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REFORMING 501(C)(3): PUTTING THE “CHARITY” BACK IN THE CHARITABLE DEDUCTION

*Jennifer McCrabb Black**

I. INTRODUCTION

Charitable organizations have an important role in American society—providing aid to the needy, giving homes to abandoned animals, and contributing to the education and culture of our society.¹ These benefits, however, come at a price. Using the most recent estimates available, the charitable contribution deduction² costs taxpayers on average \$57 billion per year.³ This cost is presented as a “tax expenditure,” which is defined as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.”⁴ The cost of the charitable contribution deduction is estimated to increase dramatically over the next several years. For example, the charitable contribution deduction for 2009 is estimated to cost approximately \$5 billion for contributions to educational organizations, \$5 billion for contributions to health organizations, and \$47 billion for contributions to all other organizations.⁵ These numbers are estimated to increase to \$7 billion each for contributions to educational and health

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1. See Treas. Reg. § 1.501(c)(3)-1(d)(2) (2009); Dean Pappas, Note, *The Independent Sector and the Tax Laws: Defining Charity in an Ideal Democracy*, 64 S. CAL. L. REV. 461, 461 (1991).

2. See I.R.C. § 170 (2006 & Supp. I 2009).

3. See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009, at 290 tbl.19-1 (2009), available at <http://www.whitehouse.gov/omb/budget/fy2009/pdf/apers/receipts.pdf> [hereinafter OMB 2009 BUDGET]; JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, at 56 tbl.2 (2008), available at <http://www.house.gov/jct/s-2-08.pdf> [hereinafter JCT ESTIMATE]. The \$57 billion figure was calculated adding the three charitable contribution deduction line items per year and per report, calculating an average per year between the reports, and then averaging all years the reports had in common together to come up with an average per year.

4. OMB 2009 BUDGET, *supra* note 3, at 287.

5. *Id.* at 290 tbl.19-1.

organizations and almost \$63 billion for contributions to all other organizations by 2013.⁶

Despite this enormous cost to the public, there is little assurance that the public is receiving adequate benefits in return.⁷ Although charities are prohibited from benefiting private individuals or shareholders with their net earnings,⁸ there is nothing that measures the actual public benefit a charity provides and nothing to hold a charity to any public benefit threshold.⁹ A solution is needed to ensure that only those organizations which are providing a sufficient public benefit are receiving a portion of the \$57 billion per year.¹⁰ The inefficient and uncharitable organizations need to be weeded out to provide taxpayers with the most benefit for their tax dollar.

As the number of charitable organizations increase¹¹ and the amount of money donated to those organizations skyrockets,¹² charity needs to be redefined for tax deduction purposes. The redefinition will ensure that taxpayers subsidize¹³ through tax-deductible donations only those entities that are truly for the public benefit and not primarily for the benefit of a small group of people.¹⁴

This paper seeks to lay out a proposal to redefine what it takes to receive tax-deductible donations. Part II of this paper will summarize the current state of the law as it applies to the charitable contribution deduction and the qualification for tax exemption under the Internal Revenue Code. Part III discusses the Charities Act 2006, a recent British act aimed at attempting to redefine charity for England and Wales by requiring organizations to prove

6. *Id.*

7. See Tiffany Keb, Comment, *Redefining What it Means to Be Charitable: Raising the Bar with a Public Benefit Requirement*, 86 OR. L. REV. 865, 889–90 (2007).

8. I.R.C. § 501(c)(3) (2006).

9. See Keb, *supra* note 7, at 890–91.

10. See *id.* at 891; Pappas, *supra* note 1, at 481.

11. See I.R.S., U.S. DEP'T OF THE TREASURY, DATA BOOK 54 tbl.25 (2007), available at <http://www.irs.gov/pub/irs-soi/07databk.pdf> [hereinafter IRS DATA BOOK].

12. See *supra* notes 5–6 and accompanying text.

13. Although there is much debate on whether tax exemption and tax deduction as related to charitable organizations is a subsidy or a means to define the income base for tax purposes, the prevailing view, and the view of the courts, is that they are subsidies. See, e.g., *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983) (“Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system.”); Kenneth C. Halcom, *Taxing God*, 38 MCGEORGE L. REV. 729, 732 (2007). *But see, e.g.*, Johnny Rex Buckles, *Is the Ban on Participation in Political Campaigns by Charities Essential to Their Vitality and Democracy? A Reply to Professor Tobin*, 42 U. RICH. L. REV. 1057, 1067 (2008). However, even if it was a means to define the income tax base, arguably it would not be base defining if the organization was not charitable and not providing sufficient public benefit. In this case, the more reasoned view would be that the organizations were receiving a subsidy.

14. See Darryll K. Jones, *Restating the Private Benefit Doctrine for a Brave New World*, 1 NW. J. TECH. & INTELL. PROP. 1, 33–34 (2003).

that they provide a public benefit before receiving the benefits of being a charity.¹⁵ Part IV proposes additions and changes to the Internal Revenue Code which, if implemented, would redefine the requirements for an organization to receive tax-deductible contributions based on their ability to provide for the public benefit. Finally, this paper concludes that change is needed to ensure that only those organizations providing sufficient public benefits are receiving tax-deductible contributions.

II. THE CHARITABLE DEDUCTION

The deduction for charitable contributions first appeared in 1917 as part of the War Income Tax Revenue Act and covered contributions to entities “organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals....”¹⁶ Since its introduction, the charitable deduction has expanded to include several additional entities and complexities. Although many rationales have been offered to justify the tax exemption and the corresponding ability to solicit tax deductible donations available to eligible organizations,¹⁷ the primary reason is that these organizations are supposed to be providing a public benefit.¹⁸

Under federal law, individuals and corporations are granted a deduction on their income tax returns for “charitable contributions” made during the year.¹⁹ For tax purposes, a charitable contribution is defined to include a contribution to an entity “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals,” provided the entity does not engage in any prohibited behavior, such as political campaign intervention or excessive lobbying.²⁰ This language is identical to the language contained in I.R.C. section 501(c)(3), describing one class of organizations

15. Charities Act, 2006, c. 50 (Eng.).

16. Charles A. Borek, *Decoupling Tax Exemption for Charitable Organizations*, 31 WM. MITCHELL L. REV. 183, 203 (2004).

17. *See, e.g.*, JOINT COMM. ON TAXATION, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 68 (2005) (summarizing the various rationales).

