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Charitable FSAs: A Proposal to Combine Healthcare and Charitable Giving Tax Provisions

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This Article considers two unrelated tax provisions—health care Flexible Spending Accounts (FSAs) and the charitable deduction. FSAs permit eligible taxpayers to set income aside tax-free to use for medical expenses. However, these accounts have a "use-it-or-lose-it" feature that discourages participation and creates incentives for unnecessary spending at year-end. The charitable deduction is available only to those who itemize their deductions, thus negating the incentive to give for the 65% of taxpayers who take the standard deduction. Prior attempts to fix these provisions separately—allowing taxpayers to roll over unused FSA amounts to the next year and moving some or all of the charitable deduction "above the line"—have failed.

I propose combining the two provisions by allowing taxpayers to donate unused FSA amounts to charity. Doing so would lower a key impediment to participation in FSAs while giving a functional above-the-line deduction (and relief from payroll taxes) to those who donate through this mechanism. Not only would this reform increase the efficacy of both provisions, but it should also avoid many of the pitfalls of prior stand-alone reform efforts.

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I. INTRODUCTION

The ongoing national debate over health care reform has revealed a deep divide over how best to promote social welfare. Regardless of this debate's outcome, one thing seems certain: tax incentives will remain an important tool in advancing health care policy. The insurance mandate and associated penalty have received the lion's share of media attention, yet a number of other provisions play an important role in encouraging individuals to acquire health insurance, save for their medical needs, and monitor their expenditures. In this article, I focus on health care flexible spending accounts (FSAs),[1] which permit taxpayers to set aside money tax-free for medical needs.

Largely ignored by legal academics,[2] FSAs loom large in the minds of those eligible to participate. Before each tax year begins, taxpayers must estimate their unreimbursed medical expenses for the upcoming year.[3] If they choose to participate, they must make an irrevocable election to set aside money to cover such expenses on a tax-free basis. FSAs are subject to a "use-it-or-lose-it" rule. Thus, if taxpayers overestimate their needs, they must either race to spend unused amounts on items they would not otherwise have purchased or forfeit those amounts to their employer.

As discussed more fully below, although most taxpayers consider FSAs to be a form of tax-favored savings account, the Internal Revenue Service (IRS) considers them to be a form of health insurance. Many of the rules that make FSAs so ineffective, such as the use-it-or-lose-it rule, can be explained in large part by this fact. No data exists regarding how much time and energy taxpayers spend trying to assess their anticipated medical expenses, how many taxpayers underfund their accounts, or how many spend unused money at year-end to avoid forfeiture. However, of the

1. As described, *see infra* note 31, the rules provide for both health care and dependent care FSAs, which allow taxpayers to set aside money tax-free to be used for dependent care expenses. Unless otherwise indicated, I use FSA in this article to refer to health care FSAs.

2. As described more fully later, s*ee infra* Part II.C, there is a growing body of economics literature assessing the efficacy of FSAs as a health policy tool.

3. For a description of the rules governing health care FSAs, see Prop. Treas. Reg. § 1.125-5, 72 Fed. Reg. 43,938, 43,957–60 (Aug. 6, 2007).

approximately 40% of U.S. employees eligible for such accounts, only 22%—about 8% of all U.S. employees—participate in FSAs.[4]

The charitable deduction is also viewed by many as being deeply flawed. Some criticize the deduction because it provides an "upside-down" subsidy, where high-income taxpayers receive a greater benefit than low-income taxpayers.[5] Others focus on the fact that some taxpayers are allowed to deduct the full market value of donated property while others are limited to deducting basis.[6] However, the issue that has received the most attention has been the placement of the deduction "below the line," so that it is not available to the approximately 65% of taxpayers who take the standard deduction.[7]

To date, stand-alone efforts to fix the perceived problems with these provisions—by allowing taxpayers to roll unused amounts over to the next year and by moving some or all of the charitable deduction "above the line"—have failed.[8] In this Article, I propose a novel solution that merges the two provisions by allowing taxpayers to donate unused funds in their FSAs at year-end to charity.

My proposal has several benefits over the stand-alone fixes previously proposed. First, combining the two provisions is likely to increase the incentive both to save for medical needs and to donate to charity. Taxpayers will be more likely to participate and fully fund their FSAs if they know unused amounts will go to charity instead of being retained by their employers. Because amounts contributed to

4. *See* BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, MARCH 2009, at tbl.36 (Sept. 2009) (describing the percentage of U.S. employees eligible to participate in health care FSAs); MERCER HUMAN RES. CONSULTING, NATIONAL SURVEY OF EMPLOYER-SPONSORED HEALTH PLANS, ll. 619–20 (2008) (describing the health care FSA participation rates for eligible employees).

5. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 22, 134 (1973).

6. *See* Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 14–16 (2002).

7. The line in question is one that differentiates deductions that are used to determine Adjusted Gross Income (AGI) and those that are not. Deductions used to determine AGI are taken "above the line" and are available to all taxpayers. Below-the-line deductions may be taken only by those who itemize their deductions. *See* I.R.C. §§ 63, 67, 68 (2006). For data on the number of people who itemize, see I.R.S., SOI TAX STATS-INDIVIDUAL INCOME TAX RETURNS PUBLICATION 1304 (COMPLETE REPORT) 32 tbl.1.2, 68 tbl.2.1 (2005), *available at* http://www.irs.gov/pub/irs-soi/05inalcr.pdf. The 35% who itemize accounted for 80.5% of all income tax revenue raised in 2005. *See id.*

8. *See infra* Part IV.

FSAs are exempt from income, *all* taxpayers who donate to charity through this mechanism will receive the equivalent of an above-the-line deduction. Second, the proposal is likely to be both less expensive and administratively easier than moving some or all of the charitable deduction above the line. Finally, the proposal is likely to garner more political support than earlier, stand-alone proposals, if for no other reason than both charitable organizations and those eligible for FSAs will join forces to support it.

Part II of this Article considers the different ways in which Congress has used the Internal Revenue Code (I.R.C., Tax Code or Code) to encourage people to acquire insurance or otherwise provide for medical needs. Part III examines the charitable deduction. Part IV reviews prior efforts to remedy the perceived flaws in both the charitable deduction and FSA provisions. Part V contains the detailed proposal to allow taxpayers to donate unused funds in an FSA at the end of the year to charity and evaluates the proposal in light of concerns raised about prior attempts to reform these provisions. While the IRS could adopt this proposal administratively without changing the nature of FSAs, I argue that Congress should instead take this opportunity to recast FSAs as tax-favored savings accounts and conform them to the way most people think about and use them.

II. HEALTHCARE POLICY IN THE TAX CODE

The Tax Code contains a number of provisions allowing taxpayers to deduct, exclude from income, or receive tax-free insurance and reimbursement of amounts spent on medical care. Some argue that these provisions are appropriate as a matter of income measurement.[9] However, most agree that provisions in the Code related to healthcare spending are subsidies.[10]

9. For example, the Schanz-Haig-Simons income definition posits that income equals consumption plus change in wealth over an accounting period. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). Most arguments regarding the propriety of deducting medical expenses focus on the question of whether medical expenditures constitute consumption. *See, e.g.*, William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314 (1972) (arguing that medical expenditures should not be considered consumption and therefore should be deductible). For an opposing view, see, for example, Mark G. 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 (1979) (arguing that spending on medical needs is a form of consumption). Thomas Griffith, who contends that the deductibility

To understand FSAs, it helps to understand where they fit in the panoply of tax provisions that affect healthcare. This Part considers the structure and efficacy of these provisions, which can be broken down into three main types. The first allows a deduction for medical spending above a set floor. The second allows taxpayers to exclude from income the value of employer-provided health insurance and amounts received under such plans. The third allows taxpayers to exclude from income amounts they save and then spend on medical expenses. Despite the financial incentives these provisions provide, most have failed to live up to their promise.

of a medical expense should depend on whether it increases overall societal welfare, notes that Andrew's argument is actually based on the impact of medical expenditures on a taxpayer's ability to pay taxes, as opposed to a definition of consumption. *See* Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 366–77 (1989).

If a deduction for medical expenses is warranted, a deduction for amounts paid for health insurance or the exclusion of the value of health insurance received from one's employer is also warranted. Premiums for health insurance represent the expected value of medical expenses over the coverage period. Allowing a deduction for such expenses or excluding the receipt of insurance from income is tantamount to allowing a deduction when medical expenses are incurred. *See* Jay A. Soled, *Taxation of Employer-Provided Health Coverage: Inclusion, Timing and Policy Issues*, 15 VA. TAX REV. 447, 452–465 (1996) (arguing for the exclusion from income of employer-provided health care on income-definition grounds).

10. The concept of the tax expenditure/subsidy was championed by Stanley Surrey, a Harvard professor who served as Assistant Secretary of the Treasury under President Kennedy. He also championed the idea of compiling an annual tax expenditure budget to track how much money Congress spent indirectly by giving tax preferences to subsets of taxpayers. *See* SURREY, *supra* note 5.

Tax expenditures have received significant criticism for complicating the Tax Code, obscuring government spending, and distorting the budgeting process. *See, e.g.*, Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1 (2010). However, given the self-executing nature of spending programs that run through the Tax Code, they may be more efficient than direct spending programs. *See* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 979–80 (2004). To the extent that they are designed to redistribute income, they may be more efficient than stand-alone legal rules. *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994). In fact, the decision to integrate spending into the Tax Code is more properly a question of institutional design. Weisbach & Nussim, *supra*, at 957–61.

A. Deductions for Medical Expenses

I.R.C. § 213 allows a deduction for certain medical expenses above a floor. Congress added the predecessor to § 213 to the Tax Code in 1942, when it converted the income tax into a mass tax to help pay for World War II.[11] The current version permits taxpayers to deduct medical expenses that exceed 7.5% of their AGI.[12] As part of the Patient Protection and Affordable Care Act of 2010 (Patient Protection Act), this threshold will rise to 10% of AGI in 2013.[13] Because this medical expense deduction falls below the line, it is available only to those who itemize their deductions.[14]

The legislative history reveals that Congress did not see the provision as necessary for income measurement; rather it viewed the provision as a tool for affecting public policy.[15] This is not to say that the provision is a tax incentive. The point is not to provide financial incentives for people to incur medical expenses. Rather, it provides relief to those who suffer extraordinary injury by freeing up resources to pay for medical care that might otherwise not be available. Allowing a deduction for medical expenses is justified because it supposedly enhances overall societal welfare.[16]

11. Revenue Act of 1942, ch. 619 § 127(a), 56 Stat. 825 (current version at I.R.C. § 213 (2006)).

12. *See* I.R.C. § 213 (2006). AGI is defined at I.R.C. § 62(a).

13. *See* Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, § 9013(a), 124 Stat. 119, 868 (2010). Taxpayers who turn 65 in 2013 through 2106 will be able to use the 7.5% figure for those years. *Id.* § 9013(b).

14. *See* I.R.C. § 62 (2006). Medical expenses are not considered "miscellaneous itemized deductions" and therefore are not subject to the 2% floor set forth in I.R.C. § 67. Medical expenditures are also not limited by I.R.C. § 68, which reduces certain itemized deductions for those whose income exceeds a floor.

15. During the hearings on the bill, a National Association of Retail Druggists representative testified that an allowance for medical expenses was ostensibly included in the personal exemption and that the proposal in the pending bill to significantly lower the exemption would in effect subject medical expenses to tax for the first time. *See Revenue Act of 1942: Hearing on H.R. 7378 Before the S. Comm. on Finance*, 77th Cong. 1675–78 (statement of Rowland Jones, Jr., Washington Rep. of the National Association of Retail Druggists). He expressed fear that people would defer medical expenses in response to the increased tax liability to their own detriment and that of the country generally. The Association thus argued for full deductibility of all expenses. *See id.* at 1678. Others supported the Treasury Department's proposal that only extraordinary expenses be covered. *See, e.g.*, *id.* at 2204 (statement submitted by Paul J. Kern, Committee on National Taxation, National Lawyer's Guild). In the end, Congress allowed taxpayers to deduct expenses above 5% of their AGI for expenses paid for medical care, with a maximum deduction of $2500 for a head of family. *See* § 127(a), 56 Stat. at 825.

16. *See* Griffith, *supra* note 9, at 370.

B. Employer Provided Health Insurance

By far the largest tax subsidy for healthcare can be found in I.R.C. §§ 105, 106, 3101(a)–(b), and 3121(a)(2). These provisions exclude from income and payroll taxes amounts employers pay to insure their employees and amounts employees receive under health and accident plans, whether in the form of direct payments to doctors or reimbursement of employee-incurred expenses.[17] However, these provisions were not originally intended as subsidies. The issue of including employer-paid insurance premiums as income first arose in 1919, when the IRS held that payments for individual policies counted as income to the employee. However, the next year the IRS ruled that premiums for group insurance were not income, on the theory that such expenditures were for the benefit of the employer and not the employee.[18] At this point, only a small number of Americans were subject to the income tax, so the ruling had little practical effect.

Two things happened during World War II to thrust the exemption for group insurance into the spotlight and make it relevant to a large number of taxpayers. First, the income tax was converted into a mass tax, which caused a large number of people to become subject to it. Second, the National War Labor Board decided to freeze wages. Given the shortage of workers, employers sought creative ways to get around the wage controls. One option was to offer health insurance.[19] In 1943, the Labor Board held that fringe benefits—including health insurance—would not be considered salary for purposes of the wage freeze, thus giving a significant boost to employer-provided health insurance.[20] Congress later codified the exclusion of health insurance from income as I.R.C. § 106. As a result, the government now subsidizes the purchase of health insurance, at least for those lucky enough to work for employers who offer this benefit.

