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The Charitable Contribution Deduction: A Historical Review and a Look to the Future

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Vada Waters Lindsey*

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I. INTRODUCTION

A taxpayer is entitled to a charitable contribution deduction for gifts of money or property made during the taxable year to nonprofit organizations.¹ A taxpayer is not entitled to a deduction for the contribution of services.² There are a wide variety of organizations to which a taxpayer can donate money or property and receive a charitable contribution deduction.³ These organizations are thought to enhance the betterment of society and are therefore generally relieved of tax obligations,⁴ and contributions to the tax-exempt organizations are deductible under § 170 of the Internal Revenue Code (the "Code").

Section 170 has gone through countless statutory revisions since its enactment in 1917. As originally enacted, the provision was designed to allow "wealthy" taxpayers to receive a deduction for charitable giving.⁵ Although the basic premise remains the same, the current statutory scheme has been transformed from a short statutory provision into a complex set of rules. Many commentators have written about the complexity of the Code, in general, and have outlined proposals for simplification.⁶ Scholarship has also addressed methods

1. I.R.C. § 170(a) (2002).

2. Treas. Reg. § 1.170A-1(g) (2002). The out-of-pocket expenses associated with the provision of services are, however, deductible. *Id.*

3. For example, during taxable year 1997, Microsoft's Bill and Melinda Gates's charitable contributions included \$200 million to establish the Gates Library Foundation, \$20 million to Cambridge University, \$10 million to Lakeside School, \$2.3 million to Johns Hopkins University, \$1.8 million to Access to Voluntary and Safe Contraception, \$1.1 million to Friends of Mandela Children's Fund, and \$1 million to the Catholic Archdiocese of Seattle. GIVING USA 1998: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 1997, at 138 (Ann E. Kaplan ed., 1998) [hereinafter GIVING USA 1998].

4. See I.R.C. § 501 (2002) (setting forth exemption from taxation for certain organizations).

5. See *infra* note 163 and accompanying text.

6. See, e.g., Daniel J. Mitchell, *Perspective: The Inevitability of the Flat Tax*, 48 EMORY L.J. 829 (1999) (asserting the inevitability of the flat tax, considering the complexity and inequality created under the current tax code); Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 334 (1972) (stating, "[b]ecause the present situation has grown to such an alarming point of

of simplifying the charitable contribution provisions.⁷ This Article will address the complexity inherent in the charitable contribution provisions and explain why such complexity is essential to maintain an equitable statutory scheme that encourages charitable giving but prevents tax abuse.

While the statutory complexity is essential, there are other problems with the statutory scheme of charitable giving. One of these problems is the strain between the charitable contribution rules and the progressive tax system. The charitable contribution rules affront the progressive tax system because of the inability of nonitemizers to claim a charitable contribution deduction⁸ and because of the impact of the so-called “upside down” subsidy. The present law precludes many taxpayers from availing themselves of the deduction and allows other taxpayers to claim the deduction while maintaining and solidifying their position and power in the community.⁹ The effectiveness of the charitable contribution deduction is also limited by Congress’s enactment of legislation that gradually eliminates the estate tax.¹⁰ Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax will be completely phased out for taxpayers dying after 2009.¹¹ Under the present estate taxation provisions, a donor is entitled to claim an unlimited charitable contribution deduction for

crisis, a commission should be established, consisting of informed experts in all participating groups, which will seek to reverse the trend toward complexity”); Richard P. Davies, Note, *A Flat Tax Without Bumpy Philanthropy: Decreasing the Impact of a ‘Low, Single Rate’ on Individual Charitable Contributions*, 70 S. CAL. L. REV. 1749, 1797 (1997) (arguing that Congress should enact an “impure flat tax plan” that furthers the goal of simplification but retains the charitable contribution deduction).

7. See, e.g., C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AMER. J. TAX POL’Y 399 (1995).
8. IRS statistics clearly show that a greater percentage of lower-income taxpayers claim the standard deduction rather than itemized deductions. For taxable year 1998, of the 85.6 million taxpayers who claimed the standard deduction, more than one-half of them had adjusted gross incomes of under \$20,000. Internal Revenue Serv., STAT. INCOME BULL., Fall 2000, at 33.
9. Alice Gresham Bullock, *Taxes, Social Policy and Philanthropy: The Untapped Potential of Middle- and Low-Income Generosity*, 6 CORNELL J.L. & PUB. POL’Y 325, 330-31, 342 (1997). Professor Bullock derives this position from the so-called “upside-down” effect or subsidy, denial of a deduction to nonitemizers, and creation of foundations by wealthy taxpayers. *But cf.* Matthew F. Jones, Comment, *The Other Family Tree: Leaving Your Legacy in a Private Foundation*, 63 ALB. L. REV. 567 (1999) (stating that one of the advantages to establishing private foundations is the donor’s ability to maintain the contributed assets).
10. The reduction of income tax rates also impacts charitable giving. See Davies, *supra* note 6, at 1750.
11. See 2001 TAX LEGISLATION: LAW, EXPLANATION AND ANALYSIS: ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001, ¶ 305, at 99 (CCH, 2001) [hereinafter 2001 TAX LEGISLATION].

bequests to a qualified charitable organization.¹² In 1997, decedents claimed \$14.3 billion in charitable contribution deductions on their estate tax returns.¹³ Empirical data show that a charitable contribution subsidy generally increases charitable contributions.¹⁴ The eventual repeal of the estate tax will obliterate the tax incentive for a decedent to make charitable bequests.¹⁵

There are, however, occasions when individuals will be overly philanthropic irrespective of the tax incentive. In recent days, there has been a concentrated effort to raise charitable funds to address the myriad of problems facing victims of the horrific September 11, 2001 attacks on the World Trade Center in New York and on the Pentagon in Virginia, as well as victims of the tragic plane crash in Pennsylvania. At least \$500 million in charitable donations has been pledged to the victims.¹⁶ After the tragedies of September 11, people even used the Internet to make charitable donations.¹⁷ This charitable giving resulted from the tragic attacks rather than from a desire to lower one's tax liability. Other than a national tragedy such as the September 11 attacks, it is doubtful that people would be willing to donate at this high of a level. Consequently, a charitable contribution tax incentive has continued vitality insofar as it encourages people to make charitable donations throughout the year.

An argument can be raised that the charitable contribution deduction is an ineffective means of subsidizing charitable organizations. In addition, the complexity and inequity of the current charitable contribution provisions raise inefficiency concerns. In light of these problems, one might opine that the charitable contribution deduction should be repealed altogether and that the government should instead subsidize charitable organizations through direct expenditures. The use of direct expenditures would simplify the Code and would have the added advantage of efficiency. However, constitutional constraints work against using public funds to directly support religious-based charitable organizations, and almost one-half of charitable contributions are made to such organizations.¹⁸ It is not impermissible for the government to subsidize religious-based and other nonprofit organiza-

12. I.R.C. § 2055(a) (2002).

13. See *infra* note 205 and accompanying text.

14. Todd Izzo, Comment, *A Full Spectrum of Light: Rethinking the Charitable Contribution Deduction*, 141 U. PA. L. REV. 2371, 2372-73 (1993).

15. Although it is unclear whether the estate tax repeal will be permanent, it is likely that it will be, or, if it is not, it is likely that the tax will be limited to large estates. See *infra* notes 206, 214-16 and accompanying text.

16. David Barstow, *A Nation Challenged: The Donations; Spitzer Plans to Coordinate Charity Efforts for Victims*, N.Y. TIMES, Sept. 26, 2001, at B10.

17. Janet Kornblum, *Donations Soar Immediately on Net*, USA TODAY, Sept. 18, 2001, at 12C. For example, Amazon reported that its site had received \$150,000 per hour while the donation ceiling was \$100 per donation. *Id.*

18. See *infra* note 142 and accompanying text.

tions indirectly through tax deductions. As such, the most effective system of governmental subsidization of charitable organizations involves the use of direct expenditures that do not implicate constitutional constraints in conjunction with the charitable contribution deduction tax incentive.

Part II of this Article explores the history of § 170 from its initial enactment in 1917 through the numerous amendments since made.¹⁹ This Part does not outline every amendment that Congress has enacted but provides sufficient detail to illustrate how the section has gone from a fairly simple provision to an extremely complex set of rules. Part III of this Article addresses various equity considerations. The first issue examined is whether charities have societal value that should be encouraged or subsidized under the Code. Alternatively, this Article considers the use of direct expenditures as the primary means of the government's subsidization of charitable organizations and discusses the constitutional roadblocks to direct expenditures. Part III also addresses whether the complex rules that exist today are necessary to achieve the statutory objectives.²⁰ Part III also addresses how the charitable contribution deduction fails to further the needs of the poor and whether the provisions should be amended to provide an additional incentive for taxpayers to make contributions to organizations that are designed to combat poverty. Finally, this Part addresses how the charitable contribution rules impact the progressive tax structure and how the current scheme is inconsistent with progressive taxation.

Part IV of this Article considers perspectives on the future of charitable giving. This Part analyzes the impact of the elimination of the estate tax and addresses whether Congress should enhance the incentives for charitable giving in light of the phaseout of the estate tax. This might be necessary if the repeal of the estate tax is made permanent. Finally, this Part addresses whether Congress must make some statutory adjustments to the charitable contribution rules to protect the integrity of the progressive tax structure.

19. This Article focuses primarily on charitable giving as it relates to individual donors. For an in-depth discussion and analysis of corporate giving, see Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, The Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994).

20. It is beyond the scope of this Article to critically analyze all the fundamentals of charitable giving. This Article also does not provide guidance for the careful planning that is required in order to maximize the objectives of the charitable organization and of the donor. For a detailed discussion of these matters, see JAMES W. COLLITON, *CHARITABLE GIFTS* (3d ed. 1999), and BRUCE R. HOPKINS, *THE TAX LAW OF CHARITABLE GIVING* (1993).

II. THE HISTORY OF § 170 AND ITS INCREASED COMPLEXITY

A. The Early Years: 1917-1924

To encourage private philanthropy, Congress included a charitable contribution deduction in the Code. The original charitable deduction was provided in the War Income Tax Revenue Act of 1917. The statutory language provided:

Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.²¹

Congress has made substantial changes to the charitable contribution rules since the original enactment in 1917. Some of the amendments were inconsequential while others represented material changes to the statutory provision.

For instance, within a relatively short period of time, Congress proposed changes to the 15% ceiling. Although not enacted, in the Revenue Act of 1924, the Senate Finance Committee proposed the elimination of the 15% ceiling where a taxpayer had contributed more than 90% of the taxpayer's net income during the current taxable year and the preceding ten taxable years.²² If Congress had repealed the percentage limitation, a taxpayer theoretically could have manipulated the taxpayer's tax liability by eliminating all taxable income through charitable giving. However, the Senate Finance Committee perceived less tax abuse where a taxpayer consistently contributed large percentages of the taxpayer's taxable income over a long period of time.²³

B. Tax Period 1938-1958

The Revenue Act of 1938 made some modest, though significant, modifications to the charitable contribution deduction rules. One significant change was that Congress permitted the charitable contribution deduction only if the taxpayer actually made the payment during

21. War Income Tax Revenue Act of 1917, ch. 63, § 1201(2), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 944 (1938).