18. *Bob Jones Univ. v. United States*, 461 U.S. 574, 590 (1983).

19. I.R.C. § 170(a)(1) (2006).

20. *Id.* § 170(c)(2)(B)–(D); *see also id.* § 501(c)(3). Also included are gifts to fraternal organizations if the gift is to be used exclusively for one of the purposes listed in I.R.C. section 170(c)(2)(B), excluding sports competitions. *Id.* § 170(c)(4).

exempt from tax.²¹ These organizations make up approximately ninety-four percent of all organizations eligible to receive tax-deductible donations.²² Also included in the definition of “charitable contributions” are gifts to veterans’ organizations or cemetery companies provided none of the net earnings benefit a private shareholder or individual.²³

Sections 501(c) and (d) of the Internal Revenue Code list the organizations which are exempt from federal tax.²⁴ Section 501(c) includes a list of twenty-eight subcategories of organizations that qualify for tax exemption, including cemeteries, insurance trusts, and clubs organized for pleasure.²⁵ However, out of those twenty-eight subcategories, only those organizations defined in four subsections of I.R.C. section 501(c) are eligible to receive “charitable contributions” as defined in I.R.C. section 170(c).²⁶ Therefore, an organization may be exempt from tax, but unable to solicit tax-deductible donations.

Organizations that are able to solicit tax-deductible donations have restrictions placed on them that are inapplicable to many other tax-exempt organizations. For example, section 501(c)(3) organizations are prohibited from participating in political campaigns for public office and from spending a substantial amount of their activities attempting to influence legislation.²⁷ Also, none of the net earnings of any organization eligible to receive tax-deductible donations may inure to the benefit of a private individual or shareholder.²⁸

Both I.R.C. section 170(c)(2)(B) (granting a tax deduction) and I.R.C. section 501(c)(3) (granting tax exemption) list “charitable” as only one of the many types of organizations.²⁹ “Charitable,” for tax purposes, is not defined solely as relief to the poor, which is its ordinary and popular meaning.³⁰ Instead, it is defined by its legal meaning, which includes not

21. *Id.* § 501(c)(3).

22. *See* IRS DATA BOOK, *supra* note 11. The ninety-four percent was calculated using the 2007 numbers which are the most recent available.

23. I.R.C. § 170(c)(3), (5) (2006).

24. *Id.* § 501(c)–(d).

25. *Id.* § 501(c).

26. *See id.* § 501(c)(3), (10), (13), (19); *see also id.* § 170(c). Contributions for public purposes to a state, a possession of the United States, or a political subdivision of a state also qualify as charitable contributions. *Id.* § 170(c)(2)(A). This type of charitable contribution will not be addressed by this proposal.

27. *Id.* § 501(c)(3).

28. *Id.* § 170(c); *see also id.* § 501(c)(3), (10), (13), (19).

29. *Id.* §§ 170(c)(2)(B), 501(c)(3).

30. *See* Borek, *supra* note 16, at 187; *see also* Treas. Reg. § 1.501(c)(3)-1(d)(2) (2009) (defining charitable using a legal definition).

only relief to the poor but also things such as the advancement of religion, education, and science, erection or maintenance of public structures, lessening the burdens of government, and the promotion of social welfare.³¹ This definition is much more expansive than the ordinary definition and has its origins in the English Statute of Charitable Uses of 1601,³² which, until recently, was the predominant source of the definition of charity.³³ Furthermore, many organizations that qualify to receive tax-deductible contributions, such as those organized for amateur sports or for the prevention of cruelty to animals or children, are not included in the legal definition of “charitable,”³⁴ suggesting that a charitable contribution deduction is allowed for organizations that are not charitable.

III. THE CHARITIES ACT 2006

After three years of debate, the United Kingdom Parliament passed the Charities Act 2006 (“Charities Act”) in November 2006 as the first major legislative reform to the definition of charity in England and Wales since the Statute of Charitable Uses of 1601.³⁵ The main purpose of this Act was to require proof of an organization’s public benefit before granting the benefits of charitable status.³⁶ Prior to the Charities Act, organizations that were religious, educational, or for the relief of poverty were presumed to provide a public benefit.³⁷ Now, in order to be a charity in England and Wales, an organization must be established for one of the thirteen purposes listed in the statute and be for the public benefit.³⁸ The Act does not define public benefit, but instead requires the Charity Commission to issue a guidance document to define the term.³⁹ At the core of the public benefit requirement, the Charity Commission has identified two key principles—that there must be identifiable benefits and that those benefits must be to the public or a section of the public.⁴⁰ None of the listed purposes are

31. Treas. Reg. § 1.501(c)(3)-1(d)(2) (2009).

32. See Borek, *supra* note 16, at 195–200.

33. See Keb, *supra* note 7, at 883.

34. See I.R.C. § 170(c) (2006); Treas. Reg. § 1.501(c)(3)-1(d)(2) (2009). Although the regulation is promulgated for a different code section, the term “charitable” has the same meaning in both. *Bob Jones Univ. v. United States*, 461 U.S. 574, 586–87 (1983).

