *War on Poverty*] (noting more poverty than at any time since war on poverty in 1960s).

3. *See* G. Jeffrey MacDonald, *The New Face of American Poverty Is Often a Child’s*, USA TODAY, Oct. 13, 2011, <http://www.usatoday.com/news/religion/story/2011-10-13/poverty-children-church/50761118/1> (detailing child-poverty statistics). “[C]hildren are the poorest age group in our country because their families—typically single moms trying to make it—can’t do so because of this flood of low-wage work that we have.” *War on Poverty*, *supra* note 2.

4. *See* MacDonald, *supra* note 3. Robert L. Fischer, Case Western Reserve University’s codirector of the Center on Urban Poverty & Community Development, noted that “faith-based service programs tend to catch people who fall through the cracks of other safety nets.” *Id.*

5. *See* *Superstorm Sandy Sparks Huge Need for Relief*, HERALDNET, Nov. 10, 2012, <http://www.heraldnet.com/article/20121110/NEWS02/711109956>. “[T]he population density of the Northeast may require a response that surpasses Katrina in the number of people served and resources required.” *Id.* (citing Salvation Army Major Darryl Leedom).

6. DEP’T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS 67-68, 74 (2012) [hereinafter 2013 BUDGET PROPOSAL], <http://www.treasury.gov/>

government could unwittingly undermine the nonprofit safety net that insulates the government from being the only provider for the impoverished.⁷

The charitable donation deduction is different from other personal deductions because the beneficiaries include not only the donor, but also the charitable organizations and especially those they serve. Therefore, it should not just be lumped in with restrictions on other itemized deductions. Instead, consequences of a cap on deductions to the charitable sector must be intrinsic to any discussions impacting donations to the charitable sector so that our national leaders do not make ill-advised decisions, especially in the face of a struggling economy and peaking demands for charitable assistance.

This Article considers several rationales for allowing charitable donations and analyzes the potential consequences of implementing President Obama's budget proposal. America's largest donors are those in the highest marginal tax brackets; thus, efforts to limit the deductibility of their charitable donations could have a chilling effect on charitable giving.⁸ This could be especially troublesome in our recent down economy, at a time when donations overall have dropped due to the recession and have never recovered.⁹ Looming threats of another fiscal crisis or economic slowdown due to rising national debt could make matters worse before they get better.¹⁰

resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf. The sweeping proposal limits all itemized deductions (not just charitable donations) and other tax advantages to 28% for those with incomes over \$200,000 (over \$250,000 for married taxpayers). *See id.* at 67, 74.

7. Government aid, of course, takes many forms and is provided by many levels of government to promote the welfare, health, and safety of its citizens. For example, free and reduced-price school lunches keep many poor children from going hungry. *See National School Lunch Program*, USDA, <http://www.fns.usda.gov/cnd/lunch/> (last visited Feb. 28, 2013). Tax-exempt military subsistence for low-ranking soldiers and their families—a significant percentage of whom are below the poverty line—puts food on their tables. *See* Michael McAuliff, *Food Stamp Cuts Could Hit Military Members, Veterans*, HUFFINGTON POST, June 18, 2012, http://www.huffingtonpost.com/2012/06/18/food-stamp-cuts-military-bases-commissary_n_1607249.html. The Food Distribution Program on Indian Reservations (FDPIR) provides meals for qualifying Native American families. *See Food Distribution Program on Indian Reservations (FDPIR)*, USDA, <http://www.fns.usda.gov/fdd/programs/fdpi/default.htm> (last visited Feb. 28, 2013). The Supplemental Nutrition Assistance Program (SNAP—formerly food stamps) and Transition Assistance for Needy Families (TANF—formerly welfare payments) are broadly available to the poor. *See Supplemental Nutrition Assistance Program (SNAP)*, USDA, <http://www.fns.usda.gov/snap> (last visited Feb. 28, 2013); *Temporary Assistance for Needy Families (TANF)*, HHS, <http://www.hhs.gov/recovery/programs/tanf/index.html> (last visited Feb. 28, 2013).

8. *See* Gerald E. Auten et al., *Taxes and Philanthropy Among the Wealthy*, in *DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 392, 392 (Joel B. Slemrod ed., 2000).

9. *See* Giving USA Found., *U.S. Charitable Giving Estimated To Be \$307.65 Billion in 2008*, JEFFREY BYRNE & ASSOCS. (June 10, 2009), <http://www.jeffreybyrneandassociates.com/docs/GivingUSA09Release.pdf> [hereinafter *Estimated Giving*] (inflation-adjusted giving by individuals dropped 5.7% in 2008); *CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA 2012: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2011*, at 18 (2012) [hereinafter *GIVING USA 2011 REPORT*], available at <http://alysterling.com/documents/GUSA2012ExecutiveSummary.pdf> (inflation-adjusted giving dropped in 2009).

10. *See generally* CONG. BUDGET OFFICE, *THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023* (2013) [hereinafter *BUDGET AND ECONOMIC OUTLOOK*], available at <http://cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf> (claiming current politics could lead to further

II. BACKGROUND

At the outset, it is appropriate to provide a brief introduction to the general tax scheme concerning deductions for charitable donations. This Part considers what the Treasury has done historically and its reasons for doing so, while the impacts of changes in the tax scheme are addressed later. This Part also addresses the current tax treatment of charitable donations as a framework for understanding how the proposed changes would depart from the status quo. Finally, this Part discusses the details of the changes in the 2013 budget proposal.

A. *The Charitable Donation Deduction: Then and Now*

1. *Inception of the Charitable Donation Deduction*

The tax deduction for charitable donations has been around for almost one hundred years¹¹—nearly as long as the Sixteenth Amendment has allowed direct taxation of individual income.¹² The charitable donation deduction was one of the earliest allowable personal tax deductions, initially serving as a reprieve from the wartime burden of income taxes on the wealthy in World War I (WWI).¹³ As originally enacted in the War Income Tax Revenue Act of

economic slowdown).

11. See War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 330 (codified as amended at I.R.C. § 170 (2006)); see also Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 848 (2001) (noting unsuccessful attempt to institute charitable deduction in 1913).

12. See U.S. CONST. amend. XVI (allowing government taxation of individual income). Prior to the Sixteenth Amendment, direct taxes had to be apportioned according to the populations of the various states in accordance with the census. See generally *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, vacated, 158 U.S. 601 (1895). The 1894 corporate income tax held unconstitutional in *Pollock* actually excluded charitable organizations from the income tax. See Peter J. Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85, 87 (1985).

13. Exemptions for insurance proceeds payable upon death, gifts, and inherited property were part of the original income tax in 1913. See Revenue Act of 1913, ch. 16, 38 Stat. 114, 167. Personal and business deductions were allowed in computing net income and included relief for taxes and interest paid, business expenses, exhaustion, wear and tear of business assets, casualty losses, and uncollectable debts. See *id.* The 1913 Act also created personal exemptions of \$3000 for single taxpayers and \$4000 for heads of families, thereby excluding most Americans from the income tax. See 38 Stat. at 168; see also *Oct. 3, 1917: War Revenue Act Passed in U.S.*, HISTORY.COM, <http://www.history.com/this-day-in-history/war-revenue-act-passed-in-us> (last visited Mar. 1, 2013) (noting less than 1% paid income tax under 1913 Revenue Act). The Treasury reduced these personal exemptions to \$1000 and \$2000 respectively in 1917—exposing more Americans to taxation. See Roy G. Blakey, *The War Revenue Act of 1917*, 7 AM. ECON. REV. 791, 793-94, 804 (1917), available at <http://www.jstor.org/stable/pdfplus/1809436.pdf>. In addition to the charitable donation deduction, the 1917 Act introduced an exemption of \$200 for each dependent child under eighteen years of age. See War Revenue Act of 1917, ch. 63, 40 Stat. 330, 331 (codified as amended at I.R.C. § 170 (2006)). The top marginal rate jumped from 15% in 1916 to 67% in 1917 due to an additional 2% war-normal tax on all incomes and an additional 50% tax on the highest incomes under the 1917 law (the additional tax was above the 2% normal and 13% highest additional tax in the 1916 Revenue Act). See Blakey, *supra*, at 794, 804. Title XII amended income taxes in 1916 and 1917 by exempting “gifts for charitable, religious, educational, and scientific purposes, to the extent of 15 per cent of the payer’s taxable net income.” *Id.* at 804.

1917, the deduction extended to organizations “operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals.”¹⁴

The chief proponent of the charitable donation deduction was Senator Henry F. Hollis, who asked that a series of editorials in favor of the proposal be admitted to the Congressional Record.¹⁵ His remarks are introduced here to put the deduction in its proper historical context, but the implications of his remarks are discussed later in concert with the various policy justifications for the deduction. These arguments have been used to support the efficient subsidy justification embraced by some commentators for such deductibility, but a more comprehensive review of the record reveals other concerns that afford additional historic justifications for the deduction.¹⁶ A deeper understanding of the full panoply of values motivating the addition of charitable-donation relief to the tax code is consistent with myriad justifications for the donation, as well as the mixed motives that stimulate donor behavior. The following remarks demonstrate these plural and incommensurable values:

If the Government takes all, or nearly all, of one’s disposable or surplus income, it must undertake the responsibility for spending it, and it must then support all those works of charity and mercy and all the educational and religious works which in this country have heretofore been supported by private benevolence.¹⁷

The tax deduction for charity is consistent with the principles of American democracy espoused in the nineteenth century by Alexis de Tocqueville that America’s greatness depends on individual and community responsibility, not

14. Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061 (2003) (quoting War Revenue Act of 1917, ch. 63, § 1201(2) (codified as amended at I.R.C. § 170 (2006))). Of course, the statute has become much more complex since that time. See Wiedenbeck, *supra* note 12, at 85-87 (stating most complexities “were added as anti-abuse measures by the Tax Reform Act of 1969”). While some tax scholars have criticized the broad reach of current allowable charitable deductions, advocated for reform in limiting charitable donees, or shown a preference for charities that serve the needs of the poor, these arguments are beyond the scope of this Article. There are also articles advocating a smaller universe of charitable donees or preferences for organizations serving the poor. See Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 606 n.14 (2011) (suggesting equal-opportunity theory to prioritize charities meriting subsidies or requiring all to support poor through free or reduced-cost services); Shannon Weeks McCormack, *Too Close to Home: Limiting the Organizations Subsidized by the Charitable Deduction to Those in Economic Need*, 63 FLA. L. REV. 857, 911-14 (2011) (suggesting priority for underfunded donees).

15. See Senator Henry F. Hollis, Address on War Revenue Bill: Amendment to Allow Deductions from Taxable Income of Gifts and Donations for Charitable, Educational, and Religious Purposes (Sept. 7, 1917), available at <http://libcucl.colorado.edu/wwi/pdf/i7375447x.pdf>.

16. See Meir Katz, *The Economics of Section 170: A Case for the Charitable Deduction of Parochial School Tuition*, 12 RUTGERS J.L. & RELIGION 224, 232-36 (2011) (discussing Senator Hollis’s remarks in support of amendment). The efficient subsidy theory is discussed *infra* at Part II.B.2.

17. Hollis, *supra* note 15, at 4.

the federal government.¹⁸ It is no surprise that as direct taxes on individual income became constitutional, Congress was mindful of protecting individual ability and autonomy to donate to charitable organizations in order to preserve the social-support function in private and community hands. Even before taxes became necessary to fund the war effort in 1917, Congress had proposed tax relief for charitable donations.¹⁹ These efforts were consistent with de Tocqueville's framework of American greatness: the preference for small central government and an engaged individual and community role in charity.²⁰

Of course these protections for charitable donations were put in place before major social reforms enacted during and after the Great Depression.²¹ While the Great Depression prompted social legislation, and initiatives like the Great Society were "major leaps forward" in formulation of a government safety net, even after these reforms, "at heart . . . [Americans] favor private charity over government dole."²²

2. Present Deductibility

Internal Revenue Code § 170 outlines the deductibility of charitable donations and allows an itemized deduction for cash and noncash donations to charity.²³ "An important effect of this provision is to lower an individual's net cost of making gifts."²⁴ Although the United States has experimented with allowing a deduction for charitable donations for nonitemizers, Congress eliminated this deduction when comprehensively recodifying the tax laws in 1986.²⁵ Therefore, the Code currently only allows those itemizing deductions to write off their charitable gifts. The substantial increase in the standard deduction in 1986 also significantly reduced the number of taxpayers who itemize their deductions.²⁶

If an organization does not qualify for an exemption as described in §

18. Jennifer A. Marshall, *Lower Charitable Deduction Bad News for NPR*, HERITAGE FOUND. (May 2, 2011), <http://www.heritage.org/research/commentary/2011/05/lower-charitable-deduction-bad-news-for-npr>.

19. See Thomas J. Burmeister, Jr., Comment, *Burnin' Down the House—and Deducting It Too: Charitable Contributions of Buildings to Fire Departments Under I.R.C. § 170*, 94 MARQ. L. REV. 1013, 1017 (2011).

20. See Marshall, *supra* note 18 (noting Framers' restraint of large national government).

21. See Richard C. Leone, *Foreword* to JULIAN WOLPERT, *PATTERNS OF GENEROSITY IN AMERICA: WHO'S HOLDING THE SAFETY NET?*, at v-vi (1993).

22. *Id.* at v.

23. See I.R.C. § 170 (2006). Of course, some charitable giving occurs in the form of bequests or devises of property to charity upon the donor's death or in the form of charitable trusts. However trust and estate tax consequences of such gifts are beyond the scope of this Article.

24. Charles T. Clotfelter, *The Impact of Tax Reform on Charitable Giving: A 1989 Perspective* 2-3 (Nat'l Bureau of Econ. Research, Working Paper No. 3273, 1990), available at <http://www.nber.org/papers/w3273.pdf>.

25. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2099.

26. See I.R.S., 8 STATS. OF INCOME BULL., no. 4 (1989), available at <http://www.irs.gov/pub/irs-soi/89rpsrbul.pdf> (dropping from 40% of all taxpayers in 1986 to 30% in 1988).

501(c)(3), donors may not deduct contributions under § 170.²⁷ To qualify for exemption under § 501(c)(3), an organization must demonstrate both that it is organized and operated exclusively for exempt purposes, and that no part of its earnings inure to private individuals.²⁸ In addition to the prevention of cruelty to children or animals and the promotion of amateur sports, these organizations are formed for a variety of reasons including “religious, charitable, scientific, testing for public safety, literary, or educational purposes.”²⁹ The IRS scrutinizes applications for § 501(c)(3) status to ensure organizations, particularly foundations, are not established to benefit the donor/founder.³⁰

Cash contributions follow comparably easy donation rules and limits, while noncash gifts of appreciated property follow more complex rules. For cash donations to a public charity, individuals can deduct up to 50% of their contribution base—modified adjusted gross income (AGI)—in the present tax year and donations in excess of this amount may be carried forward as deductions for up to five succeeding tax years.³¹ On the other hand, most gifts to private foundations are limited to 30% of the taxpayer’s contribution base (with any surplus also being carried forward for up to five tax years).³²

Contributions of appreciated capital assets to public charities are generally deductible at fair market value (FMV) at the time of the donation, up to 30% of

27. See I.R.C. § 170(c). Donors could also donate to public schools or other government agencies. See *id.* § 170(c)(1).

28. See I.R.C. §§ 170(c)(2)(C), 501(c)(3) (2006 & Supp. 2011); Treas. Reg. § 1.501(c)(3)-1(a)(1) (as amended in 2008). An organization’s articles of organization must limit its purposes to one or more exempt purposes, and must not empower the organization to engage in substantial activities that do not further the exempt purposes. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i), (iii)-(iv) (as amended in 2008); see *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945) (holding single substantial non-exempt purpose destroys exemption regardless of number or importance of exempt purposes); *Am. Sci. Found. v. Comm’r*, 52 T.C.M. (CCH) 1049, 1049 (1986) (stating petitioner must demonstrate exclusive purposes under 501(c)(3)). Gaps in the application and vague or ambiguous assertions are construed against the applicant. See *New Dynamics Found. v. United States*, 70 Fed. Cl. 782, 802 (2006) (stating general gaps in record resolved against applicant); *Share Network Found. v. Comm’r*, 78 T.C.M. (CCH) 6, 9 (1999) (drawing inference organization fails to meet requirements of 501(c)(3)); *La Verdad v. Comm’r*, 82 T.C. 215, 221 (1984) (noting petitioner must supply information demonstrating it will operate in furtherance of exempt purposes).

29. I.R.C. § 501(c)(3); see also *id.* § 170(c).

30. See I.R.C. § 508(b) (2006) (presumption of private foundation status and against 501(c)(3) status); see also I.R.S. Priv. Ltr. Rul. 201229010 (July 20, 2012), available at [http://services.taxanalysts.com/taxbase/eps_pdf2012.nsf/DocNoLookup/15523/\\$FILE/2012-15523-1.pdf](http://services.taxanalysts.com/taxbase/eps_pdf2012.nsf/DocNoLookup/15523/$FILE/2012-15523-1.pdf) (denying exemption where CEO/founder benefitted financially as only employee).

31. See I.R.C. § 170 (b)(1)(A), (d)(1)(A). In general, public charities are funded by the public at large and are comprised of churches, public entities, etc. Compare I.R.C. § 170 (b)(1)(A)(i)-(vi), with I.R.C. §§ 509(a)(3)(C), 4946 (defining private foundations as typically controlled by disqualified persons (founders or founders’ family members)). Contribution base is defined as “adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172).” *Id.* § 170(b)(1)(G).

32. See *id.* § 170(b)(1)(B), (b)(1)(F). In general, private donors who own or manage the donations fund private foundations. See *Knowledge Base: What Is the Difference Between a Private Foundation and a Public Charity?*, GRANTSPACE, <http://grantspace.org/Tools/Knowledge-Base/Funding-Research/Definitions-and-Clarification/Private-foundations-vs-public-charities> (last visited Mar. 16, 2013).

an individual taxpayer's contribution base.³³ Note that no income tax is paid on the appreciation in the hands of the taxpayer, yet the taxpayer can deduct the full FMV of the donated asset, making the deductibility of such donations doubly blessed by the Code.³⁴ The taxpayer is allowed a five-year carryover for any excess donation. Because of the potential for abuse, especially "inflated" real-estate values, the taxpayer must receive a qualified appraisal to substantiate the FMV of any gift exceeding \$5000 and must attach an appraisal to gifts over \$500,000.³⁵

Assets that constitute ordinary-income property (inventory, a farmer's crops, etc.), on the other hand, receive less favorable tax treatment. The donor of such property is allowed to deduct the lesser of his cost basis or the FMV.³⁶ The ceiling is 50% of the contribution base, and a five-year carryover applies.

Treatment of tangible personal property, such as paintings and antiques, depends on whether the taxpayer donates it to a charity for a related use (such as artwork to an art museum) or if it is unrelated to the tax-exempt purpose of the charitable organization (such as donating a painting to the Salvation Army). The donor receives a deduction for the full FMV when there is a related-use gift, whereas the lower of cost basis or FMV rule applies to unrelated gifts.³⁷ The ceiling on related-use gifts is 30% of the contribution base, whereas the ceiling on unrelated gifts is 50% of the contribution base. In both cases, excess donations can be carried forward for up to five years.

Most people, of course, cannot afford to donate anywhere near 30-50% of their contribution base; however, it is reported that the wealthy often give more than they can deduct.³⁸ This is due to at least four factors. The wealthy have more assets that have appreciated over time (after all, the wealthy, by definition, have more accumulated wealth, and if their assets did not appreciate they would no longer be wealthy). They have the means to invest and likely have done so successfully, generating capital gains rather than earned income.³⁹

33. See I.R.C. § 170(b)(1)(C). Donations to private foundations are limited to 20%. *Id.* § 170(b)(1)(D)(i)(I).

34. A donor has the option of reducing the value of the donation by the amount it appreciated if the donor wants to increase the donation ceiling from 30% to 50% of AGI, but the donor must elect this approach for all long-term property gifts. See I.R.C. § 170(b)(1)(C)(iii), (e)(1)(B); see also Treas. Reg. § 1.170A-8(d)(2) (as amended in 1972).