17. By one estimate, the government subsidy created by these provisions amounted to $202 billion in 2004. It is routinely the largest tax expenditure in the Code. *See* Richard L. Kaplan, *Who's Afraid of Personal Responsibility? Health Savings Accounts and the Future of American Health Care*, 36 MCGEORGE L. REV. 535, 553–54 (2005).

18. For a discussion of this early history, see Soled, *supra* note 9, at 450.

19. *See* EMP'T BENEFIT RESEARCH INST., HISTORY OF HEALTH INSURANCE BENEFITS (Mar. 2002), *available at* http://www.ebri.org/publications/facts/index.cfm?fa=0302fact; *see also* T.D. 5295, 1943 C.B. 1193.

20. *See* EMP'T BENEFIT RESEARCH INST., *supra* note 19.

The provision of tax-free health insurance to employees involves an implicit negotiation between employers and employees over the form their compensation will take. While employees are not given the express choice of receiving cash or an equivalent amount of health insurance, in effect those who accept health insurance are almost certainly taking home less salary than they otherwise would. Normally, those who choose between cash and some other benefit are deemed to be in constructive receipt of cash, and therefore must include the value of the benefit in income.[21] However, perhaps because employees are not making an express tradeoff, they are not deemed in constructive receipt of any income by virtue of receiving health insurance.

The efficacy of the benefit provided by I.R.C. § 106 is limited. Not only is the benefit available to a limited number of taxpayers,[22] but costs for health insurance have also risen dramatically. By one recent estimate, approximately 50 million people in the U.S. are without health insurance.[23] Those who have employer-sponsored insurance are being asked to shoulder more and more of the costs of health insurance directly.[24] The Patient Protection Act addresses some of these problems by mandating that people obtain health insurance and by providing subsidies to those who cannot afford to do so. However, the Act still relies heavily on employer-sponsored insurance and the associated tax incentives as the primary tool for expanding coverage.[25] If Republicans succeed in repealing the law or otherwise blocking its implementation, as they have threatened, the existing problems are likely to persist.

21. *See* Soled, *supra* note 9, at 479–80.

22. While virtually all full-time state and local government workers were offered retirement and medical benefits, in the private sector only 69% of workers were offered medical benefits. *See* Press Release, Bureau of Labor Statistics, Employee Benefits in the United States–March 2011 (July 26, 2011), http://www.bls.gov/ncs/ebs/sp/ebnr0017.txt. Only 22% of private sector workers had access to medical care benefits amongst the lowest 10% of wage earners. *Id.*

23. *See* THE HENRY J. KAISER FAMILY FOUND., FIVE FACTS ABOUT THE UNINSURED (2010), *available at* http://www.kff.org/uninsured/upload/7806-03.pdf.

24. *See, e.g.*, Noam N. Levey, *Workers Bearing Brunt of Higher Health-Care Costs*, ARIZ. REPUBLIC, Sept. 3, 2010, at A5.

25. *See, e.g.*, Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, § 1501(a)(2)(D), 124 Stat. 119, 242 (finding that near-universal coverage will be achieved "by building upon and strengthening the private employer-based health insurance system").

C. Cafeteria Plans and FSAs

In 1978, Congress added I.R.C. § 125 to the Code, creating "cafeteria plans." These plans allow taxpayers to make explicit choices between receiving cash or qualified tax-favored benefits without running afoul of the constructive receipt rules.[26] A key feature of qualifying benefits is that, with a few important exceptions, they may not involve deferred compensation.[27] Section 125 opened the door for FSAs, which allow employees to elect to set aside part of their salary and use it to pay their medical expenses.[28] Money contributed is exempt from both income and payroll taxes.[29] However, any amount not used at the end of the year is forfeited to the employer.[30] Until recently, the law imposed no limits on the amount that could be contributed to an FSA, though employers often set a $5000 limit.[31] As part of the Patient Protection Act, Congress has limited the amount that can be contributed to $2500 starting in 2013.[32] In addition, starting in 2011, over-the-counter

26. *See* I.R.C. § 125(a) (2006).

27. *See id.* § 125(d)(2)(A).

28. The current rules are contained in Proposed Treasury Regulation § 1.125-5, 72 Fed. Reg. 43,938, 43,957 (Aug. 6, 2007). Some health care FSAs involve only employer contributions. Such plans are not covered under I.R.C. § 125. Instead they are viewed as a form of employer-provided insurance under I.R.C. §§ 105 and 106. I focus here only on health care FSAs that are part of a cafeteria plan.

29. *See* I.R.C. §§ 105, 3121(a).

30. *See* Prop. Treas. Reg. § 1.125-5, 72 Fed. Reg. at 43,942 (discussing the "Use-or-Lose Rule" as satisfying cafeteria plan requirement of I.R.C. § 125(d)(2)(A) prohibiting deferral of compensation).

31. FSAs also exist for dependent care. Under such plans, taxpayers may put away money to be used to pay for dependent care on a tax-free basis. Many of the same issues that exist for health care FSAs exist for dependent care FSAs. I do not focus on these accounts in this Article, but many of the same arguments could be made. Section 129 of the Code imposes a $5,000 limit for dependent care FSAs, and it appears that many plans similarly limit contributions to health care FSAs. *See, e.g.*, Prop. Treas. Reg. § 1.125-2 Q&A (7)(f) ex. 2 (1989); Prop. Treas. Reg. § 1.125-5(c), 72 Fed. Reg. at 43,942. According to a 2007 study by the International Foundation of Employee Benefit plans, 54% of its members capped contributions at some amount up to $4,999, and 42% capped contributions at $5000 or more. Unfortunately, the report does not indicate how many of that 42% capped contributions at exactly $5000. *See* INT'L FOUND. OF EMP. BENEFITS PLANS, FLEXIBLE BENEFIT PLANS AND FSAS 5 (2007). The Federal FSA plan limits contributions to $5000. *See* JANEMARIE MULVEY, CONG. RESEARCH SERV., RL 32656, HEALTH CARE FLEXIBLE SPENDING ACCOUNTS 6 (2010).

32. *See* I.R.C. § 125(i) (2006), *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1403(a), 124 Stat. 1029, 1063.

drugs will no longer be eligible for reimbursement from such accounts.[33]

To most employees, FSAs look and function like tax-favored savings accounts. Employees contribute their own money and then recover it by submitting receipts documenting their health care expenditures. However, to the IRS, FSAs are a form of employer-provided health insurance. The characterization of FSAs as insurance has led to many of the rules that make FSAs difficult to use, contributing to the low participation rates discussed more fully below. To understand why the FSA rules are so restrictive, it helps to trace their history.

With the introduction of cafeteria plans in 1978, employees were permitted for the first time to direct their salary dollars towards the purchase of health insurance, including plans that would reimburse them directly for their medical expenses. Some early plans overreached, allowing employees to submit medical expenses to their employers, who then characterized an equal amount of the employees' normal salary as a reimbursement and therefore arguably exempt from tax.[34] In early 1984, the IRS announced that any amounts received under such plans did not qualify for tax exclusion under I.R.C. § 125.[35]

Later that year, the Treasury Department issued proposed regulations setting forth the first guidance on what was necessary for an FSA to qualify for tax exemption under I.R.C. § 125.[36] The regulations stated that any benefit that allowed participants to carry unused amounts over from one year to the next could not be offered in a cafeteria plan because carryover would amount to deferred compensation in violation of I.R.C. § 125(d)(2).[37] Without stating a basis for the ruling, the regulations further required that in cafeteria plans employees must elect benefits before the benefits become available[38] (i.e., before the tax year begins) and prohibited employees

33. *See* Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, § 9003, 124 Stat. 119, 854 (2010).

34. *See* I.R.S. Announcement 84-24, 1984-10 I.R.B. 39 (Mar. 5, 1984); I.R.S. News Release IR-84-22 (Feb 10, 1984).

35. *See* I.R.S. Announcement 84-24, 1984-10 I.R.B. 39; I.R.S. News Release IR-84-22.

36. *See* Prop. Treas. Reg. § 1.125-1, 49 Fed. Reg. 19,322, 19,322–29 (May 7, 1984).

37. *See id.* at 19,324, Q&A 7.

38. *See id.* at 19,325, Q&A 15.

from revoking their elections, even as to future contributions, absent a change in family status.[39]

In 1989, the Treasury Department issued another set of proposed regulations, further clarifying the rules governing FSAs.[40] These rules attempted to distinguish between medical expenses deductible under I.R.C. § 213 and amounts received tax-free under an FSA. In particular, the Treasury was concerned that FSAs were being used to allow employees to deduct their first dollar of medical expenses in contravention of the policy implicit in I.R.C. § 213, which had a floor of 7.5% of AGI. The regulations made clear that to qualify as a tax-free benefit FSAs had to function like insurance contracts described in I.R.C. § 106. To this end, the employer must bear a meaningful risk of loss, thus creating an incentive to guard against adverse selection by employees and inappropriate reimbursement of employee expenses.[41]

The regulations cast employee contributions as "premiums" and describe reimbursements as recovery on a claim, not simply receiving back one's own money. For most plans, the coverage purchased is equal to the amount of premiums paid, though employers can create plans where amounts paid out exceed the premiums paid by up to 500%.[42] While few would ever consider buying an insurance policy where the benefits equal the premiums paid, the tax savings associated with FSAs make them economically attractive to employees.[43]

Consistent with traditional insurance policies, employees need not wait until they have contributed the full amount (paid their premiums in full) before seeking reimbursement (making a claim).[44]

39. *See id.* at 19,324, Q&A 8. In 2000, the Treasury Department issued final regulations addressing what constituted a change in status that would allow FSA participants to change their elections. *See* Prop. Treas. Reg. §1.125-4, 66 Fed. Reg. 1837, 1840 (Jan. 10, 2001).

40. *See* Prop. Treas. Reg. § 1.125-2, 54 Fed. Reg. 9468 (March 7, 1989).

41. *Cf. id.* at 9482, Q&A 7(a).

42. *See id.* at 9483, Q&A 7(f).

43. A simple numeric example illustrates why the tax savings associated with FSAs make them economically attractive to employees. If a taxpayer earns $100, contributes it to an FSA, and incurs medical costs of $80, the taxpayer loses $20 at the end of the year. However, he only needs to earn $100 to cover $80 of healthcare. If the taxpayer decides not to contribute to an FSA to avoid the risk of forfeiture, he must earn $133.33 to pay for $80 of medical care, assuming a tax rate of 40%. As a result, he is better off participating in the FSA even though he forfeits money.

44. *See* Prop. Treas. Reg. § 1.125-2, 54 Fed. Reg. at 9482, Q&A 7(f) (stating that

Thus, an employee who elects to contribute $5,000 and incurs a large medical expense in January can get full reimbursement immediately even though it will take a full year for her employer to withhold the entire amount elected. It is this feature that creates the risk for the employer and makes the plan look like insurance in the eyes of the IRS. If the employee were to leave her employment in February, no mechanism exists for the employer to claw back amounts reimbursed in excess of her contributions.

Payments must be for expenses incurred during the coverage period, which must last the entire year to prevent employees from seeking coverage only during times of the year when they know they will have expenses.[45] Only qualified medical expenses described in I.R.C. § 213 are reimbursable.[46] Although the IRS significantly broadened covered expenditures in 2003 by ruling that reimbursement of amounts paid to purchase nonprescription drugs were permissible within an FSA,[47] the Patient Protection Act rescinded this rule starting in 2011.[48] Thus, only medical services, devices, and prescription drugs will be covered, making FSAs less attractive to many users. Finally, to be reimbursed, employees must submit a written statement from an independent third party (i.e., a receipt) describing the nature and amount of the expense.[49]

The 1984 regulations made clear that participants forfeited any unused amounts. The 1989 regulations set forth the appropriate use of such funds, which are described as "experience gains."[50] Such amounts may be used to reduce premiums in future years, or they may be returned to the FSA participants as dividends or premium refunds. However, any amounts returned in this manner cannot be based on the actual experience of any given participant. Thus, someone who has $100 left in his account cannot expect to receive a $100 reduction in future premiums or a $100 premium refund. Instead, the total amount left over in the fund must be allocated among all participants based on some neutral principle.

reimbursements must be available at all times during the period of coverage).

45. *See id.* at 9482–83, Q&A 7(3).

46. *See id.* at 9483, Q&A 7(4).

47. *See* Rev. Rul. 03-102, 2003-38 I.R.B. 559.

48. *See* Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, § 9003, 124 Stat. 119, 854 (2010).

49. *See* Prop. Treas. Reg. § 1.125-2, 54 Fed. Reg. at 9467.

50. *See id.*

In 2007, the Treasury Department issued another set of proposed regulations to replace those issued in 1984 and 1989.[51] The new proposed § 1.125-5 is devoted solely to FSAs and continues much of what came before. It reaffirms the use-it-or-lose-it feature but allows employers to give employees a two-and-a-half month grace period after the end of the year to spend unused funds on the theory that such a short grace period does not run afoul of the bar on deferred compensation.[52] It also continues the requirement that FSAs have insurance-like characteristics, making clear that reimbursements must conform to the rules of § 105. The regulation further clarifies that employers may retain unused premiums, use them to defray administrative costs, lessen future premiums, or refund the premiums to employees, so long as they do so on a uniform and reasonable basis.[53]

The rules described above make sense if one wants to make FSAs look like insurance policies; they make little sense if one wants employees to make full use of FSAs. They depress participation because eligible taxpayers either decide not to participate or underfund their accounts to avoid the risk of forfeiture. They also engender significant frustration among eligible taxpayers and create incentives for participants to incur unnecessary medical expenses.[54] The people for whom FSAs work the best are those with predictable, periodic medical expenses, such as prescription drugs not covered by insurance, or orthodontia. For those with less predictable medical expenses, the forfeiture rule, when combined with the requirement that employees make an irrevocable election on how much to set aside before the year begins, creates a significant risk that employees will lose some of the money they set aside.[55]

51. *See* Prop. Treas. Reg. § 1.125, 72 Fed. Reg. 43,938-4001 (Aug. 6, 2007).