22. SEIDMAN, *supra* note 21, at 733.

23. The legislative history for this proposal provides, "This provision is designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equaling virtually his entire income." *Id.* at 734.

the taxable year, irrespective of the taxpayer's method of accounting.²⁴ According to the committee reports, the intent of the amendment was to clarify uncertainty and provide uniformity as to whether a taxpayer would be entitled to a charitable contribution deduction upon a pledge of a contribution, notwithstanding that the payment would not necessarily be made until the following taxable year.²⁵ Prior to the amendment, the statute was silent as to when a taxpayer was entitled to claim the deduction where the taxpayer made the charitable pledge during the taxable year but did not make the payment until a later taxable year.²⁶

Also, Congress eventually made changes to the 15% ceiling. Under the Individual Income Tax Act of 1944, Congress retained the 15% ceiling but changed its measurement from "net taxable income" to "adjusted gross income."²⁷ Net taxable income was defined as gross income less allowable deductions except charitable contributions.²⁸ Net taxable income was not limited to ordinary net income but also included net capital gains.²⁹ The effect of this change was to increase the allowable deduction. The adjusted gross income could exceed net taxable income because taxable income was computed after factoring in allowable deductions. For example, if a taxpayer had an adjusted gross income of \$25,000, the maximum deduction would be \$3,750. Alternatively, where the deduction is based on taxable income, and the taxpayer had paid \$2,000 in taxes during the year, the maximum charitable contribution deduction would be \$3,450. In 1952, Congress made another substantive change to the ceiling by increasing the maximum amount of the deduction from 15% to 20% of adjusted gross income.³⁰

In 1954, Congress renumbered the charitable contribution deduction provisions to the current § 170. Congress also increased the permissible maximum deduction that could be claimed by individual

24. Revenue Act of 1938, [1939] 1 Stand. Fed. Tax Serv. (CCH) ¶ 328.

25. Comm. Reports on 1938 Bill, [1939] 1 Stand. Fed. Tax Serv. (CCH) ¶ 328, at 1889-90.

26. *See, e.g.*, *Mann v. Comm'r*, 35 F.2d 873 (D.C. Cir. 1929) (holding that the taxpayer was not entitled to a deduction for accrued charitable pledges because the taxpayer was a cash basis taxpayer, and it was unlikely the taxpayer would have been able to claim the deduction even as an accrual basis taxpayer); *Appeal of Musselman*, 1 B.T.A. 41 (1924) (holding that an accrual basis taxpayer is able to deduct charitable contributions during the year that he promised payment rather than the following year when he actually made the payment).

27. Individual Income Tax Act of 1944, [1944] 1 Stand. Fed. Tax Serv. (CCH) ¶ 323, at 2055.

28. *Helvering v. Bliss*, 293 U.S. 144 (1934).

29. *Id.*

30. [1952] 2 Stand. Fed. Tax Rep. (CCH) ¶ 328, at 6005 (Aug. 13, 1952) (citing "P.L. 465, 82nd Cong. (H.R. 7345)").

taxpayers from 20% to 30% of adjusted gross income.³¹ The one caveat for entitlement to the additional 10% was that it had to actually be paid to the charitable organization rather than “for the use of” the charitable organization.³² Hence, payments to a trust for the benefit of a charitable organization would not qualify for the additional 10%. More importantly, the additional 10% deduction was allowable only if the contribution was made to churches or religious orders, educational institutions, or hospitals.³³ The intention underlying this statutory amendment was to encourage additional contributions to these organizations to offset their rising costs and modest returns on endowment funds.³⁴ This amendment represented the first of several amendments to the various percentage limitations presently included in the charitable contribution rules. This was also the first time that Congress encouraged certain charitable giving by granting more generous deductions for donations given to certain charitable organizations than to others.

In 1958, Congress made several amendments to § 170(b). Under § 170(b)(3), the amount of the charitable contribution deduction disallowed because of the provision’s limitations on charitable contribution deductions became deductible in a succeeding year as a net operating loss carryover under § 172.³⁵ Congress also amended § 170(b) to avoid double deductions for both interest and charitable contributions.³⁶ Where a charitable organization had taken property subject to a liability or had assumed a liability upon the receipt of the property,³⁷ the taxpayer’s charitable contribution deduction would be reduced by any interest paid subsequent to the charitable contribution that was attributable to the liability.³⁸

C. Tax Period 1960-1969

In 1960, Congress amended the charitable contribution provisions to allow a deduction of up to \$50 per month for taxpayers who main-

31. H.R. REP. NO. 83-1337 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4190.

32. *Id.*

33. I.R.C. § 170(b)(1)(A)(i)-(iii) (1954).

34. H.R. REP. NO. 83-1337 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4050.

35. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 11, 72 Stat. 1606, 1609. While this amendment provided the carryover to corporations only, a later amendment provided the carryover to individuals. Revenue Act of 1964, Pub. L. No. 88-272, § 209, 78 Stat. 19, 43.

36. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 12, 72 Stat. 1606, 1610.

37. Where a recipient merely takes the property subject to a liability or mortgage, the recipient is not personally obligated to repay the liability. If the liability is a secured obligation, the remedy for the creditor would be foreclosure. Conversely, where a recipient assumes the liability, the recipient is personally liable and the creditor can proceed against the recipient by levying on the recipient’s assets and initiating any other viable collection methods.

38. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 12, 72 Stat. 1606, 1610.

tained an elementary, middle, or high school student as a member of the taxpayer's household.³⁹ The provision applied where the taxpayer made maintenance expenditures on behalf of the student in accordance with a program sponsored by the charitable organization and pursuant to a written agreement with a charitable organization.⁴⁰ Under a 1962 amendment, Congress reduced a taxpayer's charitable contribution deduction by the amount that would have been § 1245 gain⁴¹ if the taxpayer had sold the property at its fair market value.⁴² Further, Congress added "foundations for certain state colleges and universities" to the list of nonprofit organizations that entitled taxpayers to the additional 10% deduction.⁴³

In 1964, Congress made several amendments to § 170 by adding additional organizations that qualified for the 30% limitation. Congress increased the list of its tax-favored organizations by adding those that receive a substantial part of their support from a governmental unit or from the general public.⁴⁴ Congress also enacted an unlimited charitable contribution deduction for a taxpayer who contributed more than 90% of the taxpayer's taxable income for that taxable year and for eight of the last ten taxable years.⁴⁵ The Senate Finance Committee had introduced a similar bill in 1924, but it was not enacted at that time.⁴⁶

The next amendment to the charitable contribution provisions occurred upon the enactment of the Tax Reform Act of 1969. Congress enacted many of the current rules dealing with charitable gifts under this Act. The Tax Reform Act of 1969 was enacted at a time when members of both the House of Representatives and the Senate believed that taxpayers with the highest income were not paying their fair share of taxes.⁴⁷ For example, in 1966, there were 154 taxpayers whose adjusted gross incomes exceeded \$200,000 and twenty-one taxpayers whose adjusted gross incomes exceeded \$1 million who did not pay any income tax.⁴⁸ Members of Congress felt that many of these taxpayers were engaging in certain transactions solely to reduce their

39. Charitable Contribution Amendments of 1960, Pub. L. No. 86-779, § 7, 74 Stat. 998, 1002.

40. *Id.*

41. Generally, under § 1245 of the Code, where a taxpayer disposes of certain depreciable property, gain that is attributable to depreciation must be recharacterized as ordinary income. See I.R.C. § 1245(a)(1).

42. Revenue Act of 1962, Pub. L. No. 87-834, § 13(d), 76 Stat. 960, 1034.

43. Charitable Contribution Amendments of 1962, Pub. L. No. 87-858, § 2, 76 Stat. 1134, 1134.

44. Revenue Act of 1964, Pub. L. No. 88-272, § 209, 78 Stat. 19, 43.

45. [1964] 2 Fed. Taxes (Prentice-Hall, Inc.) ¶ 12,034, at 12,038 (Jan. 1, 1964).

46. See *supra* note 22 and accompanying text.

47. H.R. REP. NO. 91-413 (1969), reprinted in 1969 U.S.C.C.A.N. 1645, 1653.

48. *Id.*

taxes rather than to further economic objectives.⁴⁹ Higher income taxpayers used itemized deductions as a primary catalyst to reduce their tax liabilities.⁵⁰ As a result, Congress took steps to reduce the perceived tax abuse. Congress phased out the unlimited charitable contribution deduction by slowly lowering it, by 1974, to a maximum deduction of 50% of a taxpayer's adjusted gross income.⁵¹ Consequently, the unlimited charitable contribution survived for a mere five years. Congress, also in 1969, raised the previous ceiling on deductions from 30% to 50% of the contribution base⁵² and broadened the applicable contributions to include "operating foundations."⁵³ In addition, the Act also dealt heavily with the contribution of appreciated property. The 1969 Act reformed the charitable contribution rules by enacting new provisions that were intended to reduce the benefit taxpayers received when donating appreciated property. Under the Act, where a taxpayer had made a contribution of appreciated property to public charities, the deduction was limited to 30% of the contribution base.⁵⁴ If a taxpayer elected to limit the charitable contribution deduction to the adjusted basis of the contributed property, the maximum deduction was limited to 50% rather than to 30% of the contribution base.⁵⁵ Prior to the Tax Reform Act of 1969, much of the taxpayer abuse occurred where the taxpayer contributed appreciated property and claimed a deduction.⁵⁶ If a taxpayer elected to claim the deduction based on the adjusted basis rather than on the fair market value, the perceived tax abuse would be greatly reduced.

Under the Tax Reform Act of 1969, a taxpayer's charitable contribution deduction must be reduced by the amount of short-term capital gain or ordinary income the taxpayer would have had to recognize had the taxpayer sold the property at its fair market value rather than

49. *Id.* at 1655.

50. *Id.* at 1653. During taxable year 1966, itemized deductions totaled \$130 million and 116% of the adjusted gross income. *Id.*

51. 1 A PRACTITIONER'S GUIDE TO THE TAX REFORM ACT OF 1969, at 74 (Miriam I.R. Eolis & Joseph S. Robinson eds., 1970) [hereinafter PRACTITIONER'S GUIDE].

52. The contribution base is defined as the taxpayer's adjusted gross income less any net operating loss carryback. I.R.C. § 170(b)(1)(f) (2002).

53. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a)(1)(B), 83 Stat. 487, 551. The term "operating foundation" is further defined in § 4942(j)(3) of the Code as "a private foundation at least 85% of whose income is spent directly for the active conduct . . . of the purpose . . . for which it was organized." 1 PRACTITIONER'S GUIDE, *supra* note 51, at 72.

54. Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 201(a)(1)(B), § 170(b)(1)(D), 83 Stat. 487, 551.

55. *Id.* § 170(e)(1)(A), 83 Stat. at 555.

56. In 1966, almost \$79 million of the \$130 million in itemized deductions were allocable to the charitable contribution deduction. H.R. REP. NO. 91-413 (1969), reprinted in 1969 U.S.C.C.A.N. 1645, 1654. Seventy percent of the charitable contribution deductions arose from contributions of property, and the majority of that property was untaxed appreciated property. *Id.*

donated the appreciated property to a charitable organization.⁵⁷ The provision applied to assets held for six months or less,⁵⁸ § 306 stock,⁵⁹ and inventory.⁶⁰ In such a case, the charitable contribution deduction was limited to the taxpayer's cost basis of the property, unless the taxpayer elected to recognize gain on the transfer. A primary focus of this change was to prevent businesses from structuring a deal as a donation of appreciated property and receiving deductions equal to the fair market value of the property, rather than claiming a business expense, which would be deductible at cost.⁶¹ After the amendment, there was uniform treatment irrespective of whether the business made a charitable contribution or claimed a deduction for a business expense.

The apparent tax evasion that Congress intended to prevent was illustrated in *Bialo v. Commissioner*.⁶² In *Bialo*, the taxpayer owned more than 86% of the stock of a closely-held corporation.⁶³ The corporation distributed a pro rata dividend of nonvoting preferred stock on common stock at a time when the corporation had earnings and profits. Within two weeks of the stock receipt, the taxpayer contributed the stock to a charitable trust. The taxpayer acknowledged that the preferred stock was issued to enable the taxpayer to make a charitable contribution without altering the taxpayer's control over the corporation.⁶⁴ The issuing corporation redeemed the stock fourteen months after the charitable trust received the stock. The abuse arising from this transaction was succinctly stated by the court: "[P]etitioner attempted to use Universal's earnings and profits to make a charitable contribution for which petitioner took a deduction while neither recognizing dividend income nor losing control of the corporation."⁶⁵ The accountant who provided the taxpayer with tax advice regarding the transaction noted the potential tax savings. If the corporation had made a taxable distribution to the taxpayer of \$100,000, the taxpayer

57. 1 PRACTITIONER'S GUIDE, *supra* note 51, at 72.