35. I.R.C. § 170; Treas. Reg. § 1.170A-13(c) (as amended in 1996). Because substantiation requirements are statutory, they cannot be waived even when there is no dispute over value. See generally *Mohamed v. Comm'r*, 103 T.C.M. (CCH) 1814 (2012) (ruling certified real-estate appraiser's own appraisal failed to meet independent contemporaneous appraisal standards even where subsequent, untimely appraisal validated amount claimed as deduction).

36. See I.R.C. § 170(e)(1) (2006).

37. See *id.* § 170(e)(1)(B).

38. See Auten et al., *supra* note 8, at 417-18 (discussing charitable contributions of wealthy and nonwealthy individuals).

39. See Robertson Williams, *Income and Taxes of the Very Rich*, 136 TAX NOTES 121 (2012). Although the wealthiest realize a greater share of their income from investments (taxed at the lower capital gains rate)

Favorable tax provisions make it more valuable to donate appreciated stocks and bonds in order to receive the benefit of the deduction and escape the capital-gains tax. The wealthy are financially astute (either on their own or with the advice of financial counselors, accountants, and tax attorneys) so they maximize the tax benefits of their behavior. They are even sophisticated in how they give their money away and will do so in the most financially efficient way.⁴⁰ In short, the wealthy are in a position to benefit from the donation of capital assets that have appreciated on paper, but for which they have paid no taxes. This fact, coupled with the lower contribution base for capital-asset donations, results in a situation where the largest donations may not be completely written off.⁴¹

3. 2013 Budget Proposal and Expiring Tax Cuts

The 2013 budget proposal would reinstate the 36% and 39.6% brackets for high-income taxpayers and limit the value of all itemized deductions for those in these top brackets to 28%.⁴² A partial reduction of certain itemized deductions (including that for charitable donations) on high-income taxpayers would also be reintroduced.⁴³ It is worth noting that the 35% maximum

they pay lower effective tax rates. *Id.* (“Compared with others making more than \$1 million, the very rich [top 400] get much less of their income from salary and wages—less than one-tenth in recent years compared with roughly one-third for other millionaires.”).

40. Trusts, estates, and exploiting the excluded amount of gift taxes are examples of analogous tax-minimizing behavior outside the charitable-donation realm and confirm that the wealthy have (or have access to people who have) the knowledge, skill, and ability to do so in the most tax-effective manner. After all, if not for the wealthy, the entire trust and estate planning industry would dry up.

41. See JANE G. GRAVELLE & DONALD J. MARPLES, CONG. RESEARCH SERV., R40518, CHARITABLE CONTRIBUTIONS: THE ITEMIZED DEDUCTION CAP AND OTHER FY2011 BUDGET OPTIONS 1 (2010) (discussing 2010 and 2011 proposals). Deductions may never be fully enjoyed for very large donations or by donors with continuously large annual donations. See *id.* at 5-6.

42. 2013 BUDGET PROPOSAL, *supra* note 6, at 74. The proposed limits are very broad in terms of limiting all itemized deductions (not just the charitable donation deduction) and would similarly limit the tax value of the following tax preference items to 28%:

- tax-exempt state and local bond interest;
- employer-sponsored health insurance paid by employers;
- employer-sponsored health insurance paid by employees with before-tax dollars;
- contributions to health savings accounts and Archer Medical Savings Accounts (MSAs);
- health insurance costs of self-employed individuals;
- employee contributions to IRAs & defined contribution retirement plans;
- the deduction for income attributable to domestic production activities;
- certain business deductions of employees;
- moving expenses;
- interest on education loans; and
- certain higher education expenses.

Id.

43. See *id.* Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was enacted, itemized deductions (other than casualty losses, investment interest, medical expenses, and gambling losses) “were reduced by 3 percent of the amount by which AGI exceeded a statutory floor that was indexed annually for inflation, but not by more than 80 percent of the otherwise allowable deductions.” *Id.* at 67.

marginal tax rates for individuals expired at the end of 2012 allowing the 39.6% top rate to be restored for the highest-income donors, but no 28% maximum rate for charitable (or other) deductions was implemented.⁴⁴

The 2013 budget proposal would impact individuals with adjusted gross incomes above \$200,000 (\$250,000 for married couples); while the American Taxpayer Relief Act of 2012 (signed into law in 2013) only imposes the highest tax rate on single individuals earning over \$400,000 (\$450,000 for other filers).⁴⁵ Because charitable donations are an itemized deduction, the limits will not affect the two-thirds of American taxpayers who take the standard deduction instead of itemizing.⁴⁶ Therefore, this Article focuses on charitable giving by those with incomes above \$200,000 who itemize their deductions.⁴⁷ While there are few of these taxpayers, the potential impact is considerable because these donors give disproportionately large amounts to the charitable sector.⁴⁸ “The average taxpayer in the highest income class gives away in a year an amount greater than what 99 percent of households earn in a

“EGTRRA temporarily eliminated the itemized deduction limitation and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended this tax relief for two years, through 2012.” *Id.* Mechanically, the proposed rate of 28% “would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher income taxpayers.” *Id.* at 74.

44. See American Taxpayer Relief Act of 2012, Pub. L. 112–240, § 101(b)(1)(A), 126 Stat. 2313, 2316 (2013) (re-establishing 39.6% highest marginal rate for single filers over \$400,000 and married taxpayers (filing jointly) over \$450,000). The overall limitation on itemized deductions was reinstated for single individuals above \$250,000 and joint filers over \$300,000. See *id.* § 101(b)(2)(A).

45. See *id.*; 2013 BUDGET PROPOSAL, *supra* note 6, at 67, 74.

46. In tax year 2010, the most recent year for which IRS data is available, approximately 33% of taxpayers itemized (46.64 million of 142.89 million returns) versus 66% (93.68 million) taking the standard deduction. See I.R.S., PUB. 1304 (REV. 08-2012), INDIVIDUAL INCOME TAX RETURNS 2010, at 38 (2010) [hereinafter SOI 2010], <http://www.irs.gov/pub/irs-soi/10inalcr.pdf>. Numbers for 2009 confirm the same rates (45.696 million itemizers of 137.965 million returns). *Table 1: Individual Income Tax Returns: Selected Income and Tax Items for 1999-2010*, I.R.S., www.irs.gov/pub/irs-soi/histab1.xls (last visited Mar. 25, 2013).

47. Stratified IRS data concerning individuals earning over \$400,000 or married taxpayers filing jointly earning over \$450,000 has never been collected and, even if monitored in 2013 under the new law, would not be available until at least 2014-2015. See Appendix 1 for a compilation of the most recent empirical data published by the IRS.

48. Stratified IRS statistical data shows the cumulative total of all taxpayers (single and married) over \$200,000 AGI as only 3% of the taxpaying population. See SOI 2010, *supra* note 46, at tbl.1.1. These figures are up from 2.8% in 2009. *Table 1.1: Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2009*, I.R.S., http://www.irs.gov/file_source/pub/irs-soi/09in11si.xls (last visited Mar. 25, 2013). Those earning above \$200,000 donated roughly 40% of itemized donations. See SOI 2010, *supra* note 46, at 89 tbl.2.1. They gave \$68 billion of about \$170 billion in itemized charitable donations. *Id.*; see also *Table 2.1: Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009*, I.R.S., www.irs.gov/file_source/pub/irs-soi/09in21id.xls (last visited Mar. 25, 2013) [hereinafter *Table 2.1 Returns*]. Of \$140 billion in charitable donation deductions in 2009, \$56 billion came from taxpayers above \$200,000. *Table 2.1 Returns, supra*. This amount reflects a significant percentage of overall giving: \$68 billion of Giving USA’s reported \$300 billion in total donations for 2010 is 22.66%; \$56 billion of Giving USA’s reported \$298 billion total donations for 2009 is 19%. See GIVING USA 2011 REPORT, *supra* note 9.

year”⁴⁹

Such philanthropy is consistent with the idea of giving from surplus that is preserved by the charitable deduction.⁵⁰ Throughout the years, the government has allowed the charitable deduction without any rate cap, notwithstanding that the tax relief may flow disproportionately to these major donors. Several justifications have been used to defend the deduction. The next Part considers these various justifications.

B. Justifications for the Deduction

It is undeniable that favorable tax treatment motivates charitable giving, especially for the wealthiest taxpayers.⁵¹ However, the fact that nonitemizers (those who currently do not receive a tax break for such donations) continue to give shows that tax consequences are not the only contributing factor in the decision to donate. As mentioned above, the economy is another factor and in a recession it is tough for anyone to give. Nevertheless, even though donations may drop in a down economy, they do not dry up altogether.⁵² These facts suggest other, nonfinancial factors must explain or motivate some donative behavior.

A litany of nonfinancial motivators includes altruism, religious or other moral obligation, desire to be recognized as generous (perhaps being recognized in a public ceremony, by a plaque on a building, or as a role model for children or others), gratitude or reciprocity from previously enjoyed benefits (either specifically from a targeted charity or generally), and desire to make a positive difference in the world.⁵³ Indeed, the wide range of values and norms at play may somewhat undermine the motivational force of tax

49. Auten et al., *supra* note 8, at 417.

50. This widely studied and documented phenomenon is not surprising given the higher tax relief and greater ability to donate enjoyed by those with the most wealth. *See generally id.* (projecting even greater role in wake of government devolution of mid-1990s and increasing top income concentrations).

51. *See* CTR. ON PHILANTHROPY AT IND. UNIV., THE 2010 STUDY OF HIGH NET WORTH PHILANTHROPY: ISSUES DRIVING CHARITABLE ACTIVITIES AMONG AFFLUENT HOUSEHOLDS 10 (2010) [hereinafter STUDY OF HIGH NET WORTH PHILANTHROPY], http://www.philanthropy.iupui.edu/files/research/2010baml_high_networthphilanthropy.pdf. Sixty-seven percent of 800 responding wealthy households “would somewhat or dramatically” reduce charitable contributions if there was no income tax deduction; this number is up from 47% in a 2008 study. *See id.* “[S]tudies generally find that taxpayers respond to the after-tax price of giving.” CTR. ON PHILANTHROPY AT IND. UNIV., IMPACT OF THE OBAMA ADMINISTRATION’S PROPOSED TAX POLICY CHANGES ON ITEMIZED CHARITABLE GIVING 2 (2011) [hereinafter CAMPBELL & Co. 2011 STUDY], <http://www.philanthropy.iupui.edu/files/research/obamataxchanges2011.pdf>. *But see* Ray D. Madoff, *What Leona Helmsley Can Teach Us About the Charitable Deduction*, 85 CHI.-KENT L. REV. 957, 964 (2010) (suggesting charitable giving independent of tax support).

52. *See* GIVING USA 2011 REPORT, *supra* note 9, at 2.

53. Pleasure or gratification may result from feeling good about the donation. *See* JULIAN WOLPERT, PATTERNS OF GENEROSITY IN AMERICA: WHO’S HOLDING THE SAFETY NET? 5 (1993) (describing various motivations for generosity).

deductibility of the donative transfer.⁵⁴

At the same time, however, this breadth and diversity of motivating factors is, at least in part, a fundamental characteristic of these donations, implicating plural and incommensurable values. For lack of a better term, the author will refer to these nonfinancial values as “the essence of charity,” for this cornucopia of motivators explains the considerations for which pure economics cannot account. The essence of charity is the desire for doing good that “goes to the core of who we are as a nation.”⁵⁵

Obviously, the essence of charity is important for many donors, especially those who donate despite little to no tax subsidy. However, one could speculate that such donors might contribute even more if there was a tax subsidy. For example, all other things being equal, a donor in the 15% bracket who itemizes can donate \$1.15 to charity with the same after-tax consequence as a nondonor who spends \$1 on something else. If the subsidy was 25% (perhaps in the form of a tax credit, as has been advocated by some to neutralize the “upside down” effect of a heightened advantage to those in higher brackets), he could increase the donation from \$1.15 to \$1.25 and forgo the same \$1 of income otherwise available for personal consumption.⁵⁶ On a more realistic donation level, if he could afford to do without \$1000 after-tax as a sacrifice for charitable purposes, with the credit he theoretically would donate \$1250 versus the \$1150 donated under the existing scheme. This assumes, of course, sufficient cash or other assets on hand to make the higher donation.⁵⁷

As important as this potential impact could be to lower-income taxpayers, only top-tier donors are affected by the tax consequences of the President’s proposal. These donors have responded much more dramatically to tax changes in the past, perhaps because the tax consequences are higher, or perhaps because they are more likely to have professional financial help and hence be aware of changing tax impacts.

In a 2010 study, two-thirds of wealthy households “would somewhat or

54. See Henry E. Smith, *Mind the Gap: The Indirect Relation Between Ends and Means in American Property Law*, 94 CORNELL L. REV. 959, 960 (2009).

It is hard to be against human flourishing, and a concept that is in one form or another central to Aristotle, Aquinas, Catholic social thought, modern virtue ethics, some forms of natural law, and the capabilities approach . . . but one can question the degree of consensus required for implementation in a legal regime.

Id.

55. Henry J. Reske, *Obama Aims to Curtail or Eliminate Charitable Deduction*, NEWSMAX, Mar. 28, 2011, <http://www.newsmax.com/US/Obama-Congress-charitable-deduction/2011/03/28/id/390905> (quoting Steve Taylor, Senior Vice President and Counsel for Public Policy of United Way Worldwide).

56. See GRAVELLE & MARPLES, *supra* note 41, at 24-25.

57. See CAMPBELL & CO. 2011 STUDY, *supra* note 51, at 4 (stating personal consumption better indicator for predicting charitable giving than personal income). In this example, he could *consume* the larger donation even though income remained constant because the government increased the subsidy.

dramatically” reduce charitable contributions if there was no income tax deduction; this number is up from 47% in a 2008 study.⁵⁸ The Center on Philanthropy at Indiana University recently concluded: “High-earning households are disproportionately responsible for individual charitable gifts when compared to other taxpayers, and federal tax policy impacts the giving habits of these households.”⁵⁹ Another recent study, comparing the giving behavior across varying states with different tax treatments for charitable donations, also found a strong correlation between tax relief and incentives for the wealthy to donate.⁶⁰ A number of different arguments have been advanced over the years to support the deductibility of charitable donations. These arguments are analyzed next.

1. *Ideal Income Tax Excludes Charitable Donations from Income*

Economist Henry Simons defined personal income as an aggregate of consumption and an increase in the accumulation of wealth (in more elementary terms, spending plus savings).⁶¹ In a thoughtful law-review article, Professor William D. Andrews proposed modifying Simons’s conventional formulation to describe an ideal tax base in terms of consumption and accumulation of wealth, but excluding those items that make the taxpayer personally no better off from the consumption component.⁶² From a tax-policy perspective, Andrews argued that a personal deduction should be allowed for such items because, at the end of the day, they were neither consumed for the benefit of the taxpayer nor accumulated as wealth.⁶³ The charitable deduction was one such meritorious deduction because, aside from the incidental pleasure of making the gift, the benefit derived by the donation was enjoyed either by the public at large or by individuals unrelated to the taxpayer.⁶⁴

58. See STUDY OF HIGH NET WORTH PHILANTHROPY, *supra* note 51, at 10. It would have been more pertinent if they had been asked about the proposed 28% limitation instead of *no deduction* since the tenor of the question may have triggered a more negative response.

59. See CAMPBELL & CO. 2011 STUDY, *supra* note 51, at preface.

60. See generally Jon Bakija & Bradley T. Heim, *How Does Charitable Giving Respond to Incentives and Income? New Estimates from Panel Data*, 64 NAT’L TAX J. 615 (2011) “[D]ecisions about how much to donate to charity are influenced significantly by tax incentives.” *Id.* at 647. In order to measure the tax implications of donations, Bakija and Heim compared differences in donor behavior in states with different tax rates to similar income individuals in states with no income tax (as a control group). See *id.* at 617. In this way they were able to compare similarly wealthy donors instead of comparing high-income with moderate-income individuals as a control group, which had been the practice of earlier researchers in this field. See *id.* Bakija and Heim concluded, “[o]ur most convincing estimates are identified by differences in the time-paths of tax incentives across states, and suggest a persistent price elasticity in excess of one in absolute value.” *Id.* at 615.

61. See HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

62. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 375-76 (1972) (advancing definition of personal income based on taxpayer use of resources).

63. See *id.* at 316 (advocating for refined conception of aggregate personal consumption).

64. See *id.* at 314. Note that Andrews did not approve of the ability to deduct the fair market value of appreciated goods. See *id.* at 372. This is a government subsidy of the untaxed, unrealized appreciation that

Andrews assessed two types of donations: those inuring to the benefit of poor individuals (alms for the poor) and those for more broad philanthropic purposes.⁶⁵ Regarding the former, alms to the poor merely reallocate the consumption of personal goods and services from the donors to the donees. The consumption by the donees (part of the traditional definition of income) should be taxable to them at their tax rate.⁶⁶ Regarding more general philanthropy (gifts to museums, churches, educational institutions, symphonies, etc.), Andrews reasoned that common goods for shared use by any interested member of the community should be exempted. “[T]heir enjoyment is not limited exclusively or even primarily to those who pay for them. . . . [Instead] the benefit conferred on others is of the same kind as that enjoyed by the contributor himself.”⁶⁷ Like alms to the poor, taxation of these donations should be limited to those who benefit from the services received based on the benefit consumed. However, these benefits are essentially free goods because one’s enjoyment does not diminish anyone else’s enjoyment.⁶⁸ In addition, there would be valuation problems (does a wealthy person value a church sermon more than a poor person?), difficulties tracking indirect benefits (such as a more educated population), and a general damper on socially desirable behavior.

“The exact reasons for not taxing the recipients of other charitable services . . . in general . . . will arise from both the impracticability of measuring individual benefits and the undesirability of thwarting whatever purposes led the charity to make the provision of the services wholly or partly free.”⁶⁹ In fact, the historic justification for creating the deduction related to the legislative intent to preserve philanthropy in the face of steep taxes on the wealthy.⁷⁰

Others have justified the deduction on the theory that these common goods would otherwise have to be provided directly by the government.⁷¹ Andrews agrees, insofar as people will not generally agree to pay voluntarily for common goods at an optimum level, that taxing the very kind of activity that

for the highest-rate taxpayers leads to the illogical result that the taxpayer has more money for private consumption after donating property than if he would have sold it and kept the proceeds. *See id.* at 371-72. As the charitable donation deduction is considered for change, modifying it to eliminate this windfall seems more justified from a tax-policy perspective than imposing a rate limit on deductibility. Andrews’s work also contained detailed justification for the deduction of medical expenses. *See id.* at 335-43.

65. *See id.* at 347-56 (discussing alms for poor); *id.* at 356-69 (discussing broader philanthropic purposes).

66. *See Andrews, supra* note 62, at 347. Andrews recognizes that “recipients’ total income may often fall below a taxable level.” *Id.*

67. *Id.* at 357-58.

68. *See id.* at 358.

69. *Id.* at 360.

70. *See* 55 CONG. REC. 6728 (1917) (statement of Sen. Henry F. Hollis).

71. *See* J.S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861, at 17 (3d prtg. 2004).

creates shared common goods may be counterproductive.⁷² Most scholars who consider these common goods of philanthropy, however, prefer to envision the deduction as a government subsidy to motivate this positive social behavior.⁷³

Professor Mark Gergen exhaustively evaluates the subsidy theory, concluding that a charitable deduction efficiently subsidizes collective goods provided by social-welfare charities.⁷⁴ Andrews does not use the subsidy construct because he argues that such an approach ought to be reserved for looking at deductions as tax expenditures, which he feels is inapplicable for the charitable deduction because the amounts donated never rise to the level of economic income.⁷⁵ Gergen, on the other hand, views Andrews's position as "at best, a reformulation of the efficient subsidy theory."⁷⁶ This efficient subsidy theory and the equity theory, espoused originally by tax legend Boris Bittker, deserve more consideration, in part because Gergen finds these theories "valid subject to significant normative and empirical constraints."⁷⁷ More consideration is due also because many recent scholars tend to focus on the subsidy theory—either exclusively or predominantly—and often ignore other justifications that shape the charitable-donation landscape. Some recent scholars have focused on distributive justice and the distinctions between allocative functions of the tax code encouraging charitable giving, while others have focused on distributive functions of tax expenditures.⁷⁸ Inasmuch as a

72. See Andrews, *supra* note 62, at 370.

73. See David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 225-26 (2009) (providing examples of positive externalities).

