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CHARITABLE CONTRIBUTIONS: A POLICY PERSPECTIVE*

PETER J. WIEDENBECK**

I. INTRODUCTION	85
II. DISCUSSION	87
A. <i>History and Policy</i>	87
B. <i>Eligible Donees and Purposes</i>	102
C. <i>Percentage Limitations and Carryover</i>	110
D. <i>Amount Deductible</i>	117
E. <i>Contributions of Partial Interests</i>	126
F. <i>Direct Charitable Deduction for Non-Itemizers</i>	130
III. FUTURE ISSUES	132
A. <i>Minimum Tax</i>	132
B. <i>Percentage Limits</i>	137
IV. CONCLUSION	138

I. INTRODUCTION

The purpose of this article is to lay out the structure of the income tax charitable contribution deduction and provide an overview of the policies that have influenced that structure. As originally enacted, the statutory authorization of a deduction for gifts to charity¹ was two sentences in length.² Today,

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1. As used herein the terms "charity" and "charitable organization" refer to all organizations exempt from tax under I.R.C. § 501(c)(3) (1982) and eligible to receive deductible contributions under section 170(c)(2). These organizations must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international sports competition, or for the prevention of cruelty to children or animals. The term "charitable purposes" encompasses all the other specified exempt purposes (religious, scientific, educational, etc.) and in general includes any purpose beneficial to the community. This expansive interpretation of permissible charitable goals is derived from the common law of charitable trusts and is an established feature of the law of tax-exempt organizations. *Bob Jones Univ. v. United States*, 103 S. Ct. 2017, 2026-29 (1983); *Treas. Reg. § 1.501(c)(3)-1(d)(2)* (1959); *see* RESTATEMENT (SECOND) OF TRUSTS §§ 368-77 (1959); Persons, Osborn & Feldman, *Criteria for Exemption Under Section 501(c)(3)*, in IV RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 1909 (1977) [hereinafter cited as FILER COMMISSION RESEARCH PAPERS].

section 170 takes up seven double-column pages in the statute books,³ and this is only the tip of the iceberg. The statutory exposition of the rules governing eligible donee organizations requires a separate subchapter of the Internal Revenue Code,⁴ to say nothing of the special excise taxes on private foundations.⁵ Even by Internal Revenue Code standards,⁶ this is a phenomenal increase in complexity. All this detail obscures the unifying principles which underlie the tax treatment of charity. These principles are important because they influence the interpretation of the statute and because they determine the line of demarcation between the role of government and the role of private philanthropy in our society.

This article develops a coherent understanding of the federal income tax treatment of charitable giving by integrating the discussion of underlying principles with a technical analysis of the statutory provisions that implement those policies. After a general introduction to the major tax and social policy issues implicated in the status of philanthropy under an income tax, the discussion will focus on a series of hypothetical problems designed to illustrate the workings of the statute. This problem-and-discussion format permits a systematic review of the articulation and refinement of policy in concrete statutory language. The article concludes with observations on possible future developments in the tax treatment of charitable giving.

2. See *infra* note 11.

3. United States Code, 1982 edition. Unless otherwise indicated, all statutory citations in the text of this article refer to the provisions of the Internal Revenue Code of 1954, as amended, in effect on January 1, 1985.

4. Subchapter F, governing exempt organizations, comprises sections 501 to 504, 507 to 509, and 511 to 514 of the Code, all of which relate to the tax treatment of organizations eligible to receive deductible contributions.

5. I.R.C. §§ 4940-48, 4961-62 (1982 & West Supp. 1985). A private foundation is any charitable organization exempt from tax under section 501(c)(3) that is described in section 509. The term "public charity" is commonly used to refer to any charitable organization that is not a private foundation. In general, the distinguishing characteristic of a private foundation is its narrow base of support—private foundations are generally established by large endowments contributed by a single wealthy individual or family or by a corporation.

6. The Internal Revenue Code is the longest and most complicated statute yet devised by man. As many commentators have observed, much of this complexity is unavoidable because in a complex economy the goal of simplicity is often antithetical to the goals of equity and economic neutrality. *E.g.*, Goode, *Lessons from Seven Decades of Income Taxation* in *OPTIONS FOR TAX REFORM* 13, 14 (J. Pechman ed. 1984). Still, certain institutional, political, and attitudinal factors unnecessarily contribute to this complexity. The author has sometimes observed to his classes that the Internal Revenue Code ought to contain a dedication page, reading:

This document is a monument to: Taxpayer inventiveness, Judicial intransigence, and Congressional intemperance.

II. DISCUSSION

A. *History and Policy*

The charitable contribution deduction and the tax-exempt status of charitable organizations have a long history in the federal income tax. Corporations "organized and conducted solely for charitable, religious or educational purposes" were exempt from the corporate income tax of 1894.⁷ This was the statute held unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*⁸ Corporations "organized and operated exclusively for religious, charitable or educational purposes and no part of the net earnings of which inures to the benefit of any private shareholder or individual" were also exempt under the corporate income tax provisions of the Payne-Aldrich Tariff Act of 1909.⁹ Similar provisions have been a part of the tax laws ever since.¹⁰

Individuals were first permitted a deduction for contributions to qualified charities in 1917.¹¹ The deduction was extended to corporations in 1935.¹² Most of the refinements and complexities of current law were added as anti-abuse measures by the Tax Reform Act of 1969.¹³

1. Tax and Social Policy Goals

The charitable contribution deduction reduces an individual's tax base by the amount of income that, due to a gift to charity, is no longer available for personal consumption or saving.¹⁴ As such, the deduction is sometimes justified

7. Act of August 27, 1894, ch. 349, § 32, 28 Stat. 509, 556.

8. 157 U.S. 429, *aff'd on rehearing*, 158 U.S. 601 (1895).

9. Ch. 6, § 38, 36 Stat. 112 (1909).

10. I.R.C. § 501(c)(3) (1982).

11. Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330, permitted a deduction for:

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 fifteen per centum 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.

12. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014, 1016.

13. Pub. L. No. 91-172, §§ 101, 121, 201, 83 Stat. 487, 492-595. In particular, the 1969 act attempted to prevent abuses connected with charitable contributions of appreciated property and partial interests in property.

14. Professor Simons' oft-quoted definition states:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.

as necessary to provide a proper measure of disposable income.¹⁵ The problem with this rationale, however, is that gifts are generally included in the donor's tax base (i.e., no deduction is allowed) under current tax law, even though all donative transfers may be thought to reduce the donor's disposable income.¹⁶ The proper questions, then, are: What makes gifts to charity special? Does a gift to charity bear less resemblance to other consumption expenditures than the typical intrafamily gift?

Two lines of reasoning support the nondeductibility of intrafamily gifts. First, deductibility would represent too great a risk of tax-motivated transfers to lower-bracket family members who would use the gift to finance household consumption.¹⁷ The father who gives his teen-age son funds to purchase the family car is an example of such *disguised consumption* by the donor. Second, bona fide gifts to family members may be considered *intangible consumption* by the donor, who derives satisfactions from the happiness of other family members (vicarious pleasures) or from the status, power or influence derived from such transfers (ego gratification).¹⁸ Where the donor does not control the charitable recipient, there is no substantial risk of disguised consumption. Deduction may be justified here because the transfer is certain to lower the donor's consumption or savings. If, however, intangible consumption is an important reason for the nondeductibility of intrafamily gifts, an income-measurement rationale will not support the charitable contribution deduction. In this case, the psychological satisfactions of giving are deemed consumption

H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938). This definition equates the source of funds ("income" as the term is ordinarily understood, to mean a flow of receipts) with the application of such funds.

15. *E.g.*, COMM'N ON PRIVATE PHILANTHROPY & PUBLIC NEEDS, *GIVING IN AMERICA* 106, 128, 134 (1975) [hereinafter cited as *FILER COMMISSION REPORT*].

16. Vague, general concepts of "income" or "consumption" do not dictate a unique, theoretically correct tax treatment of gifts or bequests. Three possibilities—taxing the donor (no deduction), taxing the donee (deduction for gifts given, inclusion of gifts received), or taxing both—are entirely consistent with either an income or a consumption tax base. D. BRADFORD & U.S. TREASURY TAX POLICY STAFF, *BLUEPRINTS FOR BASIC TAX REFORM* 29-31, 33-35 (2d ed. 1984). Taxing both donor and donee, however, creates practical difficulties in taxpayer compliance and enforcement. *Id.* at 45.

17. Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 390-91 (1979).

18. H. SIMONS, *supra* note 14, at 57-58, 139-40. It is also sometimes asserted that the income tax is a tax on the control of resources or exercise of economic power, and therefore no distinction should be drawn between donative transfers and other expenditures. This assertion focuses on the source rather than the application-of-funds side of the income equation, *see supra* note 14, but is at base equivalent to the intangible consumption rationale. The taxpayer who exercises economic power by making a gift is presumably motivated by the greater satisfaction to be derived by this use of funds over alternative expenditures. *See* Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 851 (1979).

by the donor, and, even if labelled "altruism,"¹⁹ it is hard to see a difference between the gratifications obtained by family or social giving.

Assuming that a preference for taxing the donee, combined with a concern about rate reduction through disguised consumption, explains the tax treatment of ordinary gifts, then the charitable deduction is a proper allowance in measuring the *donor's* disposable income. What about the system's failure to follow through and tax the beneficiaries of charitable gifts? Can that be explained as anything but a tax subsidy? Obviously any attempt to allocate the benefits conferred by charitable organizations would quickly become hopeless or arbitrary—who benefits, and in what degree, from basic scientific research, or a liberal college education, or the community conscience instilled by religious institutions? Two lines of reasoning indicate that the tax immunity of charitable beneficiaries is not simply a concession to practicality, but is justified in principle. First, consider contributions to poverty relief organizations. Current law does not require the value of food, shelter, or clothing distributed by the relief organization to be included in the income of the recipient (section 102). Yet recipients of relief are very likely to be zero-bracket taxpayers, so this divergence between theory and practice should have little effect.²⁰ Second, the wide variety of charitable institutions and activities in our society means that we are all beneficiaries, more or less directly, of the services offered by charitable institutions. If the hypothesis that all individuals consume charitable goods and services in relatively equal amounts²¹ is correct, then our tax system does, in effect, tax the donees—taxing money income at the section 1 rates is simply a convenient surrogate for a less steeply graduated tax on total income, including charitable services.²² Professor Andrews points out that, "A community of people that supports a church will pay less in taxes than a community of people with the same total income, similarly distributed, that spends less on its church and more on its private homes."²³ This statement, however, assumes that each community has the same total money income and receives no external benefits from charitable institutions supported by others. The inequality in taxation is justified if, as seems likely, the community of nonchurchgoing homeowners also has the benefit of hospitals, schools or parks funded by contributors outside the community.

To summarize, the charitable deduction is a proper allowance in measuring disposable income if the nondeductibility of ordinary gifts is founded upon

19. FILER COMMISSION REPORT, *supra* note 15, at 128.

20. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 347 (1972).

21. Actually, the distributional requirement is not that stringent. Equality in the amount of charitable services consumed by taxpayers *at the same income level* is all that is required. Differences between income levels could, in theory, be taken into account in setting the rate schedule.

22. See H. SIMONS, *supra* note 14, at 52-53 (omission of leisure and psychic income proper if "these elements of income vary with considerable regularity, from one income class to the next, along the income scale").

23. Andrews, *supra* note 20, at 357.

administrative convenience. If our guiding principle were that income is taxable to the person who consumes it (or who saves it), then all gifts would be deductible by the donor and includable in the donee's gross income, except insofar as enforcement limitations require departure from this principle. In this view, current law's "general" tax treatment of donative transfers (taxable to the donor, excludable by the donee) would be seen as an *exception*, a concession to practicality necessary to take into account the ease with which consumption may be disguised due to the absence of records or other objective evidence showing the actual beneficiaries of a consumption expenditure.²⁴ Although theoretically sound, the disguised consumption analysis is not entirely consistent with present law, which follows the general principle that income is taxable to the person who earns it,²⁵ not to the person who actually consumes it. Thus, the underlying premise of current law is that intangible consumption or economic power²⁶ is a sufficient benefit to justify the imposition of a tax upon the donor.²⁷ Generally speaking, the satisfactions derived from charitable

24. The recordkeeping burdens and enforcement difficulties engendered by the difference in deductibility between business and personal expenditures (*e.g.*, I.R.C. §§ 274, 280A, 280F (1982 & West Supp. 1985)) would be a drop in the bucket compared to the taxpayer compliance problems and administrative inconvenience that would follow from making tax rates turn upon the identity of the ultimate consumer.

25. This statement of the general principle is a paraphrase of Mr. Justice Holmes in *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930): "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised"

26. On the equivalence of the "intangible consumption" and "economic power" rationales, see *supra* note 18.

27. The early assignment-of-income cases often emphasize the importance, in matters of taxation, of the control of economic resources. For example, in *Corliss v. Bowers*, 281 U.S. 376 (1930), Justice Holmes observed:

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

Id. at 378. To like effect is *Helvering v. Clifford*, 309 U.S. 331, 334 (1940). Moreover, in *Helvering v. Horst*, 311 U.S. 112 (1940), the Court seemed to acknowledge (in dicta) that the intangible satisfaction associated with gift-giving is a sufficient basis for taxation of the donor. In holding that a father's gift of unmatured interest coupons to his son did not shift tax liability, the Court stated:

Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son.

Id. at 117.

Of course, the holdings in the assignment-of-income cases do not refute a "disguised consumption" rationale because the facts of these cases involve precisely the kind of potential for abuse that would require departure from a "general" principle of

contributions are not different in kind from those derived from other gifts.²⁸ Accordingly, under the prevailing concept of income, the better view is that the charitable deduction is not a proper allowance in measuring disposable income.

Apart from income measurement, are there tax policy considerations that justify deductibility? Some commentators assert that the deduction is consistent with income tax theory because it maintains horizontal equity.²⁹ Adopting Professor Andrews' example,³⁰ compare a doctor who donates services by working one day a week at a clinic in a poor neighborhood, with a tax lawyer who must earn a fee and donate cash because an in-kind contribution of services would not be useful to the clinic or the low-income patients it serves. Because the doctor is not taxed on the value of the uncompensated services, the argument goes, equity demands that the lawyer be allowed a deduction. Conceding that horizontal equity requires consistent treatment of the doctor and the lawyer, still there is another way to achieve that equal treatment. The doctor could be required to include in gross income the value of the contributed services,³¹ without granting either the doctor or the lawyer an offsetting

taxing gifts to the donee. Since the broad language of those cases can generally be dismissed as dicta, it is important to investigate whether our tax system really contains a preference for the "intangible consumption" rationale. Although the matter deserves further study, let me suggest several situations which, I believe, indicate a general policy of taxing income to the person who earns it, even where the disguised consumption rationale might yield a different result. First, an outright gift is effective to shift liability for tax on future income produced by the property to lower-bracket family members (section 102(b)(1)) because the donee has control of the future income, even though he may choose to use it to fund consumption by the original donor. Second, gifts to political candidates and organizations are not deductible. Third, prior to the 1942 enactment of the predecessors to sections 71 and 215, alimony was taxable to the payor. *Gould v. Gould*, 245 U.S. 151, 153 (1917).

28. In certain circumstances there may be significant differences between the utility associated with some charitable contributions and other gifts (whether or not charitable). It is possible that contributions to some donees (churches, for example) or in some minimum amount are treated by many taxpayers as a moral imperative, and thus represent a priority claim on the taxpayer's income. If so, the involuntary aspect of these contributions distinguishes them from ordinary consumer spending, and may justify the deduction. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 58-59 (1972). (This argument is similar to the considerations which support the allowance for extraordinary medical expenses. C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 127-28 (1960); J. PECHMAN, FEDERAL TAX POLICY 87-89 (4th ed., 1983); Andrews, *supra* note 20, at 336-37.) This involuntary expenditure argument is not a general rehabilitation of the income-measurement rationale because it only applies to a limited class of charitable gifts. If over-extended, this argument would equate charitable contributions with casualty losses, an absurd proposition.

29. Andrews, *supra*, note 20, at 347-48; Bittker, *supra* note 28, at 59-60.

30. Andrews, *supra* note 20, at 347-48.

31. The value of services contributed to charity is very large. In 1973 nearly six billion hours were donated to religious and charitable organizations. The value of this contributed time is estimated to be about \$29 billion, or slightly more than the total

deduction. The question thus becomes, is there any policy reason for putting both the doctor and the lawyer on the nontaxable side of the line?

Economic neutrality arguably justifies the tax-free treatment. That is, by failing to tax donors of property or services, the choice that a taxpayer faces between leisure and extra work on behalf of charity is not affected by tax considerations. But why should we preserve a no-tax world in this limited area when the income tax, by its very nature, is blatantly non-neutral in its effect on the leisure/work decision?³² Only because, as a matter of social policy, not tax policy, society wants to encourage charitable contributions.

Consider what would happen if both the doctor and the lawyer were taxed on their contributions. Professor Andrews describes the phenomenon as follows:

An income tax ordinarily operates to make a person reduce his expenditures but leaves him free to decide for himself which expenditures to reduce by how much. Taxable consumption includes both food and clothing; a taxpayer may choose, however, to cast the burden of the tax wholly on one category in order to avoid any reduction in the other. As among private preclusive consumption expenditures the reduction will be distributed among items under the constraint that any particular expenditure reduction will immediately produce a corresponding reduction in consumption benefits. In the case of contributions there is no such immediate connection. Whether the services produced by a charitable organization and enjoyed by a contributor will be reduced does not depend immediately and solely on his contributions but on the sum of all contributions by all contributors; thus a rationally self-interested taxpayer might be tempted to let his contributions bear more of the burden of a tax than do his private consumption expenditures.³³

The problem, of course, is that many contributors are likely to react this way, and the consequence of this free-rider syndrome is likely to be a drastic reduction in private charitable giving.³⁴ Indeed, the charitable contribution deduc-

dollar value of contributions of money and property. Morgan, Dye & Hybels, *Results from Two National Surveys of Philanthropic Activity* in I FILER COMMISSION RESEARCH PAPERS *supra* note 1, at 157, 160.

32. R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 653-54 (4th ed. 1984); Sneed, *The Criteria of Federal Income Tax Policy*, 17 *STAN. L. REV.* 567, 586-88 (1965); see Hausman, *Labor Supply*, in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 27, 61 (H. Aaron & J. Pechman eds. 1981) (empirical estimate that the current tax system reduces the desired hours of work by 8.6% from the labor supplied in a no-tax world).

