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CHARITIES IN TAX REFORM: THREATS TO SUBSIDIES OVERT AND COVERT

EVELYN BRODY*

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I. INTRODUCTION

Charities benefit from a range of direct and indirect subsidies from taxpayers. Government grants and, more significantly these days, fees for services show up in charity budgets. This article examines the less visible indirect subsidies. Through the tax system, charities enjoy income- and property-tax exemptions, offer deductibility to donors for contributions, and may issue tax-exempt bonds. Program revenue paid to certain charities is eligible for tax credits, such as the new tuition tax credit.

To some degree, the current mix of public funds and tax benefits results from a deliberate desire to encourage charitable activity. In recent years, however, Congress has increasingly shifted its focus from helping the charitable sector to helping *individuals* in need of specific social services. While today most providers of these social services are charities, neither is this status a legal prerequisite, nor is the nonprofit market share stable. Nevertheless, this "demand-side" form of support has been growing in importance to charities as they reach the limits of the benefits they can expect from traditional tax subsidies.

Clearly, the relationship between charities and society is about more than money. But we can examine charity subsidies without necessarily believing, as suggested by stories in the popular press, that tax exemption amounts to tax

abuse.¹ The possibility of tax reform presents two very different types of threats for charities.

First, under the traditional tax rules for charity the goal, presumably, is increased activity in the overall charitable sector. However, even though the rules make few distinctions among types of charities, the current landscape produces winners and losers. Income-tax exemption most benefits charities that save rather than spend, and the charitable-contribution deduction most benefits charities supported by high-bracket individuals. Tax reform of the most general type—such as replacing the income tax with a deduction-free consumption tax—would impose a heavy cost on those charities now enjoying the greatest benefits, as well as add a level of tax on most charitable operations.² But even more modest reforms of these traditional tax subsidies could alter the winners and losers.

The other threat from tax reform, however, comes in disguise and has been largely ignored.³ Indeed, no one would defend the recent proliferation

1. See, e.g., Edward T. Pound et al., *Tax-Exempt!*, U.S. NEWS & WORLD REP., Oct. 2, 1995, at 36, 51. See generally GILBERT M. GAUL & NEILL A. BOROWSKI, *FREE RIDE: THE TAX-EXEMPT ECONOMY* (1993) (based on a series of articles in *The Philadelphia Inquirer*).

2. So far, charities have focused on the threat to the contribution deduction. For example, the lengthy report by Price Waterhouse and Caplin & Drysdale, commissioned by the Council on Foundations and Independent Sector, spends 15 pages on the overall impacts of the recent reform proposals, as discussed below in Part II, and 56 pages on the impacts on giving, including detailed projections of loss of donations, as discussed below in Part III. See PRICE WATERHOUSE LLP AND CAPLIN & DRYSDALE, *CHARTERED, IMPACT OF TAX RESTRUCTURING ON TAX-EXEMPT ORGANIZATIONS* (1997) [hereinafter PRICE WATERHOUSE]. Similarly, Clotfelter and Schmalbeck's study estimates the anticipated drop in donations, but provides no assessment of the anticipated damage from loss of tax exemption. See Charles T. Clotfelter & Richard L. Schmalbeck, *The Impact of Fundamental Tax Reform on Nonprofit Organizations*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 211, 228-35, 237-43 (Henry J. Aaron & William G. Gale eds., 1996).

This misplaced lack of concern might result from the current low value of exemption, which is useless to the extent that charities spend their resources. However, a tax system that exempts all taxpayers' investment returns would obliterate the charities' current relative benefits of exemption on investment income and from issuing tax-exempt bonds. Moreover, a tax system that treats charities as the ultimate consumer of goods and services, while taxing currently excluded employee fringe benefits, would increase the tax burden on charities' "related" business activity. See PRICE WATERHOUSE, *supra*; see also discussion *infra* Part III.B.2.