52. The IRS had announced this policy in 2005. *See* I.R.S. Notice 05-42, 2005-232 I.R.B. 1204. Not all employers have opted to amend their plans to allow this.

53. *See* Prop. Treas. Reg. § 1.125-5, 72 Fed. Reg. at 43,943.

54. *See* Daniel Kadlec, *Inflexible-Spending Accounts*, TIME, Oct. 21, 2002, at 86, *available at* http://www.time.com/time/magazine/article/0,9171,1003493-1,00.html (describing the purchase of new eyeglass frames and other medical services at the end of the year to avoid forfeiting amounts remaining in FSAs).

55. While it is possible that participants could get some money back in the form of reduced future contributions or premium refunds, few health care FSAs appear to return money to FSA participants in one of these two ways. I have heard anecdotally that the University of Minnesota's FSA plan made unused amounts available to other participants. I do not have any concrete evidence of how widespread this practice is.

According to a Bureau of Labor Statistics National Compensation Survey, as of 2009 only 39% of all workers were eligible to enroll in FSAs.[56] As of 2002 only about 12% of those eligible to enroll in such plans do so.[57] Nonetheless, the trend has been an increase in participation: a 2008 Mercer Survey revealed that 21% of those eligible participated in 2007, while 22% participated in 2008.[58] In 2008, the average contribution for those who did participate was $1,380.[59] Unfortunately, no data is available on the relationship this number bears to the average actual medical expenses. Thus, there is no way to know the extent to which people underfund FSAs to avoid a possible forfeiture penalty.

Data regarding the number of people who forfeit money suggests that most people spend all the money in their accounts. According to an International Foundation of Employee Benefit Plans survey from 2006, 62% of the respondent employers reported that less than 7% of FSA participants forfeited any money. Another 6% of respondent employers reported that between 20% and 29% of participants forfeited money, while a full 30% of these employers did not have information on forfeitures.[60] When people do forfeit funds, the data suggests that they forfeit very small amounts. The International Foundation survey reveals that 51% of respondents reported average forfeiture amounts under $300, and only 6% reported higher average amounts. Again, 30% of respondents did not have data on forfeitures.[61]

56. *See* BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY (Sept. 2009). The survey includes "civilian" workers, which excludes federal employees, who do have access to such plans. Among those who had the ability to participate, the numbers were skewed heavily towards those in higher tax brackets. *Id*. In addition, this benefit was skewed towards companies with more than 100 employees, with approximately 83% of all such companies offering FSAs, comprising 51% of all workers. *See* MERCER HUMAN RES. CONSULTING, 2009 NATIONAL SURVEY OF EMPLOYER-SPONSORED HEALTH PLANS (2009), http://www.mercer.com/survey-reports/2009-US-national-health-plan-survey (purchase required); *see also* INT'L FOUND. OF EMP. BENEFITS PLANS, *supra* note 31, at 3 (indicating that 73% of employers reported a participation rate at or below 39%; 20% reported a higher rate, and 7% did not know their participation rates).

57. *See* Kadlec, *supra* note 54, at 86.

58. *See* MERCER HUMAN RES. CONSULTING, *supra* note 56.

59. *See id*.; *see also* INT'L FOUND. OF EMP. BENEFITS PLANS, *supra* note 31, at 5 (showing that 74% reported contributions under $3000, 2.4% reported higher contributions, and 24% did not have data on this question).

60. *See* INT'L FOUND. OF EMP. BENEFITS PLANS, *supra* note 31, at 6.

61. *See id*.

It is not clear whether these forfeiture rates and amounts reflect that people are good at estimating their annual medical expenses, underfund their accounts to avoid the risk of forfeiture, or race out to spend money at the end of the year to avoid forfeiture. Nor is there any data on the amount of time spent trying to calculate anticipated medical expenses so as not to overfund FSAs. It is almost impossible to obtain this information. However, if the conversations in which I have participated while writing this article are indicative, people spend significant time trying to estimate their medical expenses. Moreover, intentional underfunding and last-minute spending sprees are the principal causes of the relatively low forfeiture rates and amounts.

D. Tax-Favored Health Savings Accounts

While FSAs appear to most users to be tax-favored savings accounts, Congress has created actual tax-favored savings accounts as part of its plan to encourage taxpayers to sign up for high deductible health insurance plans. Medical Savings Accounts (MSAs), later renamed Archer MSAs, were created in 1996 on an experimental basis to rein in the rapid growth in health care costs.[62] The notion was that high-deductible plans would be less expensive than traditional health insurance, thus prompting more people to acquire insurance. Moreover, consumers would be more cost conscious if they had to pay for medical costs out of pocket, at least until their deductibles were reached. To encourage taxpayers to elect such plans, Congress allowed taxpayers to receive an above-the-line deduction for amounts contributed to Archer MSAs.[63] If such plans were part of a cafeteria plan, contributed amounts were also exempted from payroll taxes.[64] Amounts in an Archer MSA could be spent on qualifying medical expenses without the taxpayer incurring any tax liability.[65] Any unused amounts were rolled over to the next

62. *See* Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (codified at I.R.C. § 220 (2006)). For the provision renaming the accounts, see Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 202 app. G, 114 Stat. 2763A-587, 2763A-628 to -629 (2000).

63. *See* I.R.C. §§ 62(a)(16), 220 (2006). For participants on Medicare, direct contributions by Health and Human Services were also excluded from a taxpayer's income. *See id.* § 138.

64. *See* EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS, I.R.S. Pub. 15-B, at 15 (May 24, 2011), *available at* http://www.irs.gov/pub/irs-pdf/p15b.pdf.

65. *See* I.R.C. § 220(d)(2), (f). Amounts not spent on such expenses were subject to tax

year. Unlike FSAs, taxpayers could invest funds contributed to an Archer MSA as they wished, and any returns on such investment were also exempt from tax.[66]

As noted, Archer MSAs were experimental. As a result, they had a number of features that hampered their acceptance. They had a definite end date,[67] only a limited number of accounts could be created,[68] and only self-employed individuals or those who worked for companies with fewer than fifty employees were allowed to create them.[69] In 2001, only about 80,000 accounts were set up, far below the 750,000 limit Congress established.[70]

In 2003, Congress created a permanent version of Archer MSAs, called Health Savings Accounts (HSAs).[71] Like MSAs, these accounts may only be used in conjunction with high-deductible insurance policies.[72] Both employers and employees may contribute to HSAs, although annual contributions are limited. For 2011, the limits are $3,050 for an individual and $6,150 for a family, though people over fifty-five years old may contribute an extra $1,000.[73] Those who participate in an FSA are not eligible to contribute to an HSA.[74]

and a penalty. *See id.* § 220(f)(1)–(2), (4).

66. *See* I.R.C. § 220(e).

67. The end date was extended twice, for a total of three years. *See* Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 201(a) app. G, 114 Stat. 2763A-587 to -628 (providing for a two-year extension of availability for medical savings accounts); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 612(a), 116 Stat. 21, 61 (2002) (providing for a one-year extension).

68. *See* I.R.C. § 220(j)(2)(A)(ii).

69. *See id.* §§ 220(c)(1)(A)(iii)(I)–(II), 401(c)(1)(B).

70. *See* I.R.S. Announcement 02-90, 2002-2 C.B. 684 (explaining that there were 78,913 MSAs created in 2001).

71. *See* Medicare Prescription Drug Improvement and Modernization Act of 2003, Pub. L. No. 108-173, 117 Stat. 2066 (2003) (primarily amending 42 U.S.C. § 1395 (2000)). The Act added § 223 to the Code.

72. High deductible insurance is defined as insurance with a deductible of at least $1200 for individuals and $2400 for families, where the combined cost of the insurance and the deductible does not exceed $5950 for individuals and $11,900 for families. *See* I.R.C. § 223(c)(2), (g); EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS, *supra* note 64, at 15.

Unlike MSAs, these accounts permit contributions from both employees and employers in the same year. *See* HEALTH SAVINGS ACCOUNTS AND OTHER TAX-FAVORED HEALTH PLANS, I.R.S. Pub. 969 (Jan 14, 2011), *available at* www.irs.gov/pub/irs-pdf/p969.pdf.

73. *See* I.R.C. § 223(b)(2)–(3), (g). EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS, *supra* note 64, at 15; HEALTH SAVINGS ACCOUNTS AND OTHER TAX-FAVORED HEALTH PLANS, *supra* note 72, at 5.

74. *See* I.R.C. § 223(c)(1); EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS, *supra* note

Contributions are deducted above the line[75] and are also exempt from payroll taxes if the HSA is part of a cafeteria plan.[76] Income earned within HSAs is also tax exempt.[77]

HSAs are explicitly excluded from the deferred compensation limitations found in I.R.C. § 125,[78] and unused funds at year-end are rolled over to the next year.[79] If amounts contributed to an HSA are spent for non-eligible expenses, those amounts must be included in income and are subjected to a 20% penalty tax.[80] When an HSA owner dies, the HSA continues if his spouse is the beneficiary.[81] If another person acquires the account, the money must be distributed and included in income. However, the 20% penalty is not assessed.[82] The penalty is also not assessed after an HSA owner reaches 65, regardless of what he spends the money on.[83] Thus, HSAs provide a tax-deferred savings vehicle, similar to a traditional Individual Retirement Account or 401(k) plan, for taxpayers lucky enough to reach retirement or who die without needing the money contributed to an HSA.[84]

The hope was that making MSA-type accounts permanent would spur the market for high deductible plans, further increasing the incentive for individual taxpayers to save for their medical needs while acting to slow the growth of medical costs. However, to date, the use of HSAs within plans remains below expectations. According to one study, in 2005 only 2% of employers offered such plans.[85] While the percentage jumped to 6% in 2006, even this number is substantially below target.[86] To the extent that the goal was to

64, at 15.

75. *See* I.R.C. §§ 62(a)(19), 223(a).

76. *See* EMPLOYER'S TAX GUIDE TO FRINGE BENEFITS, *supra* note 64, at 15.

77. *See* I.R.C. § 223(e).

78. *See id.* § 125(d)(2)(D) (2006).

79. *See id.* § 223(d)(1)(E).

80. *See* I.R.C. § 223(f)(2)–(4) (West 2010). Prior to 2010, the tax penalty was 10%. *See* I.R.C. § 223(f)(4).

81. *See* I.R.C. § 223(f)(8)(A).

82. *See id.* § 223(f)(4)(B), (8)(B).

83. *See id.* § 223(f)(4)(C); Social Security Act § 1811, 42 U.S.C. § 1395c (2006).

84. This problem could readily be solved by requiring that unused amounts in HSAs be donated to charity upon the death of the beneficial owner.

85. *See* CATHERINE HOFFMAN & JENNIFER TOLBERT, HEALTH SAVINGS ACCOUNTS AND HIGH DEDUCTIBLE HEALTH PLANS: ARE THEY AN OPTION FOR LOW-INCOME FAMILIES? 7 (Oct. 2006), *available at* http://www.kff.org/uninsured/upload/7568.pdf.

86. *See id.*

encourage low-income uninsured people to obtain insurance, the plan has also been a disappointment; users tend to be higher-income individuals.[87] In addition, one study of the program from 2005 to 2007 showed that between 42% and 49% of people who had a high deductible plan failed to open an HSA, suggesting that the tax incentive is unnecessary for those participants or that they simply do not have funds available to contribute.[88]

In addition, while high-deductible medical insurance plans may make economic sense for the healthy, the chronically ill will almost certainly spend through their deductible each year, eating up any possible savings that might be associated with such plans.[89] Accordingly, the plans are far more attractive to some than others, skewing the risk pools.[90] Finally, the institutions that offer HSAs often charge significant annual fees that can eat up a portion of the amounts set aside. Set-up charges can be as high as $20, with monthly fees of up to $3, for an annual total of $36.[91] It would be an understatement to say that this approach to health care cost management is controversial.[92]

E. Analysis of Health Care Provisions

The patchwork of tax provisions described above is both incoherent and ineffective. The I.R.C. § 213 deduction sets a floor below which medical spending is not deductible, presumably based upon the theory that no deduction is warranted unless taxpayers incur extraordinary expenses. Yet, the exclusion from income of employer-provided healthcare is the functional equivalent of allowing taxpayers to deduct the first dollar of medical expenses, at least if

87. *See HSA Participation Up, Mostly Among Higher-Income Earners*, 2008 TAX NOTES TODAY 95–5 (May 15, 2008).

88. *See id.*

89. HOFFMAN & TOLBERT, *supra* note 85, at 4.

90. *See id.* at 6.

91. *See* Michelle Andrews, *The Promise and the Pitfalls of Health Savings Accounts*, N.Y. TIMES, Aug. 14, 2005, at B6; *see also* I.R.S. Notice 08–59, 2008–29 I.R.B. 123 (describing how fees are to be accounted for).

92. *See, e.g.*, *Health Savings Accounts (HSAs) and Consumer Driven Health Care: Cost Containment or Cost Shift?: Hearing on H.R. 5917 Before the Subcomm. on Health of the H. Comm. on Ways and Means*, 110th Cong. 94–95 (2008) (written Statement of Gail Shearer, Director, Health Policy Analysis, Washington Office, Consumers Union), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg50037/pdf/CHRG-110hhrg50037.pdf; *id.* at 32–38 (statement of Linda J. Blumberg, Ph.D., Principal Research Associate, The Urban Institute).

taxpayers do not incur any uninsured expenses. Similarly, the exclusion of FSA and HSA contributions provides the functional equivalent of a deduction for the first dollar spent on healthcare, thus overriding I.R.C. § 213's policy of disallowing deductions below a floor.