33. Andrews, *supra* note 20, at 361.

34. If the increased revenues collected from the taxation of charitable contributions were returned to taxpayers in the form of an overall reduction of tax rates, the matter is not so straightforward as indicated in the text. Under current law, an individual in the 50% tax bracket can contribute one dollar to charity at a cost to himself of only fifty cents of foregone consumption. Without the deduction, the after-tax cost of the same contribution would be the full one dollar. This "price effect" of the tax tends to decrease contributions. At the same time, however, the tax rate reductions permitted by eliminating the deduction would reduce the top marginal rate to, say, 47%. This tax cut increases personal disposable income, making more money available to individuals

tion was originally enacted to prevent exactly this problem.³⁵

Hence, charitable donations are peculiarly susceptible to tax deterrence, and the deduction preserves the delicate balance of motivations that support social giving. Still the policy question remains: Why preserve social giving? Consider the consequences of tax deterrence. A massive reduction in contributions would force charitable organizations to increase prices. Tuition at institutions of higher education would rise³⁶ and admission charges to theaters, con-

with which to make donations. This "income effect" tends to increase charitable giving.

The net effect of the tax law change on the amount of individual charitable contributions depends on the relative strengths of the income and price effects, which cannot be predicted a priori. These strengths—the responsiveness of donors to changes in after-tax income and the after-tax price of giving—are economic quantities known as income and price elasticities. Empirical estimates of these quantities are set forth in note 41, *infra*. Since the revenue cost of the individual charitable contribution deduction (approximately \$13.5 billion in fiscal year 1985) is about five percent of current individual income tax collections (\$278 billion in 1982), nondeductibility would permit only a small rate reduction. Under these circumstances, the elasticity estimates indicate that the price effect will indeed predominate, and a large reduction in giving could be expected.

It should also be noted that even without a change in deductibility, any change in tax rates produces countervailing income and price effects. A general rate reduction, for example, raises the price of giving (greater foregone consumption) but also increases disposable income available for donations. The best available estimates of income and price elasticities indicate that the net effect on charitable giving of an overall rate reduction (such as those proposed as a component of current comprehensive income tax proposals) would be a substantial reduction in contributions. *E.g.*, Clotfelter, *Tax Reform and Charitable Giving in 1985*, 26 TAX NOTES 477 (1985).

35. A charitable contribution deduction was proposed during consideration of the Revenue Act of 1913 by the House of Representatives. Supporters of the allowance argued that "it is desirable that there should be no curtailment imposed by this act upon the benevolent members of the community." 50 CONG. REC. 1259 (1913) (statement of Rep. Rogers). Although rejected in 1913, when the top marginal rate of the income tax was seven percent, it was enacted as section 1201(2) of the Revenue Act of 1917, *supra* note 11, which dramatically increased rates (up to 52% in 1917) to help pay for America's entry into World War I. In 1917 the deduction was explicitly promoted as a means of reducing the deterrent effect of high tax rates on contributions to charity.

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."

55 CONG. REC. 6728 (1917) (statement of Sen. Hollis).

36. Data indicate that in 1974, of every \$10 spent by privately controlled non-profit educational institutions, about \$3 came from private philanthropy, \$5 came from user fees (i.e., tuition) and endowment income, and \$1 came from governmental sources. Corresponding estimates of 1974 funding sources for \$10 in outlays by health

certs, and museums would go up sharply.³⁷ Services provided by charitable organizations that are now in the nature of "public goods" (below-cost services that may be utilized by many people without regard to whether they have contributed to the institution) might become available only to those who could afford to pay a price reflecting the full cost of providing such services.

Alternatively, the reduction in private giving might induce the government to step in with direct budget outlays to hospitals, colleges, museums, etc., to prevent this "privatization" of services. This response would be based on a social policy decision that such cultural and educational opportunities should be available to a broader segment of society than their free market pricing would permit. Such a direct government subsidy program would, of course, be funded through the tax system.

Thus, if charitable contributions could be made only out of the after-tax income of the donor, society might be forced to decide between a distribution of services determined by free market pricing and the broader access to cultural, educational, and medical services that would result from government-subsidized prices (cost spreading through the tax and appropriations process).³⁸ It was observed earlier that horizontal equity between donors of services and donors of property could be achieved by either taxing both or taxing neither. It should now be apparent that allowance of the charitable contribution deduction—taxing neither—necessarily entails a social policy decision that a free market distribution of education (and other services currently provided by charitable organizations) would not be in the public interest. The

institutions are: \$1 from private philanthropy, \$5 from user fees (e.g., hospital fees) and endowment income, and \$4 from government. Rudney, *The Scope of Private Voluntary Charitable Sector*, in I FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 135, 136-38. The lesser role of philanthropy in health affairs is a reflection of an enormous post-World War II increase in public support of medical research and health care funding. Blendon, *The Changing Role of Private Philanthropy in Health Affairs*, in II FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 639, 643.

37. In 1970-71, ticket sales to theaters, symphonies, operas, and ballet accounted for approximately 46-64% of expenditures, depending on the art form. Admission charges to museums covered only 30% of operating revenues. In the performing arts (theater, symphony, opera and ballet), total private contributions ranged from three to eight times greater, depending on the art form, than total governmental grants. If capital grants are excluded, private philanthropy is more than five times as important as government funding in making up the shortfall in operating revenue in the performing arts. Hightower, *A Report on the Arts*, in II FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 713, 719-22.

38. The situation is not quite as clear-cut as indicated in the text. In some fields of traditional philanthropic endeavor, particularly health and welfare, the government has already become a major source of funding. Rudney, *supra* note 36, at 136; Winston, *Some Aspects of Private Philanthropy in Relation to Social Welfare*, in II FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 677, 679-80. In other fields, government involvement remains small (e.g., arts and culture) or nonexistent (e.g., religion). In any event, increased governmental support, even in the fields of health, welfare, and education, is a recent phenomenon (since World War II) and cutbacks in federal spending may reverse this trend.

charitable contribution deduction is a tax expenditure (an indirect subsidy) rather than a proper allowance in measuring disposable income because it is a substitute for taxing contributors and making up for the reduction in private giving by direct budget outlays.³⁹

2. Mechanism for Implementing Policy

Thus, the deduction for charitable contributions must ultimately find its justification in nontax social policy considerations. This fact does not mean that the allowance is inappropriate or unwise. It means only that the wisdom of the tax expenditure must be evaluated by comparing its effectiveness with the alternative—direct budget outlays. Although this evaluation is a complex process and expert opinion is divided on the issue, three considerations indicate that in this field the tax expenditure may be preferable.

First, a tax incentive to encourage private support for the services traditionally provided by charitable organizations may be necessary in part because of constitutional restraints on government action. The first amendment forbids government aid to religious organizations, but benefit to an individual donor-taxpayer through the general charitable contribution deduction does not violate the establishment clause.⁴⁰

Second, the best available economic research indicates that the tax deduction is *efficient*. That is, deductibility increases gifts to charity by more than it decreases tax collections!⁴¹ If this empirical evidence is correct, it is the direct

39. It must be remembered that the conclusion that the charitable contribution deduction is a tax expenditure is the result of the *assumption* that ordinary gifts should be taxable to the donor (as intangible consumption) rather than the donee. As observed earlier, this assumption is not the only possible rationale for section 102. The deduction is a proper allowance in measuring net income under the alternative (disguised consumption) rationale. Since neither view of the matter is clearly incorrect, differences in tax treatment resulting from a "tax expenditure" label should be viewed with suspicion. See *infra* text accompanying notes 65-68, 162-66, 173-81.

40. See *Walz v. Tax Comm'n*, 397 U.S. 664, 675 (1970) (property tax exemption of nonprofit charitable organizations constitutional despite financial benefit to churches); L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* § 14-9 (1978); see also *Muel-ler v. Allen*, 463 U.S. 388 (1983) (upholding limited tax deduction allowed parents for expenses associated with their childrens' attendance at any school—public, private, or parochial).

Aside from constitutional limits, there may also be important *practical* limits on the goals which government can achieve through a direct subsidy. See *infra* notes 42-43 and accompanying text.

41. FILER COMMISSION REPORT, *supra* note 15, at 129. In economic terms, the results of several recent studies show that the price elasticity of charitable giving is negative and has an absolute value slightly greater than unity (for an explanation of income and price elasticities, see *supra* note 34). Feldstein & Taylor, *The Income Tax and Charitable Contributions: Estimates and Simulations With the Treasury Tax Files*, in III FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 1419, 1423-24 (price elasticity = -1.285, income elasticity = 0.702); Feldstein & Clotfelter, *Tax Incentives and Charitable Contributions in the United States: A Microeconomic Analysis*, in *id.* at 1393, 1397-1400 (price elasticity = -1.15, income elasticity = 0.87); Feldstein, *The Income Tax and Charitable Contributions: Part I—Aggregate and Dis-*

expenditure alternative that could not survive a cost/benefit analysis.

Third, the charitable contribution deduction encourages cultural and associational pluralism. Governmental priorities are established democratically, which may lead to a tyranny of the majority. For example, if the voting population likes public TV but doesn't like fine art or music, government-only support through the tax and appropriation process would result in a uniform, perhaps stifling, set of cultural and educational opportunities.⁴² The charitable

tributational Effects, 28 NAT'L TAX J. 81, 86-90 (1975) (price elasticity = -1.238, income elasticity = 0.822). An earlier study which suggested that charitable giving was not responsive to deductibility (Taussig, *Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions*, 20 NAT'L TAX J. 1, 6 (1967)) has been much criticized and now appears unreliable. *E.g.*, Bittker, *supra* note 28, at 49-52; Feldstein, *supra*, at 97-98. An excellent review of these studies and new estimates (price elasticity = -1.27, income elasticity = 0.78) are presented by Clotfelter & Steuerle, *Charitable Contributions*, in HOW TAXES AFFECT ECONOMIC BEHAVIOR 403, 424-25 (H. Aaron & J. Pechman eds. 1981). *But see* Rudney, *Charitable Deductions and Tax Reform: New Evidence on Giving Behavior*, 26 TAX NOTES 367 (1985) (criticizing earlier studies and estimating a price elasticity of only -0.69 for taxpayers with less than \$100,000 income). A negative price elasticity with absolute value greater than one produces a curious result: repeal of the deduction would deter contributions to such an extent that despite the tax increase many taxpayers would experience an increase in disposable income! Break, *Charitable Contributions Under the Federal Individual Income Tax: Alternative Policy Options*, in III FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 1521, 1530.

Moreover, Martin Feldstein has shown that if taxpayers reduce their private giving in response to government expenditures on charitable activities, then a tax subsidy which increases giving by *less* than its revenue cost (i.e., absolute value of price elasticity less than one) may still be more efficient than the direct expenditure. Feldstein, *A Contribution to the Theory of Tax Expenditures: The Case of Charitable Giving*, in THE ECONOMICS OF TAXATION 99, 105-06 (H. Aaron & M. Boskin eds. 1980); *see* Abrams & Schmitz, *The Crowding-Out Effect of Governmental Transfers on Private Charitable Contributions: Cross-Section Evidence*, 37 NAT'L TAX J. 563 (1984).

One further observation concerning the efficiency of the deduction is in order. A complete cost/benefit analysis would take into account the transaction costs associated with alternative mechanisms of funding charitable institutions. Most charitable organizations devote a substantial portion of their budget to fund-raising. Grimes, *The Fund-Raising Percent as a Quantitative Standard for Regulation of Public Charities with Particular Emphasis on Voluntary Health and Welfare Organizations*, in V FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 2889, 2891-93 (for many organizations the ratio of total fund-raising expenses to total contributions and grants is in the range 10-35%); *see* FILER COMMISSION REPORT, *supra* note 15, at 174, 176-78 (recommending disclosure of solicitation costs to IRS and federal regulation of interstate fund-raising solicitations). It is possible that the transaction costs associated with a direct subsidy program might be substantially lower, thus rendering the spending program more cost effective.

42. The author has observed in another context:

[T]here may be a class of meritorious social programs now administered through the tax system that, *as a political matter*, could not be transplanted from the tax to the spending side of the federal budget. In general, these politically fragile programs are subsidies which benefit a nonneedy minority of the taxpaying population. Their goals may be politically unachievable

contribution deduction may reflect a judgment that pluralism is to be valued highly in its own right. The deduction encourages pluralism by permitting an assortment of social services; taxpayers are allowed in part to vote with their dollars,⁴³ rather than by the one-person, one-vote system that establishes tax and budget priorities. The preservation of residual sovereignty in the states under our federalist system of government is sometimes justified because it maintains the states as a laboratory of democracy.⁴⁴ Similarly, the charitable contribution deduction fosters the coexistence of nonmajoritarian values—it encourages experimentation by the private sector in new solutions to our social problems.⁴⁵

It must be recognized that a direct outlay program could be designed that would also promote pluralism by allowing citizens to vote with their dollars. Congress could enact a matching grant system, for example. Yet the reduced political visibility of a subsidy provided through the tax system may be an important advantage.⁴⁶ That the charitable contribution deduction partakes of

under a candid spending program because such a subsidy would be perceived by voters as a plan of redistribution from the majority to a minority of the middle class.

Wiedenbeck, *Paternalism and Income Tax Reform*, 33 U. KAN. L. REV. — (1985).

43. Studies indicate that almost all American households contribute time and/or money to religious or charitable organizations, and that sympathy with the purposes of the donee organization and personal involvement are highly correlated with giving. Morgan, Dye & Hybels, *supra* note 31, at 160, 198-207.

44. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting):

To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the Nation. It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.

See also L. TRIBE, *supra* note 40, § 5-22, at 311-12.

45. PRESIDENTIAL TASK FORCE ON THE ARTS & HUMANITIES, REPORT TO THE PRESIDENT 18 (Oct. 1981):

The use of the tax mechanism for support of charitable endeavors generally, and for the arts and humanities specifically, ensures choice of the recipient by the private donor. The tax system thus provides for pluralism, both through the range of arts and humanities activities supported and through the diversity of sources of such support.

FILER COMMISSION REPORT, *supra* note 15, at 123:

By saying with his or her own dollars what needs should be met, what objectives pursued, what values served, every contributor exercises, in a profound sense, a form of self-government, a form that parallels, complements and enriches the democratic electoral process itself.

Accord Bittker, *supra* note 28, at 61-62 (donor's ability to select the social services they support may reduce alienation toward government).

46. The Commission on Private Philanthropy and Public Needs observed:

Another major virtue of the deduction is its relative insulation from political or bureaucratic manipulation. Compared with other forms of encouragement such as matching grants, the deduction as a mechanism is not subject to

the "protective coloration" of the tax code may be the most effective method of defending pluralism against the onslaughts of political opportunism.⁴⁷

Professor Bittker is the most able proponent of this view.

When a donor takes a tax deduction for a charitable contribution his privacy is an inextricable part of the more generally protected privacy that is accorded to federal income tax returns. Thus, an attempt to breach it—for example, on the theory that deductions are equivalent to expenditures and that the public is entitled to know who is controlling the destiny of these hypothetical public funds—would be seen as a threat to the privacy of everyone's tax return. By contrast, a promise of privacy embodied in a matching grant system, not yet sanctified or steered by history, would not be protected by a similar umbrella, and might well be swept away by a revival of McCarthyism, aided perhaps by a philosophic claim (already explicit in some proposals to substitute grants for deductions) that secrecy is incompatible with democratic values

A closely related threat to the independence of donors and donees is the intrusion of official concepts of right and wrong into administration of a matching grant system. No public program is immune to either open or covert attempts to foster one set of values and discourage another, but the definition of exempt organizations by section 501(c)(3) of the Code and the administration of this definition by the tax authorities have been relatively free of bias. This freedom is fragile, of course, and it would be fatuous to assert that it will last so long as we stick with tax deductions, but will be lost forever if we shift to matching grants

. . . The issue, after all, is not in drafting a verbal formula promising independence, but its effect in real life. Acknowledging that a dogmatic conclusion is not warranted, I must say that I have very little confidence that a system of matching grants could be administered without administrative and congressional investigations, loyalty oaths, informal or explicit warnings

fine-tuning to fit administratively or legislatively determined goals. It thus leaves the greatest leeway to individual, as contrasted to collective, determination of giving patterns, and this is seen as being of decisive importance in maintaining the pluralistic role that the nonprofit sector should play

Matching grants and credits are also, the Commission feels, more susceptible to political manipulation because they can be seen to involve government funds. Matching grants in fact would flow directly from the Treasury.

FILER COMMISSION REPORT, *supra* note 15, at 130, 132. In addition, a survey of practices in other countries concluded that "governmental supervision and regulation of private charitable organizations exists to some degree in all of the [eight developed] countries [studied], with particular emphasis on organizations receiving direct governmental grants." Arthur Andersen & Co., *Overview of Governmental Support and Financial Regulation of Philanthropic Organizations in Selected Nations*, in V FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 2975.

47. Professor Surrey suggests that "the preference for the hidden subsidy over the open subsidy" may be a reason why some prefer tax expenditure programs to direct budget outlays. He concludes, however, that this approach frustrates efforts to achieve a rational use of resources and "should not be accepted." Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 733-34 (1970).

against heterodoxy and the other trappings of governmental support that the tax deduction has, so far, been able to escape.⁴⁸

Studies indicate that the IRS has generally been evenhanded in its regulation of charitable institutions. The Commission on Private Philanthropy and Public Needs recommended that the Service continue to be the principal agency responsible for oversight of tax-exempt organizations.⁴⁹

Even if one accepts the tax allowance as camouflage—a practical expedient to protect pluralism from a short-sighted or repressive majority—one may still oppose the deduction mechanism because it operates as an income-dependent subsidy. Because the after-tax cost of any deductible expenditure is proportional to the quantity $1-t$, where t is the taxpayer's marginal rate, the government shoulders more of the burden of high-income taxpayers' contributions. The very poor, for example, forgo one dollar of consumption for each dollar they drop in the church plate, but a forty percent taxpayer suffers only sixty cents of foregone consumption when he gives a dollar. Therefore, the charitable contribution deduction is often criticized as an "upside-down" subsidy,⁵⁰ because government assistance (foregone taxes) increases as the need for such assistance decreases. Thus, citizens are permitted to vote with their dollars, but the government unfairly weights their votes. A tax credit makes the after-tax cost of an expenditure independent of income (at least if the credit is refundable),⁵¹ so critics of the income-variant effect of the deduc-

48. Bittker, *supra* note 28, at 45-46.

49. FILER COMMISSION REPORT, *supra* note 15, at 167:

The Commission has considered numerous proposals to substitute another agency for the Internal Revenue Service in overseeing the affairs of exempt organizations. Among the reasons given for an alternate agency was the greater assurance of insulation of the nonprofit sector from political or executive branch interference. The Commission was not persuaded that a viable alternate to the Internal Revenue Service exists and was, in fact, satisfied that, except in several isolated instances, the Service has demonstrated its capacity for independent, impartial oversight of tax-exempt organizations including determination of exempt status.