74. See Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1450 (1988).

75. See Andrews, *supra* note 62, at 311-12 (presuming characterization of tax expenditure ignores intrinsic matters of tax policy that need consideration before examining extrinsic merits).

76. Gergen, *supra* note 74, at 1394.

77. *Id.* Indeed, Gergen goes so far as to dissect different types of charitable donations in order to compare the relative merits of the competing theories to the way in which theory comes to bear on these categories of charitable relief. See *id.* at 1433-49. This Article does not examine individual charitable donees for several reasons. First, the focus of this Article is on the overall impact of a rate cap on deductions on charitable incentives for giving. Additionally, Congress has chosen a favored set of organizations that qualify for taxpayers to make deductible donations for a variety of reasons, including historic reasons, and there simply is not enough time to do them justice. Also, a wide array of donees (there are currently over a million different qualified organizations) promote freedom and autonomy for taxpayers to choose the organizations they feel are most worthy of help. With a million organizations and hundreds of millions of donors, there is an equivalent to a free market where the donees compete for taxpayer favor. Another reason is that private giving offsets the preferences of elected majorities and "so may allocate resources to activities presently undervalued but which turn out to be socially beneficial." *Id.* at 1410 (using Salk's polio vaccine as example). Finally, religious donations make up the largest subsector of all; giving and allowing tax deductions for private donations to fund these activities walks the fine line between the Establishment Clause and the Free Exercise Clause of the First Amendment—allowing the government to do indirectly what it cannot do directly. See GIVING USA 2011 REPORT, *supra* note 9, at 11 (stating 32% of all donations went to churches in 2011); April, *supra* note 11, at 873 ("A tax deduction or credit ingeniously satisfies the values of both the Free Exercise and Establishment Clauses of the First Amendment.").

78. See Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive*

28% rate cap on charitable donations can be justified as a tax-policy matter at all, it is important to deliberate on these competing justifications.

2. *Efficient Subsidy Theory*

The basic premise for the subsidy theory is that charitable organizations provide common goods to the people without cost.⁷⁹ An example of a pure public good would include cancer research, where society could benefit from a technological breakthrough without diminishing the benefits to any beneficiaries.⁸⁰ Of course, because a person can benefit from an advance in the medical state of the art without donating to medical research, there is a potential for *freeriders*—those who will benefit although they contributed to none of the costs.⁸¹ Because of the freerider problem, and unless there is a government subsidy, society will tend to underinvest in medical research.⁸² Therefore, a subsidy is necessary. Other subsidy justifications include: desire to avoid undervaluing of common goods, as there is no ready market price to evaluate their benefits; desire to avoid underfunding, even among those who will benefit and do donate, because of a failure to appreciate ancillary benefits; and desire to avoid discouraging giving because some may be deterred from giving, knowing others will receive the same benefit without donating.⁸³

Private donations indirectly subsidized by the Internal Revenue Code in the form of deductions for itemizing donors may allow private charities to respond better to the demand for collective goods than the government.⁸⁴ With a tax subsidy, a high-preference minority may fund a good at the level the minority desires; without it, the minority may not be able “to provide the appropriate amount of the good.”⁸⁵ Another way of looking at it is that the government subsidy, in a sense, imposes part of the cost of the collective good on the freeriders in the form of tax revenue forgone.⁸⁶ In this way, if society generally

Justice, 87 WASH. U. L. REV. 505, 505-06 (2010) (explaining reasons existing scholarship “incomplete and inconsistent for generally ignoring distributive justice issues”); Gregg D. Polsky, *Rationally Cutting Tax Expenditures*, 50 U. LOUISVILLE L. REV. 643, 647-49 (2012) (discussing allocative tax-expenditure function of charitable deductions); Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 4-7 (2011).

79. See Gergen, *supra* note 74, at 1397 (discussing function of charitable organizations providing public goods).

80. See *id.* at 1397.

81. See *id.* at 1398.

82. *Id.*

83. See Gergen, *supra* note 74, at 1398.

84. *Id.* at 1399 (citing Burton Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 21 (Susan Rose-Ackerman ed., 1986)). The government, of course, spends in accordance with majority vote.

85. Gergen, *supra* note 74, at 1399.

86. See *id.* at 1400 (citing Harold Hochman & James Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, 30 NAT’L TAX J. 1 (1977), reprinted in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 21 (Susan Rose-Ackerman ed., 1986)).

benefits, it collectively shares the cost to the extent of the subsidy.⁸⁷

Gergen explains that a deduction may be the only way to allow people with a high preference for a good to cover the bulk of the cost while shifting some of the cost to freeriders.⁸⁸ For example, with a 33% tax break, the donor is still funding two-thirds of the cost while the taxpaying public subsidizes the remaining third.⁸⁹ Whether the taxpayers are getting their money's worth, however, is a different story that depends on the value of the collective goods provided by the charities.

Gergen notes that the disinterested or those opposed to a particular charity are being compelled (in the form of forgone tax revenues) to subsidize organizations they do not care to support; therefore, for a scheme to be efficient, the gain to the beneficiaries must be greater than the cost to the disinterested.⁹⁰

At the risk of oversimplification, those charities that serve the poor and needy do not cause much of an upside-down-effect concern because the wealthy save tax dollars directly in exchange for redistribution of their wealth to the impoverished.⁹¹ This redistributive effect occurs for itemizers in every tax bracket because donors contribute more to the poor than the subsidy provides. Capping the deduction at 28% would even more effectively leverage the subsidy because donors would bear a higher portion of the total costs; however, to the extent wealthy donors decide not to make contributions to the needy, the same collective-action problems would persist.⁹² Undersubsidizing,

87. See Gergen, *supra* note 74, at 1400-01. "[T]ax-free private giving [may] approximate[] a Lindahl solution . . ." *Id.* This is a situation where no one is worse off and the policy makes some people better off. See *id.* at 1400.

88. See *id.* at 1403.

89. Of course, lower-bracket individuals would bear a higher percentage share than higher-bracket individuals. For example, a taxpayer in the 15% marginal bracket would only earn a deduction of 15%, thereby bearing 85% of the cost of the donation. Because those at the lower end of the income spectrum derive less of a benefit than those in higher-end brackets, this is sometimes called the *upside-down effect*. *Id.* at 1405. To avoid this effect, advocates sometimes call for a tax credit for charitable donations instead of a deduction. Limiting the charitable deduction to 28% would not completely cure the upside-down effect because those in brackets below 28% would continue to enjoy less of a deduction than those in the higher brackets, but it would put the highest-income donors on equal footing with donors in the 28% bracket.

90. See *id.* at 1412. Gergen explains that this is why Pareto-optimal standards, which require that no one be worse off, do not apply and efficiency is better measured in Kaldor-Hicks standards, where winners' benefits outweigh losers' costs. See *id.* at 1412-13. The winners in this case are expanded beyond the classic—pure economic—definition of those who enjoy the tax subsidy to also include the beneficiaries of charitable services that otherwise would not be enabled. See *id.* at 1413. In this way, improvements to the welfare of the needy weigh heavily in favor of the benefits side of the equation, and are consistent with reality and what non-economists see as the strong redistributive value of charitable giving. See *id.* at 1413-14. "Modifying the subsidy theory to allow benefits to the needy to offset costs incurred by the relatively well-off makes it possible to account for the unpurchased pleasure of the pauper." *Id.* at 1414.

91. See Gergen, *supra* note 74, at 1414.

92. See *id.* at 1409. Some may get satisfaction from the pleasures of giving and overinvest. See *id.* "For most charities, however, the greater risk is likely to be underfunding because of freeriding." *Id.*

in other words, could be extremely detrimental to the poor.⁹³

It is important to note that a subsidy theory itself does not embrace government funding of charity even though some scholars talk in terms of the government *matching* donations.⁹⁴ While talk of a match may be helpful to some in understanding an equivalent to forgone government revenue that occurs by virtue of the deduction, there is no affirmative requirement in the subsidy theory that the government appropriate or administer a matching program. This is crucial because one paramount idea in protecting pluralism is the notion that the deduction mechanism is free from the political process.⁹⁵ The inertia of the status quo—merely ignoring revenue that otherwise would be considered spendable by the government—is one reason to favor Andrews’s approach. Once conceptualized as income, it becomes subject to tax-expenditure analysis, precisely the result Andrews sought to avoid.⁹⁶

The point is demonstrated by Americans’ overwhelming support for the charitable donation deduction, but it is doubtful they would approve a tax increase to allow the government to spend more to support charities. Any compulsion may undermine generosity and America’s reputation for generosity abroad.⁹⁷ Such a *subsidy* would be compulsory for taxpayers (substituting government action for donor autonomy and freedom). It would depart from the tradition of Americans being “the most generous people on earth.”⁹⁸

From the Rawlsian perspective of social justice, the distinction is important because the existing system preserves individual autonomy in the donative process, while a tax on all citizens to fund government matching of select social programs would be compulsory.⁹⁹ Rawls noted, “[j]ustice denies that the loss

93. See *id.* “[W]hile the donor receives some tax benefit for donations, the biggest benefit goes to the charity and those who are served.” Sean Belk, *The Charitable Tax Deduction: ‘Clutter, a Loophole or Vital to Society?’*, LONG BEACH BUS. J., Aug. 14, 2012, <http://www.lbbusinessjournal.com/long-beach-business-journal-newswatch/144-lof-scroller-articles-12-08-14/820-the-charitable-tax-deduction-clutter-a-loophole-or-vital-to-society.html> (citing Alliance for Charitable Reform). “The president’s plan will hit those who rely on charities much more than it will hit the wealthy.” *Id.* At a 50% tax rate the government matches the donation dollar for dollar because it provides fifty cents of tax relief for each dollar donated, giving the taxpayer an after-tax cost of fifty cents to make the donation. If the taxpayer did not donate the dollar, the taxpayer would simply keep the fifty cents (after tax) instead of donating it.

94. See Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 38 (1972).

95. See Polsky, *supra* note 78, at 648-49.

96. See *id.* at 647-49 (analyzing deduction as allocative tax expenditure); Andrews, *supra* note 62, at 310-14 (critiquing tax-expenditure analysis).

97. See JAMES N. MORGAN ET AL., RESULTS FROM TWO NATIONAL SURVEYS OF PHILANTHROPIC ACTIVITY 159 (1979) (citing KENNETH E. BOULDING, THE ECONOMY OF LOVE AND FEAR (1973)). Morgan, Richard F. Dye, and Judith H. Hybels contrast voluntary redistribution through philanthropy with taxes as a form of coercive redistribution akin to compulsory redistribution from robbery, extortion, or victor’s plunder incident to war. See MORGAN ET AL., *supra*, at 159.

98. CHARLES T. CLOTFELTER, FEDERAL TAX POLICY AND CHARITABLE GIVING, at xi (1985) (quoting President Ronald Reagan).

99. See JOHN RAWLS, A THEORY OF JUSTICE 3-4, 28 (1971).

of freedom for some is made right by a greater good shared by others.”¹⁰⁰

The government plays the distributive-justice role—acting like an institutional Robin Hood—through the progressive-rate structure.¹⁰¹ The progressive-rate structure cements this redistributive function—taking from the rich and giving to the poor—because the wealthy pay a higher rate of taxes than the poor. Indeed this is the essential feature that makes the tax code progressive. From a tax-policy perspective, progressivity is defensible because many believe it is fair to tax the wealthy more heavily, inasmuch as they are able to enjoy all of the fruits of government and have a greater ability to pay for these goods.¹⁰² Such a scheme satisfies Rawls’s precepts of justice as fairness, because a measure is evaluated as just when the least well-off in society are advanced by implementing the measure.¹⁰³

Unlike the original Robin Hood who needed to rescue the poor from oppressive taxation, the United States Government redistributes wealth in favor of the poor because of the progressive nature of the tax code. This redistribution is facilitated by relieving low-income taxpayers from any tax burden and allowing refundable or partially refundable credits that allow low-income families to receive a refund, even if they have no tax liability.

The most obvious of these redistributive credits is the aid to the working poor through the Earned Income Tax Credit (EITC) for taxpayers and their families who fall below the poverty line.¹⁰⁴ Ronald Reagan called this credit the “best anti-poverty, the best pro-family, the best job-creation measure to come out of Congress” and President Obama significantly raised EITC payments in the past few years.¹⁰⁵ Those receiving the EITC (and many who receive other refundable credits) actually pay *negative taxes* because they receive tax refunds beyond any tax liability as supplemental government support.

100. *Id.* at 28.

101. “Principles of distributive justice are normative principles designed to guide the allocation of the benefits and burdens of economic activity.” See Stanford Encyclopedia of Philosophy, *Distributive Justice*, INTELL. TAKEOUT (Mar. 5, 2007), http://www.intellectualltakeout.org/library/research-analysis-reports/distributive-justice-0?library_node=67789.

102. Rawls does not evaluate these concepts, but ability to pay and the advantage of broader social goods for the betterment of all members of society would be implicit in his construction of justice because all would agree to expand such benefits where everyone’s interests are expanded, but not under circumstances where there was no ability to pay. See RAWLS, *supra* note 99, at 285-89 (arguing similar protection for future generations based on sharing burden of realizing/preserving just society).

103. Rawls’s second principle of justice requires that social and economic policies, despite inequalities, be arranged so they are “reasonably expected to be to everyone’s advantage.” *Id.* at 60.

104. See I.R.C. § 32 (2006).

105. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-132, 124 Stat. 3296; American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115; Chris Farrell, *Raise the Minimum Wage*, BLOOMBERG BUSINESSWEEK, Oct. 17, 2006, <http://www.businessweek.com/stories/2006-10-17/raise-the-minimum-wagebusinessweek-business-news-stock-market-and-financial-advice> (quoting President Ronald Reagan).

Of course, the burden of refundable credits falls on the shoulders of all taxpayers, but disproportionately on the wealthiest.¹⁰⁶ According to the most recent statistics, 41% of income-tax filers (58 million households) paid no income taxes at all in 2010.¹⁰⁷ “Today, the percentage of tax filers who pay no income taxes due to the generous credits and deductions in the tax code has reached levels not seen since the income tax became a ‘mass tax’ in 1940.”¹⁰⁸ Obviously, the 60% who are paying shoulder the full cost of government.¹⁰⁹

This concept of negative income tax is troubling to those who feel every citizen should pay some of the costs of government so they are stakeholders in holding the government accountable for its spending, instead of merely benefitting from the government’s largesse.¹¹⁰ This is entirely consistent with Rawls’s notion of justice as fairness because this policy, adopted by those not in the least-favored group, advances the needs of the most disadvantaged.¹¹¹

Approaching the question of limitations on itemized deductions from a Rawlsian perspective, it would only be just to limit those deductions where doing so accrued advantageously to the least-advantaged group (the poor). Here, while the 28% rate limitation for all deductions raises revenue for the government (presumably to the advantage of the least-advantaged members of society), the charitable donation deduction is differently situated from the others because the beneficiaries of charitable donations are often the least-advantaged members of society. Unlike the mortgage-interest-deduction limitation which benefits only the itemizer, the charitable donation also benefits the poor or other socially desirable charitable endeavors. The question boils down to whether the charitable deduction advances the needs of the least-advantaged members of society or merely provides opportunities for the wealthy to escape progressive taxation on amounts donated. This is why opponents of the President’s budget proposal emphasize the adverse social

106. In 2005, for example, the top 2.7% of individual returns paid 51.3% of the income tax. See 2 NAT’L TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS 9 tbl.2 (2011), http://www.taxpayeradvocate.irs.gov/userfiles/file/TAS_arc_2011_vol_2.pdf.

107. WILLIAM L. E. FREELAND & SCOTT HODGE, TAX EQUITY AND THE GROWTH IN NONPAYERS 1 (2012), available at [http://services.taxanalysts.com/taxbase/eps_pdf2012.nsf/DocNoLookup/15473/\\$FILE/2012-15473-1.pdf](http://services.taxanalysts.com/taxbase/eps_pdf2012.nsf/DocNoLookup/15473/$FILE/2012-15473-1.pdf) (citing 2010 IRS statistics).

108. *Id.* Due to the Code’s present construction, there is an effective *zero* tax rate for any single person earning under the amount of the combined personal exemption (\$3800) and standard deduction (\$5950) amounting to \$9750. For married taxpayers filing jointly for a family of four, the zero-income threshold is \$27,100 (\$11,900 standard deduction plus 4 x \$3800). In fact, these families need not even file an income tax return. See *1040 EZ Instructions 2012*, I.R.S., at 7 (2012), <http://www.irs.gov/pub/irs-pdf/i1040ez.pdf>.

109. Although not subject to income tax, all wage earners pay payroll taxes to fund Social Security and Medicare programs. For some taxpayers, refundable credits such as the Earned Income Tax Credit can offset this entire liability.

110. See generally FREELAND & HODGE, *supra* note 107. “This trend raises serious concerns about the equity of the U.S. tax system, the fiscal stability of the federal government, and the political implications of disconnecting millions of citizens from the primary means of funding government programs.” *Id.* at 1.

111. See RAWLS, *supra* note 99, at 302 (explaining “Second Principle” of justice for institutions).

impact if the deduction is limited, while proponents focus on revenue generation or eliminating tax breaks for the rich.¹¹²

3. Equity Theory

“[P]eople who give their resources to charity are thereby made less well-off and so should pay less tax than people who spend their resources on personal consumption.”¹¹³ Two other fundamental tax principles underpin this theory. First, giving away a portion of income to charity diminishes ability to pay income tax and one basic justification for the progressive tax rates is that they should relate to that ability. Second, contributions made out of a sense of moral obligation for religious or other secular altruistic reasons remove the donor’s autonomy to enjoy this income in other more selfish ways. In this sense, the donation to charity has an involuntary aspect unlike typical consumption choices.¹¹⁴

The principle of horizontal equity requires that those similarly situated should pay the same tax unless there is a tax-related justification. Using an ability-to-pay theory, the argument is that a donor with \$1.8 million after a \$200,000 donation is similarly situated to a nondonor with \$1.8 million in income. Under moral compulsion theory, a donor compelled to tithe 10% to a church would only have \$1.8 million left after the \$200,000 donation.¹¹⁵ This donor would be similarly situated to the \$1.8 million-income nondonor who felt no similar compulsion.

However, both of these justifications create glass half-full, glass half-empty conundrums. If one views the donation as discretionary—no legal or tax-based requirement to give—then the taxpayers with \$2 million in income who make donations are better off than the \$1.8 million nondonors because the former had a choice, and decided to make the donation. These donors would obtain great spiritual benefit from the satisfaction of the donation, whether from the pure pleasure of giving or from satisfying a compulsion to give. These donors also had the ability to pay—indeed more ability to pay—than the nondonors who earned \$200,000 less. Thus, the moral-compulsion/voluntary-donation argument depends on what priority one gives to the charitable deduction. For tax expert Boris Bittker, “charitable contributions represent a claim of such a high priority that in my view, a case can be made for excluding them in determining the amount of income at the voluntary disposal of the taxpayer in question.”¹¹⁶ Bittker’s position is thus consistent with Andrews’s view of tax

112. See Belk, *supra* note 93.

113. Gergen, *supra* note 74, at 1426.

114. See Bittker, *supra* note 94, at 58-59.

115. See *id.* at 59 (using extreme example of religious members taking poverty vow and giving income to religious order).

116. *Id.*

equities of the charitable deduction.

Gergen criticizes Andrews's arguments as nothing more than a parallel to the efficient subsidy theory because Andrews makes arguments to carve charitable donations out of income altogether based on collective-goods concerns.¹¹⁷ However, the equity arguments also justify Andrews's position that the donations should first be carved out of income because the person making the donation does not selfishly benefit by consumption of the goods purchased through the donation.