3. Neither PRICE WATERHOUSE, *see supra* note 2, nor Clotfelter & Schmalbeck, *see supra* note 2, discusses the effects on charities of eliminating the tax exclusion of employer-provided health insurance, the tuition tax credits, and the other demand-side subsidies that stimulate consumption of charitable services. Recall that in the first Clinton administration, health-care reform proposals threatened to impose caps on the tax-free treatment of employer-provided health insurance. Such a proposal was also made by the Treasury Department in 1984. See U.S. DEP'T OF TREASURY, *2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC*

in demand-side subsidies as "tax reform," but these provisions do have one important characteristic that distinguishes them from the traditional subsidies to charity: The traditional tax rules are conditioned on the nonprofit organizational form, while the demand-side tax subsidies function as vouchers. Theoretically, these tax deductions and credits could make certain charitable industries—such as higher education, hospital care, and social services—so much more attractive to for-profit businesses that nonprofit providers would have trouble competing with them.

In the absence of proof that the nonprofit organizational form is itself a public good, such a trend is to be commended, because demand-side subsidies often produce more efficient and equitable results than supply-side regimes. However, the use of targeted tax credits—a technique proposed to be expanded in the Clinton administration's Year 2000 Budget⁴ and in legislation

GROWTH 23-27 (1984). According to the Administration's 2000 Budget, the exclusion for employer contributions for medical insurance premiums and health care will cost \$77.67 billion in lost income tax in 2000, and the rate of growth is projected to increase. See FISCAL 2000 BUDGET, ANALYTICAL PERSPECTIVES VOLUME, ch. 5, at tbl.5-1 (Feb. 1, 1999), reprinted in 82 TAX NOTES 1191, 1194 (Feb. 22, 1999) [hereinafter ADMINISTRATION'S 2000 BUDGET]. See generally CONGRESSIONAL BUDGET OFFICE, MAINTAINING BUDGETARY DISCIPLINE: SPENDING AND REVENUE OPTIONS 234, REV-10 (Apr. 1999) ("Limit the Tax-Exemption of Employer-Paid Health Insurance").

For discussions of eliminating or limiting the tax exclusion as a health-insurance cost reform, see generally Martin Feldstein & Milton Friedman, *Tax Subsidies, The Rational Demand for Insurance and the Health Care Crisis*, 7 J. PUB. ECON. 155 (1977), and Mark V. Pauly, *Taxation, Health Insurance, and Market Failure in the Medical Economy*, 24 J. ECON. LITERATURE 629 (1986). For a proposal to substitute a tax credit, see Alain C. Enthoven, *A New Proposal to Reform the Tax Treatment of Health Insurance*, 3 HEALTH AFF. 21, 28-37 (1984).

4. For example, among other initiatives, the Clinton administration's Year 2000 Budget proposes for low- and middle-income taxpayers increasing the percentage of creditable dependent-care expenses above the current 20%; a credit for disabled persons; and a credit for disabled workers (permitting two credits for a disabled worker with long-term care needs). See U.S. Dep't of Treasury, *General Explanations of the Administration's Revenue Proposals*, 1-5, 23-25 (Feb. 1, 1999) <<http://www.ustreas.gov/press/releases/gmbk99.htm>> [hereinafter *General Explanations*]. The American Bar Association wrote to the Secretary of the Treasury to express "disappointment" over "the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay." See *ABA Tax Section Voices Disappointment over Plethora of Proposed Tax Credits*, TAX NOTES TODAY, Feb. 26, 1999, available in LEXIS, Fedtax Library, Tax Notes Today File, as 99 TNT 42-56 (Mar. 4, 1999). The "Taxpayer Refund and Relief Act of 1999," passed by the House and the Senate on August 5, 1999, employed targeted tax provisions on a grand scale. See JOINT COMM. ON TAXATION, SUMMARY OF THE REVENUE PROVISIONS OF THE CONFERENCE AGREEMENT ON H.R. 2488, THE "TAXPAYER REFUND AND RELIEF ACT OF 1999," JCX-63-99 (Aug. 6, 1999) [hereinafter JOINT COMM. ON TAXATION, SUMMARY]; JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 2488, JCX-61-99R (Aug. 5, 1999)

vetoed in September 1999—results in its own inefficiencies and inequities. In this respect, tax reform could salutarily convert these demand-side subsidies into direct expenditures programs. However, the major fundamental tax reform proposals currently under discussion purport to be revenue-neutral: The tax savings achieved are to be returned to taxpayers in the form of lower rates across the board, with no attempt to make up the financial harm to affected sectors, including charities.

