

Renegotiating the Charitable Deduction

by Alexander Reid



Alexander Reid

Alexander Reid is of counsel in Morgan Lewis's Tax Practice. Mr. Reid advises tax-exempt organizations of all varieties, including charities, foundations, colleges and universities, museums, and other nonprofit organizations. He assists clients in structuring philanthropic enterprises and collaborations with commercial entities to accomplish charitable objectives. He represents taxpayers under audit and helps organizations improve

governance and enhance tax compliance. Mr. Reid also counsels taxpayers seeking administrative guidance from the Internal Revenue Service and Treasury Department as well as on legislative matters with the U.S. Congress.

Prior to joining Morgan Lewis, Mr. Reid served as legislative counsel for the Joint Committee on Taxation, where he advised members of Congress and staff regarding tax policy and drafted legislation, hearing publications, and technical explanations of tax legislation. He has also served at the U.S. Department of the Treasury, Office of Tax Policy, as a tax policy fellow.

Mr. Reid is chair of the Tax-Exempt Organizations Committee of the District of Columbia Bar and is vice chair of the D.C. Bar Tax Section Steering Committee.

Mr. Reid earned his J.D. and LL.M. from New York University School of Law where he served editor-in-chief of the New York University Law Review, and his B.A. from Yale University.

Mr. Reid is admitted to practice in the District of Columbia, New York, and Massachusetts.

* * * * *

The charitable contribution deduction is in peril, a potential casualty in the looming budget wars of 2013. All of the major tax reform proposals, from those offered by President Obama and former Gov. Romney to the Bowles-Simpson Deficit Commission, call for modifying, capping, or eliminating the charitable deduction to pay for tax cuts, spending, or both. With its passing, chari-

table organizations will lose an important source of financial support, but we as Americans stand to lose much more than that.

The charitable deduction protects our freedom to create, fund, and operate the institutions that make up American civil society with minimal interference from the government. America is a democracy, but Americans are not limited to the election of representatives as our sole means of contributing to the public good. We also have the right to contribute to the public good directly through charitable organizations. The strong civil society that flourishes within our borders is the envy of the world and the bedrock underlying our democratic system.

What is motivating these proposals is a confusion between the purpose of the charitable deduction and its economic effects.

The charitable deduction and charitable income tax exemption are provisions of the federal tax code, but their purpose transcends tax policy. Together they form a boundary between the state and civil society. The principles of federalism prevent the states from taxing the federal government and the federal government from taxing the states, because, in the immortal words of Justice Marshall, "the power to tax involves the power to destroy." The charitable deduction and income tax exemption should be thought of in the same manner — as a form of tax immunity that protects civil society from the government.

Income taxes are the contributions we make to the public good indirectly and involuntarily, for the causes our elected representatives choose to support. By contrast, charitable contributions are the contributions we make to the public good directly and voluntarily, for the causes we choose to support. Direct giving to the public good through charitable contributions and indirect giving to the public good through taxes are dual aspects of our right to self-governance.

The charitable deduction establishes both the amount of taxes we may offset with our giving (at most, 50 percent of adjusted gross income, less for gifts to private foundations) and broadly defines the types of activities we may support that further the public good. For a contribution to be deductible, it must be given to an entity whose purposes are limited to the prescribed statutory categories — charitable, educational, religious, scientific, etc. The entity may not have shareholders that extract net profits, and it may not intervene in politics or engage in substantial amounts of lobbying, but otherwise it is free to conduct any activity that furthers its mission.

Adjustments to the charitable deduction renegotiate the fundamental relationship between citizens and the state and risk undermining our most deeply held freedom to govern ourselves.

I. Hunting Big Game

The year 2013 is shaping up to be a watershed. The federal government is confronting a daunting situation: historically low tax rates that will expire at the end of 2012, staggering levels of public spending that will continue far into the future, and the aftermath of the worst financial crisis since the Great Depression. The national debt looms at \$16 trillion. Congress has promised to identify \$1.2 trillion in spending cuts and new revenue by 2013, yet spending cuts elude consensus, and raising tax rates is a political nonstarter. Where are we going to get the money?

One fashionable idea on both sides of the aisle is to raise tax revenue by expanding the tax base — in other words, by taxing things that are not currently taxed. As the search for revenue grows more desperate, the pressure mounts on Congress and the president to eliminate legal provisions that can be used to reduce taxes. Even long-standing and popular provisions like the charitable deduction are now candidates for the chopping block.

Some call it “taxmageddon.” Grover Norquist, author of the famous antitax pledge, calls it hunting season. “You’ve got your big five: elephant, rhinoceros, buffalo, lion, and leopard. Which one is the charitable deduction?” he recently asked.

Charitable contributions and the organizations they fund make up a significant portion of America’s \$15 trillion economy, yet much of this economic activity is outside the tax system. As of 2009, educational, religious, scientific, and charitable organizations held \$2.70 trillion of assets and generated \$1.48 trillion in annual revenues.¹ Americans individually gave \$230 billion to charity in 2008.² The Joint Committee on Taxation estimated that the charitable deduction reduced the amount of tax revenue the federal government would collect in 2011 by \$38 billion.³ So the charitable deduction is big game. But is it fair game?

Times are tough, everybody’s hands are out, and charities are being challenged by both left and right to justify their special tax status. Advocates of lower tax

rates are willing to eliminate tax deductions and credits, including the charitable deduction, in order to bring down income tax rates. Advocates of greater progressivity in the tax code view the charitable deduction as primarily benefitting the wealthy, who can most easily afford to lose it.

Despite the gravity of what is at stake for American democracy, proposals abound for tapping charitable dollars to pay for government spending, deficit reduction, and tax cuts, and they originate on both sides of the aisle. In his fiscal 2013 budget, for the fourth straight year, President Obama proposed lowering the income tax deduction for charitable giving from 35 percent to 28 percent for those in the top tax bracket. Congress has recently entertained proposals ranging from replacing the deduction with a 12 percent, nonrefundable tax credit (the Bowles-Simpson Deficit Commission proposal), to capping all itemized deductions at 2 percent of adjusted gross income (the Feldstein, Feenberg, and MacGuineas proposal), which would effectively repeal the charitable deduction for most taxpayers. During the presidential election campaign Governor Romney proposed capping all deductions at \$17,000, which would eliminate the charitable deduction for anyone whose home mortgage deductions, state tax deductions, medical expenses, and other deductions exceed \$17,000.