It is equitable to treat the deduction as resulting in horizontal equity either by disregarding its nature as income (as a matter of tax policy) or equally so by including it in the formulation of income, thereby equitably allowing a deduction to restore horizontal equity. Of course, either approach ignores the legal discretion not to donate: In the terms of *Commissioner v. Glenshaw Glass Co.*,¹¹⁸ the income has been realized because it represents an accession to wealth over which the taxpayer has complete dominion, even if the use of that dominion is to give it away.¹¹⁹ Both theories also ignore the line of reasoning of *Lucas v. Earl* and its progeny that income must be taxable to the income-generating source, no matter how clever the arrangements to assign the income to another.¹²⁰

Gergen concludes that taxing people

according to their relative well-being is a plausible allocative goal, and the objections to adjusting income to account for the effect of receipts and expenditures on well-being are unpersuasive, at least in the case of charitable contributions. If gifts to charity make [donors] worse off a deduction for them may be defended on grounds of equity.¹²¹

Nevertheless, the same equitable grounds would allow for a categorical exemption of such donations from the definition of income in the first place. As earlier explained, philosophically excluding these donations from income is tantamount to including them in income but allowing a commensurate

117. See Gergen, *supra* note 74, at 1425-26.

118. 348 U.S. 426, 431 (1955).

119. See *id.* Moreover, Bittker's moral compulsion theory would allow moral relativism to trump the legal reality of a taxpayer's unfettered dominion. See Bittker, *supra* note 94, at 58-59. These moral fetters are indeed truths to some segment of the donating populace, to the extent a donor gives because compelled; but for those who choose to give without feeling compelled (as disinterested acts of generosity), there is still an exercise of discretion inherent in charitable contributions. See *id.* Discretion also inheres in the hearts of those who feel no compulsion to give and in fact do not give. Thus, equity restores the balance between these latter groups and those compelled morally to give, but tax relief affords a windfall under this theory to those donors who feel no similar compulsion. See *id.* at 46-47.

120. See *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930). In this case, the Code essentially allows the donor to assign income to a charity that pays no taxes. See generally *id.*

121. Gergen, *supra* note 74, at 1428.

deduction of like amount—six of one, half dozen of the other.

The equitable arguments support both approaches equally so long as the donor loses the benefit of the contributed donation. Since *charitable contributions* by definition must not “inure[] to the benefit” of any private individual, the benefit that matters for tax-policy reasons is financial benefit, not the element of satisfaction or pleasure the donor may derive from the contribution.¹²² In this sense, to the extent the benefits are communal, any donor could presumably enjoy the social-welfare benefits as a freerider, linking us back to the efficient subsidy analysis. From an empirical standpoint, only 13% of donors report giving for personal benefit (satisfaction) compared with 67% who give out of a sense of obligation or for feelings of approval.¹²³

This information is critical in confirming normative standards. We can use personal experience, models of human behavior, and anonymous surveys to show that donors are not selfish or wasteful. Rather, donors are giving out of a sense of doing right and they will donate as part of human nature, not because they are acting “as egoistic, rational utility maximizer[s].”¹²⁴ It is impossible to predict with certainty how tax-incentive changes will affect donor behavior because people donate money for a variety of altruistic reasons. One can therefore understand how general consensus easily forms about the nature (or direction) of the impact from tax-law changes (lower incentives to donate will erode donations), but at the same time there is no agreement on the magnitude of the expected change.

For example, one who tithes out of moral obligation is unlikely to be deterred merely because tax incentives diminish (just as nonitemizers continue to donate even in the absence of tax relief). In comparison, the very wealthy—upon whose donations many charities overtly rely—may be much more interested in the nature and timing of donations, especially when they have access to sophisticated tax attorneys and accountants. An advisor may suggest accelerating donations to take advantage of the higher-rate relief, recommend donating appreciated assets, or earmark money for future donations to be invested in stocks, real estate, or other capital assets, which can later be donated without paying taxes on the appreciation. Tax law changes would, therefore, predictably have a much larger effect on the latter group.

4. *Distributive Justice: Rawls Revisited*

Professor Miranda Perry Fleischer explains that “the law governing the

122. I.R.C. § 170(c) (2006). Some discussants of the deduction argue the pleasure, satisfaction, prestige, or *warm glow* confer a benefit to the donor as a change agent even above the altruistic value of the donation. See Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 829-31 (2012); Schizer, *supra* note 73, at 225-26 (noting “warm glow” term of choice for many economists).

123. Gergen, *supra* note 74, at 1430.

124. *Id.* at 1428-29.

charitable tax subsidies is itself confused on the role of distributive justice.”¹²⁵ She argues that expanding our understanding of distributive-justice issues will promote better understanding of the efficient subsidy theories, help combat existing justice-related criticisms of the deduction, and help allocate societal resources in a more systematic fashion.¹²⁶ To better explore this largely ignored area of tax scholarship, Fleischer began writing a series of articles, the first of which was published in 2010.¹²⁷ Her second article, published in 2011, examines the *equality of opportunity* doctrine, which has received considerable attention outside of the tax community and relates insights from philosophic literature to the charitable deduction.¹²⁸

Like Rawls, Fleischer finds that justice does not require income equality, but rather a system that promotes equal opportunities for all Americans to achieve their income goals.¹²⁹ While this concept has previously been ambiguous, the notion is that the equality of opportunity doctrine promotes freedom of choice and neutrality as core principles.¹³⁰ Although Fleischer suggests that distributive-justice issues mean some donees are more justified recipients of donations supported by tax dollars, a discussion of the worthiness of various charitable organizations along these lines is beyond the scope of this Article.¹³¹ Instead, the author proposes that cumulative voluntary distributions of income from the wealthiest donors to charitable organizations serve a generic distributive-justice function—reallocating resources from personal consumption of the wealthy to broader societal purposes.¹³² Such voluntary redistribution is arguably more just than compulsory redistribution (collecting taxes from the wealthy and then applying the proceeds through the government to the very same approved organizations) because voluntary redistribution preserves the autonomy of the donor consistent with the freedoms and equality of opportunity advocated by Rawls.¹³³ Additionally, voluntary redistribution may (and likely does) generate greater contributions than compulsory contributions because the donors prefer this freedom and the ability to favor

125. Fleischer, *supra* note 78, at 506.

126. *See id.* (explaining benefits of understanding subsidies and distributive justice).

127. *See id.* (explaining merits of distributive-justice approach and laying groundwork for following articles).

128. *See* Fleischer, *supra* note 14, at 602.

129. *See id.* at 603 (explaining “equality of what” debate); *see also supra* notes 99-103 and accompanying text (explaining Rawls’s perspective of justice and equality).

130. *See* Fleischer, *supra* note 14, at 603 n.2 (citing Anne Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 476-77 (2007)).

131. *See generally* Fleischer, *supra* note 78 (discussing theoretical funding levels of various types of charitable donees).

132. In his article, Dean David M. Schizer adopts a similar distributive-justice approach stating, “[s]ince charity tends to be redistributive, we are promoting voluntary redistribution, while also placing public burdens on those best able to bear them.” Schizer, *supra* note 73, at 234.

133. *See supra* notes 99-103 and accompanying text (discussing Rawls’s theories on freedoms and equality of opportunity).

their own choice organizations.

5. *The Need for Salience*

Recent scholarship also suggests that an individual's response to a tax (or a change in taxes) "depends at least in part on the tax's salience."¹³⁴ Salience refers to the prominence, visibility, awareness, or vividness in the mind of the audience.¹³⁵ An example would be the introduction of the EZ-Pass, which has the effect of reducing awareness of toll costs because people no longer need to stop and look for money in order to pay the toll, which makes the cost less salient even though the price of the toll remains the same.¹³⁶ Although there is a healthy debate on the subject, some tax scholars argue that Congress should reduce or hide the tax burden of higher taxes to make them less salient and hence less objectionable.¹³⁷

The present author opposes any such hide-the-ball tactics, preferring instead a simple, transparent tax system that would be fully salient, so that the merits of various change proposals can be aired and fully considered to better enable both taxpayers and policymakers to make informed decisions.¹³⁸ An invisible or hidden tax may meet less resistance, but, because it escapes scrutiny, may be inefficient because it does not have to compete with other proposals in the budget process.¹³⁹ Indeed, Professor Stanley Surrey, former Assistant Secretary of the Treasury for Tax Policy, complained about tax expenditures forty years ago, arguing the effects were more hidden, and hence more problematic than direct federal spending for the same purposes.¹⁴⁰

On the tax-expenditure side, those deductions that are well known and understood should be more salient and therefore more important to taxpayers,

134. Jacob Goldin, *Optimal Tax Salience*, SOC. SCI. RES. NETWORK, at 1 (Mar. 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2009108.

135. See Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1312 (2012) (defining salience).

136. See generally Amy Finkelstein, *E-ZTax: Tax Salience and Tax Rates*, 124 Q. J. ECON. 969 (2009).

137. See Faulhaber, *supra* note 135, at 1308; Goldin, *supra* note 134, at 15 ("[G]overnments should typically avoid relying on fully-salient taxes, unless the purpose of the tax is to reduce consumption of the taxed good."). Goldin contends that creating a distortion is better for the government because it causes taxpayers to make optimization errors, increasing social welfare. Goldin, *supra* note 134, at 15.

138. See Patrick E. Tolan, Jr., *Stimulus Measures: The Need for Accountability and Transparency*, 127 TAX NOTES 167 (2010) (proposing rubric of transparency and accountability for federal support).

139. See Patrick E. Tolan, Jr., *Questioning Tax Expenditures for Economic Recovery*, 127 TAX NOTES 67, 69-72 (2010) (detailing background on rising costs and other problems with tax expenditures).

140. See Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 734 (1970) (arguing tax expenditures be used only as last resort). Tax expenditures must be used to avoid "confusion and divided authority in the legislative and administrative processes, difficulties in maintaining budgetary control, confusion in perceiving and setting national priorities, and dangers to the tax structure itself." *Id.* Tax-exempt municipal bonds offer one common example of an inefficient tax subsidy, which has been well documented in scholarship. See U.S. GEN. ACCOUNTING OFFICE, GAO/GCD/AIMD-94-122, TAX POLICY: TAX EXPENDITURES DESERVE MORE SCRUTINY 26 (1994).

because the taxpayers are aware of them and can act accordingly in order to maximize their utility. On the other hand, those expenditures that are hidden or misunderstood could lead to a number of outcomes: failing to claim a deduction when so entitled; failing to be motivated by the favorable tax treatment to take advantage of the deduction (a donation); trying to take the deduction when one is not eligible for the deduction; and believing that the deduction is worth more (or less) than it is actually worth. All of these outcomes impact efficiency—some making the deduction more efficient while others compromise efficiency.

For example, if people taking the standard deduction make charitable donations because they heard about the tax break and mistakenly think it applies to them, this tax-motivated donative behavior fosters social goals served by the charitable donation, even if the nonitemizer gets no tax break.¹⁴¹ Although some scholars tolerate or even advocate for such confusion based on the resulting social utility, the present author instead advocates salience to avoid mistakes about tax consequences.¹⁴² Mistakes of this nature may occur because the deduction is hypersalient to the extent that nonprofit organizations may solicit donations with the promise of a tax deduction without identifying the limited pool of those who benefit from such deduction, or disclosing the substantiation requirements incident to claiming the deduction.¹⁴³

At the other extreme, if taxpayers do not know the value of the deduction, they may under-donate. Taxpayers in the 28% bracket, for example, that think the deduction is only worth 10% will not be motivated to contribute enough. A 2012 study shows that numerous taxpayers misunderstand the charitable deduction and that it is not fully salient for these taxpayers.¹⁴⁴ For many, the belief that the charitable deduction grants no tax relief, or less tax relief than expected, produces a situation where taxpayers are not properly incentivized by the subsidy. However, because the subsidy is also hypersalient for those taxpayers who overvalue the deduction, the misunderstanding somewhat cancels out.

In addition, the study's conclusions cannot really be extended to a wealthy

141. In several years of Volunteer Income Tax Assistance service to low-income taxpayers, the author has frequently encountered taxpayers who bring in receipts for donations that have no bearing whatsoever on their individual tax liability because they greatly lack sufficient total itemized deductions to approach the amount of their standard deduction. Although there is no tax advantage whatsoever to these taxpayers, the salience (hypersalience) of the deduction alone motivates them to track and report donations anyway.

142. See Goldin, *supra* note 134, at 15 (creating distortion better for government because it causes taxpayers to make optimization errors, increasing social welfare).

143. See Faulhaber, *supra* note 135, at 1308 (arguing salience of tax proportional to taxpayer consciousness of tax's consequences). Faulhaber argues that the charitable deduction is the "most extreme" salience deduction to the point of being hypersalient because the "same level of awareness does not extend to the limitations of the deduction." *Id.* at 1309-10.

144. See Jacob Goldin & Yair Listokin, *Tax Expenditure Salience*, SOC. SCI. RESEARCH NETWORK, at 1 (July 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2097836.

taxpayer because the survey did not overrepresent this small but significant group.¹⁴⁵ The survey authors noted that the higher-income itemizers tended to be more aware of the accurate tax consequences.¹⁴⁶ Although the observation may not be statistically significant, it is consistent with the intuitive expectation that a wealthy taxpayer would either have more command of his or her finances or would receive better advice from tax professionals.

C. Charitable Deduction Evolution Throughout the Years

The deduction scheme has remained remarkably stable throughout the decades. It has been substantially impacted only by changes in three primary categories: (1) the maximum allowable percentage of annual deductible income for charitable donations; (2) changes to the pool of taxpayers who are tax-advantaged by the deduction; and (3) changes to the tax rates, which change the after-tax *price* or *cost* of a donation. By far the most numerous changes throughout history have been adjustments to the tax rates.

There has never been a limitation on the maximum allowable rate for the deduction analogous to the administration's proposal. Category one limitations, at present, limit deductibility for charitable donations in any given tax year to 50% of AGI, but that whole 50% is donated at the taxpayers' marginal rate(s). Category two changes occurred when the standard deduction was introduced, because before that time all taxpayers had to itemize to enjoy any deductions. The pool temporarily expanded back to all taxpayers in the early 1980s, when those taking the standard deduction were also allowed a full or partial deduction for charitable donations. Category three (rate) changes are most informative concerning the President's 2013 budget proposal because changes in the tax rate influence the inducement to donate (in subsidy terminology, the subsidy incentives change). The proposal to limit the deduction rate to 28% will likewise change the after-tax *price* or *cost* of a donation.

While only this third dimension—changing the after-tax price of donating—is an issue in the President's 2013 budget proposal, the other two types of tax changes are also addressed below to connect the historic dots between the original deduction and the present deduction. In addition, the timing and consequences of these other changes should be appreciated, as they sometimes interfere with an ability to derive causal connections between

145. *See id.* at 5-7. Even though the sample size was 887 taxpayers, the top 1% of this representative sample, which would reflect those most affected by the President's proposal, would only be nine taxpayers—not a statistically significant group. *See id.* Even the top 4% (all of those potentially impacted by the 2013 budget proposal) would only be thirty-six individuals, which would be of marginal statistical value. *See id.* In addition, the “top strata” evidenced in the survey report is at \$100,000-\$300,000, which barely captures the bottom of the group affected by the President's 2013 budget proposal. *See id.* at 2 (“Along several dimensions, [the charitable deduction] has low salience.”).

146. *See id.* at 12.

changes in the rates and tax effects likely caused by these other factors.

1. Changes to Limit Deductions as a Percentage of Income

Senator Hollis originally proposed a 20% limit on contributions based on net income, but the War Revenue Act of 1917 imposed a 15% limit.¹⁴⁷ The limit was increased to 15% of AGI in 1944.¹⁴⁸ The change from net-taxable income to AGI meant the percentage applied to a larger baseline amount, including net income plus the other noncharitable itemized deductions such as state income taxes, interest, and property taxes.¹⁴⁹

The limit was raised to 20% of AGI in 1952 and subsequently increased to 30% in 1954.¹⁵⁰ However, this additional 10% was allowed only for donations to hospitals, churches or religious orders, and educational institutions.¹⁵¹ Beginning in 1958, any amounts over the limit were allowed to be carried forward to succeeding years.¹⁵²

In the 1960s, unlimited contributions for those who contributed over 90% of their taxable income for that taxable year and eight of the ten preceding taxable years led to abuse, thereby resulting in the modern-day 50% limit on cash contributions to public charities and lower limits on both donations of appreciated property and donations to private foundations.¹⁵³

2. Changes to the Pool of Tax-Advantaged Donors

The standard deduction was introduced in 1944, the same year that policymakers changed the limits on income from net-income-based to AGI-based.¹⁵⁴ These changes are related, because in the early years all individual deductions, business and personal, were essentially equal because they were subtracted from gross income in determining net income. In modern parlance they were all above-the-line, because there was no line needed before the option arose to take the standard deduction. All calculations were related to net income, which was derived from subtracting all deductions from gross income.

Congress created AGI in 1944 as a reference point to put business owners on equal footing with wage earners by allowing AGI computations to include

147. See War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 330 (codified as amended at I.R.C. § 170 (2006)); Lindsey, *supra* note 14, at 1062; Burmeister, *supra* note 19, at 1018.

148. Lindsey, *supra* note 14, at 1061-62.

149. See *id.* at 1062.

150. *Id.* at 1062-63.

151. *Id.* This preferred group was expanded to all public charities in 1964.

152. Lindsey, *supra* note 14, at 1062-63.

153. See *id.* at 1063-68, 1071 (describing major changes to charitable contribution deduction); see also I.R.C. § 170 (2006). AGI, for purposes of code § 170, is computed without regard to any net-operating-loss carryback. I.R.C. § 170(b)(1)(G). See *supra* notes 23-41 and accompanying text for a detailed look at present deductibility.

154. See CLOTFELTER, *supra* note 98, at 32.

business-related deductions allowing all taxpayers, regardless of profession, to enjoy the standard deduction equally.¹⁵⁵ Along with taxes and interest, the charitable deduction was demoted to a below-the-line deduction so that taxpayers would have to itemize more than the amount of the standard deduction to enjoy a tax benefit. Therefore, there were two potential threats to charitable donation deductions. First, the deduction had formerly generated value to anyone with tax liability because every dollar, from the first dollar of charity up to 15% of income, was deductible on its own merit. After the standard deduction, an itemizer would need more total itemized deductions than the standard deduction in order to enjoy an additional tax advantage. Second, charitable donation deductions would be valueless to nonitemizers and a majority of taxpayers were expected to take this simpler approach.

While each taxpayer's circumstances would vary, the cumulative itemized deductions were effectively offset by an amount up to the amount of the standard deduction. This undercut all itemized deductions equally; itemizers lost ground to those who could donate nothing at all and claim the standard deduction.

In the 1980s, a temporary charitable donation deduction for those taking the standard deduction was phased in from 1981 to 1986 and was then eliminated after 1986.¹⁵⁶ The deduction was minimal in 1982, 1983, and 1984 because deductions for nonitemizers were limited to 25% of donations, and were further limited to a \$100 (1982 and 1983) or a \$300 maximum deduction (1984).¹⁵⁷ There was no dollar cap in 1985 or 1986, making the deduction much more valuable. In addition, taxpayers who took the standard deduction could deduct 50% of the value of their donations in 1985 and 100% of their donations in 1986 as above the line deductions.¹⁵⁸ In the Tax Reform Act of 1986 (1986 Act), Congress again sought to simplify the Code and eliminated this deduction for nonitemizers.¹⁵⁹

3. Rate Changes Throughout the Years

Other than these structural changes, the principle changes in tax incentives affecting charitable contributions have been due to modifications in the tax rates. As tax rates get steeper, those subjected to the higher rates enjoy more tax advantages from a deduction than those subjected to lower rates. This

155. See S. REP. NO. 78-885, at 24 (1944); *Historical Perspectives on the Federal Income Tax*, TAX HIST., <http://www.taxhistory.com/1944.html> (last visited Mar. 9, 2013) [hereinafter *Historical Perspectives*] (discussing history of AGI concept and definition in Senate Report 78-885).

156. See CLOTFELTER, *supra* note 98, at 11-12 (discussing implementation of Economic Recovery Tax Act and effect on charitable deductions for nonitemizers).