Accord Ginsburg, Marks & Wertheim, *Federal Oversight of Private Philanthropy*, in V FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 2575, 2613-19; Persons, Osborn & Feldman, *Criteria for Exemption Under Section 501(c)(3)*, in IV FILER COMMISSION RESEARCH PAPERS, *supra* note 1, at 1909, 1936-37, 1939-43.

50. See, e.g., Surrey, *supra* note 47, at 720-25.

51. To compare the value of a deduction and a credit, assume that two taxpayers, TPA and TPB, are in the 50% and 11% marginal tax brackets, respectively. Each has \$100 of gross income and is evaluating the tax consequences of contributing this amount to charity. The following table shows the after-tax cost of a \$100 charitable contribution made by each of these taxpayers, assuming (1) that the contribution is deductible, and (2) that the contribution is eligible for a 25% refundable tax credit.

tion often propose the substitution of a tax credit.⁵²

A complete response to this criticism cannot be given here, but three important considerations deserve mention. First, taxpayer responsiveness to the incentive may vary with income. Tax consciousness certainly does.⁵³ If so, tax benefits granted to taxpayers whose contribution behavior is unaffected may be viewed simply as wasted revenue. That is, the deduction may be more efficient as a tax *incentive* than a credit would be, if the income-variant effect of the deduction operates to target benefits on the marginal contribution

	Gross Income	Amount Contrib	Charit Deduct	Tax	25% Credit	After-Tax Funds	Cost of Contrib
<u>No Contribution</u>							
TPA	100	0	0	50	0	50	N/A
TPB	100	0	0	11	0	89	N/A
<u>Deductible Contribution</u>							
TPA	100	100	100	0	N/A	0	50
TPB	100	100	100	0	N/A	0	89
<u>Creditable Contribution</u>							
TPA	100	100	N/A	50	25	-25	75
TPB	100	100	N/A	11	25	14	75

Where:

After-Tax Funds = Gross Income - Amount Contributed - Tax + Credit; and
Cost of Contribution = After-Tax Funds (No Contribution) - After-Tax Funds
(With Contribution).

From the taxpayer's viewpoint, the cost of the contribution is the reduction in personal funds that results from the gift, and in the case of a (refundable) credit this reduction is the same for all taxpayers—the cost of a creditable expenditure is independent of the taxpayer's marginal rate. Notice that in the case of a partial credit any taxpayer whose marginal rate exceeds the creditable percentage would be better off with a deduction, and any taxpayer whose marginal rate is less than the credit rate will prefer the credit.

52. *E.g., Asher, Public Needs, Public Policy, and Philanthropy: An Analysis of the Basic Issues and Their Treatment by the Commission on Private Philanthropy and Public Needs*, in II *FILER COMMISSION RESEARCH PAPERS*, *supra* note 1, at 1069, 1084-85; *Surrey, supra* note 47, at 720-24. Although the majority favored the charitable contribution deduction, the report of the Commission on Private Philanthropy and Public Needs observed:

Commission members favoring tax credits tended to be persuaded in this direction mainly by the fact that, unlike the deduction, credits operate independently of the progressive structure of the income tax and therefore provide the same proportionate tax savings to all taxpayers regardless of their income. Under a 25 per cent credit, for instance, every taxpayer could subtract 25 per cent of his contributions from the taxes he or she owes. This uniformity of inducement was seen by some Commission members as being more equitable than the deduction and was considered preferable for this reason.

FILER COMMISSION REPORT, *supra* note 15, at 139.

53. *Morgan, Dye & Hybels, supra* note 31, at 175-78, 184-85.

decision.⁵⁴

Second, the deduction may in fact reflect an implicit judgment that, in general, the charitable goals of the rich are "better" or more socially useful than programs supported by the poor.⁵⁵ Most charitable contributions by low-income families go to their local religious congregation, while high-income groups devote a greater proportion of their gifts to educational institutions, hospitals, and the arts.⁵⁶ Although substitution of a twenty-five percent credit would not significantly affect *aggregate* charitable giving, it would have a dramatic impact on the *distribution* of contributions. The increased cost of contributions for taxpayers in marginal tax brackets greater than twenty-five percent would cause a dramatic decrease in contributions to higher education and cultural organizations, while the increased subsidy for lower-income taxpayers would cause religious gifts to rise.⁵⁷

Third, even if as a matter of fairness the income-variant effect of the charitable contribution deduction is undesirable, it must be remembered that a principal purpose of the tax allowance is to *hide* the subsidy. A tax credit, though evenhanded, is generally recognized as a means of government assistance, rather than as a proper allowance in the measurement of disposable income. In part because of this difference in perceptions, the Commission on Private Philanthropy and Public Needs rejected both the matching-grant and tax credit alternatives to the charitable contribution deduction.

Matching grants and credits are also, the Commission feels, more susceptible to political manipulation because they can be seen to involve government funds. Matching grants in fact would flow directly from the Treasury. And

54. See Bittker, *supra* note 28, at 53. Empirical studies have yielded estimates of the income and price elasticities of charitable giving. The data reveal that price elasticity (i.e., donor responsiveness to the net after-tax cost of giving) does not vary significantly through a wide range of incomes. It is estimated that the substitution of a 25% credit would yield approximately the same total *aggregate* giving at the same revenue cost as the current deduction, even though the credit would present the same cost of giving to all taxpayers. Thus, the best available data do not seem to indicate that, relative to a credit, a deduction yields more giving per dollar of foregone revenue. Feldstein & Taylor, *supra* note 41, at 1419, 1429-31, 1433-36; Feldstein & Clotfelter, *supra* note 41, at 1393, 1403-07, 1411-12; Feldstein, *supra* note 41, at 88-90. Professor Feldstein summarized the results of these studies with the observation: "Since the econometric evidence indicates that the price elasticity of giving is approximately minus one and does not differ significantly among income groups, the total cost in terms of foregone tax revenues is essentially independent of the method used to stimulate contributions." Feldstein, *The Income Tax and Charitable Contributions: Part II—The Impact on Religious, Educational and Other Organizations*, 28 NAT'L TAX J. 209, 209-10 (1975).

55. See FILER COMMISSION REPORT, *supra* note 15, at 132-33; Feldstein, *The Income Tax and Charitable Contributions: Part II—The Impact on Religious, Educational and Other Organizations*, 18 NAT'L TAX J. 209, 225 (1975); *infra* text accompanying notes 112-16.

56. Morgan, Dye & Hybels, *supra* note 31, at 208.

57. Feldstein, *supra* note 55, at 224; Feldstein & Taylor, *supra* note 41, at 1436.

the government can reasonably be considered to have an equally strong claim to funds involved in tax credits, because such funds would otherwise have to be paid in taxes.⁵⁸

With this background on the history and policy of the charitable contribution deduction, the article will turn now to an analysis of the statutory provisions.

B. *Eligible Donees and Purposes*

1. TP, our hypothetical taxpayer, is the owner of a large tract of undeveloped real estate in the City of Columbia. TP gave the city a strip of land to be used for a street extension. Can TP deduct the value of the donated property? Section 170(c)(1).

Dedicating this strip of land to the city is clearly a gift to a political subdivision of the state as required by section 170(c)(1), but the issue in this case is whether the gift has been made for exclusively public purposes. If, as seems likely, the donation to the city will benefit TP's land, perhaps permitting him to subdivide the tract, then the personal benefit to TP makes this gift nondeductible. The requirement that the gift to a governmental unit be made for "exclusively public purposes" is the analog of section 164(c). A special assessment, levied against property to pay for curbs and gutters, for example, is not deductible *as a tax* because of the direct benefit to the property owner. Similarly, section 170(c)(1) requires that to be deductible as a charitable contribution the expenditure must be made for the exclusive benefit of the governmental unit, not to advance the private interest of the donor.

2. TP wrote a \$50 check to the Lions Club.⁵⁹ Can he deduct this amount? What result if the check was made out to "Lions Club Leader Dog Program"? Section 170(c)(4).

The unconditional gift of \$50 to the Lions Club is nondeductible because section 170(c)(4) also contains an exclusive use requirement. It is easy to see why Congress imposed such a limitation. The provision of meals, social, and recreational opportunities for members is a large part of the activities of most fraternities. Individuals cannot deduct their own food and entertainment costs, and the same result applies if they join together with others in a fraternity. Because payments to the fraternity support the consumption activities of its members, they are nondeductible. On the other hand, if the gift is restricted to use in the provision of leader dogs for the blind, it is devoted exclusively to an exempt charitable activity, and the deduction would be allowed.

58. FILER COMMISSION REPORT, *supra*, note 15, at 132. See generally Wiedenbeck, *supra* note 42.

59. The names of specific organizations are used in this and other problems to provide familiar examples of fact situations which *arguably* raise the legal issues discussed. All problems are hypothetical, and no inference should be made concerning the actual structure or operations of the organizations mentioned.

3.A. TP sends a \$200 check to the University of Toronto. Is he entitled to a deduction? Section 170(c)(2)(A). What result if TP writes the check to the University of Toronto American Donors Fund, a New York charitable trust which annually distributes all of its assets to the University of Toronto? Why the difference in result?

If TP sends the \$200 check directly to the University of Toronto, the contribution will be nondeductible.⁶⁰ Assuming that the University is a Canadian corporation, it fails to meet the requirements of section 170(c)(2)(A) because it is not created or organized under the laws of the United States or of any state.

Contrast the result when TP sends the check to the University of Toronto American Donors Fund. Here, since the fund is a New York charitable trust, it is created or organized under the laws of a state, and the gift should be deductible. But why this difference in outcome, when the activities supported by the contributions will be exactly the same? This result can be explained by examining the other requirements for deductibility under section 170(c)(2). In addition to being created under U.S. law, an organization eligible to receive tax-deductible contributions must also be organized and operated exclusively for educational purposes, no part of its net earnings may inure to the benefit of any private shareholder or individual, no substantial part of its activities may consist of attempts to influence legislation, and in no event may the organization participate or intervene in any political campaign on behalf of any candidate for public office. How will the IRS assure that these conditions are satisfied in the case of a contribution to an organization located outside the United States? The IRS has no authority to audit a foreign entity that has no contact with the United States.⁶¹ Section 170(c)(2)(A) permits enforcement by assuring that the IRS will have the ability to examine the books and records of a donee that is within United States' tax jurisdiction. In our hypothetical, the IRS will be able to examine the books and records of the American Donors Fund, the New York charitable trust. The burden will be on the American

60. In certain limited circumstances, this result is changed by treaty. Beginning in 1985, United States citizens and residents may deduct contributions made directly to a college or university organized in Canada at which the donor or a member of her family was enrolled. Other donations to charities organized in Canada are not deductible against U.S.-source income. Income Tax Treaty, signed Sept. 26, 1980, United States-Canada, art. XXI, ¶ 5, ___ U.S.T. ___, ___, T.I.A.S. No. ___, at ___ (approved by Senate June 28, 1984, 130 CONG. REC. S8573 (daily ed. June 28, 1984); instruments of ratification exchanged by the contracting States Aug. 16, 1984); see Diplomatic Letter from G. William Miller, U.S. Secretary of the Treasury, to Allan J. MacEachen, Minister of Finance of Canada (Sept. 26, 1980) (confirming contracting States' understanding that the donor's "family" means brothers and sisters (whether by whole or half blood or by adoption), spouse, ancestors, lineal descendants, and adopted descendants).

61. As a practical matter, the extremely broad summons power of the IRS, I.R.C. § 7602 (1982), is limited by the jurisdiction of the district courts to enforce a summons, *id.* §§ 7402(b), 7604, which is subject to constitutional due process requirements. *E.g.*, *United States v. Toyota Motor Corp.*, 561 F. Supp. 354 (C.D. Cal. 1983).

Donors Fund to show that it is operated exclusively for educational purposes, and it will satisfy its burden by showing the nature of the University of Toronto educational programs that its annual distributions support.

3.B. What result if TP's wholly-owned corporation makes a \$200 contribution to the University of Toronto American Donors Fund? Section 170(c)(2), penultimate sentence. What if TP's corporation makes the contribution but the American Donors Fund is a New York nonprofit corporation?

A contribution to the University of Toronto American Donors Fund, if made by TP's wholly-owned corporation, will be nondeductible. Although the contribution is to a trust created under U.S. law, an additional requirement is prescribed in cases where the donor is a corporation. A gift in trust by a corporate donor is deductible only if the money is to be used inside the United States. The reason that the Code imposes a U.S.-use requirement for contributions by corporations, but not for individual donations, is not entirely clear.⁶² This additional requirement may reflect concern for individual constitutional rights. For example, it would be clearly inappropriate to restrict an individual's right to support religion because his denomination is headquartered outside the United States.⁶³ Alternatively, the U.S.-use requirement may re-

62. A general domestic use requirement would follow quite naturally from the perspective which holds the charitable contribution deduction to be a tax subsidy, because direct government provision of services in lieu of the deduction would probably extend only to the border. Indeed, the principle that the tax allowance should be limited to the same extent as the public expenditure alternative was influential in the development of section 170, but incredibly, this idea provided the original (misguided) motivation for the U.S.-organization requirement, not the U.S.-use requirement. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19-20 (1938). Despite the consistency of a domestic use requirement with the tax expenditure analysis, the subsidy view fails to suggest any distinction between corporate and individual donations.

Certain state income tax laws prohibit or restrict the deductibility of contributions which support charitable activities outside the state. MINN. STAT. ANN. § 290.21.3(d) (West Supp. 1984) (corporate charitable contributions to organizations which do not carry on substantially all of their activities within Minnesota deductible only in proportion to Minnesota taxable net income; in taxable years beginning before 1983, restriction also applied to individuals); N.C. GEN. STAT. § 105-147(15), (16) (Supp. 1983) (no limit on contributions to the state, its political subdivisions or instrumentalities; also no limit on gifts to educational institutions or nonprofit hospitals located within North Carolina; contributions to other charities limited to 15% of adjusted gross income); S.C. CODE ANN. § 12-7-700(10) (1976) (20% adjusted gross income limit on individuals' charitable contributions, raised to 30% for gifts to churches, educational institutions, hospitals, and medical research organizations "situate in this State"); see also *id.* § 12-7-700(5) (limits on corporate contributions); accord D.C. CODE ANN. § 47-1803.3(a)(8) (Supp. 1984) (activities must be "carried on to a substantial extent in the District").

63. Conditioning the deductibility of religious contributions on the situs of the church might violate the establishment clause. *Cf. Larson v. Valente*, 456 U.S. 228, 254-55 (1982) (financial reporting obligations imposed on religious organizations that receive more than 50% of their contributions from nonmembers creates unconstitutional political entanglement). Similarly, IRS audits of domestic religious organizations to ascertain that contributions are not being used outside the United States might create a

flect a sense that because corporations are licensed to exploit the U.S. economy, it is fair to require that any deductible gift of corporate profits should benefit this economy. There is a problem with this analysis, however. Note that section 170(c)(2) applies the U.S.-use requirement only to a contribution from a corporation to a trust, chest, fund or foundation—it does not apply to a contribution from a corporation to a corporation. Thus, if the University of Toronto American Donors Fund were a New York corporation rather than a trust, TP's wholly-owned corporation could claim the deduction notwithstanding the foreign use. The failure to apply the U.S.-use requirement to corporate donees apparently derives from a drafting error,⁶⁴ but it is a longstanding and well-recognized drafting error. Therefore, if one were asked to organize the Lebanon War Relief Society, it would be wise to elect a domestic corporation as the form of organization, as this would permit the Society to solicit tax-deductible contributions both from individuals and corporations.

4. TP makes a \$200 gift to a local Cambodian refugee family to assist in their resettlement. Can he deduct this amount? Consider the implications of sections 262 and 151(e). What result if TP makes the contribution to the church that sponsored the refugee family to be used for the same purpose? Can TP make a deductible gift to the church to be used to increase the pastor's salary, where TP's brother is pastor?

The section 170(c) definition of "charitable contribution" includes only gifts to governmental units and qualified organizations, not to specific individ-

risk of excessive administrative entanglement. *See* L. TRIBE, *supra* note 40, § 14-12, at 865-70. Whether the free exercise clause would require that religions be excepted from an across-the-board prohibition on the use of charitable contributions outside the United States is far from clear. *Compare* Wisconsin v. Yoder, 406 U.S. 205, 234 (1972) (first and fourteenth amendments prohibit state from requiring high school education of Amish children) *with* United States v. Lee, 455 U.S. 252, 261 (1982) (free exercise clause does not prohibit mandatory employer participation in social security). *See generally* Mansfield, *The Religion Clauses of the First Amendment and the Philosophy of the Constitution*, 72 CALIF. L. REV. 847, 877-903 (1984). Note, however, that state income tax laws which limit the deductibility of contributions to out-of-state charities (discussed in note 62, *supra*) have apparently never been challenged.