Beyond the practical reality that the government wants the money, what is motivating these proposals is a confusion between the purpose of the charitable deduction and its economic effects. The purpose of the charitable deduction is to ensure government neutrality toward civil society despite the imposition of the income tax. As a consequence of this neutrality, the charitable gifts are less costly than they would otherwise be. Proponents of reform, however, believe that the purpose of the charitable deduction is to provide a government subsidy to charitable gifts, a view that entitles the government to adjust the subsidy as it sees fit.

While it is true that when you give \$100 to charity and can deduct \$30 from the taxes you owe, your \$100 gift only “costs” you \$70 on an after-tax basis, what is controversial about this view is the notion that the subsidy involves the use of the government’s money rather than your own money. When you give \$100 to charity and deduct \$35 from your taxes, is the government giving you an extra \$35 to spend? Is the government in effect making a \$35 matching contribution to the charity? Or is the government returning the \$35 to you because the money is not the government’s money in the first place? Although these answers are arithmetically equivalent, they involve very different relationships between the citizen and the state. Under one paradigm, the state sponsors and subsidizes civil society using tax revenue; under the other, individuals create civil society using their own funds, without state interference. This distinction makes all the difference.

The reason some believe the \$35 belongs to the government rather than the contributor is they believe that those who make charitable contributions have a greater ability to pay tax than those who do not, and that charitable contributions should therefore be included in the tax base. According to principles first set forth in the

¹Internal Revenue Service, Statistics of Income Bulletin (Fall 2012).

²*Giving USA* 2009. Those who itemize deductions claimed \$176 billion of the \$230 billion contributed to charity in 2008; nonitemizers contributed the remaining \$54 billion. See “Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions,” page 39, Table 3 (Joint Committee on Taxation, October 18, 2011).

Nonitemizers claim the standard deduction rather than the itemized charitable deduction. Those who claim the standard deduction are deemed to have made some amount of charitable contributions in the tax year.

³Data from “Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions,” page 37, Table 2 (Joint Committee on Taxation, October 18, 2011).

1960s by Stanley Surrey, it is equitable to impose higher taxes on those with a greater ability to pay tax.

We tax income because it is a good proxy for the ability to pay tax. In general, the more income you earn, the greater your ability to consume, to save, and to pay tax. Charitable contributions decrease the donor's ability to pay because the donor does not consume the gift — rather, the charity does. The tax law carefully distinguishes charitable gifts from consumption, requiring donors to reduce their deduction by any items of consumption (for example, goods or services) received in return for the contribution. For example, if you buy a ticket to a charitable fundraising dinner for \$100, your deduction is reduced by the value of the food you receive — e.g. \$30 — leaving you with a deductible gift of \$70. Nevertheless, some believe that the donor's ability to choose which charities to support shows that the donor has a higher ability to pay.

Regardless of whether charitable contributions decrease a donor's ability to pay tax, however, there are good reasons for removing charitable contributions from the tax base because of the troubling constitutional issues that would be raised by leaving them in. The federal government cannot make matching contributions to churches, for example. The charitable deduction removes charitable gifts from the tax base, giving donors their own money back. It thereby implements a policy of neutrality. Viewed in this way, the deduction is an accounting mechanism not a subsidy.

At its core, the issue of whether charitable contributions should be included in the tax base is a matter of values as much as it is about economics — it is a question of what the relationship should be between citizens and the state in a democracy. If you believe that a citizen's right to elect representatives is sufficient civic participation to guarantee self-governance, then it is not necessary also to allow citizens to contribute to the public good directly. Under this view, charitable contributions are a luxury that a democratic government may choose to subsidize through charitable deductions when it is wealthy or eliminate when it is poor. All income belongs to the state; the donor's choice to donate to the public good is irrelevant.

On the other hand, if you believe that citizens should have the freedom to contribute directly to the public good without government interference, that civil society is an end in itself, and that civic engagement is healthy for democracy, then charitable contributions should not be treated as part of the tax base. The donors' right to contribute to the public good trumps the state's right to tax his or her income.

The debate on the relationship between citizens and state is as old as America itself. Our willingness to engage in it is one of the many ways that American democracy stands apart from other nations.

II. The Relationship Between Citizens and the State

Kamal Jahanbein has a vision. He believes that everyone in the world should have the right to a decent education, to speak his or her mind, and to petition the government for redress. Born in Iran, Kamal derives tremendous personal satisfaction from the American

system of philanthropy, which enables him to realize his vision of the public good without interference from anyone, an alien concept to those with experience living under an oppressive regime.

Kamal runs a neighborhood pub in Washington called the Saloon. It is an unusual place. The pub's brick exterior is covered with names inscribed in gold paint. The menu has both a long list of beer and tips on etiquette: no television, no standing, and "please do not order beer and food at the same time," it says. The most surprising thing about this popular pub is the sign on the door that says, "The Saloon will be closed for the month of August while we go to Africa to do some good."

After 20 years nurturing his profitable business, Kamal began building schools, first in the town of Abadan, Iran. Kamal has now completed more than 16 schools around the world, as well as medical facilities and homes, in places like Bafang, Cameroon; Rio Dulce, Guatemala; and Pakua, Laos. This year he will build a school in Uganda. By his own estimate, Kamal has given away more than \$1.5 million and countless hours to his humanitarian projects. The hundreds of names on the bricks that line his pub belong to individuals who have also contributed.

Kamal believes that optimism is the greatest gift, and when he builds a school, he seeks to bestow self-empowerment, the strength to strive against forces that seem greater than oneself — to have the confidence of David in a world full of Goliaths. Before he begins, Kamal asks representatives from the village where the school will be built to raise 10 percent of the funds from their own pockets, "so they are invested in the project." Then Kamal helps the village negotiate with the local government to provide the teachers, furniture, and equipment necessary to operate the school. When the project is complete, Kamal makes sure the village representatives have copies of the contract with the government so they can enforce it. "You have never seen such a beautiful sight as a government minister's office filled with determined mothers, waving their contracts and demanding the teachers that they were promised," he said, smiling.