58. Today, a short-term capital gain arises when the taxpayer disposes of an asset held for no more than one year rather than six months. I.R.C. § 1222(1) (2002).

59. Section 306 of the Code requires a taxpayer to recognize ordinary rather than capital gain income on the disposition of stock (other than common stock) that had been received in a stock distribution from a corporation and hence excluded from the taxpayer's gross income in accordance with § 305. Section 306 was enacted to prevent capital gain treatment of the so-called "preferred stock bailouts," defined as a distribution of preferred stock followed by a sale or redemption of the stock. *Bialo v. Comm'r*, 88 T.C. 1132 (1987).

60. Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 201(a)(1)(B), § 170(e)(1)(A), 83 Stat. 487, 555.

61. 1 PRACTITIONER'S GUIDE, *supra* note 51, at 73.

62. 88 T.C. 1132 (1987).

63. *Id.* at 1139.

64. *Id.* at 1135.

65. *Id.* at 1138 n.6.

would have had after-tax income of \$35,000 based on his marginal tax bracket.⁶⁶ However, by distributing the preferred stock instead, the taxpayer would not have had a realization event upon the distribution but would have received a charitable contribution deduction of \$100,000 upon his contribution of the stock to his charitable trust.⁶⁷ In another case, the Tax Court concluded that even absent the egregious evidence of tax avoidance, the tax avoidance could be inferred from the objective facts.⁶⁸ In that case, the taxpayer argued that the stock was not § 306 stock because the disposition of the preferred stock was not pursuant to a plan with a principal purpose of avoiding federal income taxes; however, the Tax Court rejected petitioner's argument.⁶⁹

The 1969 Act also addressed contributions of appreciated property where the taxpayer would have recognized long-term capital gain if the property had been sold at its fair market value. Under the Act, a taxpayer's charitable contribution deduction was reduced by 50%⁷⁰ of the appreciation that would have been long-term capital gain if the property had been sold at its fair market value.⁷¹ The reduction applied to gifts of tangible personal property to a donee or governmental unit if the item donated was unrelated to the purpose or function of the recipient.⁷² For example, the reduction would not apply to a work of art donated to a university and used in the art department for course study, but the reduction would apply if the art work was displayed in a dean's office.⁷³ In addition, the reduction applied to contributions to a private nonoperating foundation⁷⁴ unless the foundation distributed the property within two and one-half months after the close of the year in which the contribution was made. The 1969 Tax Reform Act introduced a basis allocation rule for bargain sales to char-

66. *Id.* at 1141.

67. *Id.*

68. *Pescosolido v. Comm'r*, 91 T.C. 52, 60 (1988).

69. The court concluded that the exception applied to dispositions of § 306 stock by minority shareholders only, or where there is a prior or simultaneous disposition of the common stock with respect to which the preferred stock was issued. *Id.* at 58.

70. The percentage is 62.5% if the contribution involves corporate donors. 1 PRACTITIONER'S GUIDE, *supra* note 51, at 73.

71. 1 *id.*

72. 1 *id.*

73. 1 *id.*

74. Treasury Regulations define "non-operating foundations" in the following manner:

If a foundation fails to satisfy the income test and either the assets, endowment, or support test for a particular taxable year under either the [three-out-of-four-year] method or the aggregation method, it shall be treated as a nonoperating foundation for such taxable year and for all subsequent taxable years until it satisfies the tests set forth.

Treas. Reg. § 53.4942(b)-3 (2002).

itable organizations.⁷⁵ The Act required taxpayers to allocate basis to both the sale portion and donated portion of the property. The percentage of basis allocation was determined by computing the ratio of the basis and fair market value. A corresponding portion of basis was allocated to the sale, and the taxpayer was required to recognize capital gain from the bargain sale. Of course, the taxpayer was still entitled to a deduction for the gift portion of the property transferred to the charitable organization.

D. Tax Period 1970-1988

The Tax Reform Act of 1976 brought about changes in corporate charitable contributions of inventory and deductions for expenses incurred in order to help influence legislation. Corporations, other than subchapter S corporations, could deduct up to one-half of the appreciation plus the taxpayer's basis on certain types of ordinary income property contributed.⁷⁶ Congress denied deductions for individuals incurring expenses on behalf of charitable organizations to influence legislation. The purpose of this amendment was to ensure that enforcement of lobbying expenses could be done just by examining the books and records of the organization.⁷⁷ The Revenue Act of 1978 repealed the once unlimited charitable deduction that had already been reduced to 50% in 1969.

During 1981, Congress amended the Code to permit a taxpayer who did not itemize deductions to claim the charitable contribution deduction. The amendment was effective for contributions made during taxable years 1982 through 1986.⁷⁸ Consequently, many low- and middle-income taxpayers were able to claim the deduction. Congress enacted the amendment to "stimulate[] charitable giving, thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by the Federal Government."⁷⁹ During the period that taxpayers were not required to itemize deductions in order to claim the charitable contribution deduction, they were only permitted to claim a certain percentage of an allowable dollar cap as herein shown:

75. 1 PRACTITIONER'S GUIDE, *supra* note 51, at 76.

76. Comm. Reports on Pub. L. No. 94-455 (Tax Reform Act of 1976), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,865-25,866.

77. *Id.*

78. H.R. CONF. REP. NO. 97-215, at 201-02 (1981), *reprinted in* 1981 U.S.C.C.A.N. 285, 291-92 (reporting on Economic Recovery Tax Act of 1981).

79. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY AND TAX ACT OF 1981, at 49 (Joint Comm. Print 1981).

<i>Taxable Year</i>	<i>Percentage</i>	<i>Dollar Cap</i>
1982 and 1983	25%	\$100
1984	25%	\$300
1985	50%	none
1986	100%	none ⁸⁰

A minor amendment to the charitable contribution provisions was enacted under the Tax Equity and Fiscal Responsibility Act of 1982 when Congress added amateur athletic organizations to the list of organizations warranting charitable contribution deductions. Congress made more significant amendments to § 170 under the Deficit Reduction Act of 1984. Under that Act, Congress required substantiation of the claimed value of donated property that exceeded \$2,000 and imposed penalties for overvaluation of such donated property.⁸¹ Further, the Act provided for the extension of the five-year carryover deduction for individuals to include contributions to private nonoperating foundations, and Congress increased the 20% ceiling on such contributions to 30% for contributions of cash or ordinary income property.⁸²

In 1986, Congress declined to make permanent the temporary provision that made the charitable contribution deduction an above-the-line deduction. Consequently, taxpayers could only claim the expense upon itemizing their deductions. The Revenue Act of 1987 simply clarified Congress's stance on organizations involved in political activities⁸³ by imposing a statutory disqualification for such organizations, even if they partly "qualified as a tax exempt charitable organization."⁸⁴

The Technical and Miscellaneous Revenue Act of 1988 resulted in two changes to § 170. Under the first change, if a taxpayer made a charitable contribution to a college or university and received the right to either directly or indirectly purchase athletic tickets, the taxpayer would only be able to claim a deduction of 80% of the contribution.⁸⁵ Under the second change, Congress required less strict substantiation requirements for corporate donations of inventory to be used for care of the ill, the needy, or infants.⁸⁶

80. *Id.* at 50; *see also* H.R. CONF. REP. NO. 97-215, at 201-02 (1981), *reprinted in* 1981 U.S.C.C.A.N. 285, 291-92 (reporting on Economic Recovery Tax Act of 1981).

81. Comm. Reports on Pub. L. No. 98-369 (Deficit Reduction Act of 1984), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,859.

82. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 301(a)(1), 98 Stat. 494, 777.

83. Organizations involved in political activities are defined as those that participate or intervene in any political campaign of a candidate who is running for public office. Comm. Reports on Pub. L. No. 100-203 (Revenue Act of 1987), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,857-25,858.

84. *Id.*

85. Comm. Reports on Pub. L. No. 100-647 (Technical and Miscellaneous Revenue Act of 1988), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,857.

86. *Id.*

E. Tax Period 1993-1998

In 1993, Congress passed the Omnibus Budget Reconciliation Act, which contained two provisions for § 170. First, § 170 was amended to disallow any deduction for a contribution of \$250 or more unless the taxpayer has written substantiation from the donee organization.⁸⁷ This amendment significantly decreased the amount previously set as the substantiation requirement, which had been \$2,000 under the Deficit Reduction Act of 1984.⁸⁸ The second provision required the donee charitable organization to inform, by written statement, any donor of a contribution over \$75 made partly as a contribution and partly in consideration of goods and services that the amount allowable for deduction is the excess of the contribution less the amount of goods and services received.⁸⁹

In 1996, Congress introduced a small amendment to § 170 in the Small Business Job Protection Act. The amendment allowed contributions of qualified appreciated stock to be made to private foundations in compliance with § 170(e)(5).⁹⁰ This amendment was effective only from July 1, 1996 through May 31, 1997.⁹¹ The Taxpayer Relief Act of 1997 expanded the qualified contribution list to include gifts of computer technology and equipment donated either to any educational organization or to a § 501(c)(3) entity organized for the primary purpose of supporting elementary and secondary education.⁹² One of the final amendments of this Act extended the effective date of the allowance for contributions of stock to private foundations until June 30, 1998. However, this extension would become permanent with the passage of the Tax and Trade Relief Extension Act of 1998.⁹³

F. Summary of Major Changes

It is undisputable that the charitable contribution rules have encountered many modifications since their early enactment in 1917. To recapitulate some of the most important aspects of the current charitable contribution deduction rules, the Code limits the maximum deduction for individual donors to 50% of the contribution base, which is defined as the adjusted gross income less any net carryover loss for

87. Comm. Reports on Pub. L. No. 103-66 (Omnibus Budget Reconciliation Act of 1993), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,855.

88. See *supra* note 81 and accompanying text.

89. Comm. Reports on Pub. L. No. 103-66 (Omnibus Budget Reconciliation Act of 1993), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,856.

90. Comm. Reports on Pub. L. No. 104-188 (Small Business Job Protection Act of 1996), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,855.

91. *Id.*

92. Comm. Reports on Pub. L. No. 105-34 (Taxpayer Relief Act of 1997), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,854.

93. Comm. Reports on Pub. L. No. 105-277 (Tax and Trade Relief Extension Act of 1998), [2002] 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,854.

gifts to charitable organizations such as churches, educational organizations, health care organizations, and private foundations.⁹⁴ Congress enacted the 50% ceiling under the Tax Reform Act of 1969. If a taxpayer makes a charitable contribution to other types of charitable organizations, such as nonoperating foundations, the maximum deduction is 30% of the contribution base.⁹⁵ Congress enacted this amendment under the Deficit Reduction Act of 1984. Where a taxpayer makes a contribution of appreciated property to public charities, the deduction is limited to 30% of the contribution base.⁹⁶ However, charitable contributions to all other charitable organizations made in the form of appreciated property is limited to 20% of the contribution base.⁹⁷ If the taxpayer contributed property that would have produced ordinary income, the deduction must be reduced.⁹⁸ If a taxpayer elects to limit the charitable contribution deduction to the adjusted basis of the contributed property, the maximum deduction is limited to 50% of the contribution base. Finally, to the extent that a taxpayer's charitable contribution deduction is limited, it is carried forward for up to five years.