157. Lindsey, *supra* note 14, at 1068.

158. *Id.*

159. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; see also Lindsey, *supra* note 14, at 1069.

phenomenon is typical of all deductions that are not otherwise limited or phased out for higher-income individuals and is sometimes referred to as an *upside-down* effect.¹⁶⁰

As explained earlier, concern for high taxes eroding the discretionary funds available to the wealthy to support charities was one factor in the creation of the charitable donation deduction in 1917.¹⁶¹ The base (normal) tax imposed in 1917 was only 4%, but the additional tax scheme was very progressive with a marginal income tax rate as high as 67%.¹⁶² Over the course of history, top marginal rates have varied considerably, but perhaps those garnering the most scholarly attention due to the impact on charitable donations have been the tax changes of the 1980s. For this reason, additional time is spent reflecting on these rate changes.

a. Early Tax Rates: Wartime Spikes and Progressivity

Tax rates have changed frequently throughout the years, often in fits and spurts, to higher or lower rates. Pursuant to the 1913 Revenue Act, only those earning over \$20,000 were subject to taxation and the initial rate was 1% for incomes up to \$50,000.¹⁶³ The rates increased a percent at a time up to 6% for those earning over \$500,000.¹⁶⁴ Basically, there were six brackets and the rates increased in gradual fashion.

In 1916, a *normal* tax of 2% was introduced along with an additional tax of 1% for the lowest bracket.¹⁶⁵ The additional tax again increased in gradual fashion, 1% per bracket, but additional brackets were added.¹⁶⁶ The lowest bracket was adjusted to \$20,000-\$40,000, so taxes would have tripled for this group compared to the 1% in earlier years (rising to 2% normal tax plus 1% additional tax).¹⁶⁷ A total of thirteen brackets replaced the earlier six and established a highest marginal total rate of 15% for those earning over \$2 million.¹⁶⁸

The jump in the highest rate from 15% to 67% between 1916 and 1917 was previously discussed, but WWI was so expensive that taxes were hiked again in 1918, raising the top rate to 77%.¹⁶⁹ The laws temporarily changed to include tax on incomes as low as \$5000-\$7000 and additional brackets were added.¹⁷⁰

160. See Lindsey, *supra* note 14, at 1058.

161. See *supra* notes 18-22 and accompanying text.

162. See *Marginal Tax Rates, Then and Now: Lessons To Be Learned or Spurned?*, 116 J. TAX'N 294, 294 (2012).

163. Blakey, *supra* note 13, at 794 tbl.2.

164. See *id.*

165. See *id.*

166. See *id.*

167. Blakey, *supra* note 13, at 794 tbl.2.

168. See *id.*

169. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 7-9 tbl.2.

170. See Blakey, *supra* note 13, at 794 tbl.2.

One-percent increases applied for the lowest brackets, but the rates were adjusted in a steeper fashion (from 2-5%) for higher brackets.¹⁷¹

From the postwar years through the early years of the Great Depression, the top rates dropped to as low as 25%.¹⁷² The highest rates rose to 63% in 1932, the year Franklin D. Roosevelt was elected, and climbed to 81.1% in 1940.¹⁷³ Throughout this era, the New Deal brought government involvement into the economy and, much more actively, into society in general.¹⁷⁴ The government needed more revenue to run these social programs, resulting in a surtax on the wealthy (increasing rates from 63% to 79%) that was imposed in 1936 for those earning over \$5 million.¹⁷⁵

Top rates rose again in World War II (WWII) to as much as 94% and the tax base was expanded to cover the majority of Americans, not just the wealthy.¹⁷⁶ Rates as high as 91% persisted until 1964 and then dropped to a highest marginal rate of 70% (with a couple of minor variations) until major tax reforms in the 1980s.¹⁷⁷

b. Major Rate-Change Reforms of the 1980s

Two especially significant changes to the tax code occurred in the 1980s. The first, a byproduct of the election of President Ronald Reagan, was meant to stimulate the economy by allowing taxpayers to keep and spend more of their income.¹⁷⁸ The Economic Recovery Tax Act of 1981 (1981 Act) reduced the top marginal rate from 70% to 50% and imposed corresponding proportional rate reductions for all taxpayers.¹⁷⁹ Because the top marginal rate was reduced, the effective government subsidy for charitable donations was also reduced.

A simplified example will show the impact of this change. A wealthy donor in the highest bracket in 1980 who donated \$1000 would be able to deduct \$1000 from her income.¹⁸⁰ Had she not donated the \$1000, she would have

171. *See id.*

172. *See* Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 *YALE L.J.* 1391, 1393 (2002) (reviewing DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH (Joel B. Slemrod ed., 2000)) (except for 24% in 1929).

173. *See* NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 7-9 tbl.2.

174. *See id.* at 12 (addressing increased involvement of government in economy and society).

175. *See id.* at 7-9 tbl.2.

176. *See id.* at 12 (discussing "greatest tax bill in American history").

177. *See* NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 7-9 tbl.2 (identifying exceptions in 1968-1970, when rates were 75.25%, 77%, and 71.25% respectively, and in 1981 when rates were 69.1%).

178. *See Aug. 13, 1981: Reagan Signs Economic Recovery Tax Act (ERTA)*, HISTORY.COM, <http://www.history.com/this-day-in-history/reagan-signs-economic-recovery-tax-act-erta> (last visited Mar. 25, 2013).

179. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 5, 22, 29 (Comm. Print 1981) (discussing average cut in marginal rates of 23%).

180. This assumes the donor itemizes, and the entire donation would otherwise be subject to the highest marginal rate.

paid tax of \$700 on this \$1000 income and retained the remaining \$300.¹⁸¹ In reducing her income by \$1000 through the charitable donation, she has avoided \$700 of tax liability, but she has also forgone the \$300 she would have been able to keep or spend for personal consumption. Instead, the \$300, and the \$700 that the Treasury has forgone, goes to charity. At the end of the day, because charitable organizations are tax exempt, the charity has a net gain of \$1000 while the taxpayer has a net cost of \$300, and the government has lost \$700 of revenue. From another perspective, the government subsidized her \$300 donation by matching it with \$700 federal contribution.

Economists describe the \$300 after-tax cost to the taxpayer to make the donation as the *price of giving* or simply the *price*.¹⁸² With a reduction in the highest marginal rate from 70% to 50%, the price of giving increases to \$500 for the same donation because the amount of the government's subsidy effectively drops by 20% (\$200) and the net cost of the donation effectively increases by the same 20% (\$200).

The deterrent to give caused by this *price effect*, could be of considerable importance to the nonprofit sector if the donor in our example decided to reduce her donation due to the lower effective subsidy, or worse yet, decided not to donate altogether. However, so long as the taxpayer was not deterred from making the donation by the lower tax breaks, the net result for the charitable organization would be the same—\$1000.

Nonprofits predictably lobbied against the proposed 1981 rate reductions, claiming that the change in the highest marginal rate would have a devastating, untoward impact on the willingness of high-income individuals to make donations because these individuals most needed the tax break.¹⁸³ However, these philanthropic organizations failed to account for the fact that their main donors, the wealthy, would also have considerably more after-tax revenue (disposable income) from which to make donations.¹⁸⁴ Unlike the price effect in the example above, which is a negative influence on donations, the effect of increased disposable income (income effect) is a positive influence, because the donor has more surplus funds available for consumption.¹⁸⁵

181. $\$1000 \times 0.70$ (the highest marginal rate) = \$700.

182. See CLOTFELTER, *supra* note 98, at 51 (“[V]irtually all of the econometric studies of contributions use as the basic measure of the price the after-tax foregone consumption per dollar of giving.”).

183. Clotfelter characterizes their challenges to the 1980 reforms as “some of the gloomiest predictions” and notes that doubters accused the sector of “crying wolf.” Clotfelter, *supra* note 24, at 2.

184. In fact, because rates were reduced across the board, the same, positive-cash-flow phenomenon applied to all taxpayers, most importantly to all potential itemizers. In the 1981 Act, Congress took sweeping steps to return the spending power to the taxpayer: “The Congress believed that excessively high income taxes give households too little control (and the Federal Government too much control) over the disposition of their earnings.” See STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 179, at 18.

185. See CLOTFELTER, *supra* note 98, at 54 (“[M]ost empirical studies define income as gross income less the federal income tax.”). More refined studies look not only at present-year disposable income, but also permanent income (average income measured over a period of years) or relative income (adjusting measures

To make the concept more concrete, imagine in the example above that the taxpayer has \$100,000 subject to the highest marginal rate. She would have positive cash flow of \$20,000 due simply to the change in the tax-rate structure.¹⁸⁶ Her after-tax income would escalate by \$20,000 because the liability for taxes diminished by \$20,000.¹⁸⁷

The *income effect* concept should be easily understood because it is the perfect corollary to Hollis's concern that when taxes spiked in WWI (to 67%), the wealthy would not have enough surplus (after-tax disposable income) to donate to charity. As taxes increase, after-tax disposable income decreases. By the same token, when tax rates drop, income available for consumption or donation increases. Therefore, both of these consequences are expected of rate changes. If these effects were perfectly opposite in both magnitude and direction they would cancel one another out, and no one would need to worry about rate changes affecting donor behavior; however, these variables are far more complex. Because they tend to constitute the most important tax-related considerations and trend in opposite directions, economists have developed models to measure the relative strength of these competing effects.¹⁸⁸ While there is agreement on the direction of change, the magnitude is far less certain.

It is easy to imagine that taxpayers may be motivated to give more from their surplus, notwithstanding that the tax benefit of giving may be somewhat reduced.¹⁸⁹ Even with a reduced top rate from 70% to 50%, however, the government is matching every donation dollar-for-dollar. The wealthy might see this match as a great way to leverage donations.

The 1986 Act had the same two dynamics at play as the 1981 Act: a combination of rate reductions (government subsidy fell from 50% to 28% for the highest marginal taxpayers) and increased after-tax wealth (cash flow) by 22%. Using the numbers above, the last \$100,000 in income would only generate a tax burden of \$28,000 with a 28% top rate, allowing the taxpayer to keep \$72,000—\$22,000 more than the \$50,000 she kept after applying the 50% highest marginal rate.

for income class and community).

186. Before the change, tax owed on \$100,000 of taxable income was \$70,000 ($\$100,000 \times 70\%$ marginal rate). After the 1981 Act, the taxpayer would owe \$50,000 on this same amount of income ($\$100,000 \times 50\%$ marginal rate).

187. Subtracting the \$70,000 tax obligation from the \$100,000 income only leaves \$30,000 to spend, invest, or donate before the 1981 Act; however, it leaves \$50,000 afterward.

188. Some models include demographic factors, such as age, in addition to the price and income variables to identify other important influences and motivations for donative behavior. See CLOTFELTER, *supra* note 98, at 56. As after-tax income increases, the price effect decreases, and vice versa.

189. Some studies have shown that the decision to give is influenced by an individual's level of disposable income. See April, *supra* note 11, at 870 (citing Independent Sector's 1999 *Survey of Giving and Volunteering*). This premise is what drove the charitable donation deduction to be added to the Internal Revenue Code in the first place. See 55 Cong. Rec. 6728-29 (1917) (remarks of Sen. Henry F. Hollis) (people contribute from surplus left over after satisfaction of other needs and wants).

Because the ability to donate could more than offset the reduced incentive to donate, one might expect that taxpayer charitable behavior might be unchanged or even increase as it did after 1981.¹⁹⁰ But the complex relationship between these effects, other tax changes in 1986, and the impact of timing donations to maximize tax relief before the changes were implemented make simple observations and conclusions difficult.¹⁹¹

c. Post-1980s Rate Changes: Increases, Relief, and Sunsets

The 1986 Act reduced the progressivity of the Code in two major ways: reducing numerous monotonic (*stair step*) rates to a top tax rate of 28% for high-income taxpayers; and a 15% bracket for everyone else.¹⁹² Top rates crept back up in the 1990s to a higher rate of 39.6%.¹⁹³ As top rates inched their way back up, additional stair-step brackets were also created above the 28% rate to differentiate among higher-income taxpayers, reinstalling some of the progressivity that had existed before 1986. At the turn of the century, 31%, 36%, and 39.6% brackets had been introduced.

These top rates were later reduced beginning in 2001, and by 2003 stood at 25% (versus 28%), 28% (versus 31%), 33% (versus 36%), and the 35% top marginal rate (versus 39.6%).¹⁹⁴ These Bush-era tax cuts also created an additional 10% *initial* bracket—including the first \$7000 of taxable income for single taxpayers, \$10,000 for heads of household, and \$14,000 for married taxpayers filing jointly.¹⁹⁵

Although the 2001-2003 tax cuts included a sunset provision and would have expired at the end of 2010, they were extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.¹⁹⁶

D. How Giving Has Changed in Response to Tax Changes

“[A]lmost any change in the tax rate schedule . . . will tend to have an impact on giving.”¹⁹⁷ It is undisputed that direct consequences of a change in

190. One might assume if donations go up, the cash-flow phenomenon outweighs the discouragement from the reduced write off; whereas if donations drop, the deterrent effect of the reduced incentive more than offsets the increased ability to donate.

191. See CLOTFELTER, *supra* note 98, at 274. While income tax has a strong effect on giving, this is not the only effect. See *id.* Whether a taxpayer itemizes, taxes and interest, and other itemized deductions are also significant. See *id.* at 111.

192. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

193. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 9.

194. See I.R.C. § 1(i)(2) (2006); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 42.

195. I.R.C. § 1(i)(1). The amounts of the initial rate are adjusted for inflation. *Id.*

196. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-132, §§ 101-02, 124 Stat. 3296, 3298-99.

197. Clotfelter, *supra* note 24, at 6.

tax rates are twofold and include both *price* effects (looking at the after-tax cost of giving) and *income* effects (looking at the after-tax disposable income and its impact on ability to pay). What is controversial and unresolved is the relative strength of these competing effects. The salience of the change is another factor that will likely bear on the price effect, so this more recent dimension should also be considered in any tax-reform proposal.¹⁹⁸ To these three dimensions, the author proposes to add *economic hardship* as a critical consideration. As next discussed, the lessons of the Great Depression and the recent *Great Recession* convincingly demonstrate that harsh economic times reduce charitable giving and the magnitude of this effect can dwarf both price and income effects of any tax change.

1. *The Early Years: 1913-1940*

The only relevant changes in the early years were tax-rate changes, which fluctuated frequently and wildly, predominantly spiking due to WWI, the Great Depression, and WWII.¹⁹⁹ Unfortunately, there is not much data about overall giving during these turbulent times, and there appears to be no data stratified by donor income or tax rate.²⁰⁰ However, because only the wealthy generally paid taxes prior to the 1940s, the overall price and income effects of any tax changes likely applied to this top group.²⁰¹

Estimates of overall giving indicate that donations dropped during the Great Depression from over \$1 billion in 1929, to a low of \$637 million in 1933, but rebounded to just over \$1 billion again in 1940.²⁰² Although the price incentive for giving increased substantially in 1932—from 25% to 63%—donations continued to drop due to the bad economy and finally reached a low point in 1933.²⁰³ This demonstrates that the economy might be a more influential factor than the price effect.

In addition, when tax rates held constant from 1933 to 1935, overall giving improved annually as the economy improved, so tax incentives cannot account

198. A possible avenue of further study could be the development of a salience scale to rank various tax changes through history as one way to perhaps reconcile conflicting price elasticities and the empirical results of historic tax changes. For example, the mass media/education campaign may have elevated tax awareness and salience during WWII.

199. See *supra* Part II.C.3.a (explaining rate changes in early years).

200. See CLOTFELTER, *supra* note 98, at 16-18.

201. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 10 (noting top 2.1% paid 85.4% of income tax in 1925; top 2.6% paid 83.7% of income tax in 1935—compare with top 2.5% paying 39.3% after taxes expanded to masses in WWII).

202. See CLOTFELTER, *supra* note 98, at 17 (referencing statistics for estimates of individuals' contributions from 1929 to 1981). All dollars were in *current* dollars in 1984-1985 when Clotfelter wrote the book.

203. See *id.* (discussing diminishing donations); Avi-Yonah, *supra* note 172, at 1393 (discussing fluctuation of top marginal tax rate). Income effects due to the tax change itself would not have been felt until the 1932 rate increase, but donations dropped before that.

for this increase, but economic improvement could.²⁰⁴ Then, when tax rates increased again in 1936 (from 63% to 79% top marginal rate) donations increased for two years, dropped one year, then increased again to \$967 million.²⁰⁵ Increased salience and timing to take advantage of the higher rates could account for some of the increased donations in response to a 1935 tax hike that was notoriously called the soak-the-rich tax.²⁰⁶ But economic recovery could just as easily account for the increased donations because overall income increased in 1936 and 1937, dipped in 1938, and recovered in 1939, paralleling the overall giving trends.

2. The 1940s and the Standard Deduction

In 1942, tax liability was extended to the masses in the form of a 5% victory tax on income over \$624 and a reduction of the personal exemption to \$500.²⁰⁷ The changes were accompanied by a media campaign to reach the vast newcomers now subjected to the income tax.²⁰⁸ Unfortunately, the new taxes were confusing and difficult to collect, so withholding was instituted to enable taxpayers to comply without going through the “complicated” process of preparing and filing a return.²⁰⁹

The Individual Income Tax Act of 1944 was supposed to simplify the tax code by allowing a standard deduction instead of detailed itemization of deductions.²¹⁰ But, because charitable donation was an itemized deduction, taxpayers using the standard deduction were not able to enjoy any tax benefit from making charitable donations.²¹¹

Philanthropic organizations feared this would have an adverse impact on donations, but Congress believed simplification of the Code was more important.²¹² However, a precipitous drop in donations was unlikely for several reasons. Prior to WWII, most Americans were not subjected to the income tax, so the giving behavior of these lower-income individuals would not likely be impacted by the standard deduction. This is because their inclination to give was not previously motivated by tax considerations so the lack of a tax

204. See CLOTFELTER, *supra* note 98, at 17.

205. See *id.*

206. William Safire, *On Language: Isn't It Rich?*, N.Y. TIMES MAG., Nov. 11, 1990, <http://www.nytimes.com/1990/11/11/magazine/on-language-isn-t-it-rich.html>.

207. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 20 (noting increase to 27% of tax-paying population).

208. See *id.*

209. See *id.* at 21-22. In hindsight, it is almost laughable that the one and a half hours it took to comply on average was seen as so onerous. See *id.* at 22.

210. See Individual Income Tax Act of 1944, ch. 210, 58 Stat. 231 (codified as amended at 26 U.S.C. § 1 (2006)); NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 22.

211. The inability of those who do not itemize to benefit from donations has motivated some scholars to challenge the equity of this deduction.

212. See CLOTFELTER, *supra* note 98, at 32 (citations omitted); *Historical Perspectives*, *supra* note 155.

incentive due to the standard deduction should not have been of consequence. Avoiding the perceived complexity of itemization requirements may have resulted in middle-income donors just taking the standard deduction even if itemizing would have yielded lower taxes due to charitable donations.²¹³ Finally, much like modern times, those in the highest tax brackets and making the largest donations found it most beneficial to itemize, because sizeable tax incentives remained.

“Although the income tax now affected the masses, in 1945 the richest one percent of households paid 32 percent of the revenue.”²¹⁴ For this richest one percent, the requirement to itemize was nothing new. Undoubtedly, those already making charitable deductions in the bygone days when there was no standard deduction were familiar with and undeterred by the necessity of itemization. In addition, the value of the deduction at the highest marginal rate stood at 94%, making it inconceivable that a large, seasoned donor would choose the simpler route of the standard deduction over the more lucrative itemization route.²¹⁵

Estimates of overall giving suggest that introducing the standard deduction did not significantly affect donations.²¹⁶ As a percentage of personal income, the average rate of donation remained remarkably stable (in the roughly 1.6-1.7% range) from 1941 throughout the decade.²¹⁷ Because the national economy rebounded during and after WWII, however, charitable donations in terms of constant year dollars actually increased dramatically from \$1.5 to \$4.8 billion.²¹⁸ The ability of the wealthy to benefit from the deduction would have been substantial as their wealth increased and their marginal rates afforded a significant price incentive. Although price and income effects were somewhat offsetting, there was no economic hardship effect to stifle charitable donations.