64. The distinction between incorporated and unincorporated donees dates back to the 1935 extension of the deduction to corporate contributors. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014, 1016. The corporate deduction was adopted (over strong objections from the Roosevelt Administration) as a floor amendment to the Revenue Act of 1935 sponsored by the Ways and Means Committee, but there was no discussion of the technical language of the provision. 79 CONG. REC. 12422-24 (1935); S. REP. NO. 1240, 74th Cong., 1st Sess. 6-7, & Part 2 at 4, 7 (1935). In 1942 the Senate voted to repeal the U.S.-use requirement, apparently to encourage private philanthropy to assist with the foreign aid necessitated by the war effort. *See* S. REP. NO. 1631, 77th Cong., 2d Sess. 51 (1942). However, the bill agreed to in conference reimposed the restriction on corporate-donor/unincorporated-donee transfers as of the end of hostilities. Revenue Act of 1942, ch. 619, § 125, 56 Stat. 798, 822. In 1948, the House voted to lift permanently the U.S.-use requirement, but the Senate did not act on the bill. H.R. REP. NO. 2087, 80th Cong. 2d Sess. 34 (1948) (discussing § 113(b)(1) of the 1948 Revenue Revision Bill, H.R. 6712).

uals, however needy. Accordingly, TP's gift to the local Cambodian refugee family does not qualify. Section 102 sets forth the general rule that gifts are not income to the donee, but to assure that all income will be taxed once, neither are they deductible by the donor. Personal, living, or family expenses are not deductible; a taxpayer's only allowance for such costs is the \$1000 personal exemption of section 151(e), which can be claimed only for certain relatives and members of the taxpayer's household, and then only if the taxpayer provides more than one-half of their support. The organizational-donee requirement of section 170(c) assures that these limitations cannot be circumvented, and avoids the administrative problems that would attend a rule making deductibility turn on a distinction between gifts to truly needy individuals and gifts motivated by friendship or kinship. The charitable organization's selection of beneficiaries tends to provide independent assurance that deductible contributions are supporting a worthy cause, and IRS oversight of operations is designed to assure that tax-exempt organizations confer a public benefit rather than serving the personal, private interests of the founder, major contributors, or other interested parties. Thus, if TP makes his gift to the church that sponsored the refugee family, it should be deductible.

But what if TP makes a gift to the church to be used to increase the salary of the pastor, his brother? Here, TP may be using the church as a conduit to make a personal gift to his brother, in which case no deduction should be allowed. This example demonstrates that although a taxpayer may specify the purposes for which an organization can use his donation, the general rule that gifts to individuals are nondeductible requires that this specification be kept within limits—a taxpayer cannot earmark the gift for a specific recipient.⁶⁵

Does this principle, that the donor cannot earmark the gift for a specific recipient, call into question the earlier conclusion that a donation to the church to be used to resettle a specific Cambodian refugee family would be deductible? The resettlement gift is to individuals that, although needy, the donor has indirectly designated. If the resettlement program is sponsored by the church, one may argue that mere knowledge of the ultimate beneficiary of the gift ought not bar the deduction. Absent some personal relationship between the refugee family and the taxpayer-donor, like an employer-employee relationship, or evidence that they are personal friends, the intuitive response is that the gift to the church should be deductible. The author believes that the intuitive response is the correct result, and that this result can be reached through a two-step analysis: (1) Is the organizational-donee requirement satisfied?, and (2) Is the donor's primary purpose for making the contribution charitable? Furthermore, the organizational-donee requirement should be considered satisfied whenever the charitable organization, by actions independent of the donor, establishes and exercises *control over the program* in which the

65. E.g., Rev. Rul. 61-66, 1961-1 C.B. 19; see also authorities cited *infra* note 100 (disallowance where contribution yields personal benefit to donor).

funds are to be expended, whether or not it has the technical legal right to determine the ultimate application of the donor's gift.

Applying the suggested analysis to the hypotheticals under discussion, the results would be:

- 1) Gift to needy individual selected by the donor (i.e., not designated by independent acts of the charity)—nondeductible because organizational-donee test failed;
- 2) Gift to church to raise salary of the donor's brother, the pastor—nondeductible because both primary purpose and organizational donee tests failed (assuming, for purposes of the organizational donee test, that the church did not independently identify a need for salary supplementation);
- 3) Gift to church-sponsored refugee who is a personal friend of donor—nondeductible because primary purpose test failed;
- 4) Gift to church-sponsored refugee where there is no personal relationship with the donor—deductible.

It might be argued that a primary purpose test is ill-advised, because it makes deductibility turn on the subjective motivation of the donor. Where the charity determines that a need exists and solicits assistance, all gifts will advance public purposes, and perhaps all donors should receive the deduction. In case 3 above, for example, it might be thought odd that two parishioners who assist the refugees with identical \$100 gifts would receive different tax treatment, where one is a personal friend of the Cambodian family and the other contributor is not. There is merit to this objection because the suggested functional (or programmatic) interpretation of the organizational donee requirement, standing alone, is adequate to assure that the gift will be applied to public purposes. That is, the charitable organization's oversight should prevent the transfer from yielding direct benefits to the donor, and if the nondeductibility of ordinary gifts is founded on a concern over *disguised consumption*, the organizational donee test supplies the needed safeguard.

On the other hand, if ordinary gifts are nondeductible because they provide the donor with *intangible consumption*, the imprimatur of the charitable organization is not enough. Where the donation is primarily motivated by personal friendship, it is more like an ordinary gift than the typical charitable contribution. More importantly, under the intangible consumption rationale, gifts to charity are deductible in order to provide a tax incentive, not because they do not yield intangible consumption. Where the gift is motivated by friendship or kinship, however, a government subsidy is not needed to induce the contribution. In this situation, efficient design of the expenditure program requires that gifts which would be made anyway not receive the tax benefit. Thus, the primary purpose test is justified under the intangible consumption/tax subsidy view. The two-step analysis suggested here implements both the disguised and intangible consumption theories of the charitable contribution deduction, and would amount to an explicit recognition of the equal dignity of these theories, putting an end to the tax law's schizophrenic approach.

Cases and rulings provide some support for the primary purpose test⁶⁶ and the suggested functional interpretation of the organizational-donee requirement.⁶⁷ It must be emphasized, however, that the suggested two-step analysis has not received explicit (much less authoritative) judicial approval.⁶⁸ Therefore, where a gift for a specified purpose will in all likelihood benefit known individuals, the donor would be well advised to make the check payable to the "Church of X Refugee Resettlement Program," thereby maintaining the authority of the donee-church to use the funds to support some other refugee family, or to satisfy overhead or other incidental program costs.

Finally, note that section 170(g) permits a taxpayer to deduct up to \$50 per month of the amounts expended to maintain an elementary or secondary student as a member of the taxpayer's household pursuant to an international student exchange or similar program. This deduction is available only if the taxpayer cannot claim the \$1000 personal exemption deduction of section 151(e) for the student, most probably because the sponsoring organization is providing more than one-half of the student's support. The special deduction provision of section 170(g) is required precisely because of the beneficiary designation problem discussed above.⁶⁹

5. TP, an audiologist, donates her services one day each month to the Louisiana School for the Deaf, where she examines the students, administers hearing tests, and advises the teachers. By volunteering her services, TP forgoes approximately \$400 in fees she earns each day that she sees patients in her private practice. In addition, TP uses her family car to transport herself and the testing apparatus to the school. Can TP deduct the value of her contributed services? What about the depreciation of TP's automobile and her fuel costs? Section 170(a)(1), (c)(1).

The performance of uncompensated services is not a "contribution or gift" deductible under section 170. This fundamental proposition, that a dona-

66. *E.g.*, Rev. Rul. 79-81, 1979-1 C.B. 107; *see also* *White v. United States*, 725 F.2d 1269 (10th Cir. 1984) (parents of 19-year-old Mormon missionary allowed deduction for amounts paid at the request of the Mormon Church to their son to defray costs of transportation to and living expenses at his mission post, because their primary purpose was to further aims of the Church rather than to benefit the individual recipient). *Contra* *Brinley v. Commissioner*, 82 T.C. 932 (1984). The primary purpose test, of course, derives its principal support by analogy—it is the test used to determine whether an expenditure which yields both business and personal consumption benefits is deductible. *But see* Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 874-76 (1974); Klein, *The Deductibility of Transportation Expenses of a Combination Business and Pleasure Trip—A Conceptual Analysis*, 18 STAN. L. REV. 1099, 1104-12 (1966) (discussion of the practical and theoretical difficulties of the primary purpose test).

67. *E.g.*, *Bauer v. United States*, 449 F. Supp. 755, 758-59 (W.D. La. 1978), *aff'd on other grounds*, 594 F.2d 44 (5th Cir. 1979); *Tripp v. Commissioner*, 337 F.2d 432, 435-36 (7th Cir. 1964); Rev. Rul. 69-473, 1969-2 C.B. 37.

68. The two-step analysis seems to be the approach followed by the IRS. Rev. Rul. 79-81, 1979-1 C.B. 107, 108; Rev. Rul. 68-484, 1968-2 C.B. 105, 106-07.

69. *See* I.R.C. § 170(c) (1982) (final sentence).

tion of services is nondeductible, does not obviously follow from the language of section 170(c), but may be inferred from the section 170(a) requirement that "payment" of the contribution be made within the taxable year. The Code's failure to allow a deduction for an in-kind contribution of services follows as a necessary consequence of the Code's failure to impose a tax in such circumstances.⁷⁰ TP is not taxed on the market value of her donated services, and therefore does not need an offsetting deduction to assure that her tax base reflects only personal enrichment.⁷¹ Indeed, the tax law's failure to impute income from the uncompensated performance of services provides one of the principal justifications for the allowance of a charitable contribution deduction. The deduction preserves horizontal equity as between TP, who is in a position to make a tax-free contribution of services, and another taxpayer—a securities lawyer, for example—who must earn a fee and contribute cash or property because his services are not of a kind that is needed by charitable organizations.⁷²

70. Occasionally, the distinction between a contribution of services and an indirect contribution of money presents difficult problems. Where the alleged contribution of services to charity is in substance an anticipatory assignment of income which the service-performer would otherwise earn, the performer is taxed on the income received by the charity and may claim a deduction for the contribution under section 170. Characterization of the transaction as an assignment of income can have important (adverse) tax consequences for the service-performer, because the percentage limits on the charitable contribution deduction (section 170(b)(1)(A) & (B), (b)(2)) may come into play. Where a famous entertainer agrees with her promoter that the proceeds of a benefit performance will be paid to charity, anticipatory assignment rules clearly apply. But even if the entertainer agrees to provide free services directly to the charitable organization the transaction may be deemed an assignment of income rather than a gift of services if there is a ready commercial market for the services, because the charitable organization (as employer of the entertainer) will simply contract with a promoter to obtain the same result. Rev. Rul. 71, 1953-1 C.B. 18. On the other hand, where the charitable organization is the actual promoter of the event (Treas. Reg. § 1.61-2(c) (1957); G.C.M. 27026, 1951-2 C.B. 7, *declared obsolete*, Rev. Rul. 84-39, 1984-1 C.B. 279) or where the entertainer does not participate directly or indirectly in making arrangements for the commercial exploitation of her services (Rev. Rul. 71-33, 1971-1 C.B. 30), the income is "earned" by the charity, and the entertainer has made a gift of services. *See generally* 3 B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 75.2.4 (1981); I.R.C. § 114 (1982) (overriding general assignment-of-income principles where corporate sports promoters conduct benefits for the American National Red Cross).

71. This argument assumes that gifts should not be treated as a consumption expense of the donor—that the intangible satisfactions associated with giving are insufficient to justify imposition of a tax on the donor. While justifiable in theory, this approach is not the best view of current law. *See supra* notes 17-28 and accompanying text.

72. If gifts are treated as a consumption expense of the donor (the better view of current law), then the horizontal equity criterion should be satisfied by taxing TP on the value of her services rather than allowing the donor of property a deduction. This approach would reflect intangible consumption by including both gifts of property and services in the tax base. On this view, criteria other than horizontal equity must justify the deduction. *See supra* notes 29-39 and accompanying text.

Does the nondeductibility of TP's services extend to the incidental costs (depreciation and gasoline) incurred in connection with the performance of the services? The IRS takes the position that the depreciation on TP's automobile is not deductible because it is not an out-of-pocket expense of the sort "payment of which" can be made within the meaning of section 170(a).⁷³ TP's gas costs, however, are deductible.⁷⁴

C. Percentage Limitations and Carryover

6.A. This year TP, an elderly alumnus of the University of Missouri Medical School, decides to establish a \$200,000 fund, the income from which will be used to bring prominent figures in the medical and biological sciences to the Columbia campus to present lectures and seminars. TP's adjusted gross income for the current year will be \$500,000. Should TP contribute the \$200,000 to the Board of Curators as trustee of the endowment fund, or should he name his own bank as trustee? Read section 170(b)(1)(A), paying particular attention to the introductory and final clauses, then examine section 170(b)(1)(B) & (F), section 170(b)(1)(A)(i)-(viii), and section 509(a). As a policy matter, why the difference in result?

First consider the result if TP names the Board of Curators as trustee. In this case, the contribution is made directly to the University of Missouri, an educational organization described in clause (ii) of section 170(b)(1)(A). Accordingly, the contribution will be deductible up to fifty percent of TP's contribution base for the taxable year. Section 170(b)(1)(F) provides that the term "contribution base" means, in general, adjusted gross income. Therefore, TP's full \$200,000 contribution in trust to the Board of Curators would be deductible.

On the other hand, if TP named his own bank as trustee, the contribution is not made to the University of Missouri, it is made to the bank. Note the difference between the section 170(c) definition of charitable contribution, which includes a gift "to or for the use of" a qualified organization, and the section 170(b)(1)(A) requirement that the contribution, in order to qualify for the fifty-percent adjusted gross income limit, must be made "to" one of the organizations listed in section 170(b)(1)(A). Gifts in trust are for the use of the beneficiary, but they are to the trust.⁷⁵ The effect of this subtle shift in

73. *E.g.*, *Orr v. United States*, 343 F.2d 553, 556 (5th Cir. 1965).

74. *Treas. Reg. § 1.170A-1(g)* (1972). *See generally* Newman, *The Inequitable Tax Treatment of Expenses Incident to Charitable Service*, 47 *FORDHAM L. REV.* 139 (1978). In lieu of deducting actual gas costs, taxpayers may claim a deduction based on the standard mileage rate of 12 cents a mile. *I.R.C. § 170(j)* (West Supp. 1985).

75. *Rockefeller v. Commissioner*, 676 F.2d 35 (2d Cir. 1982), *acq.*, *Rev. Rul.* 84-61, 1984-17 *I.R.B.* 8; *Treas. Reg. § 1.170A-8(a)(2)* (1972); *H.R. REP. NO. 1337*, 83d Cong., 2d Sess. A53 (1954). By its acquiescence in *Rockefeller*, the Service has conceded that expenditures made for the benefit of a charitable organization are constructive or in-kind contributions "to" the organization, even though the charity never receives cash. Accordingly, deductible expenditures made incident to the performance

language is to say that gifts in trust are subject to the fifty-percent adjusted gross income limit only if the trust is itself an organization specified in section 170(b)(1)(A).⁷⁶

Clearly, the trust is not itself an educational organization, and the question then becomes whether it falls within any of the other clauses of subsection (b)(1)(A). The trust is not a church, not a hospital or medical research organization, and not a governmental unit. Clauses (iv) and (vi) also do not apply because TP is the sole contributor—the trust does not receive a substantial part of its support from either governmental units or the general public.⁷⁷ Because the bank will invest the settlor's contribution and turn over the trust income to the University rather than selecting and paying guest lecturers itself, clause (vii) also will not apply.⁷⁸ This leaves clause (viii) as the only basis for arguing that the trust is itself an organization described in section 170(b)(1)(A).

To qualify for the fifty-percent limit under clause (viii) the organization must be described in section 509(a)(2) or (3). The trust is not an organization described in section 509(a)(2) because it will not normally receive more than one-third of its support in contributions from persons other than disqualified persons. TP, as a substantial contributor to the trust, is a disqualified person under section 4946, and his contribution will provide substantially all of the trust's support in the year of its organization. In subsequent years the trust's entire support will consist of its investment income, so the requirements of both subparagraphs (A) and (B) of section 509(a)(2) will not be satisfied.

Section 509(a)(3) does not contain the requirement that the organization receive broad public support. Therefore, it provides a more hopeful basis for arguing that the trust is eligible for the fifty-percent limit. The trust is organized and operated exclusively for the benefit of the University of Missouri,⁷⁹

of services for an organization described in section 170(b)(1)(A) qualify for the 50% limit. See *supra* notes 70-74 and accompanying text.

76. All corporate gifts are subject to a limit of 10% of taxable income, regardless of the purposes of the donee or whether the transfer is in trust. I.R.C. § 170(b)(2) (1982). The 10% limit cannot be circumvented by claiming the contribution as a business expense for advertising or community goodwill. *Id.* § 162(b).

77. Treas. Reg. § 1.170A-9(e)(6)(i) (1972) (contribution by an individual taken into account as support from the "general public" for purposes of section 170(b)(1)(A)(vi) only to the extent of 2% of the organization's total support for the relevant period); *id.* § 1.170A-9(e)(7)(i) ("support" under section 170(b)(1)(A)(vi) defined as in section 509(d)). The support test applicable to section 170(b)(1)(A)(iv) is not defined as specifically by regulations, *id.* § 1.170A-9(b)(2)(ii), yet the relevant statutory language is identical under clauses (iv) and (vi).

78. That is, the trust is not a private *operating foundation* (section 170(b)(1)(E)(i)) because it will not itself use the trust income to advance its charitable purposes. Instead, it makes grants to the University to conduct such activities. I.R.C. § 4942(j)(3)(A) (1982); Treas. Reg. § 53.4942(b)-1(b)(1) (1972). The trust is also not a *conduit foundation* (section 170(b)(1)(E)(ii)) because the settlor's entire \$200,000 contribution will not be promptly transferred to the University.

79. The regulations set forth detailed requirements concerning: (1) provisions of

an organization described in section 509(a)(1) (which refers back to the section 170(b)(1)(A) list that includes educational organizations). The third requirement of section 509(a)(3) is also satisfied, because the trust is not controlled by TP, a disqualified person.⁸⁰ Yet the second requirement, that the trust be "operated, supervised or controlled by or in connection with" the organization it supports, presents serious difficulties. If TP names his bank as trustee, the trust clearly will not be operated, supervised, or controlled by the University of Missouri.⁸¹ The only plausible argument is that the trust might operate *in connection with* the University.⁸²

The regulations under section 509(a)(3) provide that a supporting organization (here the trust) is considered to be "operated in connection with" the eligible charity it supports (here the University) only if their relationship is sufficient to insure that (1) the trust will be *responsive* to the needs or demands of the University, and (2) the trust will constitute an *integral part* of, or maintain a significant involvement in, the operations of the University.⁸³ A charitable trust meets the responsiveness test if it is enforceable by organizations which it supports that are named in the trust instrument.⁸⁴ The majority rule is that charitable trusts are enforceable by persons with a special interest in the trust (such as a named beneficiary organization), so TP's trust is responsive.⁸⁵ However, the integral part test demands that the supported organization be dependent on the type of support provided. Where, as here, the support provided is the payment of substantially all of the trust's income, the income must represent a sufficient part of the Medical School's total support to assure financial dependency and hence attentiveness to the operations of the

the organization's governing instrument (articles of incorporation or deed of trust) necessary to establish that it is "organized . . . exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more" eligible charities; (2) what constitutes adequate "specification" of the eligible charities to be supported; and (3) what expenditures satisfy the operational test. Treas. Reg. § 1.509(a)-4(a) to -4(e) (1972). Where the trust instrument obligates the bank to distribute all trust income annually to the University of Missouri, these requirements would be satisfied.