Talking to Kamal, you realize that giving to charity is a radical act. It is defining what is good for society and putting your money where your mouth is. Marshalling resources for the good of society is also what governments do, which is why there can be a tension between charities and public officials. The ability to create an institution to accomplish a particular vision of the public good creates a locus of power that is separate and apart from governmental authority. Government is about centralized power; charity is about local problem solving.

Before there is government, there is charity: ordinary people gathering together to provide for the common good by helping the needy, healing the sick, teaching the ignorant. At its core, charity is about self-reliance. The charitable institutions we create are manifestations of our right to self-governance that is truly by the people, for the people.

A nation can be judged by the amount of charity it permits within its borders. A government that represents its citizens' best interests is not threatened by the additional exercise of self-governance. On the contrary, the

exercise of self-reliance by citizens strengthens civil society, which is the stuff of which democracies are made.

The competition between the government and non-profits to best represent the public interest dates to the founding of the United States. It is understandable why the government should prefer to control the vast resources of the private nonprofit sector and to harmonize their contributions to public policy so that private institutions do not work outside the government. But that is not the system of self-rule enshrined in the Constitution. In fact, that is just the sort of government that our founders fought and died rebelling against.

III. The Right to Self-Governance

The Stars and Stripes, Lady Liberty, “Don’t Tread on Me” — freedom is the sine qua non of American civil society. Since its founding, the United States has been the world’s refuge from tyranny, and its sworn enemy. We do not suffer lightly restraints on our freedom to speak controversially, to protest publicly, or to practice religion heretically in others’ eyes. We are a nation of doers and dreamers. When we perceive a problem, we do not wait for government to act; we band together to solve it as we see fit or, just as well, we go it alone.

The greatest offense of King George III, the tyrannical sovereign who inspired the American Revolution, and the crime that was listed first in Declaration of Independence, was that “he has refused his Assent to Laws, the most wholesome and necessary for the public good.” Our ability, each of us, to define what is wholesome and necessary for the public good is the essence of American freedom, the foundation of our democracy, and that is precisely what the charitable contribution enables each of us, in our own limited capacity, to do. The act of charity — using private resources for the public good — is analogous (but not equivalent) to the power we grant to our democratically elected representatives to appropriate private resources through taxation to use for the public good.

The income tax and the charitable contribution deduction define the space in which these two fundamental democratic forces interact. The income tax provides how much we must give for the public good as our representatives define it; the charitable deduction provides how much we are permitted to give directly to the public good, as we individually define it.

America’s passion for self-governance is manifest in our many associations. We have more than 1.5 million tax-exempt organizations, including 900,000 public charities, 100,000 private foundations, and 600,000 other types of nonprofit organizations, including chambers of commerce, fraternal organizations and civic leagues, and roughly 320,000 religious congregations.⁴ Many charities are effective; many are not. Some last a century; some

⁴National Center on Charitable Statistics Business Master File (Oct. 2012). The approximately 900,000 public charities registered with the Internal Revenue Service include religious congregations; however, this figure does not include the congregations that are not registered with the Internal Revenue Service.

never get off the ground. But in America, that is our business, not the government’s. We are free to create, free to operate, and free to terminate charities as we please.

Since our nation’s founding, the federal government and charities have been rivals, and the lines of battle have shifted back and forth over the years. Today it is obvious that charities may compete with the federal government; however, it is a freedom hard fought and won by previous generations.

In 1816, the State of New Hampshire attempted to seize control of Dartmouth College, a private college established by charitable contributions in 1754 to educate the people of New Hampshire, including Native Americans. The motivation for taking over Dartmouth was political. The Jeffersonians had won the New Hampshire governorship and state legislature in the election of 1812. The trustees of Dartmouth College, however, were members of the opposition Federalist party, and the state sought to replace them with loyal Jeffersonians.

The Jeffersonians argued that the government should have the right to control charitable contributions. As Thomas Jefferson explained in a letter he wrote to New Hampshire Gov. William Plumer in 1816, a private gift to accomplish a public purpose such as education is, in effect, a gift to the people, and as the people’s representative, the democratically elected government of New Hampshire should have the right to oversee the gift. Jefferson believed that state control of Dartmouth was critical to ensure that Dartmouth educated the future leaders of New Hampshire in a manner meeting state approval. Why should a state controlled by Jeffersonians allow a Federalist educational agenda to continue?

Jefferson saw no need to protect Dartmouth from government interference because he believed that democracy itself guaranteed that the government’s purposes and those of Dartmouth College would always be synchronous. He wrote, “The idea that institutions, established for the use of the nation cannot be touched or modified, even to make them answer their end, because of rights gratuitously supposed to be in those employed to manage them in trust for the public, may, perhaps, be a salutary provision against the abuses of a monarch, but it is most absurd against the nation itself.”

The college challenged the state in the Supreme Court. Daniel Webster, a Dartmouth alumnus, argued the case for Dartmouth’s freedom to operate from government interference — even when that government is a democracy. He said:

Shall our state legislature be allowed to take that which is not their own, to turn it from its original use, and apply it to such ends or purposes as they, in their discretion, shall see fit? Sir, you may destroy this little institution; it is weak; it is in your hands! You may put it out; but if you do, you must carry on with your work! You must extinguish one after another, all those great lights of science, which, for more than a century, have thrown their

radiance over the land! It is, sir, as I have said, a small college, and yet there are those who love it.⁵

Daniel Webster's words, spoken just 40 years after the signing of the Declaration of Independence, must have resonated deeply with those present — the memory of the American Revolution still fresh in their minds — because there wasn't a dry eye in the Supreme Court gallery as he concluded his oral argument.

Chief Justice John Marshall was moved to agree with Webster. Writing for the Court, he found that the state could not replace the trustees of Dartmouth College with political loyalists because doing so would interfere with the charitable contributions of Dartmouth's donors. In Marshall's view, Dartmouth was simply the vehicle through which the individual donors pooled their resources to accomplish a public benefit. The donors appointed trustees to carry out Dartmouth's educational mission in the manner the donors deemed appropriate, and Marshall concluded that the Constitution gave the state no right to interfere with such a private contract. In other words, a gift to accomplish a public benefit is no gift to the government, and it does not give the government the power to control the gift or the institution created by the gift. The *Dartmouth* case stands for the proposition that the freedom of individuals to make gifts to accomplish public benefit purposes is constitutionally protected.