3. Changes in the 1950s-1960s

With high tax rates as powerful incentives, the ability to donate appreciated property without paying taxes on the appreciation benefitted wealthy taxpayers. The option to donate charitable property in some cases without percentage of

213. See CLOTFELTER, *supra* note 98, at 32. The mass-media campaign promoting taxpaying and the underlying necessity of supporting the war effort likely made tax avoidance or minimization less important for this new group of taxpayers. However, it could still be expected to affect the top-end donors who depended on the deduction to enable them to have enough surplus income from which to make donations.

214. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 22.

215. In fact, any property that had appreciated more than 6% would be better off donated than liquidated because the tax relief would exceed the amount of gain.

216. See CLOTFELTER, *supra* note 98, at 17.

217. See *id.* (explaining steady rate of donation).

218. See *id.* at 17-18. Early estimates of overall contributions suggest a trend of increasing contributions from 1.24% of personal income in 1929 to 1.96% in 1970. *Id.* After 1944, because only itemizers were able to take deductions, it is impossible to say what happened with nonitemizers. *Id.* Giving USA data on overall donations did not begin until 1955. *Id.* at 17.

AGI limitations in the year of donation, and the ability to carry forward *excess* donations for up to five subsequent tax years, greatly benefitted some taxpayers, particularly wealthy ones. In regard to cash donations in 1960, for example, the highest marginal bracket of 91% meant that the donor only paid nine cents for every dollar the donor sent to charity and the other ninety-one cents was subsidized in the form of tax relief from the federal government. A donor in a state allowing a state tax deduction for charitable donations or basing its state income taxes on federal taxable income could easily make money by donating cash to charity. The donor could make considerably more money by donating appreciated property because each donation of property that had doubled in value (appreciation equal to basis in the property) netted the donor a refund of \$1.19 for every dollar of fair market value of the appreciated item.²¹⁹ This typically applied to stocks and bonds, but could also apply to real estate or personal property.²²⁰

The wealthiest individuals have a far higher income from capital gains than from wages or salary; therefore they could shelter all of their earned income with donations of appreciated assets. Some of these individuals actually avoided all tax liability in this fashion.²²¹ In 1966, the situation was especially dire with itemizers claiming \$79 billion in charitable donations (of \$130 billion in total itemized deductions) compared to \$112 billion of collective AGI.²²² Worried that high-income taxpayers were dodging their fair share of tax, Congress acted to stop the abuse in 1969. “Congress in 1969 attached some significant limitations to such deductions . . . [and] eliminated some abuses, [but] it actually left the larger part of the problem intact, since donors can still generally deduct gifts of appreciated property to public charities.”²²³

The ability to donate appreciated property and claim a tax deduction for 100% of the fair market value at the time the donor donated the property means the donor is never taxed on the appreciation of the asset, yet gets to claim a deduction not only for basis, but also for the appreciation. In the 1986 Act, Congress somewhat limited this advantage by treating the appreciation component as a “tax preference item” so that those affected by the Alternative Minimum Tax (AMT) (predominantly high-income taxpayers) would only be able to deduct their basis in the donated property.²²⁴ A large gift of appreciated property could give rise to AMT liability for a taxpayer that otherwise would have avoided the AMT.

219. See Auten et al., *supra* note 8, at 394-95 (discussing potential abuses).

220. See *id.*

221. See Lindsey, *supra* note 14, at 1064-65. For example, 154 taxpayers earning over \$200,000 and 21 earning over \$1 million paid no taxes in 1966. See *id.* at 1065.

222. See *id.* at 1080.

223. Auten et al., *supra* note 8, at 394-95.

224. See *id.* at 395.

4. Changes in the 1970s

In the 1970s, tax rates remained stable with a 70% top marginal rate and no changes to the scope of taxpayers' entitlement to deduct their charitable donations (category two changes).²²⁵ In addition, the only change to the AGI limitation on deductions (category one changes) occurred in 1978, when the unlimited charitable deduction was repealed. But the Tax Reform Act of 1969 had already capped the ability to deduct at 50% of AGI, so this was a formality that did not impact incentives or taxpayer behavior. As might be expected, there was no altered taxpayer behavior because there were no tax changes to motivate such behavior. Also, despite stagflation at the beginning of the decade, donations remained at a very consistent percentage of personal income, dropping almost imperceptibly from a high of 1.96% in 1970 to a low of 1.87% in 1979 and remaining consistent between 1.91-1.95% throughout the 1960s.²²⁶

While there were few tax changes and no perceived impacts due to tax changes in this era, the 1970s are important because the charitable donation deduction began to be seriously studied and the impacts of tax incentives in general and as related to the most wealthy donors started to become more differentiated.

In 1973, John D. Rockefeller, III, and the Chair of the House Ways and Means Committee formed an independent commission (Commission) to comprehensively study the tax treatment of philanthropy.²²⁷ The Commission published *Giving in America* in 1975 and subsequently published five volumes of research.²²⁸ Two of these studies, conducted by the University of Michigan's Institute for Social Research, Survey Research Center, were the first "full-scale national surveys of philanthropy" and were conducted in cooperation with the U.S. Treasury Department, the Office of Management and Budget, and the Census Bureau.²²⁹ The surveys confirmed the existence of mixed motivations for charitable giving with "tax reasons" (among other factors) identified as a "high priority" reason to increase or decrease giving.²³⁰ This characterization oversimplifies the findings, which are discussed next in more detail.

Few mentioned tax reasons when asked to explain changes in giving. However, empirical data showed that those who were able to take advantage of tax incentives by itemizing donations were much more likely to make

225. See NAT'L TAXPAYER ADVOCATE, *supra* note 106, at 8-9 tbl.2.

226. See CLOTFELTER, *supra* note 98, at 17-18.

227. See MORGAN ET AL., *supra* note 97, at preface.

228. See *id.*

229. See *id.* at 157-58.

230. See *id.* at 318. Other high-priority factors are: changed family income; changed family needs; family touched by benefits from a charitable organization; changed participation in an organization; organization changed or donor obtained new and better information about the organization; pressure at work or from the organization; inflation; and "[g]iven enough already." See *id.*

donations and give in larger amounts than those that did not itemize.²³¹ For those who ceased itemizing, their level of giving dropped to substantially less than itemizers with similar incomes and almost to levels of those who had never itemized.²³² The confluence of these factors suggests people may not be aware of how important tax incentives are to their own behavior, even when recognizing that taxes may significantly motivate their peers who are itemizers.²³³

This finding dovetails with the salience of the deduction and related concerns, particularly concerns about how to improve the incentive effect by making the deduction more salient.²³⁴ Intuitively, one would expect the incentive to be more visible to those who receive a higher reward for using it (taxpayers subject to the highest marginal rate). Those in that category would be expected to be more informed and better able to take advantage of the incentive's full value compared to those who do not use it (those who take the standard deduction or itemizers who do not give to charity for other reasons). The survey confirmed this perception. Roughly half of the highest 1% in terms of family income would give "a lot less" without the tax credit; the percentages of who would give "a lot less" drop to about 10-15% for those at the lowest income levels.²³⁵

Another corroborating statistical measure showed that those who "had run up against the minimum tax provision" (presumably the AMT) had a much lower average rate of giving than others with like income who did not face the AMT.²³⁶ This empirical data seems to reinforce the conclusion, based on actual giving patterns, that taxes play a large role in donor behavior, even when donors may not realize it.²³⁷

Another important finding is that high-income donors give a higher percentage of their income, as well as their time as volunteers.²³⁸ While higher

231. See MORGAN ET AL., *supra* note 97, at 158, 228-29.

232. See *id.* at 158, 229.

233. See *id.* at 228-29 & fig.13 (noting disparity of beliefs). Only 40% of those earning \$50,000—then the beginning of the top 1%—thought changes would reduce their own giving compared to over 60% of those earning \$50,000 who felt it would make others with like incomes donate much less. See *id.* at 229 fig.13. Survey data should always be construed cautiously, but between itemizers and nonitemizers, the differences in donor giving are based on government statistical information concerning actual behavior. See *id.* at 157 (discussing dangers of "iffy" questions).

234. See *supra* Part II.B.5.

235. See MORGAN ET AL., *supra* note 97, at 229 fig.13.

236. See *id.* at 229.

237. The AMT is hidden more than the ordinary income tax because it only applies to a subset of filers and requires complex reformulation of taxes owed. For this reason, it may not be salient for most taxpayers. This may in part explain why a deduction, thought by some to be hypersalient, may not appear to be salient to all of those surveyed, even when it is shown to be linked strongly to the incentivized behavior as a factual matter. See Faulhaber, *supra* note 135, at 1307 (defining salience). See generally Goldin & Listokin, *supra* note 144 (showing taxpayers misunderstand charitable deduction).

238. See MORGAN ET AL., *supra* note 97, at 159. Interestingly, the total value of all donations in cash and property was virtually the same as the total value of the hours donated to charitable causes. See *id.* at 160.

donation amounts may be anticipated as merely a byproduct of an increased ability to pay, the donation of service hours suggests nonfinancial factors are also significant.²³⁹ Looking only at the dollar value of gifts and not the amount of time volunteered, those in the top 1% of all households by income level gave, on average, 8% of their pretax income to charity. Contrast this generosity with the average of 2-4% of income donated by the lowest 96% of households by income.²⁴⁰ This phenomenon accounts for the heightened importance of top-end donors being responsible for a large percentage of overall giving.²⁴¹

The surveys also confirmed that lower-income itemizers and nonitemizers tend to give predominantly to religious or social-service organizations (such as the United Way), while high-end donors tend to give to a wider array of organizations including scientific, educational, and cultural organizations.²⁴² Therefore, threatening the deduction for high-income taxpayers would have a broad impact on the whole charitable sector.

The study estimated that the magnitude of eliminating deductibility across the board would be a reduction of 10-20% of total charitable donations.²⁴³ This estimate was made by reducing the donation rate of itemizers to the donation rate for nonitemizers.²⁴⁴ This percentage seems reasonable because donations are based on a broad range of motives in addition to tax incentives.²⁴⁵ Extrapolating to present-day giving, based on the most recent IRS statistics (reporting \$170.2 billion in itemized charitable deductions), the elimination of the deduction would lead to a reduction in giving of \$17-\$34 billion.²⁴⁶ The drop could be even more extreme considering that the survey data indicated 40% or more of high-income donors believed that they, or others like them, “would give a lot less” without the tax deduction.²⁴⁷

239. *See id.* at 318. The study identified that having more to give was another high-priority reason to increase giving. *See id.*

240. *See id.* at 161-62 tbls.1-2 & fig.1. Percentages are rounded and do not add to 100% to account for the steep rise between the majority of households and the highest-income households. *See id.*

241. Study organizers oversampled the top income groups because of the disproportionate importance of their contributions to the charitable sector. Otherwise, there might be a problem with statistical significance because of small numbers. *See id.* at 157, 161 fig.1.

242. *See* MORGAN ET AL., *supra* note 97, at 232.

243. *See id.* at 160, 232 (estimating itemizing would have \$3-\$5 billion impact on \$26 billion in total gifts). The survey authors postulated, based on observed distinctions between the itemizers and nonitemizers, that there was a strong correlation between tax incentives and giving that would be consistent with substantial price elasticity postulated by Martin Feldstein in a small 1973 study by the Treasury, Office of Tax Analysis. *See id.* at 158-59. Economists now recognize a smaller permanent price effect. *See* Auten et al., *supra* note 8, at 418.

244. *See* MORGAN ET AL., *supra* note 97, at 232.

245. *See supra* Part II.A.1. The lower side of the estimate may be more likely if the top donors' altruism (as indicated by service hours) is actually higher; in the alternative, without a tax advantage, donors may choose to give more of their time than money.

246. *See* SOI 2010, *supra* note 46, at 89 tbl.2.1. This figure is based on the most recent IRS statistics reporting \$170.2 billion in itemized charitable contribution deductions. *See id.*

247. *See* MORGAN ET AL., *supra* note 97, at 228-29 & fig.13.

Of course, the recent budget proposal only reduces the rate for deductions instead of eliminating it entirely, so the survey likely overstates the impact of the recent proposal. A more reasonable estimate of the impact could be obtained by multiplying 20% (the ratio of the proposed rate reduction to the present 35% rate) by \$25.5 billion (the midpoint of the earlier estimate of the \$17-\$34 billion from totally eliminating the deduction) to establish the lower end of the range at \$5.1 billion. The upper end is estimated in similar fashion, multiplying 29% (the ratio of the proposed rate reduction to the reinstated 39.6% rate) by the \$25.5 billion to yield \$7.4 billion.

Furthermore, at the time of the studies, improved public awareness of the value of the tax incentive was expected to enhance charitable donations, especially donations of appreciated property. There is a significant need for better knowledge of the tax advantages of charitable giving for all Americans.²⁴⁸ Presumably, such knowledge will translate to greater salience and more tax-motivated giving.

The public is likely becoming more educated as tax planning has become more sophisticated, the government has become more transparent, and computers and the Internet have accelerated taxpayer knowledge.²⁴⁹ For example, taxpayer behavior for high-income donors now demonstrates awareness of the tax value of donating appreciated assets.²⁵⁰ In addition, more recent surveys show that high-end donors are aware of the value of tax incentives and are concerned about losing the deduction.²⁵¹ Although numerous surveys have been conducted to evaluate tax incentives and how various changes may impact charitable donations, many surveys adopt the same approaches as these original landmark surveys—using IRS data to identify a pool of potential respondents, and oversampling the very wealthy. Some recent surveys either continue this trend or exclusively sample the wealthiest individuals.²⁵²

248. See Bill Bischoff, *The Tax Perks of Charitable Giving*, SMART MONEY (Feb. 4, 2013), <http://www.smartmoney.com/taxes/income/the-tax-perks-of-charitable-giving-11097/>.

249. *But see* Goldin & Listokin, *supra* note 144, at 8 (showing deductions have lower-than-expected impacts on decision-making). The lack of knowledge about tax credits is perhaps attributable to the everyday taxpayer's reliance on tax preparers or tax software that only prompts users for specific factual data. In contrast, high-end taxpayers with access to sophisticated tax professionals may give greater consideration to tax consequences when making decisions. See Patrick E. Tolan, Jr., *It's About Time: Registration and Regulation Will Boost Competence and Accountability of Paid Tax Preparers*, 31 VA. TAX REV. 471, 485 (2012) (explaining taxpayers' reliance on formerly uncertified tax preparers).

250. See GRAVELLE & MARPLES, *supra* note 41, at 5-6 (describing behavior of high-income donors outlined in studies from 1990s).

251. See STUDY OF HIGH NET WORTH PHILANTHROPY, *supra* note 51, at 10 (showing correlation between wealthy household charitable contributions and corresponding tax deduction).

252. *But see* Wilson Perkins Allen Op. Research, *January 2012 National Omnibus*, DUNHAM & CO. (Jan. 5-8, 2012), http://dunhamandcompany.com/wp-content/uploads/2012/02/DunhamAndCompany_Jan_2012_National_Omnibus_TaxDeductionsForCharitableContributions_WebDeck.pdf [hereinafter Wilson Perkins Allen Survey] (surveying 1000 random taxpayers to sample public/political consensus more broadly); Goldin &

5. Tax Reform in the 1980s

Charles Clotfelter, an economist and professor at Duke University's Institute of Policy Sciences and Public Affairs, wrote the book, *Federal Tax Policy and Charitable Giving*, as a monograph for the National Bureau of Economic Research in 1985.²⁵³ Tax policy was a hot-button issue in the wake of the tax cuts under the Economic Recovery Tax Act of 1981, and the comprehensive tax code reform then pending before Congress.²⁵⁴ Clotfelter's book comprehensively examined earlier research on the relationship between tax incentives and charitable giving and extended the field of applied econometric analysis.²⁵⁵ He concluded that federal tax policy has a substantial impact on charitable giving, but also observed that it is not possible (except under very special assumptions) to state a simple relationship between the efficiency of tax incentives to motivate giving and the price elasticity of giving.²⁵⁶

Clotfelter also provided unique insight about the nonprofit sector which "plays a more important role in the United States than in any other industrialized economy" where the government assumes the functions performed by nonprofits in the United States.²⁵⁷ Because of the enormity of the nonprofit sector (the vast majority of which is comprised of charitable organizations defined under 501(c)(3)), nonprofits also play a pivotal role in the job market by employing 10% of the labor force—double the number of federal government employees.²⁵⁸

Some writers have considered a magnitude of price elasticity greater than one as efficient, because the rise in contributions would exceed the revenue lost to the government. However, evaluating an elasticity of one as break-even is mistaken because it fails to account for comparative social benefits derived

Listokin, *supra* note 144, at 5-6 (oversampling in states with no income tax but otherwise mimicking general population).

253. See CLOTFELTER, *supra* note 98, at xii.

254. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 192 (codified as amended at I.R.C. § 1 (2006)); see CLOTFELTER, *supra* note 98, at xi. An average of one new tax bill was enacted every two years since 1976 and there was "mounting discussion of comprehensive tax reform." See *id.*

255. See CLOTFELTER, *supra* note 98, at xi (using four different data sets for analysis, including three new data sets never previously explored).

256. See *id.* at 288. At the time, the value of the standard deduction was being eroded due to inflation so more people were itemizing; however, after the 1986 Act, the standard deduction was significantly increased and indexed for inflation.

257. See *id.* at 1. Concurrently, the tax subsidies for charitable giving are unparalleled, such that "it seems by no means accidental that this special reliance on nonprofit institutions and these favorable tax provisions have developed side by side." *Id.* Professor Alyssa DiRusso notes that "[f]ew other countries share America's commitment to tax as the center of nonprofit law. In some countries, tax plays no role at all." Alyssa A. DiRusso, *American Nonprofit Law in Comparative Perspective*, 10 WASH. U. GLOB. STUD. L. REV. 39, 83 (2011).

258. See CLOTFELTER, *supra* note 98, at 2-3. *Nonprofits* include all organizations that do not pay taxes under § 501(c)(1)-(19), whereas *charitable* organizations are a subset under § 501(c)(3); 80-90% of all donations go to charitable organizations versus other nonprofit organizations, such as civic clubs. See *id.* at 1 (citing nonprofit employment statistics).

from private contributions or societal benefits of alternatives to government services.²⁵⁹

Clotfelter projected that overall giving would increase after the 1981 Act due to nonitemizers taking the newly created above-the-line deduction for charitable donations; however, the increase would be slight as tax rates dropped for those in the upper tax brackets.²⁶⁰ He also projected bequests would decrease due to the drops in the marginal rate for bequests and the number of taxable estates.²⁶¹ This drop in bequests could elevate lifetime giving as the comparative value of giving during life versus giving at death increased.

In a later work, Clotfelter examined both the predicted effects of the 1980s tax reforms as well as actual tax statistics for 1987 and 1988 tax years, after the later reform was fully implemented.²⁶² Clotfelter's goal was to compare, with the benefit of hindsight, the actual and apparent effects of the tax cuts with the predicted effects. He used IRS statistical data for itemizers to see how predicted declines in giving, resulting from changing amounts of giving (due to tax cuts), compared with the models of impact on giving using a price elasticity of -1.27 and an income elasticity of 0.78.²⁶³

Acknowledging that data limitations "plus the conceptual difficulties regarding non-tax effects . . . make it impossible to devise definitive tests of the efficacy of economic models of contributions."²⁶⁴ Clotfelter nevertheless made three principal observations. First, actual performance mimics the model.²⁶⁵ "Especially noteworthy are the actual and predicted declines in average giving for high-income taxpayers."²⁶⁶ Second, income groups facing the biggest price increases in 1981 tended to show relative declines in giving.²⁶⁷ For most income classes, however, contributions decreased by less than the model predicted.²⁶⁸ Lastly, the model predicted an overall drop in giving of 24% based on price effect and an income-effect gain of 2%, or a predicted decline of 20% compared to an actual decline of 10.5%.²⁶⁹

In response to the 1986 Act, amounts contributed by those in the top income class actually dropped by more than the model predicted.²⁷⁰ IRS statistics show that the amount of cash donations from itemizers increased while the amount of

259. *See id.* at 281. Values in diversity and pluralism and in promoting underprovided services are discussed in Part II.B.