By viewing the charity tax rules as subsidies,⁵ this article raises the question of what good the public wants to subsidize. I have sought to lay the groundwork for this study in my earlier writings on the nonprofit sector.⁶ Overall, I have expressed skepticism that “nonprofitness” as an organizational form produces unique social benefits to society *ipso facto* worthy of special tax treatment. As I describe in *Agents Without Principals: The Economic*

[hereinafter JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS]. The President vetoed this bill on September 23, 1999. See Taxpayer Refund and Relief Act of 1999—Veto Message from the President of the United States, *reprinted in* 145 Cong. Rec. H8613 (daily ed. Sept. 23, 1999). No doubt many of the proposals will resurface in other legislation.

5. If, by contrast, the current tax rules reflect a properly defined tax base, then the results cannot be blamed on inartful subsidies. Elsewhere I have discussed the alternative subsidy and base-defining theories of the various special tax treatments of charity. See generally Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998) [hereinafter Brody, *Of Sovereignty and Subsidy*]. The remainder of this article assumes not only that the charitable-contribution deduction and the charity-bond interest exemption are subsidies (the prevailing view), but also that the income-tax exemption is a subsidy (a less accepted view). See, e.g., *Regan v. Taxation With Representation*, 461 U.S. 540, 544 (1983) (“Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system.”). The federal tax-expenditure budget, however, views the income-tax exemption of charities as a normative component of the tax base. Accordingly, the forgone revenue attributable to the income-tax exemption remains unestimated. Criticizing such an approach, Stanley Surrey (originator of the “tax expenditure” concept) and his co-author, Paul McDaniel, asserted that “[t]o the extent that this exempt income is utilized to provide consumption for the beneficiaries of the [exempt] organizations, and to the extent that the consumption is untaxed, significant amounts are excluded from the tax base.” STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 219 (1985). In addition, this article adopts the noncontroversial view that demand-side tax rules are subsidies.

6. See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457 (1996) [hereinafter Brody, *Agents Without Principals*]; Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997) [hereinafter Brody, *Charitable Endowments*]; Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433 (1996) [hereinafter Brody, *Institutional Dissonance*]; Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400 (1998); Brody, *Of Sovereignty and Subsidy*, *supra* note 5; see also Evelyn Brody, *Paying Back Your Country Through Income-Contingent Student Loans*, 31 SAN DIEGO L. REV. 449 (1994) [hereinafter Brody, *Student Loans*].

Convergence of Nonprofit and For-Profit Organizational Forms,⁷ all firms are subject to similar economic forces of resource dependency, institutional isomorphism, and organizational slack. Thus, nonprofits behave more like for-profits than conventionally believed, while proprietary firms suffer from many of the inefficiencies commonly laid at the door of nonprofit firms.⁸ In *Institutional Dissonance in the Nonprofit Sector*, I describe how nonprofits throughout American history have never had a defined place.⁹ Rather, in different times and in different regions, different types of organizations—public, proprietary, and nonprofit—have been employed to conduct collective activity.¹⁰ In particular, the presence of mixed-sector industries, such as hospitals and nursing homes, confounds traditional nonprofit theorists.

This article generally confines itself to the question of "fit." That is, assuming we know what charities do, and assuming we want to encourage them to do more of it, are these tax rules the best approach, both from an efficiency and a political-process perspective? My future research will turn to the distributional concerns important in evaluating tax subsidies: the differences between charitable purposes and public purposes; whether the people who make charitable contributions (and the amounts) match the income-class distribution of taxpayers; whether the distribution of tax benefits matches the distribution of tax burdens; whether charity beneficiaries are the same as public beneficiaries; and whether charity fiduciaries make decisions the same way as do bureaucrats.