Despite the subsidies for employer-provided insurance, the number of uninsured people in the United States stands at approximately fifty million.[93] Both FSAs and HSAs have failed to live up to their promise, as a surprisingly low number of those eligible to participate actually do. Moreover, these provisions may work at cross-purposes. A subsidy for health insurance makes buying insurance more attractive because it lowers the cost. However, the ability to exclude amounts contributed to FSAs and HSAs from income lowers the cost of being uninsured, reducing the incentive to acquire insurance. If health care policy is conceived of as a jet plane and these provisions its engines, it appears that Congress has pointed the engines in different directions.[94]

The recent effort at federal health care reform and the current effort to undo it reveal that it is extremely difficult in the current environment to address all of these issues on a global basis. Accordingly, I focus here on one piece of the puzzle—the FSA. While this provision is far smaller in dollar terms than the exclusion for traditional health insurance, it causes significant taxpayer aggravation, which cannot help but affect the way in which taxpayers view the income tax as a whole. However, before considering how best to improve FSAs, I turn first to discuss the charitable deduction, another tax expenditure that many see as underperforming.

III. THE CHARITABLE DEDUCTION

The Code has allowed a deduction for charitable donations since 1917.[95] Nonetheless, the rationale for the deduction is not entirely

93. *See* THE HENRY J. KAISER FAMILY FOUND., *supra* note 23.

94. *See* Kleinbard, *supra* note 10, at 17 n.61 (noting that Congress, unlike aerospace engineers, cannot always be trusted to point the engines in the same direction).

95. *See* War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330. An effort to have a similar provision included in the original 1913 Act was unsuccessful. *See* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS 1938–1861, at 945 (1938). For a discussion of the history of the charitable donation, see Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843 (2001).

clear.[96] The legislative history suggests that a key reason for enacting it was a fear that wealthy individuals would not otherwise donate to institutions of higher education, which had come to depend on donations for their survival.[97] However, the charitable deduction was not limited to this ostensible purpose; deductions were allowed for donations to all types of charitable organizations. The Code provisions related to charitable deductions have been amended numerous times over the past ninety years, further clouding the legislative history.[98]

Scholars have offered two basic justifications for a broad charitable deduction. As with the health care provisions, some argue that the charitable deduction is appropriate on income definition grounds because amounts given to charity do not constitute income in a theoretical sense and therefore should be excluded from the tax base.[99] Others argue that charity should be subsidized, and that the deduction serves as an indirect subsidy to charity because it encourages people to donate. As the subsidy theory predominates, I focus on that here.

Justifications for a subsidy for charity are many, but they generally fall into two categories. The first is that "subsidizing charities is necessary to assist them in providing public goods that would otherwise be under-produced due to market and

96. *See* David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 547 (2006) (describing the theories of the charitable deduction as "underdetermined" and "undertheorized").

97. *See* 55 CONG. REC. 6728 (1917).

98. *See generally* Aprill, *supra* note 95.

99. *See, e.g.*, Andrews, *supra* note 9, at 313; *see also*, Douglas A. Kahn & Jeffery H. Kahn, *"Gifts Gafts and Geft"—The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441, 461 (2003). For a contrary view see Kelman, *supra* note 9, at 849; Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 29–30 (1992) (arguing that charitable giving contains an element of personal consumption).

For additional theories of why a deduction should be allowed for charitable giving, see Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 58–59 (1972) (arguing for a deduction for charitable giving because such giving reduces a taxpayer's well-being or ability to pay, for which income is really a proxy); Alvin Warren, *Would a Consumption Tax be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1088 (1980) (arguing that the sum of individual incomes should equal societal income and concluding that charitable giving does not increase societal income, thus warranting a deduction so long as the recipient includes the gift in income).

governmental failures."[100] The second is that subsidizing charitable giving reinforces democratic and other values,[101] or otherwise increases general welfare.[102] Regardless of the justification offered, the underlying contention of these different theories is that society gains more from the subsidy, whether economically or in other intangible ways, than it costs to provide the subsidy.

Accepting, arguendo, that the government should subsidize charity, the question that arises is how best to do it. Options range from direct subsidies, where the government issues grants to charitable organizations, to indirect subsidies, where the government creates incentives for others to do so. If the justification for government support of private charity rests on the notion that government is incapable of producing the appropriate mix or level of public goods, direct subsidies controlled by the government make little sense because the government is likely to repeat its mistakes in making direct grants to charitable organizations.[103] Instead, it makes

100. Miranda Perry Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 MINN. L. REV. 165, 183 (2008). Theorists have articulated several reasons why government would subsidize nongovernmental actors in its quest to provide public goods rather than provide those goods itself. Where demand is heterogeneous, it will be almost impossible for the government to determine the precise mix and level of goods that will maximize welfare. Charities are likely to be far more efficient than the government, and they can serve as laboratories for ideas, much as the states purportedly do in our federal system. In addition, government may not be able to provide the goods because of constitutional or other limits. For an in-depth discussion of these reasons, see Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397–98 (1988).

101. *See* David A. Brennen, *A Diversity Theory of Charitable Tax Exemption—Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 PITTSBURGH TAX REV. 1 (2006) (arguing that private charity promotes diversity); Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405–06 (1998) (noting that tax subsidies for charities may help a portion of citizens become more involved individually with charities than they would without a tax subsidy). *But see* Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 390–91 (1972) (noting that even though the author is generally supportive of subsidized charity, the pluralistic benefits from the subsidy may be overstated).

102. *See* Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 508 & n.7 (2010) (arguing that charity enhances welfare through wealth redistribution); Alice M. Thomas, *Re-Envisioning the Charitable Deduction to Legislate Compassion and Civility: Reclaiming Our Collective and Individual Humanity Through Sustained Volunteerism*, 19 KAN. J.L. & PUB. POL'Y 269, 304–306 (2010) (citing evidence that charitable giving is beneficial for both the donor and recipient).

103. One way to retain a direct subsidy while discerning and honoring taxpayer preferences would be through direct matching grants to charities. At the end of each year, charities could provide lists of donors and amounts received. The government could then issue grants to those charities proportional to donations received. For a debate on this approach,

far more sense to allow individuals to choose where their public good dollars are spent. This is where the Code comes in.

The Code provides two possible methods for providing indirect subsidies to taxpayers. The first method is to allow taxpayers to exclude or deduct amounts donated to charity.[104] The second method is to award tax credits to taxpayers for the same activity. Under a deduction model, a taxpayer who gives away income deducts the same amount, thus lowering his income and reducing his tax liability by his marginal rate.[105] The subsidy rate implicit in this approach is equal to the taxpayer's marginal rate. As a result, those in higher tax brackets receive a higher subsidy than those in lower tax brackets.[106] Moreover, setting the subsidy at the taxpayer's marginal rate yields a result equivalent to what would happen if the taxpayer had never earned the amounts given away and possibly reflects ambivalence as to the deduction's proper justification.

Under a credit approach, taxpayers determine their income and tax liability without regard to their donations. Instead, they receive a tax credit for their donation that directly reduces the amount of tax owed.[107] Unlike the deduction approach, it is necessary to set the amount of the subsidy explicitly. Moreover, absent express provisions that phase the subsidy in or out depending on income levels, all taxpayers receive the same amount of subsidy, thus avoiding the upside down subsidy problem implicit in a deduction approach. While Congress has increased its use of tax credits in recent years, the

compare McDaniel, *supra* note 101 (advocating the use of a matching grant program instead of the current subsidy regime), with Bittker, *supra* note 99 (explaining why matching grant programs could not pass constitutional or practical concerns and are therefore unworkable). While this approach is used in England, it has never been seriously considered in U.S. political circles. For a discussion of how the English system, called Gift Aid, works, see *Gift Aid—Information for Charities*, DIRECTGOV, http://www.direct.gov.uk/en/MoneyTaxAndBenefits/ManagingMoney/GivingMoneyToCharity/DG_10015097 (last visited Sept. 14, 2011).

104. While some have called for allowing a deduction or credit for donated time, *see* Thomas, *supra* note 102, at 271, Congress to date has refrained from so doing. Accordingly, I will focus here only on donations of money or property.

105. From an income tax perspective, this approach yields a result consistent with excluding amounts donated to charity from income. However, this does not take payroll taxes into account. Amounts excluded from income are also exempt from payroll taxes. Amounts deducted from income remain subject to the payroll tax. As discussed more fully below, this can be a significant difference.

106. *See, e.g.*, SURREY, *supra* note 5, at 134–38.

107. *See, e.g.*, ARIZ. REV. STAT. ANN. § 43-1089 (2011) (allowing a dollar-for-dollar credit for contributions to school tuition organizations).

deduction remains the primary means of handling charitable donations in the federal tax system.

However, Congress has imposed a number of limits on the ability to deduct charitable donations that significantly affect the incentive to give. For instance, taxpayers may deduct the entire amount of any cash donations. In contrast, Congress has limited the deduction for most property donations to a taxpayer's basis in the property donated,[108] yielding a result equivalent to what would occur if the income had never been earned.

Congress has also limited the total amount that may be deducted in any given year.[109] Under current law, taxpayers may deduct charitable donations up to a maximum of fifty percent of income,[110] though Congress has made a number of exceptions to this rule to encourage giving.[111] Taxpayers are allowed to carry over excess amounts into subsequent tax years for five years, so, except for those

108. *See* I.R.C. § 170(e) (2006). Congress has created several exceptions to this rule. For instance, where the use of the donation by the recipient is related to the basis for the recipient's tax exemption under I.R.C. § 501, a donor may deduct the full fair market value. *See id.* at § 170(e)(1). Allowing some taxpayers to deduct the full fair market value of appreciated property raises equity concerns, *see, e.g.*, Halperin, *supra* note 6, at 1–4, and allows taxpayers to deduct amounts never included in income, a clear violation of tax logic. However, if the goal is to provide a subsidy, there is simply no reason why the level of the subsidy should be so limited. Instead, the question should be whether the subsidy level is justified by the net benefit to society.

109. Limits may serve many purposes. They may blunt the upside down nature of the subsidy and help preserve the progressivity found in the Code; to the extent that the wealthy donate to different charities than the poor, they could affect the mix of charities receiving donations; and they could also act as a crude Alternative Minimum Tax, ensuring that all taxpayers pay something even when availing themselves of legitimate tax preferences. *See* Fleischer, *supra* note 100, at 192–93, 196, 202. We could also conceive of the decision to allow a deduction as a compromise between the majority voters who set the government's agenda (the classic majority) and a second majority (the new majority), comprised of minority groups who have different preferences but cannot coalesce around one that outstrips the classic majority. Limits allow the new majority to direct the use of some, but not all, of their tax money. *See id.* at 207–10.

110. I.R.C. § 170(b). The Code actually refers to "contribution base," which is a modified version of AGI. This limit has changed numerous times over the past ninety years, always trending ever higher from the original fifteen percent of "net taxable income." For a brief history of how the limits have changed, see Fleischer, *supra* note 100, at 170–73.

111. If the donor of a conservation easement is a qualified farmer or rancher, the maximum amount of the donation rises from 50% to 100% of income. I.R.C. § 170(b)(E). Some provisions are temporary. For example, after Hurricane Katrina, Congress lifted the limits on charitable contributions in cash made between August 28, 2005 and December 31, 2005. *See* Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016, 2022–23 (2005).

who have little income, this provision mostly affects timing.[112] Congress has also tinkered with the limit by allowing some taxpayers to exclude certain amounts donated from income.[113]

Congress has also experimented with the subsidy by changing the timing for charitable deductions. Normally, deductions are taken in the tax year in which donations are made.[114] However, in response to natural disasters, in some years Congress has allowed donors to take deductions against a previous year's income.[115]

Finally, and perhaps most importantly, Congress has significantly limited the charitable deduction's incentive effect by placing it below the line, where it is not considered when calculating AGI. AGI is a preliminary measure of net income used to determine which taxpayers are eligible for certain provisions. Initially, above-the-line deductions differed in type from those that fell below the line, with below-the-line deductions more likely to be tax preferences or other

112. There is no way to know what effect the limit has on donation decisions, but statistics from 2008 reveal that approximately 440,000 returns claimed a carryover amount. *See* STATISTICS OF INCOME—2008 INDIVIDUAL INCOME TAX RETURNS, I.R.S. Pub. 1304 (July 2010), *available at* http://www.irs.gov/pub/irs-soi/08inalcr.pdf. It is not possible to know how many people refrained from donating because of the limits.

113. For instance, those who win certain types of prizes, such as the Nobel Prize, may exclude them from income so long as they donate their winnings to a charitable organization. *See* I.R.C. § 74(b). Similarly, a recent provision permits those ages 70 ½ and older who donate their IRAs to charity to exclude up to $100,000 of the donated amounts from income. *See id.* at § 408(d)(8). Originally set to expire on December 31, 2007, this provision was extended to December 31, 2009 by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, §205(a), 122 Stat. 3765, 3865 (2008); *see also* I.R.S. Notice 07-7, 2007-1 C.B. 395.

114. *See* I.R.C. § 170(a). Different rules apply to accrual method corporations. However, the bulk of American charity is from individuals. *See* Press Release, Giving USA Foundation, U.S. Charitable Giving Falls 3.6% in 2009 to $303.75 Billion (June 9, 2010), *available at* http://www.givingusa.org/press_releases/gusa/gusa060910.pdf (reporting that individuals gave $227.41 billion to charities in 2009).