260. *Id.* at 276.

261. *See id.* at 277.

262. *See* Clotfelter, *supra* note 24, at 2, 19.

263. *See id.* at 7, 20-21.

264. *Id.* at 18.

265. *See id.* at 21.

266. Clotfelter, *supra* note 24, at 21.

267. *See id.* at 27.

268. *See id.*

269. *See id.* at 22.

270. *See* Clotfelter, *supra* note 24, at 23.

donations of appreciated property spiked in 1986, then dropped precipitously.²⁷¹ Tax planning (timed to take advantage of the higher relief in 1986) may have contributed to higher than expected donations in 1986, and correspondingly lower donations in some subsequent years for donations that had been accelerated due to the pending code changes.²⁷² These timing considerations may have been even more critical to taxpayers facing AMT liability in light of the 1986 rule changes, limiting the deduction for appreciated property to the taxpayer's basis (cost of the item) when calculating AMT. Because AMT targets the wealthy, it is reasonable to assume the 1986 rule changes were more of a concern for top-income donors.

As an inflation-adjusted amount, overall donations actually rebounded to record levels following both tax changes in the 1980s; however, the percentage of contributions by the top quintile dropped simultaneously.²⁷³ "Relative to their incomes, these taxpayers gave less in 1987 than they did in 1980."²⁷⁴ This observation is consistent with the theory that price elasticity matters most for those with the highest marginal rates, and that salience of tax changes is highest for this financially astute group.

Econometric models are not perfect for a number of reasons, most notably for looking at the cost of giving (price factor) in isolation as a method of predicting the impact of tax-law changes while ignoring other factors motivating taxpayer giving behavior.²⁷⁵ Other researchers note that timing considerations to maximize short-term gain and overall after-tax income also significantly impact donor behavior.²⁷⁶ In addition, the effect of a recession in 1987 and 1988 may have impacted top donors by reducing their surplus from which to give.

Timing considerations make the effects of the 1987 recession less discernible because tax incentives to donate in 1986 instead of 1987 are consistent with declining donations, as are the lower price effects from the reduced tax rate. These effects were dissimilar to the depression-era changes where the economic effect was the opposite of the price effect, and 2007-2009, when the economic effect took place while taxes remained unchanged.²⁷⁷

271. See *id.* at tbl.5 (artworks donated, for example, dropped from 28,305 in 1985 to 17,035 in 1988); see also Bakija & Heim, *supra* note 60, at 618, 633 fig.3 (discussing large spike in giving in 1986 precipitated by looming changes in the 1986 Act and showing drop in millionaire donations from over 8% of income in 1986 to 4% in 1987).

272. See Clotfelter, *supra* note 24, at 27.

273. *Id.* at 24.

274. *Id.* at 25.

275. See *id.* at 13-15 (elaborating on limitations of econometric models).

276. See Bakija & Heim, *supra* note 60, at 636. "[E]stimates based on purely federal price variation are rather sensitive to how one controls for income and omitted time-varying influences that differ by income class." *Id.* at 638.

277. For the same reasons, even though the drop was most noteworthy for the wealthy, the reason is not obvious. The timing effects were equally important and most salient for this group, which had the most to gain

Because all three factors were in the same direction, the comparative magnitude of each is obscured, as is the cause-and-effect connection. The combination of a drop due to the price effect, economic drop in the market, and timing to move donations forward to the more beneficial tax year may all explain why these effects outweighed income effects at the top income levels and resulted in lower giving than predicted in the model.

6. *The 1990s to the Present*

The price of giving inversely corresponds to the top marginal tax rate for the wealthy. The overall drop in giving for these taxpayers in the 1980s was predicted by econometric models and was due, at least in part, to the price effect and the corresponding cost of giving increases. The cost of donating cash rose from thirty cents on the dollar before 1981 to seventy-two cents on the dollar after 1986.²⁷⁸ Similarly, the cost of donating appreciated property rose from twenty cents on the dollar to fifty-eight cents on the dollar during the same timeframe.²⁷⁹

As top tax rates began to creep up again in the 1990s, one would expect a renewed vigor in the price effect and its influence on donating by the wealthy; in fact, this did occur in the 1990s.²⁸⁰ In 1992, the top marginal tax-rate hike from 31% to 39.6% was well advertised, allowing potential donors to defer their donations for a greater tax advantage in 1993.²⁸¹ The average giving for this group fell from 6% in 1991 to 4.4% in 1992 and rose to 6.3% in 1993 and 1994.²⁸² Congressional suspension, and subsequent repeal, of the unfavorable AMT treatment of appreciated property during the 1990s restored public motive to donate appreciated property, effectively allowing taxpayers' cost of giving to drop to thirty-five cents on the dollar for noncash donations as compared with 60.4 cents on the dollar for cash donations.²⁸³ Predictably, noncash donations rose.²⁸⁴

Real AGI and real salaries and wages all rose throughout the 1990s in response to a rise in gross domestic product (GDP).²⁸⁵ Overall donations also

from timing and probably was best advised of the changes. The price effects were also important for this group because those in the 50% bracket had the most to lose from not accelerating donations, as well as the greatest drop in price incentive. The economic effects—lost wealth in the market—were also more significant for the wealthy than those with fewer assets.

278. See Clotfelter, *supra* note 24, at tbl.3.

279. See *id.*

280. See generally Auten et al., *supra* note 8.

281. See *id.* at 408.

282. See *id.* The wealthy are more likely to pay attention and to have the assistance of tax advisors. See *id.* at 401, 408.

283. See *id.* at 395-96, 403, 408. As might be expected, the wealthy tend to give more appreciated property. See *id.* at 403.

284. See Auten et al., *supra* note 8, at 403.

285. See Justin Bryan, I.R.S., *Individual Tax Returns, 2009*, 31 STATS. OF INCOME BULL., no. 2, 2011, at 15

rose annually, as adjusted for inflation, until 2001.²⁸⁶ In 2001, itemized donations dropped by 3.8% in constant year dollars, and donations from those earning over \$200,000 dropped by almost \$9 billion.²⁸⁷ The most likely reason for the drop was the 2001-2002 recession. The collapse of many Internet companies (the dot com crisis) started a two-year recession that was fueled, in part, by a 7.1% drop in the Dow Jones Industrial Average after September 11th, resulting in a decline in market worth (based on the Wilshire 5000) of 26.2% by October 2002.²⁸⁸ Real AGI, salaries, and wages also dropped, producing economic hardship.²⁸⁹

As tax rates dropped from 2001 to 2002, drops due to the price effect probably also played a role in top donors giving less in 2002 (dropping \$4 billion as overall donations almost held steady), but giving for top donors inched back to 2001 levels and rebounded to 2000 levels by 2004.²⁹⁰ Because the tax-rate changes of the 2000s were not as dramatic as those of the 1980s, and were introduced incrementally, they were probably less salient and led to less timing effects. Even though these effects were in the same general direction as those in the 1980s (lowering the price effect but increasing the tax-related income effects to donate), they were not as noticeable. For this reason, the impact of the economic hardship brought about later in the decade by the *Great Recession* masks any lingering price or income effects from the earlier rate relief.

III. DONATIONS DROP IN TIME OF SERIOUS RECESSION

Due to the recession in 2008, Giving USA reported “the largest drop [in charitable giving] since the group has been keeping track of America’s charitable donations.”²⁹¹ Total inflation-adjusted giving was down 5.7%.²⁹² To make matters worse, in the face of the lingering recession, donations continued to drop in 2009.²⁹³ “Real charitable contributions decreased by 8.3 percent for

fig.J [hereinafter SOI 2011], available at <http://www.irs.gov/pub/irs-soi/11fallbul.pdf>.

286. See *id.* at 18 fig.M.

287. See *id.* at 15 fig.J; see also *infra* Appendix 1.

288. See John Miley, *The Economy Before and After 9/11*, MSN MONEY, Sept. 7, 2011, <http://money.msn.com/investment-advice/article.aspx?post=7be1200a-e79a-4b35-a974-031570ce1a28>; Allan Roth, *Stocks—A Decade After 9/11*, CBS NEWS, Sept. 6, 2011, http://www.cbsnews.com/8301-505123_162-37744330/stocks--a-decade-after-911/.

289. See SOI 2011, *supra* note 285, at 15 fig.J.

290. See *infra* Appendix 1.

291. See *Estimated Giving*, *supra* note 9. “Individual giving, which is always the largest component of charitable contributions, was an estimated \$229.28 billion, or 75 percent of the total, in 2008. This is a decrease of 2.7 percent compared with 2007 estimates (-6.3 percent adjusted for inflation).” *Id.* Giving USA has been the cornerstone of philanthropic data for fifty-seven years; it is the “nation’s longest-running fact book on American philanthropy.” See GIVING USA 2011 REPORT, *supra* note 9, at 2.

292. *Estimated Giving*, *supra* note 9.

293. See GIVING USA 2011 REPORT, *supra* note 9, at 20 (noting inflation-adjusted giving increased every year since 1971 except for three years: 1987, 2008, and 2009).

2009.”²⁹⁴ The IRS noted a dramatic impact on itemizers, stating “it also marked the lowest amount deducted on individual returns since 1998.”²⁹⁵

Even more remarkable, the 2008 plunge was only the second drop since Giving USA started producing annual reports in 1956; the other drop was in 1987 after the tax reforms of 1986 and during another serious recession.²⁹⁶ As explained earlier, the devastating impact of the Great Depression on donations, which triggered a one-third drop in overall donations in the four-year period after the Depression began, was a clear indicator that a rapid loss of economic wealth could trigger devastating drops in donations. Such drops are a byproduct of both the loss of disposable income and the uncertainty concerning the future of the market. It is psychologically easier to part with your wealth when you not only have plenty, but have every reason to believe you will have as much or more wealth next year. If donors are to give from their surplus, they need a surplus *and* no reservations that the surplus will survive current economic hardship.

The *Great Recession* (2007-present) also hit all Americans hard by reducing overall national wealth. Like the stock market crash and run on the banks that precipitated the Great Depression, many who had investments and surplus wealth lost a considerable part of their fortune. While the impact on the poor and jobless is well-known, the wealthiest individuals in the country were also seriously affected.²⁹⁷ “Between 2007 and 2009, average income for the top 400 plunged more than 40 percent with more than 90 percent of the drop the result of lower capital gains.”²⁹⁸ Other millionaires’ average income dropped 18% over the same period, and the number of millionaires fell 40%.²⁹⁹

In addition, because there was a lower percentage of tax-preferred capital-gains income, the effective tax rate for the highest income tiers increased.³⁰⁰ Higher tax rates on lower overall income undoubtedly contributed to constricted disposable income for this most relevant donor group. Coupled with the loss of appreciated reserves, these factors crippled the funds available for donations. Considering the import of the top 3% to overall donations, it is no surprise that overall donations also fell during this period.

In fact, the overall donation drops during the recent recession could be explained purely in terms of reduced giving by the highest-income donors. Appendix 1 shows the changes in overall donations for donors above \$200,000 from 2001 to 2010. Record levels of overall giving in 2007 (roughly \$314

294. SOI 2011, *supra* note 285, at 19.

295. *Id.*

296. See GIVING USA 2011 REPORT, *supra* note 9, at 20-21.

297. See Williams, *supra* note 39, at 121.

298. *Id.*

299. See *id.*

300. See *id.* Effective tax rates jumped by one-fifth (from 16.6% to 19.9%) for the top 400 and by one-tenth (from 22.7% to 25%) for the others. See *id.*

billion) dropped by only \$7 billion in 2008,³⁰¹ while the total deductible donations of those earning over \$200,000 dropped by \$17.7 billion.³⁰² In 2009, the overall donations dropped by \$3 billion,³⁰³ while deductible donations of those over \$200,000 dropped by \$13.6 billion.³⁰⁴

Serious recessions not only impact individual donors, but also have an even greater effect on the charitable community and those they serve.³⁰⁵ Any drop in giving forces nonprofits to try to make ends meet with fewer resources.³⁰⁶ The situation was exacerbated by heightened demand due to the *Great Recession*.

Compared with 2007, 54 percent of human services charities saw an increase in need for their services in 2008 For 2009, 60 percent of the surveyed human services organizations were cutting expenses, including cutting services or staff, due to funding shortages. . . . Among organizations working to meet people's basic needs (food, shelter, clothing, etc.), more than half (53 percent) said they are underfunded or severely underfunded for 2009.³⁰⁷

Considering the escalating need for services, this sector was squeezed from both sides, meeting heightened demand with fewer resources. In some localities, circumstances are especially dire. Even though 2009 and 2010 showed some early signs of economic recovery, charitable donations to the Community Foundation of Central Florida in this period dropped from \$5.9 million to \$2.5 million.³⁰⁸ Giving was down 11% and grant funding slipped 15%.³⁰⁹

301. See Paula Wasley, *Charitable Donations Fell by Nearly 6% in 2008, the Sharpest Drop in 53 Years*, CHRON. OF PHILANTHROPY, June 10, 2009, <http://philanthropy.com/article/Charitable-Donations-Fell-by/63106/>.

302. Compare Table 3: Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2008, I.R.S., http://www.irs.gov/file_source/pub/irs-soi/08in03id.xls (last visited Mar. 25, 2013), with Table 3: Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2007, I.R.S., http://www.irs.gov/file_source/pub/irs-soi/07in03id.xls (last visited Mar. 25, 2013); see also *infra* Appendix 1 (summarizing high-income taxpayer donation statistics from 2000-2010).

303. See GIVING USA 2011 REPORT, *supra* note 9, at 20.

304. Compare Table 3. Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2009, I.R.S., http://www.irs.gov/file_source/pub/irs-soi/09in03id.xls (last visited Mar. 25, 2013), with Table 3. Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2008, I.R.S., http://www.irs.gov/file_source/pub/irs-soi/08in03id.xls (last visited Mar. 25, 2013).

305. See *supra* note 304 and accompanying text. The 0.9% increase in giving from 2010 to 2011 is described by giving USA as "flat" and other flat years typically occur in recessions. See GIVING USA 2011 REPORT, *supra* note 9, at 20. "[Charitable] giving tends to decline during recessions, after adjusting for inflation." STUDY OF HIGH NET WORTH PHILANTHROPY, *supra* note 51, at 5.

306. See *Estimated Giving*, *supra* note 9.

307. *Id.*

308. See 2010 I.R.S. Form 990 for Cmty. Found. of Cent. Fla., Inc., at 1 (2010) (on file with author).

309. See *The New State of Philanthropy: Missing Pieces of a New Economy*, UNIV. CENT. FLA. CTR. FOR PUB. & NONPROFIT MGMT., at 2, <http://www2.cohpa.ucf.edu/cpnm/documents/SCCFP%20New%20State>

Nationwide, the slow economic recovery has turned the tide on diminishing donations as rates of giving are again on the rise, albeit at a snail's pace. For the past two years, overall gifts have risen 3% and 4% respectively, but only 0.8% and 0.9% in real terms (after accounting for inflation).³¹⁰ In fact, total charitable gifts of \$298.42 billion in 2011 are still down from the \$307 billion reflected in the 2008 Giving USA Report and are well below the \$314 billion high-water mark in 2007.³¹¹

One additional disturbing data point from the most recent Giving USA results is that the total number of 501(c)(3)-exempt organizations also dropped substantially in 2011—down to 1.08 million from 1.28 million a year earlier.³¹² The report characterizes this reduction as a byproduct of a 2006 rule requiring such organizations, regardless of size, to file informational tax returns or lose their tax-exempt status and the resultant loss of such nonprofit status for those who failed to comply for three years.³¹³ The Giving USA report characterized the 200,000 organizations that lost their charitable status as “small and defunct.”³¹⁴ Nevertheless, loss of nonprofits, especially small nonprofits, would also be consistent with organizations at the margin going under in the face of increased demands, while suffering from fewer donations.

IV. ANALYSIS AND RECOMMENDATIONS

“The United States has the most robust charitable sector in the world, and one of the main reasons is our unique system of tax incentives for those who give so generously The social good the deduction generates far outweighs the money it costs. And things like education of our youth, healthcare, help for the needy, and funding for the arts can't be measured on a balance sheet”³¹⁵

The historical concerns that prompted the initial charitable deduction and the several justifications analyzed above support special treatment of the deduction because the fruits of the donation accrue not only to the donor, but even more to society in general. Because the deduction for charitable giving is different in

%20of%20Philanthropy.pdf (last visited Mar. 12, 2013).

310. See GIVING USA 2011 REPORT, *supra* note 9, at 1-2.

311. Compare *id.* (estimating charitable giving in 2011), with Katherine Shaver, *Charitable Donations Fell in 2008, Report Finds*, WASH. POST, June 10, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/09/AR2009060903233.html> (providing 2008 data).

312. See GIVING USA 2011 REPORT, *supra* note 9, at 22.

313. See *id.*

314. See *id.*

315. *Three-Fourths of Americans Favor Charitable Tax Deduction: Survey Indicates Any Changes to System Would Face Strong Opposition*, DUNHAM & CO. (Feb. 7, 2012), <http://dunhamandcompany.com/2012/02/three-fourths-of-americans-favor-charitable-tax-deduction/> [hereinafter DUNHAM & CO.] (quoting Rick Dunham, President and CEO of Dunham & Co.).

this way from other personal deductions, Congress should not simply lump it in with all itemized deductions and treat it as if all the deductions are homogeneous. For this reason alone, the 2013 budget approach should not be adopted; at a minimum, the charitable deduction should be carved out of the overall proposed 28% rate limitation for special consideration and treatment.

As explained below, reasonable minds could differ about whether this particular deduction should ever be changed at all and, if so, how best to change it. However, as a priority matter, it should not be changed now. Because this consideration is more urgent, it is addressed first.

A. *The Charitable Deduction Should Not Be Reduced Now*

“Social and Human Services are more than a safety net, and are typically used by more than 60% of citizens.”³¹⁶ In the past few years, many citizens who have never before been in economic trouble have turned to charity.³¹⁷ At the same time, reduced overall wealth has eroded the assets available for the wealthy to donate; this phenomenon tends to restrict consumption. To use Hollis’s terms, “the surplus” from which to donate has already been drained. Further reductions of wealth through tax hikes will reduce this consumption even more, and reduced tax incentives to give further threaten generosity.

The nickname *Great Recession* harkens back to a time of unprecedented national financial struggles and poverty, the likes of which this nation had never seen. By all accounts, both the severity and duration of the present economic hardship has not been seen since the 1930s, yet it could get worse before it gets better. In August 2012, the Congressional Budget Office (CBO) predicted looming fiscal changes will result in recession in 2013 characterized by “negative GDP growth . . . with the economy contracting by -0.5 percent.”³¹⁸ That forecast was “scarier” than earlier projections in January and May 2012 and envisioned unemployment rising to 9.1%.³¹⁹ The most recent CBO report notes unemployment is expected to remain above 7.5% for 2013 and 2014 while unprecedented federal debt and fiscal uncertainty stifle economic improvement.³²⁰

Just the prospect of another recession or economic slowdown could prompt

316. See *Getting Connected: Engage, Invest, and Know Your Community*, CMTY. FOUND. OF CENT. FLA., http://cmfmedia.org/web/wp-content/uploads/2011/11/Brewer_slide_pres.pdf (last visited Mar. 12, 2013).

317. See Shaver, *supra* note 311. “[D]ouble the number of people [sought] free lunches and assistance with utility bills from Bethesda Cares.” *Id.*

318. Danielle Kurtzleben, *CBO: Fiscal Cliff Effects Now Look Worse*, U.S. NEWS, Aug. 22, 2012, <http://www.usnews.com/news/articles/2012/08/22/cbo-fiscal-cliff-effects-now-look-worse> (“Updated projections show a contracting economy in 2013, with unemployment moving above 9 percent.”); see CONG. BUDGET OFFICE, PUB. NO. 4577, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022, at III (2012) [hereinafter CBO UPDATE]. “[F]iscal tightening will lead to economic conditions in 2013 that will probably be considered a recession” CBO UPDATE, *supra*.