III. EQUITY CONSIDERATIONS

A. In General

There are several interrelated equity issues that arise in the charitable contribution setting. The first logical question is whether charitable organizations add any societal value. If so, the issue arises as to whether the objectives of charitable organizations should be subsidized under the Code. The second equity consideration relates to the complexity of the charitable contribution rules and addresses scholarly proposals to simplify the charitable contribution rules by eliminating percentage limitations. A third issue is whether the charitable contribution rules should be amended to add an additional incentive for taxpayers to make contributions to organizations that are designed to combat poverty. The final issue pertains to the current inability of lower-income taxpayers to receive tax subsidies for their charitable giving and the impact of the current charitable contribution deduction on the progressive tax structure.

94. The list of eligible organizations is found in § 170(b)(1)(A) of the Code.

95. I.R.C. § 170(b)(1)(B) (2002).

96. *Id.* § 170(b)(1)(C).

97. *Id.* § 170(b)(1)(D).

98. *Id.* § 170(e)(1).

B. The Tangible Value and Promotion of Charitable Organizations

1. *The Tangible Value of Charitable Organizations*

Congress enacted the charitable contribution provisions to encourage charitable giving. Charitable organizations provide meaningful resources to the community. The societal value of charitable organizations cannot seriously be challenged by anyone. For example, in 1996, it was estimated that 8.4 million people worldwide were infected with AIDS and an additional 21.8 million people had HIV.⁹⁹ Medical advances have fortunately prolonged the lives of people affected with full-blown AIDS and HIV. The byproduct of such prolonged life spans is the increased need for long-term care and residential facilities. The Bailey-Holt House, a residential facility in New York City for people infected with AIDS, reported that the average stay was two years, while approximately ten years earlier the average stay was less than one year.¹⁰⁰ Another organization, God's Love We Deliver, prepares and provides hot meals to homebound AIDS patients.¹⁰¹ Both of these charitable organizations establish the value of charitable organizations that provide basic necessities to individuals inflicted with this debilitating disease. There are countless other charitable organizations that support other worthwhile objectives. In addition, charitable organizations provide widespread indirect benefits that supplement the actual missions of charitable organizations. Charitable organizations also strengthen the economy by employing 8% of the national workforce.¹⁰² In 1997, charitable organizations provided \$277.1 billion in salaries, other compensation, and employee benefits.¹⁰³ Hence, charitable organizations have a considerable impact on the economy by employing such a large segment of the population.

2. *Subsidizing Charitable Organizations Through Tax Incentives Versus Direct Expenditures*

The use of tax subsidies is only one way to promote charitable organizations. Alternatively, the state or federal government could subsidize charitable organizations solely through direct expenditures. The justification for the government's grant of tax incentives for charitable organizations and charitable contributions is as follows:

99. GIVING USA 1998, *supra* note 3, at 96.

100. *Id.*

101. *Id.*

102. Felicity Barringer, *Moving Beyond the Four Horsemen of Philanthropy Beat*, N.Y. TIMES, Nov. 20, 2000, at F8.

103. Internal Revenue Serv., *supra* note 8, at 49.

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.¹⁰⁴

During taxable year 1999, the amount of charitable deductions claimed on all returns totaled approximately \$270 billion.¹⁰⁵ The government subsidized a percentage of that figure based on the taxpayers' marginal tax rates. Assuming, for example, that all taxpayers were in the 39.6% bracket, the actual government subsidy would have been \$107 billion. Based on the rationale for the charitable contribution tax subsidy, the government's loss in tax revenue is offset by avoiding the direct expenditure the government would have made to promote the general welfare absent the tax subsidy.

Arguably, direct expenditures provide a more efficient manner of funding charitable organizations than do tax subsidies. However, problems can surface when Congress directly allocates funds to religious organizations because of the constitutional requirement of separation of church and State.¹⁰⁶ Federal funds may be used to benefit religious-based organizations if the funding falls within the province of the charitable choice provisions of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996.¹⁰⁷ Under this Act, religious-based organizations are authorized to participate in federally funded social programs in the same manner as any other nongovernmental provider, provided the programs are constitutional under the Establishment Clause.¹⁰⁸ The Act expressly prohibits the use of federal funds for any sectarian worship, instruction, or proselytization.¹⁰⁹

104. ROBERT W. WILLAN, *INCOME TAXES, CONCISE HISTORY AND PRIMER* 31 (1994).

105. Internal Revenue Serv., *STAT. INCOME BULL.*, Spring 2001, at 274.

106. Under the Establishment Clause of the First Amendment of the United States Constitution, "Congress shall make no law respecting an establishment of religion." The Establishment Clause prevents the government from affiliating itself with a religious organization, promoting religious doctrine and organizations, and intervening in religious affairs. *Freedom From Religion Found., Inc. v. McCallum*, 179 F. Supp. 2d 950, 966 (W.D. Wis. 2002).

107. See 42 U.S.C. § 604a (2002). *But see* Carmen M. Guericagoita, *Innovation Does Not Cure Constitutional Violation: Charitable Choice and the Establishment Clause*, 8 *GEO. J. ON POVERTY L & POL'Y* 447 (2001) (analyzing the charitable choice rules and concluding that they violate the Establishment Clause). In *Freedom From Religion Foundation, Inc.*, the district court considered whether the charitable choice statute was unconstitutional under the Establishment Clause but concluded that the case did not actually involve a challenge to the statute. 179 F. Supp. 2d at 982.

108. 42 U.S.C. §§ 604a(a) & (c) (2002). The Act permits the states to either contract with the religious-based organizations or to accept certificates, vouchers, and other disbursement methods.

109. *Id.* § 604a(j).

In determining whether a charitable program violates the Establishment Clause, the landmark United States Supreme Court opinion of *Lemon v. Kurtzman*¹¹⁰ articulated the standard that courts traditionally applied. In *Lemon*, the Supreme Court held that the Establishment Clause was not violated where a program had a secular purpose, the program's primary effect neither advanced nor inhibited religion, and the program did not create excessive entanglement between government and religion.¹¹¹ The Establishment Clause was violated where any one of the tests was answered affirmatively. In addressing the second prong, the Supreme Court in *Agostini v. Felton*¹¹² modified the traditional approach by considering whether unrestricted cash payments were made directly to religious-based organizations, which would result in a violation of the Establishment Clause.¹¹³ Specifically, the courts have applied the following standards in determining whether government involvement is impermissible under the Establishment Clause:

States may not make unrestricted cash payments directly to religious institutions In contrast, when public funding flows to faith-based organizations solely as a result of the genuinely independent and private choices of individuals, the funding is considered indirect. When a program receives indirect funding, it is the individual participant, and not the state, who chooses to support the religious organization, reducing the likelihood that the public funding has the primary effect of advancing religion in violation of the establishment clause. A plurality of the Supreme Court has held that as long as the individual selects the publicly funded program freely, thus making the funding truly indirect, it is irrelevant whether the funding passes through the hands of the individual first or goes directly to the selected program.¹¹⁴

The federal courts have decided several cases involving whether the Establishment Clause was violated as a result of the funding of a religious-based program. In *Freedom from Religion Foundation, Inc. v. McCallum*,¹¹⁵ the United States District Court for the Western District of Wisconsin recently considered whether state funds provided for religious-based residential treatment for drug and alcohol addicts and faith-based counseling violated the Establishment Clause.¹¹⁶ Faith Works, the caregiver, received its funding from four sources, but only funding from Department of Corrections contracts and Department of Workforce Development grants raised constitutional concerns. Under a contract with the Department of Corrections, Faith Works operated a halfway house for long-term treatment and received reim-

110. 403 U.S. 602 (1971).

111. *Id.*, cited in *Freedom From Religion Found., Inc.*, 179 F. Supp. 2d at 966.

112. 521 U.S. 203 (1997).

113. *Freedom from Religion Found., Inc.*, 179 F. Supp. 2d at 970.

114. *Id.* (citations omitted).

115. 179 F. Supp. 2d 950 (W.D. Wis. 2002).

116. *Id.* at 953.

bursments when offenders enrolled in the program.¹¹⁷ One of the main components of the Faith Works program was that offenders had to be willing to “develop their faith and the spiritual aspects of their lives.”¹¹⁸ The offenders were not obligated to accept treatment at Faith Works and could enroll in some other facility. However, in Milwaukee, the largest city in Wisconsin, Faith Works was the only long-term residential treatment facility.¹¹⁹ If an offender objected to participating in the Faith Works programs, the offender would have been placed in a halfway house that was not faith-based. Faith Works also received grants totaling \$150,000 for fiscal year 1998 and \$450,000 for fiscal year 1999 from the Department of Workforce Development for its faith-based, long-term residential care program that addressed spiritual, emotional, and economic stability.¹²⁰ The funds were not disbursed on the basis of the number of individuals participating in the program, but rather were disbursed in a predetermined amount.

With respect to the Department of Workforce Development funding, the court granted summary judgment against Faith Works because the funding was based on a predetermined amount without regard to the number of participants who actually enrolled in the program.¹²¹ Consequently, the court concluded that it represented impermissible direct funding. With respect to the Department of Corrections funding, the court denied the motion for summary judgment because the facts did not establish that the offender made “a genuinely independent, private choice to attend Faith Works.”¹²² At the subsequent trial on the merits, the court concluded that the program did not violate the Establishment Clause, notwithstanding that the participants could participate in the Faith Works program only if they consented to the religious content.¹²³ The government’s involvement was considered to be indirect because the court found that the offenders made a genuinely independent and private choice to participate in the program.

In another case, *Johnson v. Economic Development Corp.*, the United States Court of Appeals for the Sixth Circuit considered whether the use of tax-exempt bonds to finance the construction of a Catholic elementary and secondary school violated the Establishment

117. *Id.* at 960.

118. *Id.* at 962.

119. *Id.*

120. *Id.* at 963.

121. *Id.* at 954.

122. *Id.* at 971.

123. *Freedom from Religion Found., Inc. v. McCallum*, 214 F. Supp. 2d 905 (W.D. Wis. 2002). While the counselors recommended a particular program, the offender had to consent to the program, and the counselors had to document the consent. *Id.*

Clause.¹²⁴ The plaintiff, a resident and taxpayer of Oakland County, alleged that the Economic Development Corporation violated the Establishment Clause when it issued tax-exempt bonds¹²⁵ to the Roman Catholic school. One of the arguments that the plaintiff raised was that there had never been a Supreme Court case holding that the Establishment Clause permitted the use of public funds to reimburse expenditures made by religious schools or to provide direct financial aid to these schools.¹²⁶ In rejecting the plaintiff's argument, the court cited a Supreme Court case that upheld a New York statute allowing the state to reimburse religious and secular nonpublic schools for the cost of performing state-mandated tests.¹²⁷ The Sixth Circuit also recognized the Supreme Court's refusal to adopt a categorical approach prohibiting all direct government aid.¹²⁸

While direct expenditures include loan and interest subsidies, the Sixth Circuit in *Johnson* refused to accept the plaintiff's argument that the tax-exempt revenue bonds were equivalent to cash subsidies within the meaning of the Establishment Clause.¹²⁹ The court distinguished subsidies from tax exemptions. The most significant difference between the two was that a tax exemption did not require the government to transfer part of its revenue.¹³⁰ Finally, the court applied the *Lemon* test, as modified by the Supreme Court in *Agostini*, and concluded that the tax-exempt revenue bonds did not violate the Establishment Clause.

One area that remains controversial is the use of school vouchers or tuition aid for children who attend religious private schools. The Supreme Court recently considered the constitutionality of the Ohio voucher program.¹³¹ By a narrow 5-4 margin, the Court overruled the Sixth Circuit's determination that the Ohio voucher program violated the Establishment Clause.¹³² Under the Ohio voucher program, the

124. 241 F.3d 501 (6th Cir. 2001). The Michigan Legislature enacted the Economic Development Corporation Act in 1974 to "alleviate and prevent conditions of unemployment." *Id.* at 503. The Legislature believed that providing assistance to local enterprises for renovation, construction, and remodeling would lower the unemployment rate.

125. The tax-exempt bonds carried lower interest rates than conventional loans.

126. *Id.* at 511.