35. See Keb, *supra* note 7, at 882–83; see also Charities Act, 2006, c. 50, § 1 (Eng.) (applying to England and Wales).

36. Stephen Cook, *The Charities Act: Charity Law Finally Enters the Modern Age*, THIRD SECTOR, Nov. 22, 2006, at 18.

37. Keb, *supra* note 7, at 884.

38. Charities Act, 2006, c. 50, § 2 (Eng.).

39. *Id.* § 4.

40. CHARITY COMM’N, CHARITIES AND THE PUBLIC BENEFIT: THE CHARITY COMMISSION’S GENERAL

presumed to be for the public benefit.⁴¹ Religious and fee-charging organizations expressed concerns over how the new requirement to prove their public benefit would affect them.⁴² The Charity Commission recently issued specific guidance for entities organized for the advancement of religion or education, poverty relief, and fee-charging charities in addition to general guidance for entities not in one of those specific areas.⁴³

A. Religion and the Public Benefit

In order to be charitable, religion must be “advanced,” meaning it must “promote or maintain or practice it and increase belief in the supreme being or entity that is the object or focus of the religion.”⁴⁴ Although this sounds broad, the Charity Commission has cautioned that it is not enough that an organization does something in the name of religion; it must advance religion for the public benefit.⁴⁵ In addition to providing concrete examples of ways a religion can be advanced, such as missionary and outreach work, raising awareness and understanding, and seeking new followers, the Charity Commission sets out specific criteria that must be met in relation to the two principles of public benefit.⁴⁶ All organizations purporting to advance religion must show that there is a moral or ethical framework promoted by the religion.⁴⁷ Although this may be an identifiable benefit of a religion, it still must be sufficiently public in order to qualify as charitable.⁴⁸ For example, the public benefit requirement would not be met if an organization was established solely for the benefit of the followers of the religion.⁴⁹ This does not mean that the organization may not restrict access to its places of worship to followers of the religion, but the definition of who may become a follower must be sufficiently open.⁵⁰ This means

GUIDANCE IN PUBLIC BENEFIT 7 (2008), available at <http://www.charity-commission.gov.uk/Library/publicbenefit/pdfs/publicbenefittext.pdf>.

41. Charities Act, 2006, c. 50, § 3 (Eng.).

42. Cook, *supra* note 36.

43. See Charity Comm’n, Public Benefit Default, http://www.charity-commission.gov.uk/Charity_requirements_guidance/Charity_essentials/Public_benefit/pbreligion.aspx (providing links to the specific as well as general guidance).

44. CHARITY COMM’N, THE ADVANCEMENT OF RELIGION FOR THE PUBLIC BENEFIT 8 (2008), available at <http://www.charity-commission.gov.uk/Library/publicbenefit/pdfs/pbreligiontext.pdf>.

45. *Id.* at 9.

46. *Id.* at 11–18.

47. *Id.* at 11.

48. *Id.*

49. *Id.* at 14.

50. *Id.* at 15.

that closed religious orders that do not provide an opportunity for the public to benefit would not be considered charitable.⁵¹

B. Fee-Charging and the Public Benefit

Fee-charging charities present a unique problem when assessing the public benefit because they closely resemble for-profit entities that are not charitable.⁵² To satisfy the public benefit requirement under the Charities Act, a fee-charging organization must provide persons who cannot afford the fees a sufficient opportunity to benefit in a material way, and that benefit must be related to the charity's aims.⁵³ The Charity Commission's guidance on what constitutes an opportunity to benefit provides that entities that offer a sufficient amount of free or subsidized access to people who cannot afford the fees will satisfy the public benefit requirement.⁵⁴ Fee-charging organizations are not required to offer free or subsidized access, but the organization must be able to clearly establish that the opportunity to benefit is not unreasonably restricted by an inability to pay.⁵⁵ Opportunities to benefit that are not related to the charity's aims will not be considered in assessing the public benefit.⁵⁶

It has been suggested that a public benefit requirement similar to the Charities Act be implemented in the United States in order to ensure that charitable organizations are in fact providing a benefit to the public.⁵⁷ However, even though the Charities Act made great strides in the charity law of England and Wales in requiring a public benefit to be recognized as a charity, implementing it in the United States would not go far enough to ensure that those organizations who receive a public subsidy in the form of receiving tax-deductible donations provide enough of a public benefit to justify the subsidy. What is needed is something more comprehensive with brighter lines and more incentive for organizations to provide outreach in order to receive tax-deductible donations.

51. *Id.* at 16.

52. *See* Keb, *supra* note 7, at 893.

53. CHARITY COMM'N, PUBLIC BENEFIT AND FEE-CHARGING 5 (2008), available at <http://www.charity-commission.gov.uk/Library/publicbenefit/pdfs/pbfeecheatext.pdf>.

54. *Id.* at 12.

55. *Id.*

56. *Id.* at 11.

57. Keb, *supra* note 7, at 891.

IV. PROPOSAL

Tax exemption is arguably a form of subsidy administered through the tax system.⁵⁸ However, if the federal government were to require all currently tax-exempt organizations to prove their public benefit or lose their tax exemption, there could be many constitutional problems that arise, especially in the context of religious organizations.⁵⁹ Therefore, only the requirements for the types of organizations that can receive potentially tax-deductible donations to the donor should be modified.

A new subsection, I.R.C. section 501(c)(3)(i), should be added to require all entities organized under I.R.C. section 501(c)(3) to spend a minimum of fifty percent of all tax-deductible donations received on “charitable” endeavors.⁶⁰ Then, the language of I.R.C. section 170(c)(2)-(5) should be replaced with a new I.R.C. section 170(c)(2) that simply reads “a qualified charity organized under I.R.C. section 501(c)(3).”⁶¹ Alternatively, an additional disqualification could be added to I.R.C. section 170(c)(2)(D) which states “or is not otherwise disqualified for failure to meet the requirements of I.R.C. section 501(c)(3)(i).”⁶² This section will flesh out the details of this proposal. First, this section provides a brief overview of what the proposal will and will not affect. Second, details about the fifty percent requirement and how it would be implemented will be discussed. Third, the term “charitable” for purposes of this proposal will be defined. Finally, the practical effects of the proposal will be explored and the miscellaneous provisions addressed.