319. See CBO UPDATE, *supra* note 318.

320. See BUDGET AND ECONOMIC OUTLOOK, *supra* note 10, at 1.

wealthy donors to hold, rather than give, their assets or dollars to charity.³²¹ This economic uncertainty was not helped by gridlock in Congress and election-year politics, nor the later sequester and reductions in federal spending, which continue to threaten economic recovery.³²²

Gloom and doom terms like *fiscal cliff* and *taxmageddon* have likely made the issue of tax reform more salient because the strong negative language fosters cautious behavior.³²³ Donor fears that the market will deteriorate or will be slow to recover could easily stifle giving. Looking strictly at the strong psychological desire for self-preservation (and, correspondingly, wealth preservation), one would expect donors not to give their money away when economic prospects are still bleak because this could compromise their standard of living in the future. In other words, donors will probably look at their long-term and short-term interests when making donations, and their outlook and pocketbook will likely shape donors' behavior.³²⁴

As charitable organizations struggle to meet increasing demands, this is not the time to threaten their cash flow. Tax incentives are necessary to keep donations flowing. Limiting itemized deductions "would reduce the incentive for people to give at a time when Congress should be considering ways to increase charitable donations rather than decrease them."³²⁵

Nonprofit organizations need stable and predictable sources of income.³²⁶ However, the reality of nonprofit organizations is that they are highly dependent on gifts from donors, which are inherently unpredictable. Recent studies have evaluated consumption as a better indicator than income of donor effects.³²⁷ This is logical because only funds available for consumption are available for charitable donation. Economic hardship limits consumption in the same way tax hikes limit consumption, by reducing the surplus from which

321. *See id.*

322. *See generally id.*

323. *See* Lori Montgomery, *CBO: Taxmageddon Would Throw U.S. Back into Recession*, WASH. POST, May 22, 2012, http://articles.washingtonpost.com/2012-05-22/business/35454665_1_tax-cuts-payroll-tax-tax-hikes. "Anxiety is growing over how the impact of those tax and spending cuts would affect the nation's economic recovery come January, when what's been nicknamed 'taxmageddon' hits." *Id.*

324. This theory is consistent with the practice of timing to exploit short-term advantage (looking at consequences over several tax years) and the disparity between lifetime giving and bequests that cannot be explained by price incentives (donors underfund lifetime gifts and overfund gifts at death because, in the author's opinion, people do not know when they will die and want to make sure they do not outlast their wealth).

325. Bernie Becker, *Tax Break For Charitable Giving Targeted*, ON THE MONEY (Mar. 27, 2011, 7:15 AM), <http://thehill.com/blogs/on-the-money/domestic-taxes/152027-tax-break-for-charitable-giving-targeted-for-elimination> (quoting Neal Denton, Senior Vice President for the American Red Cross); *see also* Grace Soyoon Lee, *Mitigating the Effects of an Economic Downturn on Charitable Contributions: Facing the Problem and Contemplating Solutions*, 22 CORNELL J.L. & PUB. POL'Y (forthcoming May 2013) (suggesting, among other things, credit for all taxpayers, not just itemizers).

326. *See Nonprofit Resources*, CMTY. FOUND. OF CENT. FLA., <http://www.mycfcf.org/page16677.cfm> (last visited Mar. 12, 2013).

327. *See generally* Bakija & Heim, *supra* note 60.

taxpayers can make charitable donations.

Because disposable income drops with tax increases, the President's proposed rate increase will have an adverse effect on donations. The tax hike will also reduce disposable income due to the inability of taxpayers to take charitable deductions at the highest marginal rate. Both features of the proposal will therefore dampen charitable giving by the top-income Americans. In a sputtering and uncertain economy, such as we have now, preserving tax incentives could be vitally important because the economic effects will be negligible in a flat economy, and continued market uncertainty could motivate more cautious donor behavior.³²⁸

B. Severity of Proposed Tax Reform

With high demand and reduced donations, the charitable sector now faces a perfect storm if the federal government limits or removes incentives and reduces (through higher taxes) the ability of the wealthy to donate. Looking to the specific proposals in the 2013 budget, there are two relevant features: an increase to the 39.6% marginal rate and a 28% cap on all deductions.³²⁹

These proposals differ from all past tax changes as they couple a tax hike for the wealthy with a 28% limit on charitable donation deductions, causing a negative price effect (dropping the incentive to 28%) while simultaneously reducing after-tax income. In other words, rates go up while the deduction goes down, resulting in both an adverse price effect and an adverse income effect.³³⁰ This is contrary to the typical situation where these effects would be offsetting, as occurred with the tax-rate changes of the 1980s.

To gauge the impact of the income effect—reduced after-tax income—compare the July 2012 Joint Committee on Taxation estimates for the cost of extensions of the existing tax cuts for all taxpayers through 2014 (roughly \$300 billion) with the cost of the Middle Class Tax Cut Act, which would only extend the cuts to individuals earning under \$200,000 or married couples earning \$250,000 (roughly \$273 billion).³³¹ The \$27 billion difference (\$300 billion-\$273 billion) reflects the costs saved by not extending tax relief to

328. While charitable giving should slowly rebound as the economy recovers, charitable giving "still [has] a long way to go" to recover from the biggest recession in over 50 years. CTR. ON PHILANTHROPY AT IND. UNIV., *GIVING USA 2011: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2010*, at ii (2011), available at http://big.assets.huffingtonpost.com/GivingUSA_2011_ExecSummary_Print-1.pdf.

329. See 2013 BUDGET PROPOSAL, *supra* note 6, at 70, 73-74.

330. Higher rates for those with AGIs between \$200,000 and \$400,00 would suffer this income effect, whereas the effect is already likely in tax year 2013 for those earning over \$400,000 due to the American Taxpayer Relief Act of 2012. See American Taxpayer Relief Act of 2012, Pub. L. 112-240, 126 Stat. 2313 (2013).

331. Compare Memorandum from Thomas A. Barthold, Chief of Staff, Joint Comm. on Taxation, Revenue Estimate on Hatch Amendment to S.2237 tbl.12-2 116 (July 18, 2012), with Joint Comm. on Taxation, *Estimated Revenue Effects of the "Middle Class Tax Cut Act,"* tbl.12-2 112 R1 (July 18, 2012) (on file with author).

the high-income taxpayers addressed in the 2013 budget proposal. This means high-end taxpayers would see a tax hike of \$27 billion over two years.

Calculating the tax-related change due to the 28% rate limit for deductions is much more complicated and controversial. Because the charitable sector depends on donations, it has a vested interest in studying the effects of tax changes in order to evaluate potential repercussions. While self interest might motivate this sector to inflate projections, the members of this sector are also in a unique position to collect data about actual consequences in response to tax-law changes.³³² Therefore, it is no surprise that nonprofits have invested considerable time and attention in this regard, estimating the total drop in donations from the 28% cap on deductions to be between \$4 billion and \$7 billion annually.³³³

A 2010 survey of 800 wealthy households indicated that eliminating the charitable donation would undermine their giving.³³⁴ Sixty-seven percent of wealthy households “would somewhat or dramatically” reduce charitable contributions if there was no income tax deduction; this number is up from 47% according to a 2008 study.³³⁵ This study did not specifically focus on what should be lesser impacts from reducing versus eliminating the tax benefit altogether. However, it corroborates the conclusions of earlier econometric studies and the empirical data showing “existence of taxes and the associated deduction induce people to give more than they would have otherwise,” and that even though permanent price elasticity may be smaller than it was first perceived, “it is substantial nonetheless.”³³⁶

An October 2011 Center on Philanthropy study looked specifically at the projected consequences of the President’s proposed cap on itemized deductions for high earners at 28% and concluded that charitable giving could drop by \$2.43 billion.³³⁷ A 2010 Congressional Research Service study of President Obama’s earlier proposal to cap deductions at 28% reached consistent results.³³⁸

332. Clotfelter characterizes the charitable sector’s challenges to the 1980s reforms as “some of the gloomiest predictions” and notes that doubters accused the sector of “crying wolf.” See Clotfelter, *supra* note 24, at 2.

333. See Alliance for Charitable Reform, *Fly In/Speak Out: Preserve Charitable Giving*, [http://acreform.com/images/uploads/ACR_Lobby_Day_Hill_Packet_\(for_download\).pdf](http://acreform.com/images/uploads/ACR_Lobby_Day_Hill_Packet_(for_download).pdf) (last visited Mar. 12, 2013); DUNHAM & CO., *supra* note 315.

334. See STUDY OF HIGH NET WORTH PHILANTHROPY, *supra* note 51, at 10.

335. See *id.*

336. Auten et al., *supra* note 8, at 418.

337. See CAMPBELL & CO. 2011 STUDY, *supra* note 51, at 5 (basing number on 28% limit and assumption rates will rise to 39% following EGTRRA expiration).

338. See GRAVELLE & MARPLES, *supra* note 41, at Summary (showing drop in giving of 1-1.5%). This equates to a reduction of \$3-\$4.5 billion based on overall giving of \$300 billion or \$1.5-\$2.25 billion based on a drop in only itemized deductions. One thing to be wary of, however, is the timing effect—if any change is perceived as temporary then the effects may be amplified. For example, a wealthy donor may donate before the unfavorable change or hold on to appreciated property later in the hopes of a more favorable tax change.

Any multibillion-dollar drop in charitable donations would have a notable impact. To put these numbers in perspective, the combined annual operating budgets of the American Cancer Society, the American Heart Association, Habitat for Humanity, St. Jude's Children's Research Hospital, and World Vision total under \$4 billion.³³⁹ The top 200 charitable organizations *combined* received only about \$41 billion in donations in 2011.³⁴⁰

Due to the substitution effect, carving the charitable contribution deduction from the 28% rate cap, but allowing it to apply to all other itemized deductions and tax-preferred items proposed in the President's 2013 budget, would actually be an advantage for charitable donations. To the extent other deductions are limited to 28%, but charitable deductions are allowed to be deductible at the higher marginal rates, those charitable donations would be favored by the higher relative subsidies. As a result, donors could be motivated to shift to increase charitable donations while sacrificing rate-limited deductions (such as tax-exempt bonds or contributions to a 401(k)). Because higher marginal rates will reduce the disposable income of the wealthiest donors, positive price effect will offset the reduced income from the after-tax consequences of the higher rate. In other words, without the 28% limit on charitable donations, these donors will still have less disposable income, but their tax incentive to give to charity will be higher as tax rates on the wealthy increase.

Under the President's budget, however, both the price effect and the income effect will hamper donations. Compared to the 2012 tax laws, the highest-income donors already face a heightened tax burden due to the reinstatement of the 39.6% bracket; if the subsidy for donations drops to 28% (from 35%) the price effect would also be negative.³⁴¹ The combination of higher rates and lower deductions will undermine charitable giving by the affected donors. It may do so in a nonlinear fashion, as wealthy donors and their tax planners may search for tax shelters or other tax-advantaged possibilities to improve after-tax income.

The critical distinctions between the present proposals and past reforms serve as the major point of debarkation from the conclusions otherwise suggested by the 1980s results. In addition, the weak economy has already burdened the charitable sector, potentially amplifying the consequences of cash-flow problems that might stem from tax reform.

See id. at 10. The Center on Philanthropy Study did not consider confounding short-term effects in its analysis. *See* CAMPBELL & CO. 2011 STUDY, *supra* note 51, at 8.

339. *See* Alliance for Charitable Reform, *supra* note 333.

340. William P. Barrett, *The 200 Largest U.S. Charities for 2011*, FORBES, Nov. 30, 2011, <http://www.forbes.com/sites/williambarrett/2011/11/30/the-200-largest-u-s-charities-for-2011/>.

341. *See* American Taxpayer Relief Act of 2012, Pub. L. 112-240, § 101(b)(1)(A), 126 Stat. 2313 (2013).

C. The Need for Continued Study

“[M]ost Americans (73 percent) believe that private nonprofits are better at promoting social good than the government.”³⁴² One likely explanation is that the government is widely perceived to be an inefficient bureaucracy.³⁴³ Perhaps this is because Americans better trust the private nonprofit sector to carry out the predominant social-services role; or perhaps because limitations on individual and community support move further away from the Framers’ careful restraint on the role of federal government. Another explanation would likely include the preference Americans enjoy in terms of the freedom to donate to organizations they favor, as opposed to entrusting that important decision to the government.

In terms of socioeconomic theory, the ability to protect minority interests from intransience of the majority is another explanation.³⁴⁴ Economic theorist Burton Weisbrod proposed that the voluntary (not-for-profit) sector forms one leg of a three-sector economy together with the private sector and the public sector (government). Weisbrod explains that the voluntary sector provides services such as aid to the poor and assistance for health, education, and welfare that would typically be public services, but that are underserved by the government because it imperfectly reflects our heterogeneous society.³⁴⁵ Constraints on government create a situation tantamount to *market failure* for promoting collective goods because government policy imperfectly represents the will of the people—exceeding what some voters demand while disappointing others.³⁴⁶ This dispersion of preferences results in a political process where many are disappointed with government output and taxation levels.³⁴⁷ Voluntary charitable donations allow Americans to support their preferences while tax relief reduces the burden on private donations, allowing the charitable sector to complement the collective services afforded by the government. This may be a significant reason why 73% of Americans favor retaining the charitable deduction in its present form.³⁴⁸

Another explanation for the preference of nonprofit versus federal charitable support is that many charitable organizations are community based, whereas a

342. DUNHAM & CO., *supra* note 315. The Dunham study was based on interviews of 1000 adults and has a margin of error of minus 3.1% at the 95% confidence level. *See id.*; Wilson Perkins Allen Survey, *supra* note 252.

343. *See* Jeffrey M. Jones, *Americans Say Federal Gov’t Wastes Over Half of Every Dollar*, GALLUP POL., Sept. 19, 2011, <http://www.gallup.com/poll/149543/americans-say-federal-gov-wastes-half-every-dollar.aspx> (“Americans have become increasingly likely to see all levels of government as being wasteful of tax dollars.”).

344. *See* Andrews, *supra* note 62, at 369-70; Gergen, *supra* note 74, at 1409.

345. *See* Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 171 (Edmund S. Phelps ed., 1975).

346. *See id.* at 172, 175.

347. *See id.* at 175.

348. *See* DUNHAM & CO., *supra* note 315.

federal program is more likely to be detached and impersonal.³⁴⁹ Although governmental grants to local charities largely help alleviate this concern, without strong community-based organizations in place to implement the grants at a local level, the government would have to take on this administrative burden.³⁵⁰

Our most recent economic struggles again bring the controversy between the government and private safety nets for the poor to center stage, as unprecedented numbers of Americans suffer financially. The President's proposal would continue to implicitly shift the safety net toward the government, if not explicitly, by reducing incentives for private charitable donations. If a minimum safety net is a zero-sum game, the government will end up filling the gap for any reduction in private support (and there is no guarantee this could be done as capably, effectively, or efficiently as the private charitable sector).³⁵¹ For the reasons explained above, this is not the time for such a shift, and there may never be a time for it. Although some may support these moves for any number of reasons, based on recent survey results, Americans at heart still prefer full deductibility of donations to charity.³⁵²

At bottom, the preference for a government safety net compared to a private safety net depends on political and philosophical preferences for or against big government. Therefore, competing arguments defending or rejecting the proposal may matter less than an individual's proclivities and sense of values.³⁵³ Because these competing values underpin this discussion, consensus is likely difficult and may be impossible. However, in the meantime, it is sensible to seek a deeper understanding of these competing philosophies and values and examine potential opportunities for compromise.

While America waits for the economy to rebound to the point where

349. See Galle, *supra* note 122, at 782; JULIAN WOLPERT, WHAT CHARITY CAN AND CANNOT DO 8 (1996) ("Private, nonprofit agencies are the major frontline social service providers in their communities.")

350. See WOLPERT, *supra* note 349, at 9 (noting 37% of funding for charitable nonprofits in mid-1990s came from such grants). Wolpert notes that federal spending cuts proposed as part of the *Contract with America* would cut affected federal funding for 108 diverse charitable organizations by 25%, leading to higher charges for services, reduced staffing, and an increased competitive scramble for donations to make up the gap. *See id.* at 12-13. Wolpert concludes that charitable organizations are junior partners with government that depend on help from Washington to serve the neediest Americans, and that without such assistance, the organizations' ability to help America's poorest will be compromised. *See id.*

351. See Nina J. Crimm, *Core Societal Values Deserve Federal Aid: Schools, Tax Credits, and the Establishment Cause*, 34 GA. L. REV. 1, 8 n.8 (1999). Conventional combined market and social theory believes charitable organizations relieve the government of burdens the government otherwise would be responsible for undertaking. *See id.* (citing H.R. Rep. No. 75-1860, at 19 (1938)).

352. See Alliance for Charitable Reform, *New Study Shows Charitable Deduction Impacts Giving*, TAX ANALYSTS (Feb. 7, 2012) (on file with author). Decentralization has regressive effects and some communities are far more successful in their charitable efforts than others, resulting in holes in the safety net for the most vulnerable in less sympathetic or supportive communities. *See WOLPERT, supra* note 21, at ix.

353. Advocates in favor of the proposal note the heightened tax revenue that will be generated would be available to either sponsor government programs or buy down the national debt; those opposed protest the loss of autonomy and donor support.

charitable donations are restored to 2007 levels, further study and debate should ensue about how to modify or eliminate inefficient rewards for donations of appreciated property while continuing to foster high levels of donations from the wealthy. Any decisions shaping reform of this deduction should be based on sound tax policy rather than personal ideas of fairness. In part, this will require appropriate salient treatment of any changes to the code so incentives are fully understood and the tax motivation of the charitable donation deduction reaches its full potential.

V. CONCLUSION

This is a bad time for the government to do anything that might undermine charitable donations. More people live in poverty now than at any other point in the past fifty years, the wealthy have less disposable income to give to charity, and many organizations are already struggling because donations are down. We need to encourage the wealthy to continue to give to charity, even though the proposed changes to the law would lead to just the opposite result. Undermining the tax incentives now could be the straw that breaks the camel's back.

To make matters worse, recent Congressional Budget Office studies report another recession may be looming if uncertainty in federal fiscal policy causes investors to lose confidence.³⁵⁴ The risk to the charitable sector is great because empirical data convincingly demonstrates the adverse impact of a down economy on donations from high-wealth donors. The traditionally largest donors are already facing higher taxes. If they are simultaneously afforded less tax benefit from their charitable donations, the flow of donations to charitable organizations will drop instead of recovering at a time when the charities need the money most. The sputtering nature of our present recovery and the uncertainty of our economic future will lead donors, without sufficient surplus or inducement, to hold onto their assets instead of donating them to a worthy cause. Even if some portion of the deduction is inefficient, as a practical matter it should be preserved for now to keep the nonprofit sector afloat in these troubling times.

During recovery from a down economy, paradoxically it will be jobs and economic growth that can push donors back into a positive mindset and a positive financial position to increase donations to prerecession levels. In the meantime, tax incentives are necessary to keep donations from dropping even further. As charitable organizations struggle to do more with less, the sector risks potential job losses, charities folding, and the prospect of increasing unmet social needs.

354. See BUDGET AND ECONOMIC OUTLOOK, *supra* note 10, at 1.

APPENDIX 1

Comparison of Donations by Itemizing Taxpayers from 2000-2010
 Showing Contribution Amounts and Percentages
 for Donors with Incomes over \$200,000

Year	Total Amount of Donations by All Itemizers*	Total Donations by Itemizers with Income over \$200,000*	Percent of Donations by Itemizers with Income over \$200,000
2000	140,681,631	55,421,387	39.39%
2001	139,241,476	46,896,063	33.68%
2002	140,571,365	42,360,302	30.13%
2003	145,702,137	47,741,469	32.77%
2004	165,564,388	60,714,733	36.67%
2005	183,390,686	76,123,864	41.51%
2006	186,646,644	81,649,167	43.75%
2007	193,603,968	90,511,607	46.75%
2008	172,936,002	72,826,976	42.11%
2009	158,016,526	59,111,650	37.41%
2010	170,235,681	69,072,447	40.57%

*Money amounts are in thousands of dollars