It is difficult to overstate the importance of the *Dartmouth* decision in shaping American civil society during the past two centuries. With one stroke, Justice Marshall severed the government's control over American civil society. Justice Marshall made it clear that under the Constitution, the government cannot require charities to implement government policy — after *Dartmouth*, charities were free to operate autonomously. The government is obliged to create its own programs to educate, care for the ill and needy, and promote other policies that voters approve. It cannot rely on charities to fulfill these objectives. At the same time, charities are largely free to accomplish whatever public benefit purposes they choose — constrained only by the legal framework of the tax law and their ability to obtain resources from charitable donors.

The great flourishing of charities that followed the *Dartmouth* decision has been the hallmark of American civil society ever since. Alexis de Tocqueville, the political philosopher whom the French government commissioned to analyze the American system of democracy, was prescient to recognize it.

Writing in 1831, not long after the Court decided *Dartmouth*, de Tocqueville made the critical insight that charities are the foundation on which American democracy rests. He believed France had much to learn from the United States in this regard: "There is nothing, in my opinion, that merits our attention more than the intellectual and moral associations of America." In his view, charities are not only signs of a healthy democracy; they

are its cause. Rather than wait for the government to act in the public interest, Americans create charities to address our problems. Working together for the common good is the basis of the American system of democracy — the government is secondary. "In democratic countries, the science of association is the mother science; the progress of all the rest depends upon its progress," de Tocqueville said.

De Tocqueville took this insight about the importance of American public benefit associations as central to his prescription for how to encourage democracy abroad: "If men are to remain civilized or to become so, the art of associating must be developed and perfected among them in the same ratio as the equality of conditions increases." In other words, de Tocqueville believed that the freedom of Americans to form, fund, and operate charities is the means by which American democracy perpetuates itself.

IV. The Tax Man Cometh

The Supreme Court's decision that the state could not interfere with the right of citizens to form, fund, and operate charities was not the end of the story — the power struggle between the government and charities continues to this day. The difference is that today, the battle is waged through the tax law.

In 1913, nearly 100 years after the *Dartmouth* case, Congress attained the power to tax income "from whatever source derived" through the ratification of the 16th Amendment to the U.S. Constitution and promptly enacted the corporate and individual income taxes. Previous attempts to enact an income tax, dating back to the Civil War, all featured the income tax exemption of charitable organizations, and the exemption has remained through the many revisions the tax code has undergone. The charitable deduction was first introduced by the War Revenue Act of 1917, and it too has remained a longstanding feature of the tax code.

Senator Henry F. Hollis, like Daniel Webster a proud citizen of New Hampshire, introduced the amendment to the War Revenue Act of 1917 that became the charitable deduction to ensure that the income tax would not undermine American civil society. The situation confronting Congress in 1917 was similar to the situation Congress confronts today: The nation had tremendous need for resources because of war and other spending, and the question was whether to tap charitable dollars to pay for it. Senator Hollis submitted several newspaper editorials in support of his amendment to the *Congressional Record* on September 7, 1917, and paraphrased them on the Senate floor, arguing that without a charitable deduction, the income tax would undermine charitable giving.

The editorials Hollis submitted said the charitable deduction "does not create a new form of special privilege or a new subsidy."⁶ They were clear that the purpose

⁵Quoted in Irvin G. Wyllie, "The Search for An American Law of Charity, 1776-1844," *Mississippi Valley Historical Review* 46:203-221 (Sept. 1959).

⁶"[The charitable deduction] does not create a new form of special privilege or a new subsidy." 55 *Cong. Rec.* 6729 (1917) (quoting Edward T. Devine, "Exemption of Contributions," *The Survey*, July 7, 1917).

of the deduction “is not that benefactions should be encouraged by legislation, but that they should not be discouraged by penalties.”⁷ The record also states that charitable contributions should not be treated as part of the tax base because the donor does not get the benefit of a charitable contribution.⁸ They expressed outrage that the government would consider taking resources from civil society to finance war spending,⁹ and emphasized the fundamental relationship of philanthropy to American civilization.¹⁰

From the material published in the *Congressional Record* it is clear that Congress did not intend the charitable deduction to be a subsidy using government money. Indeed, Hollis appears to have viewed the deduction as a means of excluding charitable contributions from the tax base. Yet this legislative history has been overlooked in recent years, which has contributed to the problem charities now face in justifying their tax status.

Also notable is what is not included in the legislative history. If Congress had intended to use the charitable deduction as a subsidy, it seems likely Congress would have said what it intended to subsidize and why, and periodically reviewed whether the subsidy was effective. There is no legislative history to that effect.

The principal reason for believing the purpose of the charitable contribution deduction is to effect a policy of neutrality toward charities by excluding charitable contributions from the tax base and not a policy of subsidizing them is because of the troubling questions about the relationship between the citizen and the state in a democracy that the subsidy rationale raises. These are the same troubling questions about government control of civil society, the engine of democracy, that the Supreme Court

addressed in *Dartmouth*. The Jeffersonians argued that the government should have the right to appoint the trustees of Dartmouth College because the donor’s gift to educate the citizens and Native Americans living in New Hampshire was, in effect, a gift to the state. Today, the argument is that the charitable contribution deduction is a gift from the state — a subsidy — and that, as a contributor, the government should have the right to decide how much charity to subsidize and how best to subsidize it.

Those who believe the purpose of the charitable deduction is to effect a subsidy argue that if charities did not provide education, poverty relief, scientific research, and healthcare, then the government would have to. The problem with that view is that if the purpose of the charitable deduction were to encourage charities to perform governmental services, charities should also be under government control, just as the Jeffersonians thought Dartmouth College should be under government control. According to this view, charities should be subject to the rules that apply to government contractors, and the government should have rights similar to an employer to direct and supervise work that it commissions. But that is not how the charitable deduction operates.