A. Scope of the Proposal

The proposed change to I.R.C. section 501(c)(3) and the corresponding changes to I.R.C. section 170(c) (the “proposed statutory change”) will only affect which organizations are qualified to receive potentially tax-deductible contributions from donors.⁶³ Therefore, all organizations that currently

58. See, e.g., *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983); Lars G. Gustafsson, “*Lessening the Burdens of Government*”: *Formulating a Test for Uniformity and Rational Federal Income Tax Subsidies*, 45 U. KAN. L. REV. 787, 788–89 (1997).

59. See Halcom, *supra* note 13, at 734 (arguing that under existing case law it would be unconstitutional to impose an income tax on religious organizations).

60. The definition of “charitable” for purposes of this proposal is different from the definition currently used by the IRS. See *infra* Part III.C; see also I.R.C. § 170(c)(2) (2006).

61. See I.R.C. § 170(c)(2)-(5) (2006).

62. See *id.* § 170(c)(2)(D).

63. Deductions are only potentially deductible since an individual must itemize their deductions to claim the charitable contribution deduction and may only deduct contributions up to fifty percent of their adjusted gross income. See *id.* § 170(a)-(b) (2006 & Supp. I 2009).

qualify for tax exemption would still qualify for tax exemption under this proposal.⁶⁴ In the reverse, nothing in this proposal prevents Congress from placing restrictions on the ability of any organization to be tax-exempt, which would also affect an organization's ability to receive tax-deductible donations.

The proposed statutory change would deny a charitable deduction to veterans' organizations, cemetery companies, and fraternal organizations,⁶⁵ unless the organization could qualify for tax exemption under I.R.C. section 501(c)(3).⁶⁶ This would require these organizations to conform to the existing requirements of I.R.C. section 501(c)(3), such as its restriction on political campaign intervention and its limitations on lobbying, as well as the new requirements under the proposed I.R.C. section 501(c)(3)(i).⁶⁷ Although these would be new restrictions on these types of organizations, consolidating all organizations that can receive tax-deductible donations under one subsection and requiring them all to meet the same requirements promotes equality and fairness.⁶⁸

B. The Fifty Percent Requirement

The proposed statutory change would require all organizations that wish to receive tax-deductible donations to spend a minimum of fifty percent of those donations on "charitable" endeavors (the "fifty percent requirement"). By limiting the requirement to tax-deductible donations received, this provides relief to fee-charging institutions, such as nonprofit hospitals and colleges, which receive a substantial portion of their revenue from receipts other than donations.⁶⁹ This also ensures that only the subsidized funds are subject to restriction. Since the proposed statutory change only concerns the qualifications for tax deduction to the donor, donors should be permitted to forego tax deductibility in order to exempt the organization from the fifty percent requirement under the proposed I.R.C. section 501(c)(3)(i). This would remove the subsidy on the funds and allow organizations to tailor fundraising efforts with regard to non-itemizers who would not be losing anything.⁷⁰

64. *See id.* § 501 (2006).

65. *Id.* § 170(c)(3)–(5).

66. These organizations are currently tax-exempt under I.R.C. section 501(c)(10), (13), and (19), respectively. *Id.* § 501(c)(10), (13), (19).

67. *Id.* § 501(c)(3).

68. *But see* *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 546–48 (1983) (rejecting the argument that all subsidized organizations *must* be treated equally).

69. *See* *Keb*, *supra* note 7, at 877–78.

70. *See* I.R.C. § 170 (2006 & Supp. I 2009); *Borek*, *supra* note 16, at 205 (discussing the period of five

The fifty percent requirement would apply to the entity as a whole. Therefore, an organization that receives donations in the form of restricted funds—such as an endowment or donor-advised funds—would not be required to spend the actual restricted donation in order to meet the fifty percent requirement. Since the organization must meet the fifty percent requirement at the entity level, it could use unrestricted funds to meet the fifty percent requirement without disturbing the restricted funds.

Alternatively, endowments could be addressed by exempting them from the fifty percent requirement and instead, requiring them to spend a percentage of their annual expenditures on “charitable” purposes. The required percentage would be calculated by taking the total tax-deductible donations contributed to the endowment as a percentage of the total endowment and then applying the fifty percent requirement to that figure.⁷¹ For example, if the total endowment balance was \$5,000 and it had received a total of \$4,000 in tax-deductible contributions over its existence, every year the endowment would be required to spend forty percent of its expenditures on “charitable” purposes.⁷² To prevent the administrative difficulties that would result if the required percentage was recalculated each year for the next year, the required percentage should be recalculated every five years. Of course, if this proposal were adopted, historical records would make it hard to calculate the required percentage. Therefore, a percentage based on the prior five years of the endowment should be used as a starting point if historical records are inadequate. However, the intent of the proposal is to treat all organizations equally and ensure that the public receives ample benefit for the organization’s ability to solicit tax-deductible contributions. Therefore, any special treatment for any type of organization or fund should be carefully considered, especially since this alternative for endowments does not require organizations to actually spend from their endowment.⁷³

Prior Supreme Court cases have struck down, as unconstitutional, laws requiring that a percentage of funds received by a charity be spent on charitable purposes before that charity is permitted to solicit donations.⁷⁴

years in which the charitable deduction was available to non-itemizers).

71. This would result in a deferral between the time the tax-deductible contributions are received and the requirement to spend them on charitable purposes. Therefore, a percentage higher than fifty percent could be applied to endowments in this situation in order to offset some of that deferral.

72. \$4,000 total tax-deductible contributions divided by the \$5,000 total endowment balance equals 80%. 80% multiplied by 50% is 40%.