115. In response to the massive earthquake that occurred in the Andaman Sea on December 26, 2004, causing a massive tsunami that wiped out entire villages and killed an estimated 230,000 people, Congress allowed people to deduct in the 2004 tax year donations made through January 31 of 2005. *See* Act of Jan. 7, 2005, Pub. L. No. 109-1, 119 Stat. 3. More recently, in response to the massive earthquake that hit Haiti on January 12, 2010, killing approximately 220,000, Congress allowed cash donations to benefit the Haiti earthquake survivors to be deducted against 2009 income, so long as they were made between January 12, 2010 and March 1, 2010. *See* Act of Jan. 22, 2010, Pub. L. No. 111-126, 124 Stat. 3; *see also* I.R.S. Notice 1396 (Jan. 2010), *available at* www.irs.gov/pub/irs-pdf/n1396.pdf.

expenditures that were not considered essential when calculating relative incomes. This distinction has broken down over time.[116]

However, with the introduction of the standard deduction in 1944, placement above or below the line took on additional significance. Those who took the standard deduction were not allowed to take below-the-line deductions as well,[117] thus blunting any incentives associated with the now displaced deductions. Several members of Congress argued for moving the charitable deduction above the line to keep the incentives for giving in place.[118] Ultimately, they were outvoted by those who believed that those in the lower income brackets would give regardless of the tax incentive, that simplification gains were worth the loss of the incentive, or that no separate deduction was needed because the standard deduction was set at a level that included presumed charitable donations.[119]

Finally, as part of the 1986 reforms, Congress added I.R.C. § 68 to the Code, which limits the amount of itemized deductions taxpayers whose AGI exceeds a certain threshold may take.[120] As a result, even those who itemize may not get the full benefit of their charitable deductions, regardless of whether they are below the 50% annual limit on total deductions.[121]

For those who believe that the charitable deduction is required as a matter of income measurement,[122] the current design is faulty because the significant restrictions on deductibility yield an incorrect measure of income. For those who believe the deduction is a tax incentive, it is poorly designed because the incentive is limited to a small number of taxpayers.[123] In either case, the fix may be similar: making the deduction available to more taxpayers.

116. For a discussion of the above- and below-the-line distinction and how it has changed over time, see Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1 (2005).

117. *See* I.R.C. §§ 62–63 (2006).

118. *See* Aprill, *supra* note 95, at 850–51.

119. *See id.* at 851–52.

120. As currently structured, the threshold amount disappears in 2010 only to reappear in 2011. *See* Rev. Proc. 09-50, § 2.06, 2009-45 I.R.B. 617. The threshold for 2009 was $166,800. *See* Rev. Proc. 08-66, § 3.11, 2008-45 I.R.B. 1107.

121. Unlike I.R.C. § 170, which permits taxpayers to carryover amounts above the limits, I.R.C. § 68 contains no carryover provision, so any amounts disallowed are lost for good.

122. *See, e.g.*, Andrews, *supra* note 9.

123. As described below, some argue that the incentive is not underperforming because those who receive no incentive would nonetheless give to charity. *See* discussion *infra* Part V.

IV. EFFORTS TO REFORM FSA PROVISIONS AND THE CHARITABLE DEDUCTION

Over the years, numerous efforts have been undertaken to reform both the FSA provisions and the charitable deduction. To date, none have succeeded. This Part describes those proposals and efforts.

A. FSAs

As noted above in Part II, FSAs suffer from two main problems. First, they are available only to those whose employers offer them, or approximately thirty-nine percent of the workforce.[124] Second, a shockingly low number of people eligible to participate actually do so. A wide range of possible solutions exist. Thus, before turning to the actual attempts to reform FSAs, I first canvass these possible solutions and the policy implications they present.

There seems to be no principled reason why this tax benefit—not to mention the exclusion for health insurance generally—is tied to employment. Congress could easily change this. For instance, as with IRAs, Congress could allow all taxpayers to open FSAs with financial institutions and to contribute directly to their accounts. In all other respects, the plans could work the way they do now. Taxpayers would deduct amounts contributed to such accounts on their returns, just as they do now for IRA contributions.[125] While non-work-based plans would not partake of the feature that permits automatic withdrawal from one's paycheck, and therefore automatic exclusion for tax purposes, such a plan would be fairer than the current rule because all taxpayers could participate.

Expanding FSAs in this manner could be done without altering the characterization of such plans as insurance under I.R.C. § 106(c)(2) or altering the rule in I.R.C. § 125(d) precluding deferred compensation. Indeed, removing FSAs from the employment context and therefore out from under I.R.C. § 125 would open the

124. *See* BUREAU OF LABOR STATISTICS, *supra* note 56.

125. One difficulty is that allowing a deduction for amounts contributed to a healthcare FSA would not account for payroll taxes withheld or paid by the employer. Withheld taxes could be addressed through the return-filing system quite easily. Accounting for employer-paid taxes is more difficult. Also, assuming that the irrevocable election requirement were retained, some enforcement mechanism would need to be developed to deal with taxpayers who committed to contribute to FSAs yet failed to do so.

way to allowing rollovers on an administrative basis because the statutory bar to deferred compensation would no longer apply. The only question would be whether returning unused premiums or allowing them to be applied to the next year would be consistent with the characterization of FSAs as insurance. While this might not be wise as a business policy, there is nothing in the nature of insurance that precludes such behavior. Severing the link between employment and FSAs would also cloud the picture of risk for the purported insurer because contributions would not stop when the taxpayer left his or her job. However, the regulations make clear that these plans must resemble insurance, not match commercially available insurance in every respect. Thus, the Treasury Department could require that unused premiums be returned or rolled over to the next year.

An argument could also readily be made that FSAs and the other provisions that subsidize health care costs should be eliminated. Excluding insurance from the tax base increases demand, which can increase price.[126] Insurance also contributes to rising medical costs because insured persons do not directly bear the costs and so are more likely to engage in riskier behavior and seek medical care they otherwise would not. Allowing taxpayers to exclude from income amounts spent out-of-pocket on healthcare also distorts the decision to buy insurance by making it less expensive to be uninsured.[127] During the 2008 presidential race and the debates over healthcare reform, there was significant discussion of revoking these provisions.[128] However, Congress decided to leave the current structure largely intact.

126. *See* Laura E. Cunningham, *National Health Insurance and the Medical Deduction*, 50 TAX L. REV. 237, 238, 249 n.57 (1995); Joseph Bankman, John Cogan, R. Glenn Hubbard & Daniel Kessler, Draft: Reforming the Tax Preference for Employer Health Insurance, Presentation at the New York University School of Law Colloquium on Tax Policy and Public Finance 4–7 (Jan. 20, 2011), *available at* http://www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website__academics__colloquia__tax_policy/documents/documents/ecm_pro_067719.pdf. If good health is a public good, where the beneficiaries fail to capture all the benefits, the market may undersupply the good from a societal perspective, and subsidies may be warranted. This is an empirical question that is far beyond the scope of this article, but many believe this to be unlikely.

127. *See generally* Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CALIF. L. REV. 1485 (1991) (arguing that the most efficient system would be to tax the receipt of health insurance and to deny a deduction of medical costs).

128. *See, e.g.*, Greg D'Angelo & Robert Moffit, *Health Care Reform: Changing the Tax*

A number of reasons may warrant eliminating FSAs on a stand-alone basis. For instance, FSAs appear to be most effective for those who have predictable expenses.[129] There seems to be little reason to afford such people a special tax benefit. FSAs may also contribute to changes in the private insurance markets that require insured people to shoulder more of the burden of their own healthcare costs.[130] While this might be beneficial from a cost containment perspective, it may unduly burden those who cannot afford to pay more than they currently do. In addition, one study suggests that the tax benefits of FSAs are offset by corresponding increases in out-of-pocket expenditures on an individual basis. When the costs of allowing the tax benefit are factored in, FSAs likely decrease welfare.[131]

FSAs functionally allow taxpayers to deduct medical expenses beginning with the first dollar spent, thereby conflicting with the policy implicit in I.R.C. § 213, which sets a floor. HSAs accomplish many of the same goals as FSAs, but without many of the cumbersome rules. They also create an incentive to purchase high deductible insurance, which is arguably good because it creates incentives for people to monitor their spending. As a result, FSAs may no longer be necessary. Finally, the rules implemented to make FSAs look like insurance frustrate taxpayers, causing them to spend significant time trying to estimate their otherwise uninsured medical expenses, to fail to sign up for or underfund accounts, and to race out to spend money on unnecessary items or procedures to avoid forfeiture. Simply put, the game may not be worth the candle.

Treatment of Health Insurance (Webmemo #2344), THE HERITAGE FOUNDATION (Mar. 16, 2009), http://www.heritage.org/research/reports/2009/03/health-care-reform-changing-the-tax-treatment-of-health-insurance; Jeff Liebman, *Senator McCain's New Tax on Health Insurance*, TPMCAFÉ (Oct. 6, 2008, 10:28 AM), http://tpmcafe.talkingpointsmemo.com/2008/10/06/senator_mccains_new_tax_on_hea/ (describing McCain's proposal to tax employer-provided health insurance benefits while giving all taxpayers a $5000 tax credit to be used to buy insurance).

129. *See* James H. Cardon & Mark H. Showalter, *An Examination of Flexible Spending Accounts*, 20 J. HEALTH ECON. 935, 936 (2001).

130. *See id*. at 953; William Jack, Arik Levinson & Sjamsu Rahardja, *Employee Cost-Sharing and the Welfare Effects of Flexible Spending Accounts*, 90 J. PUB. ECON. 2285, 2300 (2006).

131. *See* Jack et al., *supra* note 130, at 2300. *But see* James H. Cardon, *Flexible Spending Accounts and Adverse Selection*, 77 J. RISK & INS. 145, 146 (2010) (suggesting that health care FSAs may improve pooling for insurance purposes in a way that leaves both low and high risk taxpayers better off).

One could also argue for a change to I.R.C. § 213 to allow taxpayers to deduct the first dollar of medical expenses, thus rendering FSAs unnecessary. However, such a deduction would function as a type of free insurance that distorts the market for insurance by reducing demand.[132] That said, reducing the demand for insurance could significantly reduce medical expenditures, thus warranting a deduction for all medical expenditures.[133] Indeed, given that we currently distort the market *for* insurance by allowing it to be provided tax-free in the employment setting, excluding amounts spent on healthcare may actually enhance efficiency by acting as a countermeasure, at least to the extent it is available to those who get their healthcare tax free.[134]

Another proposal would allow a deduction for *expected* health care costs, which could be calculated based on the insurance policy purchased.[135] If one's actual healthcare costs were less than the expected costs, the taxpayer would get a deduction for amounts not spent. Conversely, if one spent more than anticipated, no deduction would be allowed for the excess expenditure. The thought here is that such a deduction would counteract the tax benefit offered for employer-provided insurance, while creating a stronger incentive to monitor health care costs than would an allowance for actual expenditures.[136]

FSAs offer three advantages over simply allowing taxpayers to deduct their actual or expected medical expenses. First, a third party verifies the validity of the expenses before reimbursing taxpayers, decreasing the likelihood of cheating.[137] Second, the FSAs require ex ante savings. Third, amounts contributed to FSAs are exempt from income *and* payroll taxes. Section 213 of the Code only allows a deduction against income. As a result, taxpayers are better off

132. *See* Kaplow, *supra* note 127.

133. *See* Bankman et al., *supra* note 126.

134. *See* JOHN F. COGAN, R. GLENN HUBBARD & DANIEL P. KESSLER, HEALTHY, WEALTHY AND WISE: 5 STEPS TO A BETTER HEALTH CARE SYSTEM (2d ed. 2011). Of course, if health insurance is a public good, it is likely undersubscribed because those paying for health insurance do not reap all the benefits, thus justifying a subsidy on efficiency grounds. In such a case, a countervailing subsidy would be ill-advised.

135. *See* Bankman et al., *supra* note 126.

136. *See id.*

137. Of course, numerous other deductions are available simply by listing the expenditures on one's return. It is not clear why these types of deductions should be treated differently.

excluding income than deducting it. One could amend I.R.C. § 213 to allow an extra deduction to account for payroll taxes to level the field, but it is not clear how one would handle the employer-paid portion of those taxes.

To date, there have been no legislative or administrative efforts either to broaden the availability of FSAs beyond the employment context or to eliminate them. Instead, legislators and administrators have attempted to tinker around the edges. For instance, to combat the problems arising from the use-it-or-lose-it rule, legislators have introduced eight different bills to allow taxpayers to roll over unused amounts in their FSAs at year-end. Some have passed the House, but, so far none has made it all the way through the legislative process.[138]

In 2003, the Treasury Department administratively broadened the appeal of FSAs by treating over-the-counter medications as eligible expenses.[139] In late 2004, apparently frustrated by the lack of legislative action on the question of rollovers, Senator Charles Grassley, then Chairman of the Senate Finance Committee, wrote a letter to the Treasury Department asking whether it could administratively allow rollovers.[140] The Treasury Department took

138. In 2001, Representative Ed Royce, along with seven cosponsors introduced a bill that would do just this, but the bill died in committee. *See* H.R. 167, 107th Cong. (2001). Later that year, he introduced another bill, this time with eleven cosponsors, to the same effect and with the same result. *See* H.R. 3105, 107th Cong. (2001). In 2003, he tried again, garnering twelve cosponsors. *See* H.R. 176, 108th Cong. (2003). Later that year, Jim DeMint introduced a bill that allowed carryovers, but limited the amount to $500. This bill garnered seventy-three cosponsors. Still later that year, Bill Thomas introduced a bill that mainly addressed Health Savings Accounts. *See* H.R. 2351, 108th Cong. (2003). During the markup of this bill, the language suggested by Rep. DeMint was added in. Eventually, a form of this legislation was included in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. Unfortunately for proponents of carryovers, this language was dropped from the final version. *See* Pub. L. No. 108-173, 117 Stat. 2066 (2003).