Under current law the government cannot tell charities what goods and services to provide, when and where to provide them, or how much they should cost. The government cannot hire and fire charities at will, reward the ones that perform better, or dock the ones that perform worse. The government has no right to appoint a charity’s board of directors or to select its officers. The government cannot refuse to subsidize charities controlled by individuals the government does not like. When a new government is elected, disfavored charities do not lose their tax benefits, and loyal charities do not get extra credit.

On the contrary, anyone can form a charity, regardless of his or her experience, expertise, or political persuasion. To secure tax exemption and be eligible to receive deductible contributions, all that is required is that the organization promise the IRS that it will primarily conduct activities that further its charitable purpose, that it will not intervene in political campaigns or engage in excessive amounts of lobbying, and that it will not distribute its profits to shareholders. To maintain tax exemption, the organization simply must file annual information returns and continue to operate as promised. As for oversight, the government may periodically audit the organization to confirm that it is not breaking its promises, but beyond that, the government stays out of the picture, and charities are content to govern themselves.

If the charitable deduction is intended to implement a subsidy, it is poorly designed. It is costly, inefficient, and produces an uncertain return on investment. More important, however, is the fact that for many of the goods and services charities produce — religion being chief among them — a government subsidy would be unconstitutional.

The Supreme Court has expressly rejected the subsidy theory as an explanation of the charitable exemption from income tax because it cannot be reconciled with the

⁷55 Cong. Rec. 6729 (1917) (quoting *The Washington Post*, “Conscription of Income,” July 12, 1917).

⁸ “[The charitable deduction] would remove the absurdity of exacting a tax even on that share of a man’s income which he devotes not at all to himself, but to the pressing needs of educational and charitable institutions which operate without private profit.” 55 Cong. Rec. 6729 (1917) (quoting *Boston Transcript*, “Do Not Penalize Generosity,” June 29, 1917).

⁹ “The time may come when the Government will have to choose between national defense, on the one hand, and the continuance of educational and philanthropic institutions. We may have to turn our schools and hospitals and playgrounds into battleships and ammunition. That time has not yet come even in France. To begin the war tax with burdens on universities, settlements, and other voluntary social agencies is analogous to the wonderful scheme for making industries more efficient by removing the legislative protection of women and children and thereby reducing the productive power of labor.” 55 Cong. Rec. 6729 (1917) (quoting Edward T. Devine, “Exemption of Contributions,” *The Survey*, July 7, 1917).

¹⁰ “This country can not abandon or impoverish the great structure of private charity and education that has been one of the most notable achievements of American civilization. Therefore with every additional dollar the Government finds it necessary to take in taxation it becomes increasingly necessary to accept the principle of the pending amendment and leave untaxed that part of every citizen’s income which he may give voluntarily to the public good.” 55 Cong. Rec. 6728 (1917) (quoting *The Washington Post*, “Exempting Charity,” Aug. 25, 1917).

religion clauses of the Constitution (namely, the establishment and free exercise clauses of the First Amendment).

The Court has found that tax exemption of churches in general is necessary precisely because it is the best means of ensuring that the state does not infringe on individuals' religious freedom. As Chief Justice Burger wrote in *Walz v. Tax Commission of the City of New York*, 397 U.S. 664, 677 (1970):

The exemption creates only a minimal and remote involvement between church and state, and far less than taxation of churches. It restricts the fiscal relationship between church and state, and tends to complement and reinforce the desired separation insulating each from the other.

In other words, churches are exempt from tax not because the government is trying to subsidize religion but because the government is trying to stay out of churches' business, which is best accomplished by tax exemption.

V. Immunity or Subsidy?

Charitable contributions are deducted from the income tax base not because the government wishes to subsidize charitable activity but because the government seeks to limit its entanglement with the exercise of individual freedom. Through charitable contributions, Americans exercise many of our constitutionally protected rights — we create nonprofit organizations to engage in freedom of speech, freedom of association, and freedom to practice religion. The civil society we create through our nonprofit institutions is both the bedrock on which our democracy rests and its replenishing source of nourishment.

The justification for the charitable deduction is akin to the intergovernmental immunity from taxation that the Supreme Court recognized in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819), the decision in which Justice Marshall famously wrote that "the power to tax involves the power to destroy." Just as the principles of federalism limit the federal government's power to tax the states and the states' power to tax the federal government, the individual freedoms the Constitution guarantees to American citizens to engage in civil society by creating and funding nonprofit organizations should be protected from excessive government interference through taxation.

Although economically similar, tax immunity and tax subsidy posit entirely different relationships between the citizen and the state. Tax subsidy is a framework under which the federal government chooses not to tax in order to encourage behavior that the government supports, which implies that the government commissions or otherwise controls that activity. Tax immunity is a framework under which the federal government is limited in its ability to collect revenue from activity that it does not control. Given the important role of civil society in America, the charitable deduction should be understood as a limited tax immunity rather than as a subsidy.

Charities do not provide the goods and services requisitioned by the government. In fact, charities often

provide goods and services that the government cannot or will not provide because doing so is unpopular, impractical, unconstitutional, or all of the above. The history of philanthropy in America is the story of Americans banding together to solve problems when the government fails to act. Charitable giving made possible the growth of educational institutions for Native Americans at Dartmouth College and newly freed African Americans at institutions like Spelman College and Morehouse College in Atlanta. In 1909 the Rockefeller Sanitary Commission for the Eradication of Hookworm helped treat many of the roughly two million victims of hookworm and promoted sanitation and prevention education, a politically unpopular initiative because many states refused to acknowledge the existence of hookworm. Philanthropists such as Bill Gates, the co-founder of Microsoft and The Bill and Melinda Gates Foundation, are working to find a vaccine for malaria because it is too costly for governments and insufficiently profitable for corporations to do so. The reality is, democratically elected governments are institutionally biased to address the policy needs that are most popular, not those that are most important or that save the most lives. There is ample room for civic-minded individuals to step in when governments fail to act.

True to de Tocqueville's observation that charity is an engine of democracy, charity can even spawn democratic movements that fundamentally alter the governments complexion. Initiatives from abolition of slavery to women's suffrage to the civil rights movement all began with individual Americans marshalling their resources for the good of society as they saw it. In each case, the government has been more of an adversary than contributor until the government itself was changed by the movement.