127. *Id.* (citing *Comm. for Pub. Educ. & Religious Liberty v. Regan*, 444 U.S. 646 (1980)).

128. *Id.* The court cited a Supreme Court case for the proposition that "[i]t is . . . well established . . . that not every law that confers an indirect, remote, or incidental benefit upon religious institutions is, for that reason alone, constitutionally invalid." *Id.* at 510 (citing *Comm. for Pub. Educ. & Religious Liberty v. Nyquist*, 413 U.S. 756, 770 (1973)).

129. 241 F.3d at 511-12.

130. *Id.* (citing *Walz v. Tax Comm'n of N.Y.*, 397 U.S. 664, 675 (1970)).

131. *Zelman v. Simmons-Harris*, 122 S. Ct. 2460 (2002).

132. *Id.* at 2465. This Article does not attempt to address the myriad of constitutional issues that arise when public funds are used for religious-based schools. For de-

participating schools were authorized to use the program's monies for whatever purpose they deemed appropriate. Most of the schools that participated in the program were sectarian,¹³³ and most of these schools included religious teachings in their classes. The primary issue that the Court addressed was whether the program was unconstitutional because it advanced or inhibited religion.¹³⁴ Because the program benefits were available to participants on "neutral terms," without placing a premium or enhanced benefits for families selecting religious schools,¹³⁵ the Court concluded that the program did not offend the Establishment Clause.¹³⁶

Conversely, a circuit court judge in Florida ruled that that state's school voucher program was unconstitutional.¹³⁷ According to the court, the Florida Constitution¹³⁸ clearly and unambiguously prohib-

tailed discussion of these issues, see Nina J. Crimm, *Core Societal Values Deserve Federal Aid: Schools, Tax Credits, and the Establishment Clause*, 34 GA. L. REV. 1 (1999); Steven K. Green, *The Legal Argument Against Private School Choice*, 62 U. CIN. L. REV. 37 (1993); Roy Whitehead, Jr. & Walter Block, *Direct Payments of State Scholarship Funds to Church-Related Colleges Offend the Constitution and Title VI*, 14 BYU J. PUB. L. 191 (2000); R. Craig Wood & Michael C. Petko, *Assessing Agostini v. Felton in Light of Lemon v. Kurtzman: The Coming of Age in the Debate Between Religious Affiliated Schools and State Aid*, 2000 BYU EDUC. & L.J. 1; Kimberly M. DeShano, Note, *Educational Vouchers and the Religion Clauses Under Agostini: Resurrection, Insurrection and a New Direction*, 49 CASE W. RES. L. REV. 747 (1999); Scott A. Fenton, Comment, *School Voucher Programs: An Idea Whose Time Has Arrived*, 26 CAP. U. L. REV. 645 (1997).

133. For the 1999–2000 school year, 96% of the students enrolled in sectarian schools and 82% of the schools participating in the program were sectarian. *Zelman*, 122 S. Ct. at 2464.
134. *Id.* at 2465.
135. Interestingly, the Court found that the Ohio program actually provided financial "disincentives" for selecting religious schools because the participating public schools received more governmental assistance, and the families that participated were required to make a co-pay if their children attended either a religious or nonsectarian private school. *Id.* at 2468.
136. *Id.* at 2467–68. According to the Sixth Circuit, the Ohio program was ineffective to guarantee that the public funds would be used "exclusively for secular, neutral, and nonideological purposes." *Simmons-Harris v. Zelman*, 234 F.3d 945, 953 (6th Cir. 2000) (citing *Comm. for Pub. Educ. v. Nyquist*, 413 U.S. 756, 780 (1973)). The Sixth Circuit reasoned that, although the statute appeared facially neutral, the effect was not neutral because the Ohio voucher program discouraged participation of schools that were nonreligious, and parents could only select schools that participated in the program. *Id.* at 959. In addition, the religious schools had lower tuition because they had lower overhead costs and received monies from private donations. Because of the lower costs, they were more attractive to lower-income families. As a result, the Sixth Circuit concluded that the Ohio voucher program failed the second prong of the *Lemon* test.
137. See Dana Canedy, *Florida Court Bars Use of Vouchers*, N.Y. TIMES, Aug. 6, 2002, at A10.
138. Article 1, section 3 of the Florida Constitution provides: "No revenue of the state or any political subdivision or agency thereof shall ever be taken from the public

ited the use of public money to benefit sectarian institutions.¹³⁹ While the recent Supreme Court decision in *Zelman* gave solace to school voucher proponents by holding that the Ohio voucher program did not violate the Federal Constitution, the Florida ruling indicated that constitutional hurdles remain a concern under religion clauses in state constitutions.¹⁴⁰

In light of the constitutional hurdles that are associated with direct expenditures to religious-based charitable organizations, it is not viable to use direct expenditures to fund these charitable organizations. These hurdles are reduced where Congress uses tax incentives instead of direct expenditures. Concededly, the use of the charitable contribution deduction tax incentive clearly adds complexity to the Code. Some scholars believe that tax incentives overly complicate the Code and that Congress therefore should make use of direct expenditures to subsidize nontax objectives.¹⁴¹ However, the use of tax incentives allows the government to indirectly subsidize charitable organizations, including religious-based organizations, without violating the Establishment Clause. Obviously, the government is entitled to provide direct funding to nonreligious charitable organizations; however, a large percentage of charitable contributions are made to religious-based charitable organizations. For example, in 1997, 47% of all charitable contributions were made to religious organizations.¹⁴² While the government did not subsidize all of these contributions because not every taxpayer was eligible to claim the deduction, the government encountered no constitutional prohibitions that would have existed under improperly structured direct expenditure programs.

This Article does not conclude that the government should altogether refrain from using direct expenditures to subsidize charitable organizations. Rather, in light of the constitutional constraints, direct expenditures should not be relied on as the sole method of governmental subsidization of charitable organizations. They should be used in conjunction with the charitable contribution deduction tax incentive.

treasury directly or indirectly in aid of any church, sect, or religious denomination or in aid of any sectarian institution."

139. Canedy, *supra* note 137.

140. According to Robert H. Chanin, general counsel of the National Education Association, thirty-six other states have religion clauses in their constitutions similar to Florida's clause. Lyle Denniston, *Judge Says School Vouchers Violate Florida's Constitution, Says Law Restricts Transfer of Funds*, BOSTON GLOBE, Aug. 6, 2002, at A2.

141. See, e.g., Roberts, *supra* note 6, at 350; Stanley Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Expenditure Assistance*, 84 HARV. L. REV. 352 (1970) (contending that the task of tax reform is that of replacing tax expenditures with direct expenditure programs).

142. See GIVING USA 1998, *supra* note 3, at 23.

When used concurrently, direct expenditures and tax incentives are an effective means of promoting charitable organizations.

C. Historical Reasons for the Complexity

Many American taxpayers are frustrated with the current length and density of the Code. In fact, the former Treasury Secretary, Paul O'Neill, believes that the 9,500 pages of the Code is an "abomination."¹⁴³ Tax incentives, such as the charitable contribution deduction, contribute to the complexity. The charitable contribution rules have grown substantially since their modest enactment in 1917, from one short paragraph to seven statutory pages and 108 pages of Treasury Regulations.¹⁴⁴ The progression from the original modest enactment in 1917 to the current complicated scheme has already been outlined in this Article. While many changes were modest, the totality of constant modification during the past seventy years has, in fact, culminated in the complexity of the rules in existence today. However, this complexity is an essential byproduct of the charitable contribution deduction, and any simplification is an idealistic impossibility.

Congress created much of this complexity under the Tax Reform Act of 1969 in order to prevent tax abuse. While the empirical data showed the abusive effect of itemized deductions, not everyone believed that the percentage limitations were appropriate. Shortly after the enactment of the 1969 legislation, members of the Committee of Tax Policy, New York State Bar Association Tax Section, wrote the following:

The Tax Reform Act of 1969 added new restrictions to many provisions reformers thought inequitable or subject to abuse (such as private foundations, charitable contributions, the alternative capital gain tax) making each more complicated than it was before. In some of these instances, the scheme devised by Congress was an overreaction to a limited problem (such as the private foundations provisions). The taxpayers affected by these provisions are now put in a position of having to contend with greater complexity in order to reap reduced advantages¹⁴⁵

To reduce the complexity, the Committee recommended that Congress should enact tax laws that are "more generalized" with "broad tax objectives rather than detailed rules."¹⁴⁶ Some scholars have also

143. See John O. Fox, *Many Unhappy Returns, They're Cutting Taxes. What They Ought to Do Is Cut the Code*, WASH. POST, May 27, 2001, at B02. Specifically, former Secretary O'Neill stated, "the code today encompasses 9,500 pages of very small print. While every word . . . has some justification, in its entirety it is an abomination." *Id.*

144. Steuerle & Sullivan, *supra* note 7, at 402.

145. Roberts et al., *supra* note 6, at 346-47.

146. *Id.* at 348-49; see also James W. Colliton, *Standards, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265 (1995) (stating that the tax laws have become more complex because Congress has replaced the broad standards with statutory rules that require longer and more complex statutes).

proposed additional simplification of the Code by eliminating the percentage limitations on charitable contribution deductions. For example, C. Eugene Steuerle and Martin A. Sullivan stated the following in addressing the 30% limitation: "The provision add[ed] an inordinate amount of complexity to the tax law and probably discourage[d] giving as much by this complexity and its 'signaling' effect as by any real economic effect on donors."¹⁴⁷

In actuality, the detailed rules are necessary to achieve the fundamental tax policy of fairness and to curtail tax abuse. Tax abuse goes hand in hand with more general charitable contribution rules. Also, there is an inverse relationship between the general rules and tax fairness. If the detailed rules were repealed, tax abuse and unfairness would ensue. There is ample support for this proposition by considering the history of the statutory provisions. A large component of the complexity is the percentage limitations contained in § 170. The percentage limitations were enacted at a time when both the Senate and House of Representatives found that the tax scheme in place at that time was unfair. In 1966, there were 154 taxpayers, each with an adjusted gross income of over \$200,000, who did not pay any income tax.¹⁴⁸ Twenty-one of those 154 taxpayers had adjusted gross incomes that exceeded \$1 million.¹⁴⁹ According to the legislative history of the 1969 Tax Reform Act, the use of itemized deductions had allowed taxpayers in high brackets to avoid taxes.¹⁵⁰ In taxable year 1966, itemized deductions totaled \$130 million, and the itemized deductions were 116% of the adjusted gross income.¹⁵¹ The charitable contribution deduction totaled almost \$79 million.¹⁵² Hence, the charitable contribution deduction accounted for a large percentage of the total \$130 million of itemized deductions. Seventy percent of the \$79 million figure was attributed to taxpayers contributing property to charitable organizations, and a majority of that property had appreciated in value prior to the taxpayers' contribution.¹⁵³ Concededly, the percentage limitations add complexity to the charitable contribution deduction rules. However, the purpose of the percentage limitations should not be minimized. Under the Tax Reform Act of 1969, Congress enacted many complex charitable contribution rules to reduce the amount of the charitable contribution deduction. The legislative history indicates that the restrictions were imposed because of the

147. Steuerle & Sullivan, *supra* note 7, at 417.

148. H.R. REP. NO. 91-413 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1653.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* at 1654.