In 2004, Rep. Royce again introduced his bill to allow carryovers, this time garnering only four cosponsors. *See* H.R. 4007, 108th Cong. (2004). A similar bill, *see* H.R. 4279, 108th Cong. (2004), was introduced later that year with 16 cosponsors. It found itself attached to another piece of legislation, the Help Efficient, Accessible, Low-Cost Timely HealthCare Act of 2004. H.R. 4280, 4281, 108th Cong (2004). While the combined bills passed the House, the Senate did not act on them. In 2005, Royce again introduced his bill to allow unlimited carryovers. *See* H.R. 1805, 109th Cong. (2005). He also introduced bills in 2007 (no cosponsors), *see* H.R. 3306, 110th Cong. (2007) and 2009 (one cosponsor), *see* H.R. 544, 111th Cong. (2009).

139. *See* Rev. Rul. 03–102, 2003-2 C.B. 559.

140. *See Treasury Thanks Pension Group for Letter on FSA Restrictions,* 2006 TAX NOTES TODAY, 124–31 (June 22, 2006).

the position that allowing a rollover would violate the rule found in I.R.C. § 125 prohibiting deferred compensation and argued that Congress had effectively ratified its construction of the statute.[141] Thus, any efforts to fix this rule would need to come from the legislature. Nonetheless, in mid-2005, reasoning that a limited rollover would not implicate the restriction contained in I.R.C. § 125, the IRS allowed taxpayers a 2.5 month grace period for incurring medical costs beyond the end of a year, provided their plans allow it.[142]

As part of the Patient Protection Act, Congress took two steps to cut back on FSAs. First, reimbursement for over-the-counter medications will no longer be allowed as of 2011.[143] Second, the maximum amount contributable to an FSA will be set at $2,500 for 2013, with the total amount adjusting thereafter based on inflation.[144] Despite these moves, it is not at all clear that FSAs are currently disfavored. Congress could easily have eliminated the plans had it seen fit to do so. Moreover, the upcoming limit far exceeds the average contributions to such plans,[145] so it is unclear what effect this restriction will have.

B. The Charitable Deduction

When Congress created the standard deduction it was fully aware that those who chose it would lose the tax incentive to give to charity. There was significant concern for the financial welfare of charities; however, those in favor of the proposal reasoned either that the gain in simplicity was worth the cost or that nonitemizers were likely to give regardless of whether they received a deduction. Moreover, because an amount for presumed charitable donations would be included in the standard deduction itself, nonitemizers

141. *See id*. The Treasury addressed neither the purported insurance nature of such contracts nor the notion that allowing rollovers would weaken the argument that healthcare FSAs were really a form of insurance.

142. *See* Prop. Treas. Reg. § 1.125-1, 72 Fed. Reg. 43,938, 43,941 (Aug. 6, 2007); I.R.S. Notice 05-42, 2005-1 C.B. 1204.

143. *See* Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, § 9003, 124 Stat. 119, 868 (2010).

144. *See* 26 U.S.C.A. § 125(i) (West 2011) (as amended by Pub. L. No. 111-152, § 1403(a), 124 Stat. 1029, 1063 (2010)).

145. *See* MERCER HUMAN RES. CONSULTING, *supra* note 56; *see also* INT'L FOUND. OF EMP. BENEFITS PLANS, *supra* note 31, at 5.

were being treated on par with itemizers, thus defeating any equity argument.[146]

Despite losing the debate in 1944, those in favor of a charitable deduction for all taxpayers continued to push to move the deduction above the line. They briefly succeeded between 1982 and 1986, until Congress reinstated the deduction below the line as part of a major overhaul of the tax system.[147] Since then, the push to move the deduction back above the line has continued unabated. Both scholars[148] and politicians[149] have argued for changing the law, citing both incentive and fairness concerns.[150] Some proposals call for allowing all charitable deductions above the line, while retaining a sizeable standard deduction.[151] Other proposals are more complicated, employing floors or ceilings on the amount deductible above the line.[152]

146. *See* Aprill, *supra* note 95, at 850–52.

147. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 121, 95 Stat. 172, 196 (1981). For 1982 and 1983, individuals were allowed to deduct 25% of the first $100 of charitable donations, or $25, above the line. For 1984, the cap increased to $300, for a maximum $75 above-the-line deduction. For 1985, individuals were allowed to deduct 50% of their charitable donations with no cap. In 1986, the amount deductible above the line was increased to 100%. The provision expired at the end of 1986.

148. *See, e.g.*, M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 611 (2009) (arguing for an above-the-line deduction for all charitable contributions); Joseph Cordes et al., Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options, 7 URB. INST.'S CHARTING CIV. SOC'Y 1, 3 (May 1, 2000) [hereinafter URBAN INSTITUTE REPORT], *available at* http://www.urban.org/url.cfm?ID=310338 (modeling several possibilities).

149. *See* Aprill, *supra* note 95, at 854 (describing, among other proposals, President Clinton's 2001 proposal to allow 50% of deductions above a certain floor to be taken above the line and President Bush's 2001 proposal to allow the charitable deduction to nonitemizers); STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2005 BUDGET PROPOSAL (JOINT COMM. PRINT JCS-3-04 No (I.R.S.)).

150. *See* Aprill, *supra* note 95, at 854–56.

151. *See* Henderson & Malani, *supra* note 148, at 611.

152. For instance, one proposal called for 100% of all charitable deductions to be allowed above the line up to the amount of the standard deduction. *See* Charitable Giving Tax Relief Act, H.R. 777, 107th Cong. (2001). Another called for nonitemizers to be allowed to deduct contributions in excess of $1000 ($2000 if filing jointly). *See* Giving Incentive and Volunteer Empowerment (GIVE) Act, H.R. 1338, 105th Cong. (1997). This bill would also have allowed taxpayers to deduct 120% of the amount donated, thus increasing the subsidy beyond the tax that would have been owed absent the donation. Thus, taxpayers would be better off from an income tax perspective earning money and giving it away than they would have been by not earning it in the first place. Another called for allowing a deduction for cash contributions to charity to the extent such contributions exceeded $500, but not to exceed $1000 for joint returns. *See* Charitable Giving Act, H.R. 7, 108th Cong. (2003). Still another

A 2000 Urban Institute study modeled four different possibilities, including (1) allowing deductions of all charitable donations above the line, (2) allowing itemizers to deduct donations above the line in excess of $500, (3) allowing all taxpayers to deduct contributions above the line in excess of $500, and (4) allowing all taxpayers to deduct donations in excess of a revenue neutral floor.[153] Assuming that these proposals had been fully in place in 1995, the study attempted to predict increased giving and potential revenue losses. It concluded that, under certain assumptions, the anticipated increase in giving outweighed the cost.[154]

A 2002 Congressional Budget Office (CBO) report also considered a number of different proposals to move charitable deductions above the line.[155] Starting with two Bush-era proposals—a proposal to phase in above-the-line deductions for all donations and another to phase in a deduction of up to $500 ($1000 if filing jointly) above the line—the CBO noted that the Treasury and Joint Committee on Taxation (JCT) estimated costs ranging from $52.1 to $84.4 billion for the former and $29.3 to $32.6 billion for the latter, while predicting that giving would likely increase no more than 4%, or approximately $4.8 billion.[156]

called for an above-the-line deduction for all charitable contributions in excess of $2000 (for those filing jointly) for five years, with the floor reducing to $1000 after the five-year period. *See Treasury Explains Clinton Budget Revenue Proposals*, 2000 TAX NOTES TODAY 27–26 (Feb. 9, 2000). In yet another proposal, nonitemizing taxpayers would have been allowed to deduct $100 ($200 if filing jointly) above the line, with the total amount increasing to $500 ($1000 if filing jointly). *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2003 REVENUE PROPOSALS 2 (2002).

153. These amounts are for those filing jointly. The floors for those filing singly are half as much. *See* Cordes et al., *supra* note 148. For purposes of the report, the authors assumed 1995 income levels.

154. In situations where this is not the case, it would make far more sense for the government to make direct grants to charity. For instance, if the government were to collect $100 million less in revenue but spur only $80 million in additional giving, the government would be better served by giving $80 million to charity, thus saving $20 million. The study did not consider whether an investment in charity would produce a commensurate or greater level of public goods.

155. *See, e.g.*, CONG. BUDGET OFFICE, EFFECTS OF ALLOWING NONITEMIZERS TO DEDUCT CHARITABLE CONTRIBUTIONS (2002) [hereinafter 2002 CBO REPORT], *available at* http://www.cbo.gov/ftpdocs/40xx/doc4008/12-13-CharitableGiving.pdf. The report was prepared at the request of the ranking member of the House Ways and Means Committee and provides a history of the standard deduction. It also examines patterns of giving and the tax incentives provided in the Code.

156. *See id.* at 5, 22.

The report also modeled four proposals, including allowing (1) unlimited above-the-line deductions, (2) deductions up to $100, (3) deductions above a $250 floor, and (4) deductions up to 2% of AGI.[157] Given the difference in the proposals analyzed, it is hard to compare the Urban Institute Report to the CBO report, but the conclusion of the CBO report is that the proposals would not generate a rise in giving sufficient to justify the costs.[158]

Whatever the reason, Congress has not enacted any of these proposals,[159] and the charitable deduction remains a blunted instrument, unavailable to a large percentage of Americans who either will not or cannot donate sufficient funds to charity to make itemizing attractive.

V. CHARITABLE FSAS

Assuming that Congress is not simply being cynical in its decision to offer FSAs and a charitable deduction, it seems appropriate to try to make these provisions as effective as possible. Given the repeated failures to reform FSAs by removing the use-it-or-lose-it feature and to move the charitable deduction above the line, it seems clear that another way forward is needed. In this Part, I propose combining FSAs with the charitable deduction, with the goal of improving both. In particular, I propose that taxpayers be allowed to donate any unused funds in an FSA to charity at year-end. To limit the possibility that this proposal would simply afford a deduction for giving that already occurs, taxpayers would be allowed to select only one charity as recipient.[160] Plan administrators would simply forward any money left in such accounts year-end to the designated charity.

157. *See id.* at 19.

158. Another important difference between the reports is that the 2002 CBO REPORT, *supra* note 155, assumed lower elasticity of giving than did the URBAN INSTITUTE REPORT, *supra* note 148.

159. There have also been numerous calls to convert from deductions to tax credits, both to remedy the upside-down subsidy problem Surrey identified and to allow all taxpayers to receive tax benefits for donating to charity. *See, e.g.*, Todd Izzo, Comment, *A Full Spectrum of Light: Rethinking the Charitable Contribution Deduction*, 141 U. PA. L. REV. 2371 (1993). However, to date, this approach has not gained traction either.

160. While giving through FSAs could displace existing giving, the residual nature of the donation coupled with the fact that one could only give to a single organization make this a poor substitute for the types of giving in which many engage.

Not all charities or charitable purposes are created equal, and some may object to money saved for health care needs going to the local opera. To address such concerns, Congress could also limit the types of charities to which donations could be made. Consistent with the purpose for which the amounts were originally set aside, Congress could allow taxpayers to designate only health-care related charities or those that help the poor. Or, Congress could provide that unused amounts be donated to a fund that would subsidize the now mandatory health insurance for those who cannot afford it, in effect creating a charity to receive unused FSA funds.[161]

Combining these two provisions offers several benefits that the stand-alone fixes attempted to date do not. From a health care perspective, if taxpayers know that unused funds will go to a charity of their choosing—as opposed to their employers' pockets—they may be more likely to increase the amount they save for medical needs. This likelihood includes both a probable increase in the number of eligible people electing to participate and in the amounts participants set aside. The proposal would also likely reduce the time people spend each year determining how much to set aside. For those who contribute too much, the proposal will likely lessen the incentive at year-end to spend unused money on unneeded items or services.

From a charitable-giving perspective, nonitemizers would receive the functional equivalent of an above-the-line deduction for such donations. Indeed, it is better than an above-the-line deduction because amounts contributed to FSAs are not subject to payroll taxes. Because donated funds will already have been excluded from income, there would be no need for taxpayers to report the donation or claim a deduction, thus preserving the simplifying benefits associated with the standard deduction. It is also likely to be less costly than moving the deduction—or parts of it—above the line because, as discussed below, it seems more likely to afford a tax benefit to new giving than for giving that already occurs.

The remainder of this Part describes how the proposal could be implemented and then evaluates it from both policy and political perspectives.

161. Limiting the donations in this way is not necessary and indeed could be counter-productive if taxpayers are disinclined to donate to the allowed charities. I take no position on whether Congress should limit donations in this way.

A. Implementing the Proposal

A key benefit of this proposal is that it does not require congressional action. First, allowing a donation to charity would not implicate the deferred compensation bar found in I.R.C. § 125(d) because the donation in Year 2 of amounts contributed to an FSA in Year 1 should not be considered compensation. Even if it were, the delay of a few months after the end of the year would no more constitute deferred compensation than the current rules permitting taxpayers a 2.5 month grace period in which to spend their FSA dollars. Second, as noted above, nothing in the nature of insurance prevents rollovers or the donation of unused premiums to charity. Thus, the Treasury Department could administratively amend the rules to allow such contributions without running afoul of I.R.C. §§ 106 and 125.