To return to the present — and to the debate about how best to return the United States to fiscal health — we must bear in mind that the charitable deduction is about more than taxes. The charitable deduction is an artery within our body politic. It nourishes American civil society and gives strength to our democracy. It gives form and substance to our basic freedom of self-governance, a right that is not fully discharged by our ability to elect representatives. It is not a luxury we can do without.

If the charitable deduction were eliminated Americans would no doubt continue to give generously. But that is not the point. The charitable deduction does not exist to subsidize giving, even though it makes giving less costly. Its purpose is to limit government interference with our right to engage in activity that directly furthers the public interest. It is a mechanism for ensuring that the government does not lay claim to something it should not own: income earned by the people, controlled by the people, and devoted to the good of the people.

The charitable deduction is a negotiated bargain between citizens and the state, establishing a delicate balance of power. It sets the limit on how much money we may contribute in a single year as a percentage of gross income, and broadly defines the activities that further the public good. It also carefully limits the types of property that can be given and the arrangements that constitute a gift to protect the tax base from erosion through abusive tax shelters.

Much as we might like to see balanced budgets and low tax rates in the short term, sacrificing the charitable deduction is not the best means of accomplishing these priorities. The appropriation of revenue by the federal government from the nonprofit sector by altering the charitable deduction entails a profound renegotiation of the relationship between the government and civil society, and it runs counter to the policy and spirit of American democracy.

Appendix
55 Cong. Rec. 6728-30 (1917)

CONGRESSIONAL RECORD — SENATE

September 7, 1917

55 Cong. Rec. 6728-30 (1917)

[Page 6728]

MR. HOLLIS. Mr. President, in this connection I desire to call attention to an amendment which I shall offer before we vote this afternoon to this effect:

Sec. _____. That section 5 of such act of September 8, 1916, is hereby amended by adding at the end of subdivision (a) a further paragraph No. 9, to read as follows:

“Ninth. Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of 20 percent of the taxpayer’s taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.”

The effect of that amendment will be to permit a wealthy man to contribute to charitable, educational, and scientific institutions, and then when he comes to make up his income-tax returns to make a deduction from his gross income of the amount that he has contributed for those purposes, not to exceed 20 percent of his entire net income. I believe that the Senate will see the necessity for voting that exemption in war times.

I have myself been on the other side of this proposition that colleges, hospitals, and charitable institutions should be supported by private contributions. I myself had the privilege of going to a large school. Before I went there I supported myself entirely for two years. I went there and received a tremendous amount of benefit; I enjoyed my experience there; but what I contributed in tuition did not begin to pay my share of the expense, and I never felt comfortable that I had been there because of private bounty. I have tried since I graduated to make it up by contributions to class funds and teachers’ funds, and so on, so that I feel that I am square with the college; but I should have felt much better if I had gone to an institution which was supported by public taxes. So I am on the other end of this proposition ordinarily; but what have we done? We have permitted these institutions to grow

up and become firmly established on the plan of depending upon private contributions. Now, however, the war affects those institutions more seriously than it does any other character of institution. The soldiers we draw come very largely from our colleges. I have seen no estimate, but I should imagine that fully one-half of the students will be taken out of the large institutions because of the war, and it is going to be a very serious problem whether they can be kept open at all. I understand ex-President Taft has written to the committee stating that, in his judgment, institutions like Hampton Institute will be seriously handicapped unless this amendment is adopted.

It will work in this way: Usually people contribute to charities and educational objects out of their surplus. After they have done everything else they want to do, after they have educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific purposes. Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize, namely, in donations to charity. They will say, “Charity begins at home.”

I should not favor allowing any man to deduct all of his contributions to these objects from his income-tax return, but if we limit it to 20 percent of his income we can not be doing much harm to the Public Treasury.

Look at it in this way: For every dollar that a man contributes for these public charities, educational, scientific, or otherwise, the public gets 100 percent; it is all devoted to that purpose. If it were undertaken to support such institutions through the Federal Government or local governments and the taxes were imposed for the amount they would only get the percentage, 5 percent, 10 percent, 20 percent, or 40 percent, as the case might be. Instead of getting the full amount they would get a third or a quarter or a fifth.

MR. VARDAMAN. Mr. President —

The PRESIDING OFFICER (Mr. Hitchcock in the chair). Does the Senator from New Hampshire yield to the Senator from Mississippi?

MR. HOLLIS. I yield.

MR. VARDAMAN. I do not wish to interrupt the Senator, if he is going to continue with the discussion of his second amendment. I desire to ask him something about his first amendment, which I will do after he gets through discussing the amendment to which he is now referring.

MR. HOLLIS. I will be through that branch of my discussion in a moment.

Mr. President, I have many letters from men who have been prominent in charitable work, from men in the Red Cross Association, from all of the larger colleges, and from many charities in all sections of the country. I ask that I be permitted to insert in the Record without reading, instead of these letters, editorials in favor of this amendment from *The Washington Post*, *The New York Times*, *The Survey*, and the *Boston Transcript*.

MR. SMOOT. Mr. President, do I understand the Senator to say that these letters refer to the amendment in relation to the donations which may be made for charitable purposes?

MR. HOLLIS. Yes; they refer to that.

MR. SMOOT. And they have no reference to the Senator's pending income-tax amendment?

MR. HOLLIS. They do not relate to the income-tax amendment. I will say frankly the reason I am speaking about the second amendment now is that I do not know that I shall get an opportunity to speak upon it before the vote is taken, and I desire to explain it. I ask that the editorials to which I have referred may be printed in the Record.

The PRESIDING OFFICER. Without objection, it is so ordered.

The editorials referred to are as follows:

[From *The Washington Post*, Aug. 25, 1917]

EXEMPTING CHARITY

The Senate was expected to reduce somewhat the high income-tax rates which the House approved in adopting the Lenroot amendment. It has, however, voted to retain the Lenroot rates in the war-revenue act, and may even increase them. This gives added importance to the amendment to exempt from the tax, by means of allowable deductions, gifts for charitable, educational, and religious purposes, which the Senate must soon vote upon and which it will do well to adopt. Such deductions are limited to one-fifth of the individual's otherwise taxable income.