73. There have been proposals that would require colleges to spend a certain percentage of their endowments each year. See, e.g., George F. Will, *Willie Sutton Goes to Harvard*, WASH. POST, Oct. 23, 2008, at A19.

74. See *Sec’y of Md. v. Joseph H. Munson Co.*, 467 U.S. 947, 949–50 (1984); *Vill. of Schaumburg v.*

However, these cases dealt with First Amendment issues and the ability to solicit donations, not the tax treatment of those donations to individuals.⁷⁵ This proposal does not limit an organization's ability to solicit donations, but simply affects whether the donations will be tax-deductible to the donor. This makes the proposal similar to the prohibition on campaign intervention contained in I.R.C. section 501(c)(3),⁷⁶ a violation of which can also result in a loss of tax exemption under I.R.C. section 501(c)(3) and in contributions being non-deductible to donors.⁷⁷ This prohibition has been upheld as constitutional, so arguably this proposal would also be constitutional.⁷⁸ Furthermore, existing law already recognizes a distinction between tax-exempt organizations and tax-exempt organizations that can receive tax-deductible donations.⁷⁹ Although this proposal would place limits on an organization's ability to solicit tax-deductible donations, "the Constitution 'does not confer an entitlement to such funds as may be necessary to realize all the advantages of that freedom.'"⁸⁰

1. Reporting the Fifty Percent Requirement

All tax-exempt organizations are required to file an annual tax return on Form 990 providing details on their receipts, expenses, assets, and even the salaries paid to their employees.⁸¹ Religious organizations are exempt from filing and disclosing this information.⁸² Form 990 already requires filers to report their donations received separately, as well as divide their expenses into program, management, and fundraising expenses.⁸³ Furthermore, an organization's Form 990 is available for public inspection, allowing potential donors to evaluate an organization before making a contribution.⁸⁴ This form could easily be modified to include a place to report the amount

Citizens for a Better Env't, 444 U.S. 620, 622 (1980).

75. See *supra* note 74.

76. I.R.C. § 501(c)(3) (2006).

77. *Id.* § 170(c)(2)(D).

78. See *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 550–51 (1983); see also *Branch Ministries v. Rossotti*, 211 F.3d 137, 143–44 (D.C. Cir. 2000); *Christian Echoes Nat'l Ministry, Inc. v. United States*, 470 F.2d 849, 856–57 (10th Cir. 1972).

79. See *supra* notes 24–26.

80. *Regan*, 461 U.S. at 550 (quoting *Harris v. McRae*, 448 U.S. 297, 318 (1980)).

81. I.R.C. § 6033(a)–(b) (2006).

82. *Id.* § 6033(a)(3)(A).

83. See, e.g., I.R.S., U.S. DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 990: RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX 29–37 (2008), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> [hereinafter FORM 990 INSTRUCTIONS]; I.R.S., U.S. DEP'T OF THE TREASURY, FORM 990: RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX, OMB No. 1545-0047, at 9–10 (2008), available at <http://www.irs.gov/pub/irs-pdf/f990.pdf> [hereinafter FORM 990].

84. See *supra* note 83.

spent on “charitable” items. This could be achieved by adding an additional column to Form 990, Part IX “Statement of Functional Expenses” for charitable expenses.⁸⁵ In the alternative, the columns for program, management, and general expenses could be collapsed, resulting in the same number of total columns—charitable, fundraising, and other expenses. Which of the existing columns should remain for information purposes is a policy decision that should be made, but that is immaterial for purposes of this proposal. Organizations would continue to split their expenses between the categories as provided in the instructions for Form 990, which only requires that expenses be reported using “any reasonable method of allocation.”⁸⁶ For example, an organization could split an individual’s salary based on hours worked or on a reasonable estimation of the percentage of time devoted to certain activities. In the case of free or reduced services, the organization could allocate applicable costs based on the total number of free or reduced cases compared to the total number of cases.⁸⁷

The proposal aims to treat all organizations eligible to receive tax-deductible donations the same. Therefore, the mandatory exceptions from filing under I.R.C. section 6033 should be eliminated, and all organizations, including religious ones, should be required to file the annual Form 990.⁸⁸ Filing an annual return is the most effective way to ensure that organizations meet the fifty percent requirement and promote the public purpose of the charitable contribution deduction.⁸⁹

Although the proposal would require religious organizations to file tax returns, this would not violate the Establishment Clause. The Supreme Court, in *Jimmy Swaggart Ministries v. Board of Equalization*, held that administrative and recordkeeping requirements may be imposed on religious organizations without violating the Establishment Clause.⁹⁰ The administrative and recordkeeping requirements at issue involved the imposition of sales tax on sales of non-religious materials in California.⁹¹

85. See FORM 990, *supra* note 83, at 10.

86. See FORM 990 INSTRUCTIONS, *supra* note 83, at 33–37. This also provides guidance on how to split indirect costs. *Id.*

87. For example, if a church provided day care to 100 children a year and of those 100, fifteen were free and ten only paid 50% of the cost, the church could allocate 20% ((15 free + (50% x 10 reduced)) / 100 total) of the costs associated with the day care to “charitable” expenses. This example assumes that the free and reduced day care services are not provided to children of members or supporters of the church. See *infra* Part IV.C.2.

88. See I.R.C. § 6033(a)(3)(A) (2006).

89. See Werner Cohn, *When the Constitution Fails on Church and State: Two Case Studies*, 6 RUTGERS J.L. & RELIGION 2 (2004).

90. *Jimmy Swaggart Ministries v. Bd. of Equalization*, 493 U.S. 378, 393–95 (1990).

91. *Id.* at 381–82.