80. Note, however, that if TP were a joint trustee with the bank, the trust would be considered controlled by a disqualified person, and if TP owned a majority of the voting stock or was a principal officer of the bank indirect control would be found. Treas. Reg. § 1.509(a)-4(j) (1972).

81. The terms "operated, supervised or controlled by" demand that the eligible charity (here the University) possess a substantial degree of direction or control over the conduct of the trust, comparable to the relationship between a parent and subsidiary. *Id.* § 1.509(a)-4(f)(4), -4(g).

82. The trust is not "supervised or controlled in connection with" the University because control or management of the organizations is not vested in the same persons. *Id.* § 1.509(a)-4(f)(4), -4(h).

83. *Id.* § 1.509(a)-4(f)(3), -4(i).

84. *Id.* § 1.509(a)-4(i)(2)(i), (iii).

85. RESTATEMENT (SECOND) OF TRUSTS § 391; *id.* comment c (1959). TP's trust is charitable because it is devoted to the advancement of education. *Id.* §§ 348, 370.

trust.⁸⁶ The precise proportion of total support that must be provided to assure attentiveness depends on all the facts and circumstances,⁸⁷ but the annual income from the trust's \$200,000 corpus seems unlikely to assure attentiveness when compared to the Medical School's total budget.

The preceding analysis indicates that if TP names his local bank as trustee, the trust will not qualify under section 509(a)(3), and hence TP's gift will not qualify for the fifty-percent limit on charitable contribution deductions. But what is the purpose of these technical requirements? And in particular, why must a supporting organization be "operated, supervised or controlled by or in connection with" the eligible charities it supports? The "responsiveness" and "integral part" tests of the regulations provide a clue—Congress wanted to assure that the organization supported had both the *legal authority* (responsiveness test) and the *practical incentive* (integral part test) to oversee the operations of the supporting organization and if necessary enforce its charitable obligations. The organizations described in section 170(b)(1)(A) are tax-favored charities (higher deduction limits), and Congress has conditioned that special status on a showing that either: (1) the organization actually conducts a preferred activity (religion, education, medical care or research, government services),⁸⁸ (2) the organization receive broad public support,⁸⁹ or (3) the organization supports a preferred activity or an organization receiving broad public support *and* circumstances indicate that the supporting organization is likely to be managed to provide the maximum benefit to the organizations supported.⁹⁰ Returning to our hypothetical, if TP names his bank as trustee,

86. Treas. Reg. § 1.509(a)-4(i)(3)(iii) (1972). Note that it is the proportion of the Medical School's total support, not the absolute amount of income provided by the trust, that determines attentiveness to the operations of the trust, and hence whether the integral part test is met. (An exception is provided in circumstances where the supporting organization's income funds a particular important function or activity; despite the small proportion of funds provided, in these circumstances continuance of an important function is likely to assure oversight.) *Id.* § 1.509(a)-4(i)(3)(iii)(a) (penultimate sentence); *id.* at 4(i)(3)(iii)(b). The regulations expressly provide that the supporting organization's income should be compared to the total support of a department or school, rather than to the total support of the University, where a particular department or school is the beneficiary of the support. *Id.* § 1.509(a)-4(i)(3)(iii)(a) (final sentence).

87. *Id.* § 1.509(a)-4(i)(3)(iii)(d).

88. I.R.C. § 170(b)(1)(A)(i) to (v) (1982).

89. *Id.* §§ 170(b)(1)(A)(iv), (vi); *id.* 509(a)(2).

90. *Id.* § 509(a)(3). The private operating foundations described in I.R.C. § 170(b)(1)(E)(i) (West Supp. 1985) do not fit neatly into this tripartite classification. These foundations need not advance a preferred activity and do not receive broad public support, but they are subject to detailed requirements to assure that they actually conduct activities in pursuance of their charitable purposes (i.e., an operating foundation must operate, not merely provide financial support). This activity requirement and the IRS supervision it entails is apparently deemed adequate assurance that the organization will advance truly public purposes. In this view, operating foundations are analogized to organizations that receive broad public support, except that the activity requirement, rather than dependence on contributions from the general public, is

the Medical School (despite its legal authority as a beneficiary named under the trust instrument) may not have the financial incentive to scrutinize the bank's performance as trustee, to assure an adequate investment yield for the University, or prevent conflicts of interests or self-dealing.

6.B. If TP names the bank as trustee, how much of the \$200,000 endowment fund can he deduct? What if he also contributes \$180,000 this year to the University of Missouri-Columbia Hospital?

If the bank is named as trustee, the gift in trust will still qualify as a charitable contribution under section 170(c), but a different percentage limitation will apply. Section 170(b)(1)(B) provides that any charitable contribution that is not made to one of the favored donees listed in section 170(b)(1)(A) is deductible, but only up to a limit of thirty percent of the donor's contribution base. TP's contribution base for the current year is his adjusted gross income (AGI), \$500,000. Thus, if TP names his bank as trustee, he may deduct only \$150,000 of the corpus. If TP also makes a \$180,000 contribution to the University hospital this year, an even smaller portion of the trust corpus can be deducted, because section 170(b)(1)(B) provides that the thirty-percent limit cannot operate to increase the total deductible contributions for the year above fifty percent of the donor's contribution base. Because the \$180,000 charitable contribution to the hospital is described in section 170(b)(1)(A), only \$70,000 of the trust corpus would be deductible, as this amount brings TP's total charitable contribution deduction to \$250,000, one-half of his adjusted gross income.

6.C. Again assuming that TP makes the \$180,000 gift to the University hospital during the current year, what becomes of the excess contribution? Section 170(b)(1)(B), final sentence, and 170(d)(1).

If the Board of Curators is named trustee, all of TP's charitable contributions are made to organizations subject to the fifty-percent limit, and the \$130,000 excess contribution (\$380,000 total contributions minus \$250,000 AGI limit) will be available as a carryforward to each of the next five taxable years until it is absorbed within the fifty-percent limit for those years. If TP names his bank as trustee, the five-year carryforward would also be available, but the excess contribution remains subject to the thirty-percent limit in the years to which it is carried.⁹¹ Thus, if TP makes no charitable contributions in

considered sufficient to assure maximum societal benefits from the charity. Conduit foundations, on the other hand, fit into the third category described in the text. *Id.* §§ 170(b)(1)(E)(ii); *id.* § 4942(g)(1). The House Ways and Means Committee stated the principle as follows:

Because as a general rule public charities and operating foundations directly carry out charitable functions, expend charitable donations more promptly, and have public involvement, support and supervision, the committee believes that a tax preference for contributions to public charities and operating foundations continues to be appropriate.

H.R. REP. NO. 432, 98th Cong., 2d Sess. 1464 (1984).

91. Prior to 1984, no carryover was permitted for excess contributions subject to

the succeeding year and his adjusted gross income is \$400,000, only \$120,000 (thirty percent of \$400,000) of the \$130,000 carryforward will be deductible.

6.D. What is the purpose of the fifty-percent limit?

Prior to 1970, certain wealthy taxpayers who lived on their savings and devoted all income to charity could deduct the full amount of their contributions, thereby paying no tax on large incomes.⁹² Present law reflects a judgment by Congress that although charitable contributions are important and should be encouraged, every taxpayer should bear part of the burden of supporting the government.⁹³ Yet many of the activities that charitable contribu-

the lower adjusted gross income limit (then 20%). Thus if TP established the trust in 1983 and named his bank as trustee, \$130,000 of the corpus would never be deductible. Thus, prior to 1984 contributions made to a donee not described in section 170(b)(1)(A) were disfavored in three respects: (i) they were subject to a 20% limit; (ii) excess contributions were not available as a carryforward and therefore could never be deducted; and (iii) the rules of section 170(d)(1) provided that a carryforward of excess contributions from a prior tax year would count towards the 50% limit in a subsequent year before any 170(b)(1)(B)-type contributions made in the subsequent year were taken into account (thus, in effect, bumping disfavored contributions by prior excess favored contributions). Congress explained its decision to permit a carryforward of excess contributions subject to the 30% limit as follows:

The committee believes that the failure of present law to provide a carryover deduction in the case of excess contributions to private nonoperating foundations merely requires the donor to divide a planned large gift to a nonoperating foundation into smaller amounts contributed over several years. Accordingly, the committee believes that extension of the carryover rules to contributions to nonoperating foundations is not inconsistent with longstanding Federal tax policy that provides a tax advantage to contributions to public charities and operating foundations.

H.R. REP. NO. 432, 98th Cong., 2d Sess. 1463-64 (1984). In short, the failure to provide a carryforward for 170(b)(1)(B)-type contributions was a trap for the unwary (and the ill-advised).

92. I.R.C. § 170(b)(1)(C) (amended by Pub. L. No. 91-172, § 201(a)(1), 83 Stat. 487, 549, 557-58 (1969), which gradually lowered the unlimited deduction to 50% over the period 1970-74).

93. For example, in a 1968 study of tax reform proposals the Treasury Department observed:

The general purpose of [the charitable contribution deduction percentage] limitation is to prevent people from discharging their entire tax liability to the Government by making donations to selected charities equal to the amount of their otherwise taxable income. In this manner, persons are encouraged to support charitable organizations but at the same time also contribute to the costs of running their Government

In keeping with the basic principles underlying the structural revision of the charitable contribution deduction—that all individuals should pay their fair share of taxes in order to support the Federal Government—this provision of the reform program would repeal the unlimited charitable deduction.

HOUSE COMM. ON WAYS & MEANS, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, U.S. TREASURY DEPT. 204 (Comm. Print 1969). Perhaps a more important factor behind the repeal of the unlimited deduction than this theoretical concern was a popular perception of abuse resulting from a number of widely publicized cases of tax-

tions support, such as poverty relief, education, and medical care, would require government support if not funded through charity.⁹⁴ Therefore, it can be argued that the taxpayer who gives all of his income to charity is reducing the burdens of government, not avoiding his fair share of taxes or shirking his obligation to support our society. Perhaps the appropriate response to this argument is that even under a regime with no charitable contribution deduction, the government would not take over all the functions (e.g., religion or family planning) that exempt organizations now provide,⁹⁵ and the government would certainly set a different list of priorities than most private donors.⁹⁶

But if we resist direct government support because we believe in the value of pluralism, how can we have too much of a good thing? Why not replace the charitable contribution deduction with a dollar-for-dollar credit against tax? This approach would recognize that in the absence of voluntary private support many activities of charitable organizations (such as poverty relief and the provision of cultural and educational opportunities) would become the function of government, and would therefore treat public and private provision of these social services consistently. Thus, taxpayers would be permitted to satisfy their federal tax liability by selecting among charities and the federal government. This approach would not make the tax system voluntary, taxpayers would still have to devote that portion of their annual income that is determined under

payers with incomes in excess of \$1 million paying no federal income tax due to the unlimited deduction. *E.g.*, H.R. REP. NO. 413, 91st Cong., 1st Sess. 52 (1969). Yet it appears to have been the Treasury itself that instigated the public outcry by releasing the data. HOUSE COMM. ON WAYS & MEANS, *supra* at 85-95.

Similar limits have been applied to certain other tax incentive provisions, but there is no comprehensive or consistent approach. For example, the investment tax credit is limited to a percentage of tax liability (currently 85% in excess of 25,000 (I.R.C. § 38(c)(1) (West Supp. 1985)) and benefits and contributions under qualified retirement plans are limited to a percentage of the participant's compensation (I.R.C. § 415(b)(1), (c)(1) (1982)). *See* S. REP. NO. 1881, 87th Cong., 2d Sess. 17 (1962); H.R. REP. NO. 807, 93d Cong., 2d Sess. 112 (1974). In contrast, there is no limit on the amount of exempt income that can be earned in the form of interest in municipal bonds, and the accelerated cost recovery deduction is allowed to eliminate taxable income.

94. Since World War II, government funding has come to play an increasingly important role in several areas of traditional philanthropic endeavor, particularly in the provision of health care and poverty relief. *See supra* notes 36, 38.

95. R. GOODE, *THE INDIVIDUAL INCOME TAX* 162 (rev. ed. 1976).

96. The 1984 Treasury Department tax reform proposals would eliminate the 50% limit for contributions either to or for the use of the favored donees listed in section 170(b)(1)(A). (Note that under present law gifts "for the use of" such charities are subject to the lower 30% limit.) The lower limit (currently 30%) on gifts to or for the use of other charities would be retained, however. U.S. DEP'T OF THE TREASURY, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH—GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS 75-77* (1984), *reprinted in* 1984 FED. TAXES (P-H) Bull. 12 Extra, § 2 (Dec. 20, 1984) [hereinafter cited as *TREASURY REPORT ON TAX REFORM*]. The proposed retention of percentage limits on contributions toward organizations not on the "favored" list of section 170(b)(1)(A) apparently reflects a judgment that such organizations do less to satisfy needs for essential public services.

the progressive rate schedules to public purposes and file a return. But to satisfy their debt to society each taxpayer could select between the government's slate of priorities, the United Way's slate, and his or her own personal combination.

The credit approach would force the government to compete for social service dollars. Such competition may be thought inefficient or unseemly (consider the advertising campaigns likely to result). But there is a more fundamental reason for rejecting the dollar-for-dollar credit. Many government services are not competitive and could not be provided by the private voluntary sector—for example, national defense or economic stabilization. As to these functions there is a legitimate concern that consumers cannot be trusted to evaluate properly the relative merits of, for example, a stronger defense versus better museums or public parks.⁹⁷ This consideration may supply a convincing reason for rejecting charitable contributions as direct offsets to tax where the taxes fund uniquely governmental functions. But in many fields government and private philanthropy are complementary, and here perhaps consumers should be permitted to vote with their dollars. The fifty-percent deduction limit can perhaps be viewed as a mechanism to effectuate an appropriately limited consumer sovereignty over social service expenditures.⁹⁸

D. *Amount Deductible*

7. TP and her husband attended the annual Museum of Natural History benefit dinner. TP paid \$50 apiece for the tickets. The gala affair was held in and catered by the museum cafeteria. How much can TP deduct? Section 170(c).

Given the quality of the food, TP can probably deduct substantially all of the \$100 she paid for the tickets. Section 170(c) teaches that charitable contribution means gift. All but the value of the meals provided is a gift—this is just a scrambled transaction, and only the gift part is deductible. But what constitutes a gift? Recall the *Duberstein* standards: whether the payment proceeds from “the constraining force of any moral or legal duty” or from “detached and disinterested generosity.”⁹⁹ How would these standards be applied to the Metropolitan Museum of Art in Gotham City, which doesn't charge admission to the galleries, but makes it very clear what the “recommended dona-

97. If consumers are permitted to make such categorical budget decisions the likely result would be overfunding of those public services that yield the most direct and immediate consumption benefits for the contributor, while services that produce highly diffuse or deferred benefits would be underfunded. *See* Wiedenbeck, *supra* note 42.

98. Accordingly, the best justification for the deduction limit is not that government could not take over all the activities of private philanthropy (see *supra* text accompanying note 95), but that private philanthropy could not take over all the functions of government.

99. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

tion" is as visitors file past the cash register? Is payment of the recommended donation deductible? Where the recipient is a charitable organization rather than a business associate as in *Duberstein*, should the IRS be less inclined to assert a disqualifying "moral obligation"?¹⁰⁰

8.A. TP owns certain property worth \$10,000 that has a \$5000 adjusted basis. What is the general rule concerning the amount of the charitable contribution deduction where the gift is of property rather than cash? Compare section 170(a)(1) with section 170(e)(1).

Section 170(e)(1) is a special rule that reduces the amount of the deduction, in certain circumstances, by the unrealized appreciation in the value of the property. This special rule indicates that the general rule governing the amount of the charitable contribution deduction is that the taxpayer may deduct the fair market value of the property.¹⁰¹ Compare this general rule for charitable deductions with section 102(a), which consistently provides that, at the time of a gift, the donee may exclude the full fair market value of the property.

8.B. Assume TP is in the seventy-percent tax bracket (applicable to taxable years beginning before 1981) and that the gain on the sale of his property would generate ordinary income. If he sold the property and kept the proceeds, how much cash would he have after taxes? If instead he gave the property to charity, how much cash would he have in pocket, taking into account the deduction? What is the purpose of section 170(e)(1)(A)?

TP's gain on the sale of the property is \$5000 (\$10,000 fair market value minus \$5000 adjusted basis). Therefore, upon sale TP would be left with \$6500 in pocket after taxes (\$5000 return of basis plus \$1500 after-tax proceeds at the seventy-percent rate). Before section 170(e) was enacted, if TP donated the property to charity he would have a \$10,000 charitable contribution deduction which would shelter unrelated income from tax. Absent this deduction, TP would be left with only \$3000 of the unrelated income after taxes. Accordingly, upon making a charitable contribution of the property, TP would be left with \$7000 in after-tax proceeds attributable to the transfer. Under the fair market value rule, he is \$500 better off by making a charitable contribution of the property than he is by selling it for cash! Section 170(e)(1)(A) is designed to prevent this result whenever income from the sale of the property would be ordinary income or short-term capital gain. In a transaction such as this, where the taxpayer actually profits by his gift to charity, the IRS could argue that the deduction is not allowable because the "gift"

100. See *Winters v. Commissioner*, 468 F.2d 778 (2d Cir. 1972); Annot., 33 A.L.R. FED. 373 (1977); 2 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 35.1.3 (1981); Colliton, *The Meaning of "Contribution or Gift" for Charitable Contribution Deduction Purposes*, 41 OHIO ST. L.J. 973 (1980); Note, *Measuring Offsets and Eliminating Inequities in the Charitable Contribution Deduction*, 33 STAN. L. REV. 893 (1981).

101. Treas. Reg. § 1.170A-1(c) (1972).

does not proceed from detached and disinterested generosity. Merely by lowering the highest marginal tax rate to fifty percent in 1981, Congress assured that taxpayers could not profit from the donation of appreciated property to charity. But section 170(e)(1)(A), which was enacted while the top marginal tax rates were higher than fifty percent, goes farther—it limits the amount of the deduction upon a contribution of inventory or short-term gain property to the adjusted basis of the property.¹⁰² Thus, under section 170(e)(1)(A) a gift of unrealized income is treated like a gift of services—no deduction is allowed because the contribution was never subject to tax.