153. *Id.*

abusive nature of itemized deductions, including those for charitable contributions.¹⁵⁴

The need for complexity to maintain the objective of tax fairness is also established by an examination of the history of the § 170 provisions. According to Internal Revenue Service statistics,¹⁵⁵ the number of returns that included a charitable contribution deduction and the total amount of the deductions were as follows:

Year	Returns Reporting Charitable Contribution	Total Amount of Charitable Contributions Reported (in thousands of dollars)
1975	24,642,672	\$15,393,331
1980	26,601,428	\$25,809,608
1985	36,162,178	\$47,962,848
1990	29,230,265	\$57,242,757
1994	29,848,727	\$70,544,542
1995	30,540,637	\$74,991,519
1996	31,591,983	\$86,159,305
1997	32,612,634	\$99,191,962
1998	33,835,992	\$109,240,078

The intention of the Tax Reform Act of 1986 was to simplify the Internal Revenue Code.¹⁵⁶ Congress eliminated many deductions and severely limited the deductibility of several expenditures. While simplification of the Internal Revenue Code was a valid congressional objective, it created an inequity because nonitemizers were unable to claim the charitable contribution deduction.¹⁵⁷ During the period in which nonitemizers were eligible to claim the charitable contribution deduction, the number of returns that included the deduction increased by approximately ten million. When Congress decided against making permanent the temporary provision that enabled nonitemizers to claim the deduction, the number of taxpayers claiming the deduction was reduced by approximately seven million. Significantly, the Internal Revenue Service's statistics illustrate that, since the 1986 amendment, fewer individuals are claiming the deduc-

154. See *supra* notes 47-56 and accompanying text.

155. Internal Revenue Serv., *supra* note 8, at 206.

156. S. REP. NO. 99-313, at 3 (1986) (stating general purpose of the Tax Reform Bill of 1986 (H.R. 3838)).

157. In a treatise on charitable giving, Professor Bruce R. Hopkins states:

Makers of tax policy frequently tout, often in a political setting, objectives such as "fairness" and "simplicity." But these objectives are often in conflict. Frequently, "fairness" can only be achieved by means of "complexity." Complexity stems from having to write tax laws that make distinctions between taxpayers in varying circumstances, to achieve equity. The citizens of the United states [sic] live in an intricate, complex society; it should not be surprising that the U.S. tax laws reflect this intricacy.

HOPKINS, *supra* note 20, at 35.

tion, but the total amounts of the claimed deductions have increased.¹⁵⁸ The inference to be drawn is that wealthy taxpayers are claiming higher deductions, but lower-income taxpayers are not receiving government subsidization for their charitable contributions.

D. Impact on Progressive Taxation

This country has maintained a progressive income tax system since the inception of the historic 1913 Income Tax Act. Progressive taxation is based on the principle that higher-income taxpayers should pay a larger percentage of income taxes. The underlying premise of progressive taxation is that income taxation should be based on an ability-to-pay principle, and higher-income taxpayers have a greater ability to pay taxes. While the progressive income tax system remains controversial, every attempt to dismantle it in favor of a flat tax or consumption-type tax has been unsuccessful.¹⁵⁹

The current statutory rules of charitable giving are inconsistent with this traditional progressive tax structure.¹⁶⁰ Under the current charitable contribution provisions, the progressive tax system is weakened in two ways. First, the denial of the charitable contribution deduction to taxpayers who are unable to itemize deductions weakens the progressive tax system by allowing only higher-income taxpayers to claim the deduction. Because only itemizers may claim the charitable contribution deduction, the only contributions that the government subsidizes are those made by itemizers.¹⁶¹ Secondly, the current scheme creates the so-called "upside-down" subsidy. The "upside-down" subsidy means that low-income taxpayers will receive

158. Internal Revenue Serv., STAT. INCOME BULL., Fall 1998, at 248.

159. For example, in 1995, Senators Sam Nunn and Pete Domenici proposed the "USA Tax Act of 1995." See S. 722, 104th Cong. (1995). The Senators proposed the enactment of a consumption-type tax. The Act would have allowed for tax deferral on income that the taxpayer saved, but it would have also allowed for a deduction for charitable contributions. *Id.* § 101(b)(4). In addition, Representative Dick Armev introduced the "Freedom and Fairness Restoration Act of 1995," which also proposed the enactment of a consumption-type tax. See H.R. 2060, 104th Cong. (1995). Unlike the proposal presented by Senators Nunn and Domenici, the Armev bill proposed a flat 20% tax (17% after 1997) on wages, retirement distributions, and unemployment compensation, less the standard deduction. *Id.* § 63(a). The Armev proposal did not tax accretions to wealth in the form of interest and dividends. See also H.R. 3097, 105th Cong. (1998) (proposing that the current Code be eliminated and replaced with a low tax rate for all taxpayers); S. 488, 104th Cong. (1995) (proposing a 20% flat tax but allowing for a charitable contribution deduction not to exceed \$2,500).

160. See Bullock, *supra* note 9, at 341 ("[r]efusing a deduction entirely to [middle- and low-income individuals] breaches a basic tenet of the progressive rate structure").

161. The recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 exasperates this. The Act eliminates the phaseout of itemized deductions for higher-income taxpayers over a five-year period of time beginning in 2006. See 2001 TAX LEGISLATION, *supra* note 11, ¶ 210, at 51.

lower tax subsidies than high-income taxpayers because of their lower marginal income tax rates.¹⁶²

The legislative history of the predecessor to § 170 indicates that the purpose of the original charitable contribution deduction was to allow a wealthy taxpayer to receive a deduction for charitable giving.¹⁶³ While this may have been justified during 1917 because only wealthy taxpayers paid taxes, this is not the reality in today's society. In modern times, many lower- to middle-income taxpayers pay income taxes but are prevented from claiming a charitable contribution deduction. Statistics show that charitable giving by low-income individuals is "generous."¹⁶⁴ There is evidence suggesting that taxpayers who claim the standard deduction are responsible for approximately one-third of all charitable contributions.¹⁶⁵ In fact, statistics show that the lower-income taxpayers actually contribute a greater percentage of their income to charitable organizations than do their higher-income counterparts.¹⁶⁶

According to Internal Revenue Service statistics, 69% of tax returns filed during 1998 claimed the standard deduction.¹⁶⁷ More than one-half of the returns claiming the standard deduction had adjusted gross incomes of less than \$20,000.¹⁶⁸ The standard deduction is intended in part to subsidize charitable contributions made by nonitemizers; hence, it is likely that many of the taxpayers whose gross income is less than \$20,000 are receiving a comparable deduc-

162. Many scholars have addressed the "upside-down subsidy" in their scholarship. See, e.g., Charles T. Clotfelter, *What is Charity? Implications for Law and Policy: Tax Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 672 (1989) ("[d]istortions in the price of giving arise because different people face different subsidy rates (and prices) which bear little relationship to any objective characteristics of the gift"); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1405 (1988) (stating that the use of charitable contribution deductions is troubling because it is cheaper for high-income taxpayers to make charitable contributions than low-income taxpayers); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 361 (1989) (stating that the "upside-down" subsidy could be avoided by making rate changes that will ensure that the deduction will be "revenue neutral" and "distributionally neutral"); Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 383 (1972) (stating that the charitable contribution deduction provides the greatest incentive to those who financially need it the least); John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 VA. TAX REV. 229, 244 (1984) ("[t]ax expenditure budget advocates deprecate the charitable contribution deduction as an 'upside down' subsidy of the kind that Congress would never enact in the direct expenditure budget").

163. SEIDMAN, *supra* note 21, at 944-45.

164. *Tax Report*, WALL ST. J., May 2, 2001, at A1.

165. See GIVING USA 1998, *supra* note 3.

166. See Bullock, *supra* note 9, at 341, 343; Davies, *supra* note 6, at 1771.

167. Internal Revenue Serv., *supra* note 8, at 213.

168. *Id.* at 33.

tion. However, eleven million taxpayers with adjusted gross incomes of between \$40,000 and \$75,000 also claimed the standard deduction.¹⁶⁹ An additional 1.3 million taxpayers with adjusted gross incomes of between \$75,000 and \$100,000 claimed the standard deduction, as well.¹⁷⁰ According to Internal Revenue Service statistics, more than one-half of the charitable contribution deductions claimed during taxable year 1998 were attributable to taxpayers with adjusted gross incomes of at least \$100,000.¹⁷¹ Approximately 76% of the charitable contribution deductions were attributable to taxpayers with adjusted gross incomes of at least \$60,000.¹⁷² Taxpayers with adjusted gross incomes of \$1 million or more made 1.2% more contributions in the form of property compared to contributions of cash.¹⁷³ It is probable that many of the noncash charitable gifts are in the form of appreciated property. This raises the fairness issue discussed above.

The case of *Herman v. United States*¹⁷⁴ illustrates how wealthy taxpayers are able to take advantage of substantial tax savings, which results in a reduction of their effective income tax rates. During taxable year 1990, the plaintiffs in *Herman* donated medical equipment to a hospital. While the appraised value of the equipment exceeded \$1 million, the plaintiffs purchased the equipment from the donee, a hospital, two years prior to the donation for \$40,000 after the donee had filed a petition for bankruptcy. The hospital had planned to sell the property at an auction and hoped to net \$37,000.¹⁷⁵ Each plaintiff claimed a charitable contribution deduction in the amount of \$501,190, but the Internal Revenue Service only allowed a deduction for each plaintiff in the amount of \$20,000. While the district court acknowledged that the plaintiffs received tax windfalls, it concluded that they were in fact entitled to use the appraised value for purposes of determining their charitable contribution deductions. There was no indication that the plaintiffs acted fraudulently. However, this case shows how the higher-income taxpayers manipulated the rules by purchasing property well below the fair market value, donating the property to a charitable organization, and claiming a deduction in the

169. *Id.*

170. *Id.*

171. *Id.* at 41.

172. *Id.*

173. *Id.* Thirty-seven percent of charitable contributions by taxpayers with adjusted gross incomes of between \$200,000 and \$500,000 were noncash contributions, and 62% of the contributions made by taxpayers with adjusted gross incomes of between \$500,000 and \$1 million were noncash contributions. *Id.* For all other taxpayers, the percentage of noncash gifts ranged from 17% to 27%. *Id.*

174. 73 F. Supp. 2d 912 (1999).

175. The hospital's attorney testified at trial that the \$37,000 amount was based on an appraisal of the equipment's liquidation value. In dicta, the court stated that the property was grossly undervalued, to the detriment of the hospital's creditors.

amount of the fair market value. At the same time, nonitemizing taxpayers are denied the opportunity to claim even a modest deduction.

E. The Use (or Lack Thereof) of Charitable Contributions to Reduce Poverty

1. Empirical Data Outlining Trends in Charitable Giving

The breakdown of charitable giving for 1997¹⁷⁶ was as follows:

Type of Charitable Organization	Amount of Contribution (in billions of dollars)	Percentage of Total Charitable Giving
Religion	\$74.97	47.0%
Education	\$21.51	13.5%
Foundations	\$11.20	7.0%
Health	\$14.03	8.8%
Human Services	\$12.66	7.9%
Public/Society Benefit	\$8.38	5.3%
Arts	\$10.62	6.7%
Other	\$6.05	3.8%

There are two categories of charitable organizations that reduce the effects of poverty: human services organizations and public/society benefit organizations. Human services organizations include crime prevention, youth services, sports, housing, disaster relief, nutrition, and vocational training.¹⁷⁷ Public/society benefit organizations include community improvement and development corporations that are instrumental in the revitalization of neighborhoods.¹⁷⁸ According to the empirical data, charitable giving during 1997 totaled approximately \$159.42 billion, but donors contributed only \$21 billion to human services organizations and public/society benefit organizations. Consequently, it would appear that a large percentage of the charitable contributions made during 1997 were not made to organizations designed to alleviate poverty. However, while this category includes poverty-relief organizations like the Salvation Army, it covers many other charitable organizations that have other objectives. Moreover, some studies show that most human services organizations do not focus on the needs of low-income individuals, and only a small portion of human services organizations attempt to alleviate poverty by providing food, clothing, or other basic necessities.¹⁷⁹ The empirical data from 1997 is similar to charitable giving in other years. For example, in 1999, the total amount of charitable contributions was

176. GIVING USA 1998, *supra* note 3, at 23.

177. *Id.* at 40.

178. *Id.* at 42.