The proposal means that, while the individual is asked to give up a large part of his income to the Government, which will determine what is to be done with it or how it is to be spent, and presumably in this emergency will devote it chiefly to effective measures for winning the war, he will still have the privilege of giving up one-fifth of his total income to war purposes, the Red Cross relief, or to humanitarian, educational, or public objects which he may elect and in which he may exercise a choice as to how the money shall be spent.

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.

It would be a mistake to change abruptly the traditional policy under the stress of war conditions. This country can not abandon or impoverish the great structure of private charity and education that has been one of the most notable achievements of American civilization. Therefore with every additional dollar the Government finds it necessary to take in taxation it becomes increasingly necessary to accept the principle of the pending amendment and leave untaxed that part of every citizen's income which he may give voluntarily to the public good.

[From *The New York Times*, Aug. 24, 1917]

THE CONSCRIPTION OF WEALTH

The emotionalists at Washington and elsewhere, especially those who are opposed to the war, have had a great deal to say about "taxing wealth" and "the conscription of wealth." Every tax is a tax on wealth or income. Every tax is a conscription of wealth or income. Taxation is not a subject for rhetoric, fine frenzies, or phrases. The expenses of the Government being greatly increased by the war, taxation must be greatly increased. During the Civil War, after 1862, and for some three years after its close, the internal-revenue receipts were greater than the customs receipts. These are the two main sources of Government revenue. The case was the same in the Spanish War. Normally the customs receipts have exceeded the internal-revenue receipts, though in the last few years the conditions have been reversed on account of the inheritance tax and the income tax. The latter, urged by many of its advocates as an "emergency tax," was imposed before the emergency arose. Now, when there is supreme emergency, it is right that the tax should be increased. It is right that the taxes on large incomes should be increased.

It is the prevailing theory of taxation that every person's payment to the Government should correspond with his resources. Increased income taxes are sound economically to the extent that they will furnish a great revenue. If they are increased to such an extent that trade and industry, the productive sources of income, are injured, they are unsound and pernicious.

These are sober truisms to be kept in mind in judging the Senate's action on Wednesday in overturning the Senate Finance Committee's income-tax schedule except as to incomes under \$60,000 and providing an ascending graduated scale from 13.75 percent on incomes between \$60,000 and \$80,000 to 50 percent on \$1,000,000 or over. Since the amendment of Senator Gerry providing a supertax of 35 percent on incomes from \$500,000 to \$750,000, or 45 percent on those from \$750,000 to \$1,000,000, of 50 percent on those above that sum, was passed by a vote of 74 to 0, it is to be concluded that the Senate has no compunctions as to the amount of "conscription" to which great incomes should be subject. In one day the Senate voted to add \$75,000,000 to the income taxes, which, as laid in the Senate scheme at present, are expected to reach the enormous sum of \$850,000,000. The Senate gave up the other day the \$12,000,000 it was proposed to raise on stamp and parcel-post taxes, easily borne and widely distributed. A small "conscription," but a just one, the congressional objection to which is unfathomable.

On large incomes the tax seems to be laid on the principle "of all the traffic will bear." Senator Lodge's caution against too swift imposition of rigorous income taxes was eminently wise. We are but just beginning what may be a long struggle. We should be careful [Page 6729] not to exhaust the sources of revenue. We must not rely on taxation too largely for war expenses or make taxes so high that they can not be made higher at need later.

There is a necessary social effect to this taxation of great incomes. It diminishes or dries up the springs of philanthropic eleemosynary and educational life. The

foreign calls on charity and benevolence since the war began have reduced contributions to American educational and humane works. The presidents of the colleges, whose incomes from tuition and dormitory fees will be notably lessened by the war service of so many collegians, so many "rich men's sons," and sons of the well to do, are in grave perplexity. A rich man can spend only so much on himself and his family. Out of his surplus come his regular gifts for public purposes. This is a consideration to be regarded in income-tax legislation. Not that in the common defense much or all property and life may not be required of a citizen. Only in laying income or any other kind of taxation let prejudice and passion be put aside. As a matter of economics and finance is a particular amount of tax desirable and necessary?

Rich men are doing and willing to do their part in this war. They are ready to pay, some of them have already paid, their children's lives to the defense of democracy; and they should be taxed, and are willing to be taxed, high. They ought not to be maligned in addition. The few men at Washington who habitually insult wealth and "the rich" are trying to divide a country in which all patriots should be united. It will not escape attention that the bitterest plutophobes are usually opponents of the war or seekers of a dishonest and fatal peace.

[From "Social forces in war time,"
by Edward T. Devine, *The Survey*, July 7, 1917]

EXEMPTION OF CONTRIBUTIONS

The Hollis amendment to the war-revenue bill, authorizing the deduction of gifts to educational and charitable corporations from gross income along with certain other deductions, such as taxes and bad debts, does not create a new form of special privilege or a new subsidy. It does not enable a wealthy man to secure a lower income-tax rate, nor does it violate any established principle of taxation. There is no presumption that any lessening of revenues attributable to this amendment would increase the burdens of those who have small incomes. The difference may quite as well be made up by increasing the tax on war profits.

What the Hollis amendment does is to save the revenue bill from penalizing gifts to colleges, churches, and charitable agencies. By means of this exemption contributions to recognized religious, charitable, and educational institutions are put on the same basis as the loss of money in business, or the payment of money in taxes. Since the taxpayer, or the bad investor, or the donor does not have the use of the money, he is not asked to pay the income tax on it. In the first case it is taken from him by the State; in the second, he loses it involuntarily; in the third, he parts with it voluntarily for a public or social purpose. In no one of the three does he in fact have the money from which to deduct the amount of the income tax. If required to pay it in the third case, as he is not in the other two, he must take it from some other source. Every gift to philanthropy, in other words, costs the donor not only the amount of his gift but a substantial sum in addition.

Of course the added expense can be deducted, if the donor chooses, from the amount which he had intended to give; but in that case it ceases to be an income tax and

is instead a tax on the philanthropic institutions. The time may come when the Government will have to choose between national defense, on the one hand, and the continuance of educational and philanthropic institutions. We may have to turn our schools and hospitals and playgrounds into battleships and ammunition. That time has not yet come even in France. To begin the war tax with burdens on universities, settlements, and other voluntary social agencies is analogous to the wonderful scheme for making industries more efficient by removing the legislative protection of women and children and thereby reducing the productive power of labor.