Congress was apparently surprised by the effectiveness of section 170(e)(1)(A) in discouraging tax-motivated contributions.¹⁰³ Note the exceptions for certain favored contributions set forth in section 170(e)(3) and (4). Under these provisions, a taxpayer may still deduct up to one-half of the ordinary income and short-term gain components of unrealized appreciation in cases where the contribution is to be used for care of the ill, needy, or infants (such as food or medical supplies), or consists of certain new scientific equipment to be used in research at qualified educational institutions. Can Apple Computer, Inc. deduct the full list price of its products if it pursues a program of donating a new computer to every elementary school and high school in America?¹⁰⁴

8.C. If TP's \$5000 gain on the sale of the property qualifies as long-term capital gain, only forty percent of the gain would be included in his taxable income under section 1202(a). Now do you understand the point of section 170(e)(1)(B)? How much can TP deduct if the property is a building site which he donates to the University? Stocks and bonds? A Picasso sketch? What justifies these limitations on section 170(e)(1)(B)?

If the income upon the sale of the property would be classified as long-term capital gain, section 170(e)(1)(B) requires that the taxpayer reduce the amount of his charitable contribution deduction by forty percent of the gain. The sixty percent of the gain that would not be taxed upon a sale of the prop-

102. Section 170(e) was enacted by the Tax Reform Act of 1969, but the fallacy of a deduction for unrealized appreciation was recognized much earlier. The House version of the Revenue Act of 1938 contained a provision that would have limited the amount deductible on an in-kind contribution to the lesser of adjusted basis or fair market value of the property. But the conference committee struck this limitation. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 20 (1938).

103. S. REP. NO. 938, 94th Cong., 2d Sess. 78 (1976); S. REP. NO. 144, 97th Cong., 1st Sess. 87-88 (1981).

104. Answer: No. It is not a qualified research contribution because the recipient schools are not institutions of higher education and the computers will not be used in research or research training. The "Computer Equipment Contribution Act of 1982," H.R. 5573, 97th Cong., 2d Sess. (1982), would have added a new exception to section 170(e)(1)(A) to encourage such contributions. The bill passed the House, but was not enacted. See H.R. REP. NO. 836, 97th Cong., 2d Sess. (1982); S. REP. NO. 647, 97th Cong., 2d Sess. (1982); Apcar & Chase, *Apple Wants a Big Tax Break So It Can Give One of its Computers to Every Public School*, Wall St. J., Mar. 19, 1982, at 29, col. 4.

erty is still available as a charitable contribution deduction.¹⁰⁵ Accordingly, the general rule reflected in section 170(e)(1) is that the amount of the charitable contribution deduction is reduced from fair market value by the amount of the unrealized appreciation (whether ordinary income, short-term capital gain, or long-term capital gain) that would be subject to tax upon a sale of the property.

At first glance the rule of section 170(e)(1)(B), which grants the donor a partial deduction for income on which he has never paid tax, seems inconsistent with the theory of the charitable contribution deduction. It must be remembered, though, that the donor never would pay tax on sixty percent of the long-term gain. If section 170(e) did not contain an allowance corresponding to the tax concession granted long-term capital gains, the donor would simply sell appreciated capital assets (or section 1231 property¹⁰⁶) and contribute the after-tax proceeds to charity.¹⁰⁷ The forty-percent reduction of section 170(e)(1)(B) makes the tax consequences of an in-kind contribution equivalent to the tax consequences of a market sale of the property followed by a cash contribution of the property's fair market value.¹⁰⁸

Because the University is not a private foundation¹⁰⁹ the donation of a

105. The reduction in the case of a corporation (28/46) is the ratio of the corporate capital gains tax rate (28% under section 1201) to the generally-applicable tax rate on corporate taxable income (46% under section 11). The 40% reduction in the case of an individual is also the ratio of the rate of tax on net capital gain to the tax rate on ordinary income, by virtue of the 60% deduction of section 1202(a).

106. The 40% reduction also applies to depreciable business property and real property used in a trade or business held for more than six months (so-called "section 1231 property"), even though such property does not technically qualify as capital assets under section 1221(2). I.R.C. § 170(e)(1) (1982) (final sentence).

107. Query whether the donor, in these circumstances, would be met with a step transaction argument by the IRS.

108.

Let: X = adjusted basis of property in hands of the donor,
Y = unrealized long-term gain, and
tm = marginal tax rate of donor.

Then, on an in-kind contribution,

Deduction = $X + 0.60Y$, via section 170(e)(1)(B).

Whereas if the donor sells and contributes the after-tax proceeds,

Deduction = $X + (1 - 0.40tm)Y$, and $0 \leq tm \leq 0.50$, via section 1.

In both cases, the donor has disposed of the entire value of the property (either to the charity alone, or to the charity and the IRS), but the deductions differ. This demonstrates that an in-kind contribution does *not* yield the same tax consequences as a sale of the property followed by contribution of *only* the after-tax proceeds; from the donor's tax perspective the gift in kind is less advantageous. Yet, if the donor sells the property and contributes the after-tax proceeds *plus* an amount of cash equal to the capital gains tax paid (i.e., contributes the fair market value of the property), then the donor's deduction is $X + Y$, which is greater than the deduction for the in-kind contribution by the amount $0.40Y$. Although the deduction is greater, the donor has paid out an extra amount of cash, equal to the capital gains tax ($0.40tmY$). The extra deduction will produce a tax saving exactly equal to the extra cash paid out.

109. I.R.C. §§ 509(a)(1), 170(b)(1)(A)(ii) (1982). A full fair market value de-

building site that had been held by the donor for more than six months¹¹⁰ would entitle the donor to a \$10,000 deduction, the full fair market value. The contribution is not reduced under section 170(e) because the unrealized appreciation would generate long-term capital gain if the property were sold, and the building site is real property. The same result applies to a donation of securities that have been owned for the long-term holding period; although the stocks and bonds are personal property, they are intangible personal property, and section 170(e)(1)(B) does not apply. The Picasso sketch presents the hardest case. Clearly, the sketch is tangible personal property, so the availability of a full fair market value deduction turns upon whether the use of the sketch by the University will be unrelated to the purpose or function which constitutes the basis for the University's tax exemption—that is, its educational mission. If the sketch is used for display in the University's museum or in art history classes, this educationally-related use would entitle the donor to a full fair market value deduction. On the other hand, if the University sells the sketch and uses the cash to support its educational program, the use is unrelated.¹¹¹

The preceding examples illustrate that taxpayers can still deduct the full fair market value of property in several important situations. All long-term appreciation is deductible where a public charity receives realty, intangible property, or related-use tangible personal property. These are glaring exceptions to the forty-percent reduction rule; because most wealthy taxpayers own appreciated stock or real estate, the practical effect of the statute is to exempt wealthy contributors from the impact of section 170(e). Why this undeserved extra deduction for the rich? The exceptions to the forty-percent reduction rule appear to be the result of political compromise, plain and simple.¹¹² This tax "loophole" proved unassailable, not because of a capitulation to the wealthy, but because of congressional concern about the effect of the forty-percent reduction on the volume of contributions to certain organizations. Almost all substantial gifts of property are made by upper-income taxpayers,¹¹³

duction is now allowed for gifts of readily marketable stock to a private foundation (even if it is not an operating or conduit foundation), because such gifts do not involve the opportunity for abuse through overvaluation of the contributed property that is present in other situations where the donor has practical control over the foundation. I.R.C. § 170(e)(5) (West. Supp. 1985); H.R. REP. NO. 432, 98th Cong., 2d Sess. 1464 (1984).

110. The long-term holding period under section 1222 has been reduced to six months for property acquired after June 22, 1984 and before January 1, 1988. Tax Reform Act of 1984, Pub. L. No. 98-369, § 1001(a)(1) to (2), 98 Stat. 1011.

111. Treas. Reg. § 1.170A-4(b)(3)(i) (1972).

112. See e.g., 115 CONG. REC. 40872 (1969) (colloquy between Rep. Reid and Rep. Mills); 115 CONG. REC. 22576-77 (1969) (statement of Rep. Broyhill).

113. Morgan, Dye & Hybels, *supra* note 31, at 186-88 (largest charitable gift during the year included corporate stock for 31% of households with income of \$500,000 or more; no stock gifts reported by households with income below \$50,000); FILER COMMISSION REPORT, *supra* note 15, at 144-45 (50% of property gifts made by persons with \$100,000 or more income, and at upper income levels those who give

who are the principal contributors to higher education, hospitals, and cultural organizations.¹¹⁴ Thus the forty-percent reduction rule would have a disproportionate adverse impact on the funding of these organizations.¹¹⁵ Concern for this adverse impact on some donees outweighed the desire for equitable tax treatment of all donors.¹¹⁶ Yet since appreciated realty and securities would be tax free if held until death, some have argued that the inequity lies in section 1014, and that the fair market value deduction is necessary to avoid an undesirable deferral of charitable contributions.¹¹⁷ The 1984 Treasury Department tax reform plan proposes to limit the charitable deduction to the inflation-adjusted basis of contributed property, thereby disallowing all deductions for untaxed appreciation.¹¹⁸

Although the fair market value rule still holds sway over the important area of gifts of appreciated stock and realty to public charities, gifts of such property are subject to special (more restrictive) percentage limitations. Taxpayers are given an election with respect to charitable contributions of appreciated realty, intangible property, and related-use personalty that would otherwise be subject to the fifty-percent limit on deductibility.¹¹⁹ The donor may elect to reduce his deduction by forty percent of the appreciation on all such property contributed during the year (including carryovers to the taxable year), in which event the fifty-percent limit applies.¹²⁰ Absent the election, all appreciation is deductible but the total value of all gifts that escape the reduction rule is limited to thirty percent of adjusted gross income.¹²¹ If property bearing long-term appreciation is contributed to a private foundation other than an operating or conduit foundation (i.e., to a donee normally subject to the thirty-percent limit), the aggregate of all such contributions is subject to a

appreciated property give more generously than those who contribute only cash).

114. See *supra* text accompanying note 56.

115. Feldstein & Taylor, *supra* note 41, at 1435-36 (3% overall drop in contributions if deductibility of appreciation were eliminated would translate into 8% drop for educational organizations); Feldstein & Clotfelter, *supra* note 41, at 1411-12 (constructive realization of appreciated property gifts predicted to cause 64% reduction in gifts by household with income of \$100,000 or more, no decrease in giving at lower income levels).

116. This special treatment of gifts of appreciated realty and securities might be viewed as proof that the choice of a charitable contribution deduction (in lieu of matching grants or tax credits) involves a judgment that the charitable goals of the rich are "better" or more socially useful than programs supported by the poor. See *supra* text accompanying note 55.

117. FILER COMMISSION REPORT, *supra* note 15, at 145-46. Given the different incentive effect of the estate tax charitable contribution deduction (I.R.C. § 2055), it seems reasonable to expect that charitable giving by high-income taxpayers would not only be deferred until death, but reduced as well. FILER COMMISSION REPORT, *supra* note 15, at 146.

118. TREASURY REPORT ON TAX REFORM, *supra* note 96, at 72-74.

119. These are contributions to (not in trust for) a donee described in section 170(b)(1)(A)—public charities and private operating or conduit foundations.

120. I.R.C. § 170(b)(1)(C)(iii) (1982).

121. I.R.C. § 170(b)(1)(C)(i) (West Supp. 1985).

twenty-percent limit, even though the amount of each such contribution other than readily marketable stock is reduced by forty percent of the appreciation under section 170(e)(1)(B).¹²² The usual five-year carryforward is available for contributions that exceed either of these appreciated property percentage limits.¹²³

The overvaluation of in-kind contributions is a continuing enforcement problem for the IRS and a major source of friction between taxpayers and the Service. The Commissioner now has an art advisory panel to assist in dealing with difficult valuation problems. In addition, a new overvaluation penalty now applies. Section 6659 provides for a penalty of thirty percent of the amount of any underpayment that results from a greater-than-fifty-percent overvaluation of charitable deduction property. This penalty applies, however, only if the underpayment of tax resulting from the overvaluation is greater than \$1000.

The Tax Reform Act of 1984 strengthened compliance in this area by mandating the issuance of regulations under section 170(a)(1) that condition the allowance of a deduction for a contribution of property (other than publicly-traded securities) claimed to have a value of more than \$5000 on obtaining a qualified appraisal of the property by an independent appraiser and the filing of a summary of the appraisal with the return on which the deduction is claimed.¹²⁴ If the donee disposes of the property within two years of its receipt, it will be required to file an information return (with a copy sent to the donor) indicating the amount realized on such disposition to facilitate audit adjustment in case of overvaluation.¹²⁵

8.D. Again assuming that TP's property is worth \$10,000 and has a \$5000 adjusted basis, suppose the property is stock and TP makes a bargain sale to a public charity for \$5000. TP asserts the \$5000 is received tax-free because he had no gain under section 1001, and TP also claims a \$5000 deduction for the appreciation because this was the gift component of the scrambled transaction. What result? Section 1011(b).

This problem illustrates the bargain sale to charity, a device that was formerly used to give the taxpayer the best of all possible worlds—the investment in the property was received tax-free, the appreciation in value was not taxed, and the taxpayer claimed a deduction for this appreciation component.

122. *Id.* § 170(b)(1)(D); H.R. REP. NO. 432, 98th Cong., 2d Sess. 1464 (1984) (20% limit applies to gifts of capital gain property to private nonoperating foundations "including gifts of certain appreciated stock which are deductible under the bill at fair market value"). This statement assumes that the term "capital gain property," although undefined in section 170(b)(1)(D), was intended to have the same meaning as under section 170(b)(1)(C)(iv).

123. I.R.C. § 170(b)(1)(C)(ii) (1982); I.R.C. § 170(b)(1)(D)(ii) (West Supp. 1985).

124. Pub. L. No. 98-369, § 155(a), 98 Stat. 494, 691. The regulation implementing this requirement is Treas. Reg. § 1.170A-13T(c), T.D. 8003, 1985-6 I.R.B. 5, 8.

125. I.R.C. § 6050L (West Supp. 1985); *see also* 31 U.S.C.A. § 330(c) (West Supp. 1985).

Today, under section 1011(b), TP's reporting position will not withstand attack. First, consider the after-tax consequences of the transaction for TP in the absence of section 1011(b). Assuming TP is in the fifty-percent bracket, if he merely sold the stock he would be left with \$9000 of cash after taxes—\$5000 of the sale proceeds would be treated as a return of capital, plus \$3000, which is the untaxed sixty percent of the long-term gain, plus \$1000, which is fifty percent of the taxable appreciation. A bargain sale to charity would net TP almost as much, \$7500—\$5000 sale proceeds, all of which would be treated as a return of capital, plus \$2,500, the tax savings that would result from the deduction of the appreciation component for a fifty-percent taxpayer. The results could be truly egregious in the case of a bargain sale of highly appreciated property by a taxpayer subject to the seventy-percent marginal rate.

Under section 1011(b), the bargain sale transaction is unscrambled by treating it as though it consisted of a sale of one-half of the block of stock for its fair market value and a gift of the remaining one-half of the stock. TP's asserted unscrambling principle—that the bargain sale should be treated as a sale of the entire block of stock for its adjusted basis plus a gift of the appreciation component—has been rejected. Hence, under current law the bargain sale device would leave TP with \$7000 of cash after taxes (recall the sixty-percent deduction for long-term capital gain), rather than \$7500, again assuming TP is a fifty-percent taxpayer.

9. General Millers, Inc. processes grain and manufactures prepared food products. Its biggest seller is a breakfast cereal called "Flakos," famous for its big orange box. General Millers often prints limited-offer coupons and prize competitions on the box. Any Flakos boxes that remain on grocers' shelves when the coupons or competitions expire are pulled and shipped back to General Millers. General Millers either destroys the returns or processes them into livestock feed, thereby realizing a small fraction of the product's retail value, although the Flakos are still wholesome and edible. Why doesn't General Millers donate the Flakos to a charity that would distribute the cereal to the poor? Sections 170(a) & (e), 165(b). Hint: compare the fair market value of the Flakos before and after the expiration date of the coupons or competitions.

To understand the origin of this socially unjustifiable behavior, first assume that General Millers reprocesses the cereal into cattle feed. In this event, General Millers would claim a loss on the transaction computed under section 1001 as the adjusted basis of the Flakos reduced by the amount realized. The combination of General Millers' loss deduction and the proceeds of the sale of the feed (if any) will equal its adjusted basis in the product, which is its cost of producing the Flakos. Hence a manufacturer or dealer is assured a tax-free recovery of its investment where devalued merchandise is disposed of by abandonment, destruction, or distress sale.

The tax consequences for General Millers are quite different if it instead donates the cereal to charity. The general rule under section 170 for the

amount of a charitable contribution deduction is fair market value. But what is the fair market value of the Flakos after the expiration date of the coupon offers or prize competitions? Since the grocers won't sell the Flakos after the expiration date, the fair market value is drastically reduced, and in all likelihood is less than General Millers' adjusted basis in the Flakos—that is, less than its actual cost of production. Consequently, General Millers would never get to deduct its full production costs if it donates the depreciated inventory to charity. The company is better off tax-wise if it destroys the product rather than devoting it to socially beneficial uses! This hypothetical illustrates that the fair market value rule of section 170 cuts both ways—in some situations taxpayers may be permitted to deduct unrealized appreciation, but in the case of a donation of depreciated property the taxpayer cannot even recover the actual after-tax investment in the property.¹²⁶

The fact that a charitable contribution of devalued inventory is not as beneficial from a tax standpoint as the destruction or abandonment of the property causes a serious disincentive for businesses to make badly needed contributions of food and clothing. Recognizing this disincentive, in 1984 the IRS amended its regulations to provide for a full adjusted basis deduction for contributions of devalued inventory described in section 170(e)(3)—property to be used for the care of the ill, needy or infants.¹²⁷ Despite its questionable legal authority,¹²⁸ the new regulation solves the practical problem, but *only*

126. The Treasury Department tax reform plan would also limit the deduction for contributed property to fair market value, where this is less than the property's current adjusted basis. TREASURY REPORT ON TAX REFORM, *supra* note 96, at 73.