Having said that, the time is ripe for Congress to revisit FSAs and recharacterize them as tax-favored savings accounts, consistent with how people view them. From the perspective of most participants, FSAs operate much the same as HSAs. Participants contribute their own money to an account and later withdraw it by submitting receipts for eligible medical expenses. The only differences in the eyes of most taxpayers is that FSAs are subject to a number of rules that make them unattractive to use, and FSAs don't allow taxpayers to invest the funds as they wish. Most taxpayers would be shocked to discover that the government views FSAs as a form of insurance. So long as premiums for FSAs equal coverage, the formal distinction between FSAs and HSAs is hard to maintain.

Tax-favored savings accounts did not exist when Congress opened the door for FSAs by creating cafeteria plans, and framing the accounts as insurance was the only way they could fit within the then-existing statutory framework. Now that such accounts exist, Congress can and should reclassify FSAs. Doing so would not only exempt the accounts from the ban against deferred compensation found in I.R.C. § 125(d),[162] but it would also relieve the Treasury Department of the need to create and enforce taxpayer-unfriendly rules necessary to make the plans look like insurance.

In response to the concern that recognizing FSAs as tax-favored savings accounts would improperly allow taxpayers to deduct their

162. *See* I.R.C. §125(d)(2)(D) (2006).

first dollar of medical expenses, in direct conflict with the policy set forth in I.R.C. § 213 which prohibits deductions below a set floor, I would note that exempting employer-provided health insurance and amounts contributed to Archer MSAs and HSAs from income also contravenes this policy. Insurance payments are nothing more than ex ante medical costs. Assuming no uninsured expenses, allowing the first dollar of insurance benefits to be excluded from income is the same as allowing a deduction for the first dollar spent on medical needs.[163]

Arguably, insurance and HSAs are worthy of an exception to the general policy of I.R.C. § 213 because we want to encourage people to negotiate for health insurance and buy high-deductible policies. However, if we classify FSAs as a form of employer-provided insurance and justify exclusion from income on those grounds, then the justification for exempting insurance premiums from income applies equally to amounts contributed to FSAs. If we think of FSAs as savings accounts, they facilitate the purchase of high-deductible health insurance by affording a tax benefit for amounts paid up to the deductible limit, thus encouraging people to monitor their spending.

B. FSAs

Implicit in the unsuccessful efforts to allow rollovers is the belief that low participation rates are a result of the forfeiture provision.[164] The obvious solution is simply to allow rollovers, but the Treasury Department has indicated that it feels bound by its prior rulings and Congressional inaction in light of those rulings. Congress has had numerous opportunities to act and has refused to do so, suggesting that a second best solution may be called for, one that either does not require congressional action or that is more likely to garner political support.

163. If we were serious about maintaining a floor on the exclusion of medical spending, we would exempt only those amounts paid for insurance above the floor.

164. People may underfund or decide to pass on FSAs altogether because they are risk or loss averse or are frozen by the uncertainty surrounding the outcome. Some may refrain from participating because they believe the hassle of keeping track of medical spending and submitting receipts outweighs the tax savings. It may be that the combination of these two issues is really to blame. Unfortunately, no empirical evidence exists on why people refrain from participating.

My proposal avoids or at least alleviates the forfeiture penalty without requiring Congress to act, though legislation adopting the proposal is the preferred course. For those who regularly donate to charity, donating unused FSA amounts to charity is nothing more than an extension of a practice in which they already engage. Such taxpayers are not likely to see such donations as a forfeiture and are more likely to fund their accounts consistent with their anticipated medical needs. If they do not itemize, they will also get a tax benefit for donating which they currently do not receive. Those who do not normally donate to charity are more likely to view a donation to the charity of their choice as better than forfeiting unused amounts to their employer, though they may view keeping the money to spend on themselves as better yet and thus not change their behavior in response to the proposal. Those who give may also receive the benefits that research suggests come from donating to charity.[165]

Reducing barriers to FSAs is also consistent with a healthcare policy aimed at lowering medical costs. Health insurance presents a moral hazard because people have less incentive to monitor their medical spending. FSAs lessen the cost of being uninsured or carrying insurance with a high deductible, thus depressing the market for insurance.[166] Moreover, because FSAs are tied to employment, the subsidies for FSAs are likely to be targeted at those who receive health insurance tax-free. To the extent that one believes the subsidy for health insurance is inefficient because it causes people to overinsure, expanding the use of this countervailing subsidy could be welfare-maximizing.

It is important to consider whether the proposal could have unintended negative consequences. Will employers stop offering FSAs if they are no longer allowed to keep forfeited funds? The answer depends on the extent to which companies rely on forfeited amounts to cover the costs of such programs. Employers potentially incur two kinds of costs associated with FSAs. The first is administrative, including internal costs associated with managing

165. *See* Thomas, *supra* note 102, at 271–92 ("Social scientists make the connection between volunteerism (i.e., doing for others) and the cultivation of compassion and civility in the individual volunteer. This research finds that there are emotional and physical health benefits that inure to the well-being of the volunteer."). *See generally* Lalin Anik et al., *Feeling Good About Giving: The Benefits (and Costs) of Self-Interested Charitable Behavior* (Harv. Bus. Sch., Working Paper No. 10–012, 2009), *available at* http://www.hbs.edu/research/pdf/10-012.pdf.

166. *See supra* Part II.C.

enrollment, advising employees, and managing reimbursements. If the employer retains a benefits company to administer claims,[167] it will incur external costs as well. It is difficult to know how much a company spends internally on FSAs. Usually, these plans are offered in conjunction with a variety of other benefits, and it would be hard to disaggregate marginal costs associated with offering an FSA. Where companies contract out administration of the program to a third party, the monthly cost comes to about $3 per participant, for an annual cost of around $36 for each employee who contributes to an FSA,[168] which is consistent with the fees charged by institutions that offer HSAs.[169]

The second kind of cost involves "experience loss," i.e., situations where an employee makes a claim and is reimbursed, and then leaves the company before he or she contributes the full amount into his or her account. No data exists on how often this occurs or how much money is involved. That said, it is hard to imagine that such losses are significant. The soon-to-be-implemented caps ensure that the loss cannot exceed $2500 for any one employee.

Relying on the survey results reported above in Part III, it is possible to estimate the cost of offering an FSA. For instance, if we assume a company with 2500 employees and a 40% participation rate,[170] that company will have approximately 1000 participants in its FSA who will contribute $1,300 on average to their accounts, for a total of $1,300,000. If the company hires an outside firm to administer the plan, it will incur out-of-pocket costs of approximately $36,000 in addition to internal administrative costs associated with the plan. It may also suffer some experience losses when employees leave mid-year. The total cost of offering an FSA should be relatively low. For our purposes, let's assume a total cost, including internal costs, external costs, and experience loss, of $50,000.

167. *See, e.g.*, ASIFLEX, http://www.asiflex.com/ (last visited Aug. 24, 2011) (ASIFlex provides FSA administration).

168. *See, e.g.*, Contract Between Arizona Board of Regents and Application Software, Inc., at app. A, (setting the rates for 2011 at $3 per month per participant) (on file with author).

169. *See supra* text accompanying note 91.

170. This participation rate is double the national average. *See supra* note 4.

It is also possible to determine the revenue stream and cost savings associated with offering an FSA. The data suggests that the number of people who currently forfeit money and the amounts that they forfeit are quite low. As noted above, a large majority of employers report that fewer than 7% of their employees forfeit money, and the average amount forfeited is less than $100,[171] though anecdotal evidence suggests that some taxpayers forfeit significant sums. If we assume that 5% of the participants at the company described above forfeit $100, the total amount forfeited would be $5000. This amount would defray about 10% of the costs of offering an FSA, suggesting that companies must have other means available to fund their plans.

One source of funds is the tax breaks that companies receive from participating in FSAs. Amounts contributed to FSAs are exempt from both income and payroll taxes.[172] Thus, companies do not need to pay payroll taxes on contributed amounts. The employer's portion of payroll taxes is 7.65%.[173] Returning again to our 2500 employee firm, if we assume that the 1000 participants contribute on average $1300, for a total of $1,300,000, the company saves $99,450 in taxes. These tax savings far exceed the costs of administering an FSA, making such accounts financially attractive to employers, even if the company is not allowed to retain forfeited amounts. To the extent that employees increase participation in FSAs as a result of this proposal, the tax savings should increase. For every $400 in increased participation, the company would save about $32 in payroll taxes, just about covering the annual external cost of one participant.

Should tax savings—whether participation remains unchanged or increases—be insufficient to cover the costs of offering FSAs, amounts lost as a result of this proposal could be made up through fees charged to plan participants, as is done with HSAs.[174] Indeed, from an equity perspective, using fees to fund the program would be an improvement over the current system, as it would apportion the costs based on a per-person basis and not based on the accuracy at

171. INT'L FOUND. OF EMP. BENEFITS PLANS, *supra* note 31, at 6.

172. *See* I.R.C. §§ 105, 3121(a)(2) (2006).

173. *See* I.R.C. § 3101(a) (2006).

174. *See supra* text accompanying note 91.

predicting one's medical expenses.[175] Thus, it seems highly unlikely that companies will drop FSAs if this proposal is adopted.

C. The Charitable Deduction

Those opposed to moving the charitable deduction above the line have generally raised five arguments.[176] The first is economic. The second is based on administrative convenience. The third is based on fairness. The fourth is a concern about the effect on volunteerism. The fifth is based on efficiency. In this Subpart, I evaluate this proposal in light of these objections, comparing it to prior reform efforts where appropriate.

The first objection to moving the charitable deduction above the line is that it would be too costly.[177] At a time of great deficits, one must be careful not to exacerbate the problem. This argument rings somewhat hollow in light of the decision to renew the Bush tax cuts for two additional years, which are projected to add approximately $3.9 trillion to the deficit over the next ten years.[178] However, the recent fight over raising the debt ceiling suggests that Congress may be serious about this. Regardless, the question isn't solely about how much it costs, but rather whether it produces a net societal gain. Surprisingly little research has been done attempting to identify the requisite level or mix of public goods or whether the charitable deduction as currently structured provides a sufficient subsidy to produce those goods. At best, the data attempts to predict increased charitable giving relative to cost.[179]

175. Using fees is not without risk. Unlike forfeited amounts, which taxpayers may or may not suffer, fees would be explicit and certain. Some taxpayers might resist participating, even if on a net basis they benefited from the program. Those who use up all their FSA funds currently pay nothing for the program. If fees were levied on all participants, they would have to bear some cost. What effect explicit fees might have on participation is an empirical question that is difficult to answer.

176. In a 2001 article, Ellen Aprill considered whether moving the deduction above the line would be in the best interests of religious organizations and society more generally. *See* Aprill, *supra* note 95. While addressed primarily to religious organizations and focused on donations to such, the article provides a good framework to explore the issue of whether allowing people to donate unused amounts in health care FSAs to charity might be superior to moving part or all of the charitable deduction above the line.

177. *See, e.g.*, 2002 CBO REPORT, *supra* note 155, at 1.

178. *See* Ron Scherer, *What Will Deal on Bush Tax Cuts Mean for the Federal Deficit?* CHRISTIAN SCI. MONITOR (Dec. 6, 2010, 9:40 PM), http://www.csmonitor.com/USA/Politics/2010/1206/What-will-deal-on-Bush-tax-cuts-mean-for-the-federal-deficit.

179. *See, e.g.*, URBAN INSTITUTE REPORT, *supra* note 148; 2002 CBO REPORT, *supra*

Accepting cost arguments as made in good faith, my proposal is superior to moving the whole deduction above the line because it limits the total amount of charitable deductions allowed. The actual impact depends on how people respond to the proposal, but for any individual the additional above-the-line effect is capped at the marginal tax rate multiplied by the contribution limit, which will soon be set at $2500. If the additional incentive does not induce taxpayers to increase their participation or amounts contributed to FSAs, the effect on revenue collection would be limited to the small amounts that are currently forfeited and included in the employers' tax base. If taxpayers increase their FSA contributions with only their healthcare needs in mind, the program's cost will go up, but FSAs will come closer to fulfilling their purpose. It would be odd to argue against the proposal because it will make FSAs more effective, in line with their underlying purpose.[180]

Finally, some may "take advantage" of the proposal by intentionally contributing more than their anticipated health care needs to an FSA with the goal of donating leftover amounts to charity. Setting aside the fact that this would increase amounts available for health care if necessary, such behavior would reduce income tax revenues only if (1) it displaces charitable giving for which no deduction is currently available,[181] or (2) it represents additional giving. If the proposal spurs additional giving, it will have accomplished one of its goals. If taxpayers simply shift giving from a nondeductible to a deductible format, the proposal will have accomplished little, while decreasing government revenues. The

note 155, at 7–9.

180. Presumably the government could design an incentive with the expectation that few would take advantage of it, hoping to score political points without actually providing the advertised benefits. Indeed, some suspect that the Child Tax Credit enacted during the Bush years partook of this. Legislators could claim they were giving people a credit, all the while knowing that income limits and the Alternative Minimum Tax would significantly restrict the number of beneficiaries. In the case of health care FSAs, this seems unlikely, as the prohibition against rollovers were created by the IRS's interpretation of I.R.C. § 125's antideferral rules. In any event, the better approach is to expressly limit the program to its intended targets, rather than make the program so cumbersome that people will not participate.

181. Because amounts contributed to health care FSAs are exempt from payroll taxes, taxpayers who itemize could choose to donate through health care FSAs instead of through currently deductible giving to avoid paying payroll taxes. This type of behavior would cost the government tax revenue. However, it would not be difficult to impose payroll taxes on those who itemize and donate through this mechanism to make such a strategy equivalent to regular donations. Indeed, to avoid giving nonitemizers an extra tax break, one could readily impose full payroll taxes on those who donate in this manner.

likelihood of this occurring is discussed more fully below in the discussion of efficiency.