Furthermore, the filing of an annual Form 990 would not result in more entanglement than filing quarterly and annual payroll returns, which religious organizations must file.⁹²

2. Administrating the Fifty Percent Requirement

Requiring organizations to meet the fifty percent requirement on a year-by-year basis would result in administrative and economic inefficiencies. Since Form 990 is filed on an annual basis,⁹³ organizations would have to reevaluate their status year-by-year and could be forced to make economically inefficient decisions in order to meet the annual requirement. For example, an organization may be forced to spend money in the current year rather than saving it until the next year. These problems could be eliminated by requiring the organization to meet the fifty percent requirement over a five-year period.

Under the proposed I.R.C. section 501(c)(3)(i), regulations should be promulgated that require the organization to meet the fifty percent requirement on an aggregate five-year period (the “five-year look-back rule”). This would allow organizations some flexibility in how they spend donations and ease the administrative burden of determining if the organization passes or fails each year. The five-year look-back rule is best suited for regulations, because this would allow the Treasury to lengthen or shorten the time period to best meet the intent of the proposal—that organizations receiving tax-deductible donations spend the requisite amount on “charitable” works.

Under the proposed I.R.C. section 501(c)(3)(i), if any organization fails to meet the fifty percent requirement under the five-year look-back rule, that organization would be ineligible to receive tax-deductible donations. The organization would cease to be tax-exempt under I.R.C. section 501(c)(3) and would instead be tax-exempt under another subsection, such as I.R.C. section 501(c)(4).⁹⁴ This is similar to the consequences an organization faces for violating the prohibition on campaign intervention under I.R.C. section 501(c)(3).⁹⁵ The change from tax exemption under I.R.C. section 501(c)(3) to tax exemption under another subsection would be effective the year following the application of the five-year look-back rule. The organization would also no longer be subject to the other

92. See I.R.S., U.S. DEP’T OF THE TREASURY, PUBLICATION 15-A: EMPLOYER’S SUPPLEMENTAL TAX GUIDE 9 (2010).

93. See I.R.C. § 6033(a)(1) (2006).

94. See *id.* § 501(c)(4).

95. See *Branch Ministries v. Rossotti*, 211 F.3d 137, 142–43 (D.C. Cir. 2000).

restrictions contained in I.R.C. section 501(c)(3), such as the restriction on campaign intervention and the limitations on lobbying.⁹⁶

Once an organization loses its status under I.R.C. section 501(c)(3) it should be permitted to reapply and receive tax exemption under I.R.C. section 501(c)(3) again. However, to prevent I.R.C. section 501(c)(3) from becoming a revolving door, regulations should be promulgated under the proposed I.R.C. section 501(c)(3)(i) to set a waiting period for the organizations wishing to reapply. The waiting period should range from three to five years to provide some penalty, but nothing too harsh. In considering whether to grant an organization's reapplication, the Internal Revenue Service ("IRS") should consider all the factors, including, but not limited to, the organization's actions during the waiting period and how many times the organization has lost its status under I.R.C. section 501(c)(3). The IRS should not consider the fifty percent requirement in determining whether or not to grant the organization's reapplication.

Now that the details of the proposal to change the requirements of the charitable contribution deduction have been laid out, the next step is to consider how an organization can meet those requirements. The proposal requires a certain amount to be spent on "charitable" endeavors. What is charitable? Although many scholars have taken up the debate on what the meaning of charitable should be,⁹⁷ this proposal seeks to find a middle ground between an expansive and narrow definition of the word—one that will meet contemporary notions and public perceptions.

C. Defining Charity

The definition of charity has grown over time from its ordinary meaning of relief to the poor to an expansive legal definition, which includes the advancement of religion and science, as well as the erection and maintenance of public buildings and lessening the burdens of government.⁹⁸ Many scholars and courts have suggested new definitions of charity to meet contemporary times or to narrow the list of organizations that qualify for charitable benefits.⁹⁹

96. See I.R.C. § 501(c)(3) (2006).

97. See, e.g., Gustafsson, *supra* note 58, at 791–92; Keb, *supra* note 7, at 866–67.

98. See Treas. Reg. § 1.501(c)(3)-1(d)(2) (2009); Lars G. Gustafsson, *The Definition of "Charitable" for Federal Income Tax Purposes: Defrocking the Old and Suggesting Some New Fundamental Assumptions*, 33 HOUS. L. REV. 587, 592–93 (1996).

99. See, e.g., Borek, *supra* note 16, at 208–11 (arguing that the definition should be limited to relief of the poor); Gustafsson, *supra* note 98, at 602–18 (summarizing the historical evolution of the definition of charity).

1. The Many Definitions of Charity

There have been many definitions of “charity” throughout the years, and there are even many conflicting definitions today. For example, Webster’s Dictionary defines “charity” to include relief for the poor and a “gift for public benevolent purposes.”¹⁰⁰ However, Black’s Law Dictionary defines it to include “[a]id given to the poor, the suffering, or the general community for religious, educational, economic, public-safety, or medical purposes.”¹⁰¹ Although similar, the latter definition is arguably much broader than the former. This may represent the difference between the ordinary and legal definition of the word.

Courts in the United States have also struggled to define “charity” both for tax exemption purposes and for purposes of charitable trusts. In the pre-income tax case of *Perin v. Carey*, the Supreme Court held that, in the context of a charitable bequest, “a charity is a gift to a general public use, which extends to the rich, as well as to the poor.”¹⁰² More recently, the Supreme Court in *Bob Jones University v. United States* defined charity by stating that an organization, to be entitled to the tax benefits of being a charity, “must serve a public purpose and not be contrary to established public policy.”¹⁰³ Furthermore, the Court justified the tax benefits that charities receive “on the basis that the exempt entity confers a public benefit.”¹⁰⁴ This “public benefit” may advance the work already publicly supported through the tax system but is not required to be one that society chooses or is able to provide.¹⁰⁵ The Court also held that the definition of charity should be determined using contemporary standards.¹⁰⁶ The Charities Act is similar in that it defines a charity as an institution established for one of the enumerated “charitable purposes” so long as it demonstrates a public benefit.¹⁰⁷

Common in all these definitions of charity is the notion of a “public benefit.” Consequently, tax exemption has been denied where an organization provides too much of a private benefit or too little of a public

100. WEBSTER’S NEW COLLEGIATE DICTIONARY 228 (9th ed. 1983).

101. BLACK’S LAW DICTIONARY 250 (8th ed. 2004).

102. 65 U.S. 465, 506 (1860).