127. Treas. Reg. § 1.170A-4A(c)(3), T.D. 7962, 49 Fed. Reg. 27317 (July 3, 1984). The amended regulation works indirectly to provide relief. The deduction available under section 170 is still limited to the value of the contributed property, but the donor's cost of goods sold is reduced by the lesser of adjusted basis or fair market value, thereby assuring that any decline in value of the contributed item will be reflected as a reduction in the donor's gross income from sales of other items. The statement of basis and purpose published with the amended regulation provides:

Where the basis of the contributed inventory property qualifying under section 170(e)(3) exceeds the property's fair market value, the underlying purpose of the section to encourage contributions of this type of property for the purposes specified in section 170(e)(3) may be frustrated. This is because the entire basis of the contributed property is removed from the cost of goods sold while the charitable contribution is limited to the property's fair market value. It would be more advantageous for the taxpayer to destroy or sell the property than to contribute it for the care of the ill, the needy, or infants. A taxpayer would then be entitled to deduct its entire basis in the property as a loss deduction under section 165 or as part of the cost of goods sold as compared to a charitable contribution amount limited to the property's fair market value.

In order to remove this disincentive, these final regulations provide that the taxpayer's cost of goods sold will be reduced by the lesser of the fair market value or the amount of the basis of the contributed property.

49 Fed. Reg. 27313 (July 3, 1984).

128. The amended regulation purports to interpret section 170(e)(3), which is an exception to the general reduction rules of section 170(e)(1). Because section 170(e)

where the contributed property is to be used for the care of the ill, needy, or infants. Accordingly, a computer company that is discontinuing an outdated model would still be deterred by the tax law from contributing its excess inventory to educational institutions, for example.

E. Contributions of Partial Interests

10. TP transfers 1000 shares of General Motors stock in trust, the income to be paid to his daughter for ten years, remainder to the University of Missouri. TP names his bank as trustee. Can TP take a charitable contribution deduction for the value of the remainder interest? Sections 170(f)(2)(A), 664(d), 642(c)(5). What result if the trust corpus consists of twenty-year GM bonds that pay interest at ten percent annually, and the trustee has no authority to change investments? What is the underlying policy of section 170(f)(2)(A)?

Section 170(f)(2)(A) provides that no deduction is allowed for the value of a remainder interest in a trust contributed to charity, unless the trust qualifies as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. Treating first the case where the trust corpus consists of GM stock, because the trust is not maintained by the University of Missouri and consists of property transferred by only one donor, it does not qualify as a pooled income fund. The investment return of the trust, consisting of dividends on the GM stock and income from other investments the trustee may make in the exercise of its management powers and duty to diversify, is of course variable. Because the trust income to be paid to TP's daughter is not a sum certain or a fixed percentage of the fair market value of the corpus, the trust does not qualify either as a charitable remainder annuity or unitrust, and no deduction will be allowed for the contribution of the remainder interest.

If instead the trust corpus consists of ten percent GM bonds and the trustee has no authority to alter the investment, TP's daughter, the income beneficiary, will receive a sum certain which is greater than five percent of the initial fair market value of the trust corpus, payable annually for ten years. Hence the trust should qualify as a charitable remainder annuity trust.¹²⁹ Yet if the draftsman of the trust instrument did not pay careful attention to the precise technical requirements contained in the regulation defining "charitable re-

operates only to reduce the amount of a charitable contribution below fair market value in certain cases involving donations of appreciated property, it is difficult to understand how section 170(e)(3) can be read to authorize an increase in the taxpayer's deduction above market value. Note especially the language of section 170(e)(3)(B), which refers to "the amount of the reduction."

129. The regulations require that the "governing instrument provides that the trust shall pay a sum certain not less often than annually," and define a sum certain as a "stated dollar amount." Treas. Reg. § 1.664-2(a)(1) (1972). Arguably, these requirements should be considered to be satisfied where, as here, the trust instrument specifies that the corpus must be invested in certain assets which yield a stated dollar amount annually.

remainder annuity trust," TP will not be entitled to a deduction. Here, for example, there is no indication that the trust instrument prohibits future additions to trust,¹³⁰ or that the amount of the trust income to be distributed to TP's daughter during the trust's taxable years in which her annuity payments begin and end is the properly annualized portion of the sum certain.¹³¹ These strict requirements, which present serious traps for the unwary, are imposed to assure level payments (and therefore a readily calculable present value of the remainder interest) throughout the annuity term.

These special restrictions on the deductibility of a remainder interest contributed to charity are designed to assure that the present value deduction given the grantor¹³² will reasonably correspond to the amount that the charity will in fact eventually receive.¹³³ Prior to 1970, the contributor's deduction for the remainder interest was computed by treating an income interest as an assumed annuity in an amount equal to three and one-half percent of the value of the property placed in trust, even though there were no restrictions on the amount or method of computing the noncharitable income payments. Since it was also assumed that this three and one-half percent payout to the income beneficiary represented the *total* rate of return on trust assets, the charity was expected to receive property with a value, measured at the time the income interest(s) expire, equal to the original value of the property settled in trust. That is, prior to 1970 the deduction for a charitable remainder was computed by discounting the value of the property for the expected duration of the income interest(s), but using a discount rate of only three and one-half percent! Consider what might happen under this approach if the trustee was the spouse of the grantor (the mother of the income beneficiary in our hypothetical) and had complete authority to direct the investments of the trust. The trustee could put the corpus in high-yield, high-risk investments, thereby shifting most of the financial benefit of the property to the income beneficiary at the expense of the charity.

11. Now assume that TP transfers stock to his bank as trustee, and that the trust instrument requires that ten percent of the annual fair market value of the trust be distributed yearly to the local hospital, for eight years, at which time the trust will terminate and the corpus will be distributed to TP's daughter. Can TP deduct the value of the income interest? Section 170(f)(2)(B). What result if TP himself retains the remainder interest? Section 673(a). Why the difference in result?

Although a fixed percentage of the fair market value of the property in

130. *Id.* § 1.664-2(b).

131. *Id.* § 1.664-2(a)(1)(iv). For example, a trust created on December 20 that uses a calendar year accounting period may receive a quarterly interest payment on the GM bonds before December 31, but could not, consistently with the definition of an annuity trust, pass along the entire interest payment to TP's daughter.

132. *Id.* § 1.170A-6(b)(2); Treas. Reg. §§ 1.664-2(c), 20.2031-7 (1984).

133. S. REP. NO. 552, 91st Cong., 1st Sess. 86-90 (1969); H.R. REP. NO. 413, 91st Cong., 1st Sess. 58-60 (1969).

trust is distributed annually, if TP's daughter is the remainderman no deduction will be allowed because TP is not treated as the owner of the income interest under section 671. If TP retains the remainder himself, he will be treated as the owner of the income interest of the trust pursuant to sections 671 and 673(a), and he will be entitled to deduct the value of the income interest. If TP is treated as the owner, he will be subject to tax on the trust income under the grantor trust rules, so the allowance of a deduction of the present value of the income interest merely serves to wash out the future income.¹³⁴ If TP is not, for tax purposes, the owner of the income interest, the trust is an effective method of shifting liability for tax on the property income. Because TP will not be taxed on the future income, he is not also allowed to deduct the value of the income interest. Note that in order to deduct the value of the income interest under section 170(f)(2)(B) the interest must take the form of a guaranteed annuity or the annual payment of a fixed percentage of the trust's fair market value, in order to permit a reasonably accurate valuation of the interest.¹³⁵

12. TP owns an enormously valuable collection of Picasso sketches. By deed of gift, TP transfers the collection to her brother for life, remainder to the National Museum of Art. When can TP claim a deduction, and for how much? Section 170(a)(3). What result if TP transfers the collection to the National Museum for the life of her brother, remainder to her niece? Section 170(f)(3)(A).

Under section 170(a), an individual's charitable contribution deduction is allowed for the year in which the donation is actually paid, without regard to the taxpayer's method of accounting—an accrual-basis taxpayer that makes a pledge to charity during the taxable year cannot claim a deduction until the taxable year in which the pledge is satisfied by actual payment. The gift of a future interest in tangible personal property is not treated as paid until all intervening interests terminate or are held by persons other than the taxpayer and the persons related to the taxpayer that are specified in section 267(b). Accordingly, TP would not be allowed a deduction until the death of her brother, and the amount deductible at that time would be determined by the then-current fair market value of the property.¹³⁶

134. The deduction is allowed as a lump sum in the year the trust is created.

135. The hypothetical assumes TP created a unitrust (i.e., income payout is a fixed percentage of the trust's annual asset value). Because the unitrust payout is determined according to the variable asset value of the trust, computing the present value of the income and remainder interests under a unitrust is quite complicated. *See* Treas. Reg. § 1.170A-6(c)(3)(ii), -6(b)(2) (1972); Treas. Reg. 1.664-4 (1984).

136. In his tax return for 1969, President Nixon claimed a deduction for a charitable contribution to the United States of his Vice Presidential papers, valued at \$576,000. The deed of gift provided that during the time Mr. Nixon held the office of President of the United States only he and such other persons as he might designate could have access to the papers. The staff of the Joint Committee on Internal Revenue Taxation concluded that this restriction made the transfer a gift of a future interest which under section 170(a)(3) was not deductible in 1969. STAFF OF THE JOINT COMM.

If instead TP transfers the collection to the National Museum of Art for the life of her brother, remainder to her niece, the present possessory interest constitutes immediate payment, but section 170(f)(3) must be consulted to determine whether the value of this partial interest is deductible. The general criterion for deductibility of a partial interest not in trust contributed to charity is whether a deduction would be allowed under section 170(f)(2) if the partial interest had been transferred in trust. If the collection were transferred in trust the Museum would have an equitable life estate *pur autre vie*, which is "other than a remainder interest." No deduction would be allowed for the value of such an interest under subsection (f)(2)(B), since it does take the form of a guaranteed annuity or a fixed percentage of the fair market value of the property payable annually. Again, this result is justified by the problem of valuing uses.

13. TP owns farmland that is frequently flooded by runoff from adjacent property owned by the federal government. Will TP be allowed to deduct the value of a flowage easement contributed to the United States? Assume first that the runoff is from the parking lot of the local VA hospital. Section 170(f)(3)(A), (f)(2). What if the flooding is due to the government's failure to control a river that is preserved in its natural, free-flowing state under the Wild and Scenic Rivers Act?¹³⁷ Section 170(f)(3)(B), (h).

The contribution of an easement consisting of the right to use TP's property for flooding would not give rise to a deduction under the trust rules because use of the land does not generate a guaranteed yield equivalent to an annuity or the annual payment of a percentage of the fair market value of the realty.¹³⁸ Section 170(f)(3)(B) provides certain exceptions to the very stringent limitations on the deductibility of contributions of partial interests not in trust. TP's grant of the flowage easement is not a contribution of a remainder interest in a farm¹³⁹ nor is it a contribution of an undivided portion of his entire interest in the property.¹⁴⁰ However, if the flooding is caused by the overflow of a wild and scenic river, TP's contribution may constitute a quali-

ON INTERNAL REVENUE TAXATION, EXAMINATION OF PRESIDENT NIXON'S TAX RETURNS FOR 1969 THROUGH 1972, H.R. REP. NO. 966, 93d Cong., 2d Sess. 39-41, A-85 to A-151 (1974).

137. 16 U.S.C. § 1271 (1982).

138. Whether the flowage easement should be analogized to an income interest (as a right of use) or a remainder interest (as a perpetual interest) in the land is unclear, but under either subparagraph (A) or (B) of section 170(f)(2) the corresponding interest in trust would not qualify for the charitable deduction.

139. Special rules are prescribed to prevent abuse in the valuation of a real property remainder interest. I.R.C. § 170(f)(4) (1982).

140. Treas. Reg. § 1.170A-7(b)(1)(ii), based on language in the conference report to the Tax Reform Act of 1969, states that an open space easement in gross shall be considered a contribution of an undivided portion of the donor's entire interest in property. This strained interpretation of the undivided interest exception was superseded by the 1980 amendments to section 170 that added the qualified conservation contribution provisions. S. REP. NO. 1007, 96th Cong., 2d Sess. 11 (1980).

fied conservation contribution. The United States is a qualified organization, and the donation is made exclusively for conservation purposes, so the flowage easement will constitute a qualified conservation contribution under section 170(h), provided that the easement is a restriction in perpetuity on the use which TP may make of the underlying farmland. The flowage easement may or may not be a perpetual restriction on TP's use of the real estate. The determinative issue becomes whether the easement is just an affirmative right to flood TP's land, or whether TP is in addition prohibited from altering the land (such as by cutting trees or erecting structures).¹⁴¹ Where the easement qualifies as a perpetual conservation restriction, the amount deductible is the fair market value of the contributed property, which is the difference in value of the grantor's land before and after contributing the servitude.¹⁴² If development inconsistent with the land's conservation uses is not prohibited or is a remote factual possibility (i.e., where the easement does not significantly restrict in both law and fact current or foreseeable future uses of the land), only a nominal deduction is allowable.¹⁴³

F. Direct Charitable Deduction for Non-Itemizers

14. Prior to 1982, the charitable contribution deduction, like other personal deductions for interest, taxes, casualty losses and the like, was allowed only to taxpayers who itemized their deductions. Read section 170(i), added by the Economic Recovery Tax Act of 1981. What organizations and activities would you expect to derive the greatest benefit from section 170(i)? Note that the direct charitable deduction first becomes fully effective for taxable years beginning in 1986, yet expires on December 31, 1986. Why?

An overwhelming majority of all taxpayers, some sixty-five percent in

141. The proposed regulations under section 170(h) equate the term "perpetual conservation restriction" with an easement under state real property law, and in addition provide that the statutory term perpetual conservation restriction "is not intended to preclude the deductibility of a donation of affirmative rights to use a land or water area" for recreation or education of the general public. Prop. Reg. § 1.170A-13(b)(3), 48 Fed. Reg. 22,941, 22,942 (May 23, 1983). Despite the apparent breadth of this definition, not all easements will qualify because the regulations also require that no deduction will be allowed if the grant "would permit destruction of other significant conservation interests." *Id.* § 1.170A-13(e)(3). And under state law, the grant of an easement (a right to use another's realty) standing alone, does not restrict the grantor's right to use the servient tenement in ways not incompatible with the use authorized by the easement (here, flooding). RESTATEMENT OF PROPERTY §§ 486, 481, 483(b) & comment g (1944). Where the easement does not significantly restrict the donor's right to use his land, the issue may also be framed in terms of the amount deductible.

142. Prop. Reg. § 1.170A-13(h)(3) (1983), 48 Fed. Reg. 22,941, 22,942 (May 23, 1983).

143. Valuation disputes are currently a major point of contention between the IRS and conservation groups attempting to promote such donations. Wall St. J., Oct. 24, 1984, at 1, col. 5.

1982,¹⁴⁴ do not itemize their deductions. Prior to 1981 these taxpayers received no tax allowance for their contributions. Thus, they bore the full cost of giving—each dollar donated to charity reduced their after-tax income by a dollar. Yet recent economic studies indicate that low and middle-income households (in which nonitemizers are concentrated) are quite sensitive to the after-tax cost of giving. These studies found that itemizers contribute substantially more than nonitemizers at the same income level (more than twice as much for income below \$30,000¹⁴⁵), and that extending the deduction to nonitemizers would probably increase charitable contributions by more than double the resulting drop in tax revenue.¹⁴⁶ Congress responded to this evidence by enacting the direct charitable contribution deduction in 1981. The deduction for nonitemizers has a built-in expiration date because Congress designed it as an experiment. The expiration date will force Congress to evaluate the effects of allowing the deduction to nonitemizers and judge its efficiency.¹⁴⁷ If it should appear in 1986 that the direct charitable deduction increases donations to charities by an amount that is less than its revenue cost to the federal government,¹⁴⁸ reenactment would be unlikely.

The organizations likely to benefit most from the direct charitable deduction are those that receive contributions predominately from nonitemizers, who are in general lower-income taxpayers. Lower-income taxpayers on the average make most of their charitable contributions to religious and community

144. INTERNAL REVENUE SERVICE, SOI BULLETIN, Summer 1984, at 119, 120.

145. Morgan, Dye & Hybels, *supra* note 31, at 192-95.

146. Boskin & Feldstein, *Effects of the Charitable Deduction on Contributions by Low Income and Middle Income Households: Evidence from the National Survey of Philanthropy*, 59 REV. ECON. STAT. 351, 352 (1977) (estimated price elasticity of charitable giving for households with incomes between \$1000 and \$30,000 is -2.54, considerably greater than prior studies' estimate of -1.2 for the entire population). Although this level of responsiveness to the tax allowance may at first seem counterintuitive, it should be remembered that the value of a deduction at low income levels is small, so that the resulting increase in the dollar amount of gifts per household, even if double the tax reduction, would nowhere near double annual giving. *Id.* at 354. Yet the aggregate increase in giving, with nonitemizers constituting 65% of the taxpaying population, is potentially enormous.

147. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., SUMMARY OF H.R. 4242: GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT 49 (Comm. Print 1981).

148. A bill to make permanent the direct charitable deduction for nonitemizers has been introduced. S. 337, 98th Cong., 1st Sess. (1983). Testimony at a hearing on the bill indicated that section 170(i) has stimulated contributions. *See* 25 TAX NOTES 13 (1984). But other studies indicate that it may take a period of several years to accustom taxpayers to the deduction before the full stimulative effect is obtained. Morgan, Dye & Hybels, *supra* note 31, at 194: "It would seem that it takes longer to build to a higher level of giving with a new tax incentive than to cut down when the incentive is removed." *Charitable Contribution Deductions: Hearings on S. 219 Before the Subcomm. on Taxation & Debt Management of the Senate Comm. on Finance*, 96th Cong., 2d Sess. 229 (1980) [hereinafter cited as *1980 Hearings*] (testimony of C. Clotfelter) ("it would take 4 to 8 years for 90% of the long-run increase in giving to be realized after the change in incentive").

service organizations, such as churches and the United Way. In contrast, high-income taxpayers, who generally itemize their deductions, direct proportionately more of their charitable contributions to higher education, hospitals, and cultural organizations (such as museums, theater groups and orchestras).¹⁴⁹

Although religious and community service organizations will receive the most direct and immediate benefit from the deduction for nonitemizers, in the long run all charities will gain, if the effect of the provision is to broaden the base of philanthropy and develop a habit of charitable giving. During 1980 congressional hearings on an above-the-line deduction proposal (i.e., a deduction available to taxpayers who do not itemize), it was observed that while the total dollar amount of charitable contributions has increased in recent years, the number of contributors, and especially the number of young contributors, has declined significantly.¹⁵⁰ The above-the-line deduction may encourage younger taxpayers, who generally have lower incomes and do not itemize, to make charitable contributions.¹⁵¹ Over time, such taxpayers may adopt a behavioral pattern of giving. In later life such individuals, who might otherwise not have formed a philanthropic habit, may become substantial contributors. Consequently, the deduction for nonitemizers may be important to the long-term vitality of the nonprofit sector, including those organizations that rely heavily on contributions from well-educated, high-income individuals.