[From the *Boston Transcript*, June 29, 1917]

DO NOT PENALIZE GENEROSITY

In simple justice and for the national welfare the United States Senate should promptly write the Hollis amendment into the taxation bill. This would remove the absurdity of exacting a tax even on that share of a man's income which he devotes not at all to himself, but to the pressing needs of educational and charitable institutions which operate without private profit. The exaction of such a tax is, at this time, worse than an absurdity. Under the conditions obtaining to-day it would be a form of calamity. It passes beyond individuals and strikes at America's whole organization for social progress and education, the relief of distress, and the remedy of evils.

In America, as perhaps nowhere else in the world, educational and philanthropic institutions have been built up and maintained by private subscription. This has been due in part to the rapid growth of the country, but still more to the splendid tradition of individual and volunteer service which has been established here. In many countries of slower development the Government has assumed most of the burdens of work for the people's welfare, one by one as the need appeared. Upon the occurrence of war the Governments so charged remain responsible. They have incurred the obligation and must still find ways to meet it as best they are able. Even so, the responsibility continues in America, if anything enhanced and not decreased by the war, but it continues at the charge of the many private agencies which have assumed the work. Unlike the Government, moreover, these agencies can not raise their necessary funds by fiat or taxation. They must continue to depend in large part upon private gifts. Meanwhile the Government's special needs for the conduct of war will be cutting sharply into this very source of supply on which so much of our welfare depends.

In this predicament the very least which the United States Government can do is to leave these sources of supply as wide open as still may be possible. It should not continue to tax men and women upon that part of their income which they freely give to the Nation's social and educational work. It should not put a penalty upon generosity. In all the privately endowed colleges boards of trustees have not only to face a probable decrease in the total of gifts received but they will also have less from tuition fees — thanks to the loyal help they have given in urging students to enter the Government's services for war. At Harvard next year's deficit is roughly figured at

\$200,000. The urgency of the situation is plain. Not a day should be lost in accepting and passing the Hollis amendment.

[From *The Washington Post*, Aug. 1, 1917]

POPULARIZING TAX BURDENS

The Senate Finance Committee must add several hundred million dollars — perhaps a billion — to the revenue bill which it is expected to report this week. That means increasing the rates of the war-income tax, the war excess-profits tax, finding new objects of taxation, or issuing more bonds. The needs of the Government outlined by Secretary McAdoo must be met. There are billions to be had for the war, but not a dollar for waste or extravagance. The people will pay cheerfully any sum, no matter how large, which the Government can spend wisely and economically in the vigorous and successful prosecution of the war. There is patriotism enough to assure that, but the ensuing taxes will be popular or unpopular in proportion as the people feel that Congress is scrupulously careful to safeguard economy and efficiency in public expenditures and is just and fair in distributing the burden of the tax as between individuals upon whom it must ultimately fall.

A case in point is presented in support of the two amendments which, respectively, allow deductions from taxable income of gifts to education, charity, and religion, and exempts from the Federal estate tax bequests and legacies for the same purposes. The increased demand for revenue is an added reason for and not against granting these deductions and exemptions, which may mean a loss of from \$5,000,000 to \$100,000,000 of revenue annually to the Government.

It is good social psychology, Dr. Lindsay argues, to assume that five or ten times the loss, whatever it may be, can be levied in increased taxes upon the taxable portion of the same incomes or estates and will be more cheerfully paid by reason of the simple act of justice and consideration implied in the granting of the deductions and exemptions.

The primary purpose of the amendments is, of course, to safeguard the continuance of the valuable public work of educational, charitable, and religious institutions in this hour of need and to enable them to meet the new demands the war will make on them. Only secondarily do they consider the incidental effect of the deductions and exemptions upon the donors or contributors whose generosity and public service they so justly recognize. This ought not to be overlooked when burdens of such magnitude are piling up. Generosity and fairness on the part of Congress will beget liberality and cheerfulness on the part of the taxpayers.

The Senate Finance Committee in its eagerness to get added revenue will show farsighted statesmanship and not be lacking in an appreciation of sound social psychology if it gives up the revenue it would lose by adopting the proposed amendments. It can easily capitalize in this bill or in others soon to follow the good will such action will create in the minds of taxpayers. It will thereby make a good investment.

[From *The Washington Post*, July 12, 1917]

CONSCRIPTION OF INCOME

The Hollis amendment to the revenue bill, which would exempt charitable, scientific, educational, and religious bequests from the income tax, wisely follows the terms of the similar exemption contained in the existing taxes on corporations. In order that an individual may not avoid taxation completely by giving his whole income to a charitable institution, the Hollis amendment provides that the exemption shall apply only to 20 percent of the income.

If a man with a \$2,000,000 income wished to give 20 percent of it to charity, the Government under the proposed exemption might lose a little revenue, but it would be infinitesimal compared with the amount that would be given to the public.

Back of the present taxation program lies the theory that wealth as well as man power must be conscripted for the war. This is a sound theory. But just as the selective feature is the very essence of conscription of man power, so it should be regarded as the important feature of conscription of income.

In conscripting men the Government takes careful account of the work they are now doing. The Government does not call out men who are needed in the war industries. It will not call men on whom families are absolutely dependent for support. The basic idea is to avoid unnecessary burdens. If men with dependent families were taken by the Army, the burden of supporting those families would fall on the State.

The same rule should apply to the income tax. Where necessary public institutions are supported by private subscription, the State is saved much money. Voluntary contributions to the Red Cross, for instance, have saved the Government \$100,000,000, and eventually will save the Government much more. Where money is already performing useful service for the Government, it ought to be exempted. It would be disastrous if any educational and charitable institution aiding the Nation in peace and war should fall because of a nearsighted policy of Congress.

Shall the Government frame its tax measures so far as possible to put the tax upon the luxuries of the rich rather than upon the benefactions of the rich? The argument is not that benefactions should be encouraged by legislation, but that they should not be discouraged by penalties. To say to the man who gives \$10,000 to the Red Cross that he must pay a penalty on the gift is to discourage private generosity and throw the burden upon the shoulders of the Government itself.