103. 461 U.S. 574, 586 (1983). The Court also noted that although the categories listed in I.R.C. section 501(c)(3) were presumptively charitable, they could not violate public policy and still qualify for tax-exemption. *Id.* at 587 n.11.

104. *Id.* at 591.

105. *Id.*

106. *Id.* at 593 n.20.

107. Charities Act, 2006, c. 50, § 1–2 (Eng.); see Part III (providing a more in depth discussion of the Charities Act).

benefit.¹⁰⁸ Although it has been suggested that we should return to the ordinary meaning of charity as opposed to the legal definition,¹⁰⁹ arguably this would not comport with the contemporary standard envisioned by the Supreme Court¹¹⁰ and would exclude many organizations that provide a public benefit from the definition of charity. This proposal seeks to find a middle ground between these definitions of charity, while still maintaining the spirit of the conflicting views.

2. The Proposed Definition of Charity

For purposes of the fifty percent requirement,¹¹¹ the term “charitable” should be defined as “providing a public benefit or service to those outside the membership or supporters of the organization.” This is similar to the definition provided by the Supreme Court in *Perin* that “a charity is a gift to a general public use, which extends to the rich, as well as to the poor.”¹¹² This definition ensures that at least half of tax-deductible donations are used to benefit the public, as opposed to allowing supporters of an organization to receive a tax deduction for money that is ultimately used for their benefit.¹¹³ In fact, from 1935 through 1940, regulations excluded funds benefiting only the contributing members of those funds from the definition of a charitable fund.¹¹⁴ The following examples demonstrate how this definition would work in practice:¹¹⁵

- a. Organization A is a nonprofit symphony that provides free or reduced tickets to its members based on their level of contributions. To qualify for tax-deductible contributions, including to the members who contribute over the fair market value of the tickets they receive, Organization A could provide free concerts that are open to the public at large.
- b. Organization B is a nonprofit hospital. In order to meet the definition of charitable, Organization B could provide free or

108. See *Bob Jones Univ.*, 461 U.S. at 597; see also Jones, *supra* note 14, at 11–12.

109. See Borek, *supra* note 16, at 222; Gustafsson, *supra* note 98, at 644.

110. *Bob Jones Univ.*, 461 U.S. at 593 n.20.

111. See *supra* Part IV.B.

112. *Perin v. Carey*, 65 U.S. 465, 506 (1860).

113. See Jones, *supra* note 14, at 4–7. Professor Jones also proposes a very well-reasoned regulation that deals with limiting the private benefit for purposes of tax-exemption. *Id.* at 25–30; see also Pappas, *supra* note 1, at 461 n.3 (noting that some view churches as non-charitable because they are funded by and serve a specific group of people).

114. Gustafsson, *supra* note 58, at 805–06.

115. See also CHARITY COMM’N, PUBLIC BENEFIT AND FEE-CHARGING 12–14, 34–38 (2008), available at <http://www.charity-commission.gov.uk/Library/publicbenefit/pdfs/pbfeecheatext.pdf> (giving some examples for fee-charging organizations in England and Wales).

reduced cost services to those who are unable to pay.

c. Organization C is a university that receives donations that are both general and specific. For the general donations, Organization C could provide scholarships (merit or need-based) or libraries that are open to the public. For specific donations (ex. donations to benefit the sports program), Organization C could provide scholarships or open some games to the public at no charge. This would be an example of an organization that has members or supporters and the benefits that it provides could not be limited or primarily directed at those supporters.

d. Organization D is a church that receives donations primarily from its members. Organization D uses those donations to pay for its pastor and utilities and provide other services, such as youth groups and daycare. Since the people who are providing the donations are also the ones benefiting from the services, in order to qualify for tax-deductible donations, Organization D could provide meals for those in need, open its facilities on cold nights to the homeless, allow non-members to use their daycare services on the same terms as members, or provide outreach to the sick or elderly who are in nursing homes or hospitals, so long as these services are not provided only to people who are also members or supporters of the church.

These examples are not intended to illustrate the only ways that organizations could spend for charitable endeavors; they are provided to show how any organization could spend for charitable endeavors and illustrate how an organization must go outside its circle of supporters in order to qualify. However, as with the Charities Act, amounts spent by an organization for charitable endeavors should be sufficiently related to the organization's mission and similar to the benefits received by the members or supporters of the organization.¹¹⁶ This notion of benefiting those outside the organization is also consistent with I.R.C. section 274(a)(3) which denies a tax deduction for club dues.¹¹⁷ Although this new definition of charitable for the purpose of determining which organizations are eligible to receive tax-deductible donations would have little effect on some organizations, others would have to change their operations dramatically to remain qualified.

116. *See id.* at 11.