The 1984 Treasury Department tax reform plan proposes repeal of the deduction for nonitemizers, primarily for reasons of simplification and administrative convenience. The report asserts that the adverse impact on giving "is not expected to be significant" but offers no data or authority in support of this proposition.¹⁵²

III. FUTURE ISSUES

A. *Minimum Tax*

1. In General

For taxable years beginning in 1976, 1977, and 1978, the charitable contribution deduction for individuals was included in the computation of "adjusted itemized deductions" subject to the fifteen-percent add-on minimum tax.¹⁵³ "Adjusted itemized deductions," an item of tax preference, was defined

149. See *supra* text accompanying note 56.

150. 1980 Hearings, *supra* note 148, at 93 (testimony of J. Pier); *id.* at 225-26 (statement of Sen. Moynihan).

151. Available data indicate that charitable giving increases substantially with age. Boskin & Feldstein, *supra* note 146, at 352-53.

152. TREASURY REPORT ON TAX REFORM, *supra* note 96, at 78-79. An econometric study indicates that repeal of the deduction for nonitemizers is likely to reduce charitable giving by about four percent. Clotfelter, *supra* note 34, at 481.

153. I.R.C. § 56(a) (1976), amended by Tax Equity and Fiscal Responsibility Act of 1982 (hereinafter cited as "TEFRA"), Pub. L. No. 97-248, § 201(d)(1)(A), 96 Stat. 324, 413 (limiting the add-on minimum tax to corporations), and I.R.C. §

as the amount by which all itemized deductions excluding taxes, medical expenses and casualty losses, exceeds sixty percent of the taxpayer's adjusted gross income for the year.¹⁵⁴ For taxable years beginning between 1979 and 1982 (inclusive), such "adjusted itemized deductions" were instead made subject to the alternative minimum tax of section 55.¹⁵⁵ In 1982, the charitable contribution deduction was eliminated from the base of the alternative minimum tax.¹⁵⁶

It might be assumed that this checkered history is attributable to congressional ambivalence over whether charitable contributions are properly characterized as an "item of tax preference" (that is, a tax expenditure). However, the "preference" label apparently was never seriously questioned. The add-on minimum tax was enacted for primarily cosmetic reasons.¹⁵⁷ Against this background it was natural to strike at excessive use of "voluntary" itemized deductions (interest and charitable contributions) because these expenditures, when combined with the deduction for long-term capital gains, were the principal route by which many high-income individuals had managed to escape all tax liability.¹⁵⁸ During Senate debate on the Tax Reform Act of 1976 an

57(a)(1) (1976), *amended by* TEFRA § 201(b)(1)(A). For effective dates, see Tax Reform Act of 1976, Pub. L. No. 94-455, § 301(g), 90 Stat. 1520, 1553, and Revenue Act of 1978, Pub. L. No. 95-600, § 421(b)(2), (g), 92 Stat. 2763, 2874, 2877.

154. I.R.C. § 57(b) (1976), *amended by* TEFRA § 204(b) (1982). The Revenue Act of 1978 made a technical correction to the definition of adjusted itemized deductions by providing that taxes, medical expenses, and casualty losses (i.e., those itemized deductions not viewed with suspicion) must be excluded from both the numerator (total itemized deductions) and the denominator (adjusted gross income) in applying the 60% test for excessive use of itemized deductions. Pub. L. No. 95-600, § 421(b)(3), (g), 92 Stat. 2763, 2874, 2877 (1978).

155. I.R.C. § 55(b)(1)(C)(i) (Supp. II 1978), *amended by* TEFRA § 201(a) (1982). The Revenue Act of 1978 also removed adjusted itemized deductions from the list of preferences subject to the add-on minimum tax by adding a new sentence at the end of section 57(a). Pub. L. No. 95-600, § 421(b)(2), (g), *repealed by* TEFRA § 201(b)(2)(B) (1982).

156. TEFRA § 201(b)(1)(A) (1982).

157. The add-on minimum tax was enacted by the Tax Reform Act of 1969, and its principal original targets were the deduction for long-term gains and the tax-shelter effect of excessive depletion, depreciation, and amortization. The Finance Committee report observed:

The fact that present law permits a small minority of high-income individuals to escape tax on a large proportion of their income has seriously undermined the belief of taxpayers that others are paying their fair share of the tax burden. It is essential that tax reform be obtained not only as a matter of justice but also as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues. For this reason alone, the tax system should be improved.

S. REP. NO. 552, 91st Cong., 1st Sess. 13 (1969); *see also id.* at 112.

158. The 1976 extension of the minimum tax to itemized deductions was ex-

amendment was offered which would have removed charitable contributions from the definition of excess itemized deductions. Yet proponents of the amendment argued that the minimum tax should not be permitted to deter charitable contributions, not that contributions are not properly classified as tax expenditures.¹⁵⁹ For their part, opponents of the measure also did not address this fundamental issue, instead emphasizing that charitable contributions were included in the minimum tax base to placate taxpayers.

In the effort to be sure that people could not of their own volition and their own choice just avoid paying any income tax and have us trying to explain that all the time, we had to do something about the charitable deduction¹⁶⁰

Again in 1982, when charitable contributions were removed from the reach of the minimum tax, classification of the deduction as a tax preference was unchallenged. Congress apparently concluded that the percentage limits of section 170(b) provide adequate assurance that contributors pay their fair share of support to the federal government.¹⁶¹

It was demonstrated earlier that the charitable contribution deduction is a tax expenditure if the nondeductibility of ordinary gifts follows from viewing such transfers as the purchase of "intangible consumption" by the donor. But if the nondeductibility of ordinary gifts is an anti-abuse measure, premised on the ease with which gifts could be used to shift tax liability without shifting beneficial enjoyment of the property ("disguised consumption" by the donor), then the charitable contribution deduction is a proper allowance in measuring the contributor's disposable income.¹⁶² Although the "intangible consumption" rationale seems to be more consistent with current law, neither Congress nor

plained as follows:

This preference is intended to reduce the number of situations in which a person with a large adjusted gross income is able to avoid paying any income tax. Medical and casualty deductions are excluded from this preference item because they are limited to expenses that are beyond the control of the taxpayer.

STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 (H.R. 10612, 94TH CONGRESS, PUBLIC LAW 94-455) 105-06 (1976); *see also* S. REP. NO. 552, 91ST CONG., 1ST SESS. 13 (1969) ("Many [high-income taxpayers] were nontaxable because they were able to exclude one-half of capital gains from their income and offset all their itemized deductions against the remaining income subject to tax.").

159. 122 CONG. REC. 20246 (1976) (colloquy between Sens. Curtis and Brock), 20268-69 (remarks of Sen. Curtis).

160. 122 CONG. REC. 20268 (1976) (remarks of Sen. Long).

161. S. REP. NO. 494, 97TH CONG., 2D SESS. 108 (1982). Note, however, that voluntary charitable contributions could, in combination with other deductions and credits, reduce taxable income to zero despite the percentage limits. This fact was emphasized by Senator Long in his remarks in opposition to the 1976 proposal to delete contributions from the "adjusted itemized deductions" preference item. 122 CONG. REC. 20268-69 (1976).

162. *See supra* notes 14-28 and accompanying text.

the Supreme Court has ever explained why, since 1913, ordinary gifts have been taxed to the donor rather than the donee.¹⁶³ Hence the classification of the charitable contribution deduction as a tax expenditure rests upon tenuous inferences drawn from meager circumstantial evidence. In these circumstances the wisest course may be to recognize that there is very little practical difference between these approaches from the standpoint of the overall structure of an income tax, and that nice academic arguments which conclude by labelling the charitable contribution deduction a "subsidy" ought not be permitted to create such differences. Accordingly, the charitable contribution deduction should not again be made subject to the minimum tax.

In recent years, it has become almost automatic for tax theorists and policymakers to treat the charitable contribution deduction as a "preference" or "tax subsidy." This view is reflected in the tax expenditure budget¹⁶⁴ and has crept into the Supreme Court's analysis and interpretation of the tax-exempt status accorded charitable organizations.¹⁶⁵ Unthinking acceptance of this label, however fashionable, is likely to produce undesirable consequences, such as renewed attempts to subject charitable contributions to the minimum tax. Concerning another area (accelerated depreciation) in which there is no single "correct" definition of income, Professor Kahn has cautioned that the tax expenditure label creates a "substantial risk that congressional debate on that item will be limited to the merits of subsidizing particular behavior and

163. It is interesting to note that under the 1894 act gifts and inheritances of *personal* property would have been taxed to *both* the donor and donee. Act of August 27, 1894, ch. 349, § 28, 28 Stat. 509, 553 (income includes "money and the value of all personal property acquired by gift or inheritance"). Although this provision was enacted, it was vehemently opposed on the grounds that it was in substance an inheritance tax, that the federal government had no business usurping the traditional power of the states in the field of inheritance taxation, and that intrafamily gifts could not properly be considered as income. 26 CONG. REC. 6778-80, 6820-25 (1894) (colloquy between Sens. Hoar, Hill, Vest, and Chandler). When the matter was again considered in 1913, the exclusion of gifts and bequests was apparently founded on a view that such transfers are more appropriately handled under a separate tax. 50 CONG. REC. 506 (1913) (statement of Rep. Hull) ("Bequests, devises and so forth, are not considered as taxable income; an inheritance tax applicable to them would naturally contain rather highly graduated rates, so that this tax would properly be contained in a separate enactment.").

164. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT FY 1985 G-46 (1984), lists as tax expenditures the deductibility of charitable contributions for education (revenue loss = \$810 million), health (revenue loss = \$1.62 billion), and all other functions (revenue loss = \$11.06 billion).

165. *Bob Jones Univ. v. United States*, 103 S. Ct. 2017, 2028 (1983); *Regan v. Taxation with Representation*, 103 S. Ct. 1997, 2000 (1983) ("Both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system."). For criticism of the Supreme Court's new subsidy analysis, see Kelley, *A New Meaning for Tax Exemption?*, 25 J. CHURCH & STATE 415 (1983); Schachner, *Religion and the Public Treasury After Taxation with Representation of Washington, Mueller and Bob Jones*, 1984 UTAH L. REV. 275.

will not investigate whether it offers a proper measure of net income."¹⁶⁶ This warning is equally applicable to the charitable contribution deduction.

2. Unrealized Appreciation

Ordinary charitable contributions should not be subject to the minimum tax, but gifts of appreciated property are another matter. The exceptions to the reduction rules of section 170(e)(1) were enacted to encourage certain types of contributions (e.g., clothing to be used for the care of the needy, or scientific equipment for use in research) or to maintain the level of support for certain donees (e.g., stock and realty contributions to hospitals and colleges), and are without independent conceptual support. Therefore, there is substantial merit in the contention that all deductible unrealized gain (including the deductible sixty percent of long-term gain on assets subject to the reduction rule of section 170(e)(1)(B))¹⁶⁷ should be subject to the minimum tax. Congress has considered similar proposals in the past,¹⁶⁸ so future developments along these lines should come as no surprise.

The interaction between the charitable contribution deduction and the minimum tax may become a moot issue if Congress enacts one of the comprehensive income tax proposals now under consideration. Major tax reform of the base-broadening sort might eliminate the deduction for unrealized appreciation.¹⁶⁹ In addition, the minimum tax itself should be repealed as unnecessary if most tax expenditures are eliminated.¹⁷⁰

B. Percentage Limits

The percentage limits of section 170(b) are another front on which future battles can be expected. Different annual limits on deductibility based on the

166. Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 5 (1979).

167. Because the 60% long-term capital gain deduction is an item of tax preference on the sale of an asset under section 57(a)(9)(A), consistency would seem to require that the same amount be subject to the minimum tax if appreciated property is contributed in kind.

168. In 1968, and again in 1969, the Treasury proposed that deductible unrealized appreciation on in-kind contributions should be subject to a minimum tax. STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., CHANGES IN THE MINIMUM TAX AND LIMITS ON ITEMIZED DEDUCTIONS 3-4 (Comm. Print 1975). The minimum tax status of charitable contributions was also a major item of contention in 1974. *Id.* at 8-10.

169. *E.g.*, TREASURY REPORT ON TAX REFORM, *supra* note 96, at 72-74. Note, however, that the other major tax reform proposals—the Bradley-Gephardt "FAIR Tax" (H.R. 800 and S. 409, 99th Cong., 1st Sess., *reprinted in* 131 CONG. REC. S1173 (daily ed. Feb. 6, 1985)) and the Kemp-Kasten "FAST Tax" (H.R. 777 and S. 325, 99th Cong., 1st Sess., *reprinted in* 131 CONG. REC. S895 (daily ed. Jan. 31, 1985))—would not repeal the appreciated property deduction.

170. *E.g.*, TREASURY REPORT ON TAX REFORM, *supra* note 96, at 112-14, 130-32; BILL BRADLEY, THE FAIR TAX 163, 167 (1984).

nature of the charitable donee first appeared with the 1954 Code.¹⁷¹ Since then, the class of favored donees has been broadened repeatedly.¹⁷² The gap between favored donees and private nonoperating foundations was narrowed substantially by the Tax Reform Act of 1984—the adjusted gross income limit on contributions to private nonoperating foundations was raised from twenty to thirty percent and for the first time a carryover for excess contributions was allowed.¹⁷³ To the extent that the difference in percentage limits is founded upon a concern over excessive accumulations or the potential for conflicts of interest between a private foundation and its control persons (management and substantial contributors), the reason for the distinction has been largely undercut by the excise taxes on private foundations and a continuing trend toward increased regulation.

Is a difference in contribution limits appropriate, other than as an awkward attempt to limit abuses? The lower deductibility limit on gifts to private nonoperating foundations may or may not be justified as a matter of principle. Here again, the answer will depend on the prevailing view of the policy justification for the charitable contribution deduction. If it were agreed that the proper tax treatment of gifts is to tax only the recipient because he is the taxpayer who ultimately consumes the income, then no distinction among charitable donees would be appropriate, provided there are sufficient regulatory safeguards to prevent self-dealing and other transactions that benefit the donor (“disguised consumption”).

If it is instead agreed that section 170 is a tax expenditure (the “intangible consumption” rationale), the matter is more complex. The question then turns upon why we subsidize charitable contributions. Two fundamentally different explanations are generally advanced—charitable contributions should be encouraged because they (1) reduce the burdens of government, or (2) promote pluralism.

The first of these explanations views charitable organizations as quasi-governmental agencies.¹⁷⁴ Following through on this analogy, one might conclude that the tax subsidy is appropriate only for charities that provide services government would otherwise need to furnish. Of course, voluntarism has always been a significant factor in American life, so it is impossible to answer the hypothetical question, “Which of the social services that government has never had to provide would be continued in the absence of private initiative?” This uncertainty might lead one to conclude that important but “nonessential”

171. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 25 (1954), *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4019, 4050, 4190.

172. Clause (iv) of section 170(b)(1)(A) was added in 1962, clauses (v) and (vi) were added in 1964, clauses (vii) and (viii) were added in 1969.

173. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1464 (1984).

174. *See* *Bob Jones Univ. v. United States*, 103 S. Ct. 2017, 2026-28 (1983). Viewed as quasi-governmental agencies, the tax-exempt status of charitable organizations becomes merely an extension of the principle of intergovernmental tax immunity. I.R.C. § 115 (1982).

social services (in the sense that substitute government financing is in doubt) should not be entirely ineligible for the tax subsidy, but deserve a reduced rate of subsidy.¹⁷⁵ Note that organizations receiving broad public support, which are fifty-percent donees under section 170(b)(1)(A), are the organizations whose activities are likely to have sufficient political appeal to attract substitute government funding.

If the primary function of the charitable contribution deduction is to promote pluralism, the different percentage limits of section 170(b) should be repealed. It is exactly the organizations with nontraditional views, views which do not receive broad public support, that contribute most to a pluralistic society. These are the organizations that experiment and innovate, but these are also organizations likely to be subject to the thirty-percent limit of section 170(b)(1)(B).

The tension between reducing the burdens of government and promoting pluralism will never be resolved, of course. Both policies are embodied in the charitable contribution deduction; both are asserted whenever either the percentage limits or the definition of charitable organizations is at issue. Inevitably, any change in section 170(b) will require a new compromise between these interests.¹⁷⁶

IV. CONCLUSION

Three different treatments of ordinary gifts—taxing the donor, taxing the donee, and taxing both—are completely consistent with an income tax base.¹⁷⁷ Since 1913, our system has chosen to tax the donor, but it is not generally understood that this result could follow as well from a preference for taxing the *donee*, combined with recognition of the formidable enforcement difficulties that would entail. These competing rationales for the current tax treatment of ordinary gifts (donor tax versus donee tax) translate into differing policy justifications for the charitable contribution deduction—tax expenditure versus proper allowance in measuring disposable income. These competing rationales could produce significantly different resolutions of several important charitable contribution issues, including the U.S.-use requirement,¹⁷⁸ earmarked gifts,¹⁷⁹ percentage limitations,¹⁸⁰ and the applicability of the minimum tax.¹⁸¹ Yet the results in these areas remain ambivalent; the rules of

175. Of course, the amount of tax subsidy depends upon the donor's marginal tax bracket, and is not directly related to the percentage limits. However, private foundations are almost always endowed by top-bracket donors, so a limitation on the amount of deductible endowment could be viewed as a crude device for limiting the subsidy. Break, *supra* note 41, at 1531.

176. *See supra* note 96.

177. *See supra* note 16.

178. *See supra* note 62.

179. *See supra* notes 65-68 and accompanying text.

180. *See supra* text accompanying notes 173-76.

181. *See supra* text accompanying notes 162-66.

current law sometimes reflect the tax expenditure rationale, sometimes the income measurement rationale, sometimes both. Because these competing rationales have coexisted for seventy years without significant discord, we should be very suspicious of any change motivated by a tax expenditure view of the charitable contribution deduction that is not also in harmony with the income-measurement view. The long and short of it is that, in this field, tax expenditure analysis should be granted little, if any, effect.