A second common objection to moving the charitable donation above the line is administrative.[182] The whole point of the standard deduction was to eliminate the need to track itemized deductions. Were the charitable donation moved above the line, many of these simplification benefits would be lost. Indeed, these concerns were a leading reason why Congress decided to move the charitable deduction back under the line as part of the 1986 tax reforms.[183] Donating unused FSA amounts to charity would avoid this problem because the amounts would already have been excluded from employee income. They would automatically be transferred to charities at the end of the year. As a result, there would be no need for employees to document amounts or recipients, thus avoiding administrative difficulties normally associated with above-the-line and itemized deductions. For those taxpayers who use the FSA mechanism to reduce their itemized deductions below the amount of the standard deduction,[184] the administrative burden would actually decrease.

In an effort to reduce the cost of the charitable deduction, several of the proposals to date seek to limit the amount of charitable deductions taken above the line by using a floor or maximum amount. Such provisions add significant complexity to the Code, making tax planning difficult. The proposal offered in this Article is far easier to grasp and plan for.

The third argument is based on fairness, i.e., that it is unfair to give itemizers an incentive to give, while denying the incentive to nonitemizers, but this argument is more difficult. Where two people give the same amounts to charity, it seems wrong that one gets a tax deduction because he has additional itemized deductions, such as home mortgage interest, while the other receives no deduction.[185] However, some amount for presumed charitable giving is included in the standard deduction. Thus, while nonitemizers get no direct incentive to give, their taxes are lowered as if they had given to

182. *See* Aprill, *supra* note 95, at 859–60.

183. *See* 2002 CBO REPORT, *supra* note 155, at 3 (citing Amy E. Dunbar & John Phillips, *The Effect of Tax Policy on Charitable Contributions: The Case of Nonitemizing Taxpayers*, 19 J. AM. TAX'N ASS'N 1, 5 (1997)).

184. *See id.* at 13.

185. *See* McDaniel, *supra* note 101, at 394.

charity. While the exact amount of their donations may not match the portion of the standard deduction associated with presumed charitable giving, they are certainly receiving some tax relief, and those who give little to charity get a greater tax benefit than they deserve.

Even if they are not financially disadvantaged, nonitemizers could argue that the current rules are unfair because all taxpayers are not treated the same. The better path, they might argue, would be to reduce the standard deduction by some amount and allow all taxpayers to deduct some or all charitable giving above the line. However, such an approach would undermine many of the administrative benefits associated with the standard deduction.

The fourth objection to moving the charitable deduction above the line is that it might affect volunteerism by making charitable donations more attractive relative to volunteering.[186] This concern is addressed primarily to churches, which rely heavily on volunteerism and could suffer if people donate in lieu of volunteering. One who foregoes income by volunteering has no income and no deduction. In contrast, a taxpayer who earns money and then donates it to charity must report the income but gets no corresponding deduction if he takes the standard deduction. Thus, he is worse off than if he volunteers. Allowing an above-the-line deduction would put volunteering and donating on the same footing.

Professor Ellen Aprill rejects this concern, concluding that donations and volunteering are more likely complements than substitutes.[187] However, to the extent that this concern may have validity, this proposal avoids the tradeoff to some degree because the donation is residual, determined as of the end of the year. Volunteers cannot wait until the last day of the year to decide whether or how much to volunteer. Thus, it seems unlikely that allowing taxpayers to contribute unused FSA funds to charity will unduly suppress volunteering.

Finally, there are a number of efficiency-based objections to moving the charitable deduction above the line. First, low-income taxpayers tend to give to religious organizations and do so for reasons entirely independent of receiving a government subsidy.[188]

186. *See* Aprill, *supra* note 95, at 862–64.

187. *See id.* at 863.

188. *See* 2002 CBO REPORT, *supra* note 155, at 8. For a discussion of the Judeo-Christian religious obligation to be charitable, see Adam S. Chodorow, *Maaser Kesafim and*

They currently donate significant amounts without any subsidy.[189] Thus, there is no need for a government subsidy, at least for such taxpayers. Second, a number of studies suggest that low-income taxpayers are unlikely to increase their giving when offered a subsidy because their tax rate is low. In contrast, taxpayers in higher brackets are much more likely to increase giving in response to greater tax incentives. Third, because it is not clear the extent to which religious organizations create benefits for nonmembers, donations to such organizations may be different in kind from other types of donations and therefore less worthy of government subsidy.[190]

As Aprill notes, the evidence on the second and third of these concerns is contradictory.[191] With regard to self-serving donations, it is simply not possible to determine the societal benefits of donations to one's church. However, if one is concerned about this, one could limit the types of charities eligible to receive unused FSA funds to those associated with health and medicine, consistent with the original purpose for setting the funds aside in the first place.

With regard to the relative responsiveness of high- and low-income taxpayers to subsidies, some studies suggest that low-income giving is far less responsive than high-income giving,[192] because nonitemizers tend to have low marginal rates, thus blunting the tax incentives. In contrast, high-income taxpayers are responsive because they receive significant subsidies for their giving. Other reports find high elasticity among nonitemizers, suggesting that charitable giving would surge were nonitemizers given a tax incentive to do so.[193]

the Development of Tax Law, 8 FLA. TAX REV. 153 (2007).

189. *See* 2002 CBO REPORT, *supra* note 155, at 8 ("All of the $21 billion in contributions by taxpayers who claimed the standard deduction were made without any tax incentive.").

190. *See* Aprill, *supra* note 95, at 865–66.

191. *See id.* at 859.

192. *See* John R. Robinson, *Estimates of the Price Elasticity of Charitable Giving: A Reappraisal Using 1985 Itemizer and Nonitemizer Charitable Deduction Data*, 12 J. AM. TAX'N ASS'N 39, 58 (1990). For a recent study on high-income taxpayer responsiveness to tax incentives, see Jon Bakija & Bradley Heim, *How Does Charitable Giving Respond to Incentives and Income? Dynamic Panel Estimates Accounting for Predictable Changes in Taxation* 7 (Nat'l Bureau of Econ. Research, Working Paper No. 14237, 2008), *available at* http://www.nber.org/papers/w14237.

193. *See* Yong S. Choe & Jinook Jeong, *Charitable Contributions by Low- and Middle-Income Taxpayers: Further Evidence with a New Method*, 46 NAT'L TAX J. 33, 36 (1993); Dunbar & Phillips, *supra* note 183, at 18 (relying on data from 1982 to 1986, when nonitemizers were allowed to deduct charitable contributions above the line). *But see*, 2002 CBO REPORT, *supra* note 155, at 11 (noting the difficulty of disaggregating timing effects

Whether the tax incentive for low-income taxpayers is sufficient to spur additional giving is really something of a red herring. If low-income taxpayers don't respond to the incentive by giving more than they currently give, then the incentive will simply be ineffective. Instead, the efficiency of any proposal depends on the extent to which it subsidizes activities that are already taking place. Indeed, this is the chief problem the CBO identified with the proposals it considered in its 2002 report.[194] The proposal here avoids or lessens the concerns that the government will be paying for existing giving, at least relative to moving the charitable deduction wholesale above the line.

If we assume people contribute more to their FSAs in response to the proposal, consistent with the actual anticipated medical needs, it seems likely that any residual amounts donated to charity will be in addition to existing giving.[195] Potentially more troubling is a scenario where taxpayers fund their FSAs at levels above their anticipated medical needs with the intent of donating any excess. If such contributions reflect additional giving, again there is no problem. However, if taxpayers displace donations they otherwise would have made but for which no or only reduced tax incentives were available, the proposal could increase costs without a commensurate increase in giving.[196]

While some taxpayers may do this, several elements of the proposal suggest that donating through an FSA is not a good substitute for other types of giving, and therefore this may not be as big a problem as it appears. To begin with, the proposal allows

associated with changes in the law from normal incentive effects); Peter J. Frischmann, *Discussion of the Effect of Tax Policy on Charitable Contributions: The Case of Nonitemizing Taxpayers*, 19 J. AM. TAX'N ASS'N 21 (1997) (cautioning against reading too much into the Dunbar and Phillips findings).

194. *See* 2002 CBO REPORT, *supra* note 155, at 2 ("All four options would be likely to increase overall contributions by less than 4%, and their primary effect, as is the case with most deductions, would be to reward taxpayers for their existing behavior.").

195. Increased funding of health care FSAs should not displace charitable giving because healthcare expenses will have to be met regardless. Increased use of FSAs simply provides a tax-exempt way to do so.

196. In some cases, taxpayers who would otherwise have itemized may elect the standard deduction if their charitable donations are handled through an FSA. According to the 2002 CBO Report, as of 1997, moving $200 of donations above the line for joint filers could cause 450,000 filers to claim a benefit without changing giving. *See* 2002 CBO REPORT, *supra* note 155, at 12. The projected revenue losses from those switching from itemizing to taking the standard deduction ranged from $50 to $300 million per year, depending on plan considered. *See id.*

taxpayers to designate only one charity as the recipient of unused FSA funds. Taxpayers who routinely give to more than one charity would not find this approach adequate. If Congress were to limit the possible recipients of such funds, the incentive to alter giving patterns would be even further reduced. In addition, amounts given through this mechanism are residual. Thus, taxpayers who are intent on ensuring that their specific charity receives a set amount will be better served by giving directly to the charity. Further, if one is truly concerned that a significant number of taxpayers will shift their giving, one could reduce the standard deduction by some ratio of the amount donated in this manner, though this would add additional complexity. Finally, if people do shift their giving patterns to donate through FSAs, they will necessarily be setting aside money that *could* be used for health care needs, consistent with the purpose of having FSAs.

This discussion brings up one concern that should be addressed: is there a chance that this proposal could actually decrease charitable giving? For instance, if taxpayers displace existing giving with giving through FSAs, there is a risk that they could treat the FSA as a wasting fund, where charity only receives what is left at the end of the year. If a taxpayer's health care needs exceeded expectations, charity would receive less than anticipated. Several factors suggest that this is not likely to happen.

First, many people give throughout the year, as requests come in. Donating residual amounts left in an FSA is a poor substitute for this practice. Second, the limitation of one charitable recipient would likely preclude taxpayers from seeing FSAs as a perfect substitute for their normal charitable giving. Third, and perhaps most important, a large number of givers are target oriented, establishing at the beginning of the year how much they intend to give. Those who give for religious purposes often seek to donate 10% of their income to charity.[197] Such taxpayers are unlikely to reduce the total amount given to charity because they have an alternate and contingent means of giving. If they shift some of their charitable giving to the FSA and discover at year's end that they have unexpectedly used it to cover health care costs, they can always adjust the amount of non-FSA donations to meet their goals. While they may need to wait until the

197. This behavior is consistent with the notion that some portion of nonitemized giving is inelastic. For a discussion of the Jewish practice of tithing and the origin of the 10% figure, see Chodorow, *supra* note 188.

end of the year to make such adjustments, many taxpayers already do this.[198]

D. Political Considerations

In today's political climate, it is not enough simply to put forward an idea and show that it advances a policy goal and is economically feasible. It is also necessary to demonstrate that it has a real possibility of being enacted. This proposal should garner significant support among politicians, charitable organizations, and frustrated taxpayers, while engendering little opposition.

First, the proposal should be popular with politicians, regardless of their political leanings. Both Republican and Democratic administrations have sponsored proposals to make the charitable deduction more widely available by moving at least portions of the deduction above the line.[199] Moreover, both parties have railed against the complexity of the tax laws and the burdens imposed on those trying to make sensible economic decisions. Softening the forfeiture barrier to using FSAs would significantly reduce taxpayer frustration at a fairly low cost and therefore should be politically popular. In sum, this is the type of proposal that should receive bipartisan support—no mean feat in the current political environment.

Second, the proposal should garner significant popular support. Not only will it appeal to nonitemizers seeking a subsidy for donating to charity, but it will also appeal to the millions of Americans who face the annual frustration of trying to figure out how much to contribute to FSAs. Third, the charitable lobby should support this proposal as it is likely to increase charitable giving. This lobby is well organized and should be a valuable ally in pushing for the proposal. Working together, these constituencies have a better chance of getting this legislation passed than they have had working separately on stand-alone provisions.

198. Indeed, one can predict that target savers may increase their donations. Targets are normally minimums. Under current rules, once amounts are committed to health care FSAs, they are sunk costs. Taxpayers who fund their health care FSAs to meet expected medical needs and then donate unused amounts are no worse off than if they had used the FSA moneys for medical needs. It is not at all clear that they will cut back other giving in light of their good medical fortune.

199. *See supra* Part IV.B.

The one group likely to oppose the proposal is employers, who stand to lose the amounts that would otherwise have been forfeited to them. That said, the total amount forfeited each year for any given employer is relatively small. Employers who offer FSAs are almost certainly financially ahead as a result of payroll tax savings described above. While employers should get some financial incentive to offer FSAs, the claim that they should get to keep forfeited amounts in addition to tax savings is less than compelling, especially when compared to the alternative use of such amounts to fund charities. Should they somehow be able to demonstrate that FSAs are not economically viable absent forfeited amounts, introducing fees to replace such amounts offers a far more equitable means of funding FSAs. Thus, employer opposition could readily be diffused should it arise.

VI. CONCLUSION

Prior efforts to reform the FSA and charitable deduction provisions—by allowing taxpayers to rollover unused amounts in FSAs and moving the charitable deduction above the line—have failed. This Article offers a new way forward. Allowing taxpayers to donate unused funds in an FSA at the end of the year to charity may improve the efficacy of both provisions by creating new incentives for people to donate to charity, while removing, or at least softening, the risk of forfeiture associated with FSAs. While the proposal could be implemented administratively, the better path is to have Congress revisit FSAs and conform their legal status to the way people view and use them.