117. I.R.C. § 274(a)(3) (2006). Arguably, at least some of these clubs would be tax-exempt. *See id.* § 501(c)(7).

D. The Effect of the Proposal

By requiring organizations to spend fifty percent or more of the tax-deductible donations they receive on charitable activities, many organizations currently able to solicit tax-deductible donations would be unable to meet the requirement and, therefore, would lose that ability. The fifty percent requirement would likely have the most effect on hospitals¹¹⁸ and organizations that are primarily self-supporting, such as churches with little outreach. Although some organizations may argue that the fifty percent requirement would spell their demise, since they are unable to offer tax deductions in exchange for contributions, many people give regardless of tax incentives, and many give who are currently unable to itemize.¹¹⁹ Further, the ability to solicit tax-deductible donations is not a right, but a privilege.¹²⁰ Under this proposal, an entity only has the possibility of losing the tax deductibility of their contributions, not their tax exemption itself. Tax exemption is a benefit that for-profit entities in the same or similar lines of business do not have and places tax-exempt organizations at a competitive advantage.¹²¹ Therefore, it is not unreasonable to require organizations to provide a measurable amount of public benefit before receiving any more benefits.¹²²

E. Miscellaneous Provisions

The proposed statutory change to I.R.C. section 501(c)(3) would not modify the existing prohibition on campaign intervention (the “electioneering ban”) or the limitations on lobbying.¹²³ If this proposal were adopted, only I.R.C. section 501(c)(3) organizations would be eligible to receive tax-deductible donations. Leaving the electioneering ban in place ensures that the political speech of charities is not subsidized over other organizations that do not receive a subsidy.¹²⁴

118. See Keb, *supra* note 7, at 879 (explaining that some hospitals only give away one percent of their gross revenues, do not advertise charitable care, and attempt to collect for charitable services). Although under this proposal so long as the hospital spent fifty percent of its donated revenue, it would qualify, nothing in this proposal prevents Congress from deciding to place restrictions on tax exemption, which would affect an organization’s ability to receive tax-deductible donations as well.

119. See Borek, *supra* note 16, at 221.

120. Gustafsson, *supra* note 58, at 831 (“Tax-exemption is not a right, but a privilege . . .”).

121. See *id.*; Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Synthesis*, 27 STETSON L. REV. 395, 428 (1997).

122. See Pappas, *supra* note 1, at 470.

123. See I.R.C. § 501(c)(3) (2006).

124. See generally Sarah Hawkins, *From Branch Ministries to Selma: Why the Internal Revenue Service Should Strictly Enforce the § 501(c)(3) Prohibition Against Church Electioneering*, 71 LAW &

All organizations should be required to apply for tax-exempt status under I.R.C. section 501(c)(3) if they wish to receive the benefits.¹²⁵ Currently, religious organizations are exempt from applying for tax-exempt status and are automatically presumed to be qualified under I.R.C. section 501(c)(3).¹²⁶ Requiring all organizations to apply for tax-exempt status under I.R.C. section 501(c)(3) ensures that all organizations are treated equally and promotes accountability.¹²⁷

Since an organization's ability to receive tax-deductible contributions may change over time,¹²⁸ an organization should be required to disclose to donors their status at the time the contribution is solicited or received. Any receipt given by the organization should contain this information as well. Disclosure allows donors and potential donors to decide whether or not to contribute to the organization and puts them on notice as to the potential tax treatment of their donation. The disclosure could take many forms, including verbal notification, a visible sign, or inclusion on any solicitation materials provided by the organization.

V. CONCLUSION

Organizations should be required to spend a minimum of fifty percent of the contributions they receive, which are not only tax-exempt but tax-deductible to the donor in ways that benefit the public which subsidizes those tax benefits.¹²⁹ Donations are similar to non-deductible gifts under I.R.C. section 102,¹³⁰ since they require a "detached and disinterested generosity" on the part of the donor giving to the organization.¹³¹ By allowing a tax deduction for a gift to an entity, taxpayers are giving up something and should receive something in return. This proposal requires

CONTEMP. PROBS. 185 (2008) (discussing the reasons why the electioneering ban should stay in place).

125. See Cook, *supra* note 36 (discussing how the Charities Act now requires all charities to register if they are above the income threshold, including those previously exempt from registering).

126. I.R.C. § 508(c) (2006).

127. See Cohn, *supra* note 89.

128. See *supra* Part IV.B.2.

129. See, e.g., *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983) (explaining that tax exemption and tax deduction makes all other taxpayers indirect donors); *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983) (stating that tax exemption and tax deductibility are subsidies).

130. I.R.C. § 102 (2006).

131. See *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Comm'r v. LoBue*, 351 U.S. 243, 246 (1956)).

organizations to give back to the taxpayers who are providing them with tax benefits in the form of spending for the public benefit.¹³²

The proposal ensures that only the most efficient organizations are fully subsidized through the tax system. An organization may provide a worthwhile service, but due to inefficiencies be unable to meet the fifty percent requirement. Just as desirable for-profit businesses may go out of business due to inefficiencies, so too should the public not fully subsidize through tax-deductible donations those organizations that are inefficient, even if they perform a desired service.¹³³ The fifty percent requirement also cuts down on the potential for excess private benefits and subsidizing private consumption through organizations.¹³⁴

The benefits of this proposal would easily outweigh any cost to any individual or group of organizations. With the national debt now in excess of \$10 trillion¹³⁵ and with more spending on the horizon,¹³⁶ tightening the requirements for the charitable contribution deduction could result in more tax revenues if organizations are unable to meet the requirements. More importantly, the proposal would encourage outreach and more charitable work by organizations that wish to keep their ability to receive tax-deductible donations. In this regard, the public and taxpayers are the primary ones who benefit—through additional tax revenues available to reduce the public debt and through increased outreach and benefits provided to them by charitable organizations.

132. See Pappas, *supra* note 1, at 481, 507.

133. See Gustafsson, *supra* note 98, at 646–47.

134. See Pappas, *supra* note 1, at 481. For example, religion has been said to be inherently personal. See *Trebilcock v. Comm’r*, 64 T.C. 852, 854 (1975), *aff’d* 557 F.2d 1226 (6th Cir. 1977).

135. See U.S. National Debt Clock, http://www.brillig.com/debt_clock/ (last visited Jan. 15, 2010).

136. See Joseph Williams, *Obama Goes to Bat for Stimulus*, BOSTON GLOBE, Jan. 6, 2009, at 6.