179. See Bullock, *supra* note 9, at 346-47.

\$190.16 billion.¹⁸⁰ The majority of this charitable giving was made to religious organizations, and the second highest amount was made to educational institutions.¹⁸¹

Charitable giving to organizations benefiting the neediest sector of the population is relatively modest.¹⁸² In 1999, of the top twenty-five organizations receiving the highest charitable donations, only three are to be considered poverty-relief organizations.¹⁸³ For 1999, of the top twenty-five organizations receiving the highest donations, six were educational institutions.¹⁸⁴ The top recipients were Harvard University, Cornell University, Duke University, Stanford University, Columbia University, and the University of Pennsylvania.¹⁸⁵ Obviously, these universities are among the most elite in the country, and no one could seriously contend that the charitable contributions to them result in widespread benefit to low-income individuals. These statistics are consistent with those of charitable bequests by decedents. In 1995, decedents made approximately one-third of charitable bequests to educational, medical, or scientific organizations, but they made no more than 1% of charitable contributions to organizations designed to improve the social welfare and plight of the needy.¹⁸⁶ This is consistent with the data establishing that donors support charitable organizations that provide them with either direct or indirect benefits.¹⁸⁷

2. *Enacting Legislation to Encourage Charitable Giving to Poverty-Relief Nonprofit Organizations*

a. *In General*

In view of the fact that individuals are contributing a nominal amount to organizations designed to provide assistance to lower-income individuals, Congress has made proposals to spur charitable giving to those organizations. The current rules already provide varied

180. JUST GIVE, DONOR INFO, at http://www.justgive.org/html/don_info/billions.html (last visited Oct. 3, 2001) (available in the University of Nebraska Law College library). Seventy-five percent of that amount is derived from individuals. *Id.*

181. *Id.*

182. Peter Kilborn, *Charitable For Poor Lags Behind Need*, N.Y. TIMES, Dec. 12, 1999, at A1.

183. NETSCAPE, CHARITIES RECEIVING HIGHEST DONATIONS IN 1999, at <http://webcenter.netscape.inforplease.com/ipa/A0770757.html> (last visited Apr. 11, 2001) (available in the University of Nebraska Law College library). The Salvation Army received the most donations, America's Second Harvest received the eighth-most donations, and Habitat for Humanity International received the ninth-most donations. *Id.*

184. *Id.*

185. *Id.*

186. Internal Revenue Serv., STAT. INCOME BULL., Summer 1999, at 81-82.

187. See Bullock, *supra* note 9, at 343.

percentage limitations based in part on the classification of the charitable organizations. Under the current charitable contribution provisions, the amount of the deduction is generally limited to either 50% or 30% of one's adjusted gross income, depending on the type of charitable organization receiving the contribution. For instance, charitable contributions made to churches, educational institutions, hospitals, museums, and anti-poverty organizations are treated consistently under the Code and subject the donor to the 50% limitation. Charitable contributions made to organizations such as private foundations subject the donor to the 30% limitation. Scholars have addressed whether disparate treatment for certain charitable giving is appropriate.¹⁸⁸ In addition, members of Congress have proposed legislation that is designed to encourage charitable giving to organizations that serve the needs of the poor. There is a congressional proposal pending that is intended to spur charitable giving to organizations that serve the needs of the poor. Representative James T. Kolbe of Arizona introduced a proposal on February 14, 2001 that would amend the Code to provide a nonrefundable credit of up to \$100 for single taxpayers and \$200 for taxpayers who file a joint return for charitable giving to organizations that combat poverty.¹⁸⁹ The charitable organization receiving the contribution must provide services to individuals whose incomes do not exceed 150% of the poverty threshold.¹⁹⁰

The tax laws should not be amended to grant more favorable treatment to organizations designed to alleviate poverty. If Congress wants to provide a source of increased funding to nonprofit organizations that combat poverty, the most appropriate and practical manner would be in the form of direct expenditures. While Congress would be unable to appropriate funds directly to religious-based charitable organizations because it would run afoul of constitutional barriers already discussed in this Article, it could make direct expenditures to other types of charitable organizations whose goals are to reduce the effects of poverty. For example, Habitat for Humanity makes affordable home ownership available to low-income individuals by contributing supplies and by using volunteers to help build the homes.¹⁹¹ Any contribution of cash or supplies is already deductible under the Code. If Congress would like additional funds to support the efforts of Habitat for Humanity, it should allocate grant monies to the Department of Housing and Urban Development to avoid the technical difficulties of using the Code to provide the additional incentive.

188. *See, e.g.,* Gergen, *supra* note 162.

189. *See* H.R. 673, 107th Cong. § 25B (2001). A taxpayer is entitled to elect to take the charitable contribution deduction in lieu of the nonrefundable credit. *Id.* § 25B(f).

190. *Id.* § 25B(d)(2).

191. GIVING USA 1998, *supra* note 3, at 51.

Theoretically, the proposal to amend the tax laws to encourage additional charitable giving to organizations that combat poverty represents sound congressional tax policy. However, in practice, the proposal is wrought with technical difficulties, three of which will be discussed. First, there are substantial administrative problems with defining just which nonprofit organizations would be eligible for the comparatively favorable tax treatment. Second, there are other types of charitable organizations that provide societal value equal to or in excess of that provided by those nonprofit organizations that work to eradicate poverty. Finally, if Congress were to amend the rules to provide more favorable treatment to these types of organizations, it would inevitably lead to a multitude of other special interests lobbying Congress to enact provisions favorable to their causes as well.

b. Administrative Constraints

The proposed legislation includes a reasonable description of what types of charitable organizations would entitle the donor to enhanced tax incentives. The charitable organization must provide assistance to individuals whose incomes do not exceed 150% of the poverty threshold. In addition, at least 70% of the charities' reasonably expected annual expenditures must be on behalf of an exempt purpose.¹⁹² This proposal is almost identical to a proposal that had been introduced in 1995 and criticized by Professor Alice Gresham Bullock.¹⁹³ Professor Bullock explained that the standard for determining how an organization used the funds was insufficient.¹⁹⁴ She also stated that taxpayers would have to keep additional records, and the Internal Revenue Service would have increased costs.¹⁹⁵ Finally, the proposal would increase the administrative burden of the charitable organizations.¹⁹⁶ The proposal that Representative Kolbe introduced in 2001 did not address these administrative shortcomings. Hence, while there were some benefits that could be derived from the enactment of the proposal, the administrative constraints outweighed those benefits.

c. The Comparable Value of Other Nonprofit Organizations

The value of charitable organizations that attempt to alleviate poverty is substantial. Hence, the value of these organizations must not be diminished. However, is the objective to eradicate the effects of

192. See H.R. 673, 107th Cong. § 25B(d)(3)(A) (2001). No more than 30% of the expenditures can be made for administrative expenses, lobbying, fundraising, and litigation. *Id.*

193. See Bullock, *supra* note 9.

194. *Id.* at 358.

195. *Id.*

196. *Id.* at 359.

poverty more worthwhile than causes promoted by other types of charitable organizations? For example, charitable giving to nonprofit healthcare organizations is, at a minimum, as valuable and arguably more valuable than charitable giving to organizations that combat poverty. The charitable organizations classified as healthcare organizations are diverse and include organizations devoted to research and service organizations that focus either on general health issues or specific diseases.¹⁹⁷ Presumably, this category would include organizations such as the American Cancer Society, which has consistently waged campaigns that are designed to discourage cigarette smoking. The probable justification for these campaigns is to reduce the harsh effects of smoking, such as lung cancer and heart disease. Other health organizations engage in research to find cures for debilitating or fatal diseases such as Parkinson's disease, AIDS, cancer, and Alzheimer's disease. The charitable contribution deduction provisions already distinguish among recipient charitable organizations by providing higher percentage limitations for gifts to certain charitable organizations, including nonprofit health organizations and those that combat poverty. Consequently, no additional incentive should be enacted by Congress to further encourage charitable contributions to organizations combating poverty.

d. The "ABC Syndrome"

During taxable year 1997, the Internal Revenue Service recognized 580,416 active nonprofit charitable organizations as § 501(c)(3) tax-exempt organizations.¹⁹⁸ The total amount of contributions, gifts, and grants for these organizations during 1997 totaled \$146.2 billion.¹⁹⁹ If Congress passed an amendment to the charitable contribution rules to enhance the incentives for charitable giving to combat poverty, it would lead to a multitude of other special interests lobbying Congress to enact provisions favorable to their causes as well. Members of Congress have already introduced bills that would amend the charitable contribution deduction rules to provide an additional incentive for charitable giving in other areas.²⁰⁰ This phenomenon has been coined as the "ABC Syndrome."²⁰¹ The impact of the "ABC Syndrome" is increased statutory complexity. Congress should avoid creating addi-

197. GIVING USA 1998, *supra* note 3, at 93.

198. Internal Revenue Serv., *supra* note 8, at 47.

199. *Id.* at 48.

200. See, e.g., H.R. 744, 107th Cong. (2001) (encouraging charitable giving for medical research); S. 462, 107th Cong. (2001) (promoting education by granting a credit for contributions to organizations providing scholarships to students attending elementary and secondary schools).

201. See Vada Waters Lindsey, *The Widening Gap under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1 (2001).

tional complexity into an already necessarily complex statutory provision.

IV. PERSPECTIVES ON THE FUTURE OF CHARITABLE GIVING

A. The Effect of the Estate Tax Repeal

Under the current estate and gift tax provisions, a tax is imposed on devises, bequests, and inter vivos gifts.²⁰² A donor is entitled to an unlimited deduction for charitable bequests²⁰³ and gifts to charitable organizations.²⁰⁴ In the past, decedents have made sizeable gifts to charities in the form of charitable bequests. For estate tax returns filed during 1995–1997, the Internal Revenue Service estimates that decedents claimed the following charitable deductions:²⁰⁵

Year	Charitable Contribution Deduction	Percentage of Returns Including Deduction	Percentage of all Deductions	Percentage of Gross Estate
1995	\$9.7 billion	18.3%	16.2%	7.1%
1996	\$10.2 billion	17.9%	16.9%	7.8%
1997	\$14.3 billion	17.3%	19.4%	8.8%

In 2001, President George W. Bush signed into law a massive \$1.35 trillion tax cut. The law included a phaseout of the estate tax. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the estate tax will be completely phased out for taxpayers dying after 2009.²⁰⁶ For decedents dying after 2001 and prior to 2010, estate tax liability has been reduced as a result of adjustments to the unified credit and the estate tax rates.²⁰⁷ The new rates and credits are as follows:

202. See I.R.C. §§ 2001(a), 2501(a) (2002).

203. See *id.* § 2055(a).

204. See *id.* § 2522(a).

205. Internal Revenue Serv., *supra* note 186, at 80, 96, 99, 102, 105.

206. There is a possibility that the repeal will be temporary because the Economic Growth and Tax Relief Reconciliation Act of 2001 is scheduled to expire at the end of 2010. Therefore, unless future legislation is enacted reinstating the tax cut enacted in 2001, the repeal of the estate tax will be short-lived.

207. For purposes of the gift tax, the amended tax rates are applicable, but the applicable exemption applies only to the estate tax. After the complete phaseout of the estate tax, the maximum gift tax rate will be 35%. See 2001 TAX LEGISLATION, *supra* note 11, ¶ 308, at 105.

<i>Year</i>	<i>Exemption Amount</i>	<i>Tax Rate</i>
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%

Generally, prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act, where a taxpayer devised property, the recipient received a “stepped-up” basis equal to the fair market value of the property at the decedent’s death or on the alternate valuation date.²⁰⁸ To offset any possible tax abuse resulting from the tax-free income tax consequences and the estate tax relief, Congress eliminated the so-called stepped-up basis of § 1014. Under the 2001 Act, a donee of property generally receives a carryover basis. However, Congress only partially repealed the generous stepped-up basis rules. Under the new rules, the basis of estate property can be increased by up to \$1,300,000.²⁰⁹ Any basis increase cannot exceed the fair market value of the property.²¹⁰ In addition, for estate property that passes to a surviving spouse, an additional \$3 million basis step-up is permitted.²¹¹ While the amendment to the stepped-up basis rules offsets some of the inevitable double tax benefits resulting from the repeal of the estate tax, there remain significant tax benefits to retaining property until death and devising it under a testator’s will.

When considering the repeal of the estate tax and the maximum step-up of \$4.3 million, there exist negligible incentives to contribute money or appreciated property to a charitable organization. Hence, it is probable that the phaseout of the estate tax will have a negative impact on charitable bequests.²¹² While donors make charitable bequests for a variety of reasons, effective estate planning for the wealthy would result in their making large charitable bequests to reduce estate tax liability. In 1997, decedents claimed \$14.3 billion in charitable contribution deductions, which represented 8.8% of the de-

208. I.R.C. § 1014(a) (2001).

209. 2001 TAX LEGISLATION, *supra* note 11, ¶ 332, at 118.

210. *Id.*

211. *Id.*

212. *See, e.g.,* Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499 (2001) (stating that while it is impossible to predict the extent of the increased costs of charitable giving, repeal of the estate tax might alter the allocation of charitable bequests and hurt charitable organizations that are more sensitive to tax changes); *see also* James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U. L. REV. 825 (2001) (outlining reasons why the federal transfer tax is appropriate).

cedents' gross estates.²¹³ In order for the government to continue promoting charitable giving under the Code, it might be necessary for Congress to bolster the charitable contribution tax incentive. This is particularly true if the repeal of the estate tax becomes permanent after 2010. Congress's initial attempt to make the repeal permanent failed,²¹⁴ but it is likely that there will be continuous efforts to either weaken or permanently eliminate the estate tax.²¹⁵ There is legislation pending that would eliminate the sunset provision of the 2001 Act.²¹⁶ If the legislation is enacted, all tax cuts enacted under the 2001 Act will be permanently extended, including a permanent repeal of the estate tax.

B. Reformation of the Charitable Contribution Rules

Some members of Congress have recognized the need to subsidize nonitemizers' charitable contributions. During 2001, the House of Representatives passed a proposal that would allow nonitemizers to take an annual deduction of up to \$25 for charitable contributions made during taxable years 2002 and 2003.²¹⁷ The maximum deduction would be increased to \$100 beginning in taxable year 2010.²¹⁸ For taxpayers filing joint tax returns, the maximum deductible amount would be \$50 during taxable years 2002 and 2003 and \$200 beginning in taxable year 2010.²¹⁹ While the enactment of the statutory proposal would have reduced some inequity, it failed to sufficiently redress much of the disparate treatment between taxpayers who itemize their tax returns and those who claim the standard deduction. In any event, Congress has not taken any action to enact this proposal.

Alternately, Congress has considered the enactment of a credit to supplement the current income tax charitable contribution rules. For example, on February 7, 2001, Representative Dan Burton introduced the "Charitable Giving Act of 2001" that would have allowed taxpayers to claim a credit of up to \$200 for cash contributions in lieu of the

213. See *supra* note 205 and accompanying text.

214. The vote on the repeal was 54-44, and the Senate needed sixty favorable votes for the measure to pass. See Shailagh Murray, *Permanent Repeal of Estate Tax is Put Down by Vote in Senate*, WALL ST. J., June 13, 2002, at A1.

215. See John D. McKinnon & Lynn Asinof, *Why You Should Rewrite Your Will: Estate-Tax Repeal is Dead, but Families Must Still Adjust Plans; Protecting the Spouse*, WALL ST. J., June 13, 2002, at D1.

216. See H.R. 2327, 107th Cong. (2001).

217. Tom Herman, *Tax Report: A Special Summary and Forecast of Federal and State Tax Developments*, WALL ST. J., July 25, 2001, at A1.

218. *Id.*

219. *Id.*

current charitable contribution deduction.²²⁰ The enactment of the \$200 credit would not supplant the current charitable contribution deduction. Rather, it would supplement the current deduction and allow all taxpayers to receive a credit of up to \$200 for cash contributions. Taxpayers would be able to claim a deduction for cash contributions in excess of \$200 and contributions of property. The credit would take precedence over the deduction, and the taxpayer would have to make an affirmative election to make the credit inapplicable. The bill was referred to the House Ways and Means Committee, but no additional action was taken on the proposal. In view of the phaseout of the estate tax, it is important to adjust the charitable contribution rules to provide more incentive for charitable giving. The enactment of a nonrefundable credit creates an additional incentive for charitable giving because tax credits result in more tax savings than tax deductions.²²¹

One significant drawback of the enactment of a credit in conjunction with the current deduction is that itemizing taxpayers, usually higher-income taxpayers, will be entitled to claim both a deduction and credit whereas the nonitemizing, lower-income taxpayers will only be able to claim the modest credit. Moreover, based on the nonrefundability feature of the proposed credit, the taxpayers will not be able to receive any tax benefit if they do not have a tax liability during the taxable year. A tension does exist between countering the impact of the estate tax repeal on charitable giving and protecting the integrity of progressive taxation. Although it may not be possible to satisfy both objectives concurrently because of the inherent conflict, it is possible to structure any future amendments to the charitable contribution rules in a manner that diminishes the tension.

The enactment of a \$200 credit in conjunction with the current charitable contribution deduction would lessen the impact of the upside-down subsidy by providing nonitemizers with governmental subsidization of their charitable contributions. However, additional modifications should be made to the proposed bill to further strengthen the tax incentive. First, the credit should be allowed for contributions of property in addition to cash contributions. As the estate tax is phased out, there is less of an incentive to make charitable bequests of appreciated property. If Congress made gifts of appreciated property eligible for the proposed credit, it would provide imme-

220. H.R. 494, 107th Cong. § 30B (2001). Several scholars have analyzed the viability and impact of transforming the charitable contribution deduction to a tax credit. See, e.g., Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687 (1999); Bullock, *supra* note 9.

221. A deduction merely reduces a taxpayer's taxable income, while a tax credit represents a dollar-for-dollar reduction in actual tax liability. The one limitation with a nonrefundable credit is that it provides no tax benefit if the taxpayer does not have any tax liability during the taxable year.

diate tax savings and partially offset the disincentive of decedents making charitable bequests as a result of the estate tax repeal. Under basic time value of money principles, an immediate tax deduction or credit is more favorable than future tax benefits. Second, to strengthen the tax incentive, the maximum credit should be increased to \$400 for single taxpayers and \$800 for married taxpayers filing joint returns. Third, the amount of the credit should be reduced by a percentage of the taxpayer's adjusted gross income. As the adjusted gross income increases, the amount of the allowable credit should decrease. The justification for the reduction is to protect the integrity of the progressive tax system. The reduction also works to assure that the credit is not too costly for the government. Congress must weigh the impact of any newly enacted tax incentive against the cost of the tax incentive measured by reference to the loss of tax revenue. Hence, the modification to the proposed bill minimizes the cost of the charitable contribution credit and addresses the problem of how the government can continue encouraging charitable giving without weakening the progressive tax system.

Congress has relied on varied percentages in determining the amounts of credits under other tax provisions. Many of these other credits are associated with purported socially desirable activities, such as encouraging adoption and higher education. The maximum credit for the child and dependent care expenses is 35% of the taxpayer's adjusted gross income.²²² As the adjusted gross income increases, the credit is reduced to a minimum credit of 20% of allowable expenses.²²³ The child tax credit begins to phase out for single taxpayers when adjusted gross income reaches \$75,000 and for married taxpayers filing joint returns when adjusted gross income reaches \$110,000.²²⁴ Congress promotes adoption by granting a nonrefundable credit for expenses related to adoption.²²⁵ The credit begins to phase out where the taxpayer's adjusted gross income reaches \$150,000.²²⁶

Congress also promotes education in several ways under the Code. A taxpayer is entitled to a credit for eligible educational expenses, but the credit is also phased out if the taxpayer's adjusted gross income exceeds \$50,000 for single taxpayers and \$100,000 for taxpayers filing joint returns.²²⁷ Similarly, in order to provide an additional incentive for charitable giving, Congress should enact a credit to supplement the current charitable contribution deduction. It is within Congress's

222. I.R.C. § 21(a)(2) (2002). The 35% figure applies for taxable years after December 31, 2002. Prior to that time, the figure was 30%.

223. *Id.* For taxpayers with adjusted gross incomes of at least \$43,000, the credit is 20% of the allowable expenses.

224. *Id.* § 24(b).

225. *See id.* § 23.

226. *Id.* § 23(b).

227. *Id.* § 25A(d)(2).

discretion to determine the proper percentages and phase-out amounts after a consideration of factors, including the proposed credit's impact on revenue and the probable effect that the phaseout of the estate tax will have on charitable contributions.

Finally, a taxpayer should be able to carry forward for a five year period the amount of the credit that has been reduced by the applicable percentage. The charitable contribution provisions already allow for the carrying forward of charitable contribution deductions that are disallowed by the percentage limitations. As applied to the credit, assuming that a single taxpayer makes a charitable contribution of \$1,000, the taxpayer would be able to claim a maximum credit of \$400. If, for example, Congress enacted a 20% credit for this taxpayer's income level, the credit for the current taxable year would equal \$80, and the balance of the \$400 would be carried forward for five years. The taxpayer's credit for the subsequent years would be allowed to the extent that it did not exceed the 20% maximum credit. Consequently, if the taxpayer made an additional \$1,000 charitable contribution, the taxpayer would not be able to claim any of that amount as a charitable contribution credit. That additional charitable contribution would be reported as a deduction under the general provisions of § 170.

V. CONCLUSION

The charitable contribution deduction remains an integral part of the Code. However, in its present form, the tax incentive does not benefit all taxpayers. In 1998, only approximately 27% of all income tax returns reported charitable contribution deductions.²²⁸ Consequently, the charitable contribution deduction is ineffective in creating a bona fide income tax incentive for the majority of taxpayers. Its present form is inconsistent with our established progressive tax system. Congress should implement reforms to the charitable contribution rules. These reforms are essential to encourage charitable giving, which will likely be undermined by virtue of changes to the estate and gift tax provisions. The estate tax provisions contain unlimited charitable contribution deductions, but it is likely that there will be a reduction in charitable giving in the future because of the phaseout of estate taxation. While the income tax and estate and gift tax provisions are distinct statutory acts, charitable contributions are intertwined in both acts.

To remedy the problems associated with the charitable contribution rules, Congress should make several adjustments to § 170 in order to strengthen the tax incentive. The recommended adjustments provide an additional incentive for charitable giving but promote the fundamentals of the progressive tax system. Some scholars might

228. Internal Revenue Serv., *supra* note 8, at 205-06.

opine that it is inappropriate for the government to encourage low- and low-to-middle-income taxpayers to contribute funds to charitable organizations because these taxpayers should use their available funds to purchase basic necessities of life. That is, the Code should not encourage these taxpayers to contribute money when they are the least able to afford such contributions. There is some validity to that position. However, to the extent that a low- or low-to-middle-income taxpayer is making charitable contributions, they should receive a subsidy in the same way as do higher-income taxpayers. By not allowing these taxpayers to claim the tax incentive, only the higher-income taxpayers dictate which charitable organizations will essentially receive governmental subsidization. Moreover, the allowance of the credit for low-income taxpayers protects the integrity of the progressive income tax structure. By making the recommended changes, Congress could maintain the delicate balance between creating a tax incentive that benefits all taxpayers and ensuring that the tax incentive remains effective as the estate tax is gradually phased out.

The current income tax provisions continue to provide income tax incentives that encourage charitable giving. However, Congress should enhance the income tax incentives to offset the probable decline in charitable bequests. Moreover, even if the repeal of the estate tax is temporary, Congress should enact some form of a charitable contribution credit to allow nonitemizing taxpayers the opportunity to receive a tax subsidy for their charitable contributions. In such a case, the phaseout of the credit should be based on relatively modest adjusted gross income levels.