This article contains three substantive parts. Part II describes the current tax subsidies to the charitable sector, both the traditional supply-side subsidies and, using education as an example, key demand-side subsidies. Part III examines the effects on charities of five types of possible changes, from incremental to radical: (1) replacing the contribution deduction with a tax credit; (2) eliminating exemption for designated commercial activities; (3) reforming the tax exemption to reduce charities' incentive to save; (4) removing charities' relative advantage as investors under corporate/shareholder integration; and (5) shifting to a broad-based consumption tax. Part IV considers the effects of compensating for the loss of tax subsidies (if desired) with direct grants or demand-side stimuli.

Let me offer a few predictions. While charities would lose some of the bragging rights that come with economic power, they might wish to jettison a weighty albatross from a dangerously listing ship and support repealing the

7. See Brody, *Agents Without Principals*, *supra* note 6, at 528-29.

8. See *id.*

9. See Brody, *Institutional Dissonance*, *supra* note 6, at 437.

10. See *id.* at 445.

tax exemption of nonprofit hospitals.¹¹ The highly visible and increasingly commercial-looking nonprofit educational institutions would then become the next category of contention. Congress might also adopt a low-level investment tax to offset charities' incentive to save. More generally, by existing at the periphery of the tax system, charities quietly have garnered billions of dollars' worth of benefits that would be hard to retain in a stampede for a broad-based, simple regime favoring savings over consumption.

Depending on the administrative structure of a post-reform tax system, charities might not be able to recoup governmental financial support based on their organizational form. Moreover, charities face the political hazards explored in the public choice literature. Assuming that Congress would be inclined to compensate charities with direct grants for lost tax support, Congress would have a choice in the form of subsidy. Judging by recent trends, Congress might adopt demand-side vouchers for social services, thus permitting recipients to choose among providers, whether nonprofit, for-profit, or governmental. However, consumer vouchers cannot address all market failures, so subsidies for pure public goods such as nonprofit art collections might still be necessary for the provider¹²—and here organizational form might continue to matter. Of course, constitutional limitations preclude making direct payments for religious purposes, so the easiest approach to churches might, once again, be to simply carve them out and leave them as they are.¹³ Thus, even if all special tax treatments were eliminated in favor of direct grants, a combination of both an inputs and outputs approach could be applied to rationalize public support for public goods.

11. Cf. Fred Stokeld & Carolyn D. Wright, *EO Practitioners Learn the Latest at Nonprofit Conference*, 77 TAX NOTES 1009, 1009 (Dec. 1, 1997):

Citing a congressional study on tax implications for deregulation of the power industry, [Joint Committee on Taxation Chief of Staff Kenneth J.] Kies commented that "the analogy with the health care industry is hard to miss" and that it is "well worth keeping an eye on" the way Congress addresses nonprofit versus for-profit issues in the power industry. The approach Congress takes toward the competition that has arisen between for-profit and nonprofit power companies could foreshadow the legislators' approach toward joint ventures between exempt and for-profit health care providers, he advised.

Id.

12. See Gerald M. Brannon & James Strnad, *Alternative Approaches to Encouraging Philanthropic Activities*, in 4 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS: RESEARCH PAPERS 2361 (1977) [hereinafter FILER COMM'N RESEARCH PAPERS].

13. For a discussion of the constitutional issues, see Part IV.B, *infra*.

II. WHAT TYPES OF TAX SUBSIDIES TO CHARITY EXIST?

Like a photo-negative, the tax treatment of charities presents a reverse image of normal incentives.¹⁴ Nominally peripheral to the tax system, charities actually benefit from a tax structure that imposes high rates on their for-profit competitors and their donors. The greater the regular corporate tax burden, the greater the relative value of the charity's tax exemption. The higher the individual income-tax rates, the lower the price of giving to charity. (Similarly, charities are big defenders of the estate tax.) However, we have probably reached the limit of what we can do for charity directly through the income tax.¹⁵ The income-tax exemption has no value to the many charities that spend as much as they receive. Individual giving has held constant for decades at about two percent of personal income.¹⁶ While no official estimate exists of the value of charities' income-tax exemption,¹⁷ the charitable-

14. Discussions of the third sector often use the terms "charity" and "nonprofit" interchangeably. However, many different types of entities organize without stock ownership under state nonprofit law. Because social clubs, labor organizations, trade associations, and other less-altruistic forms of collective action provide mutual benefits, the government generally confers fewer tax benefits on non-charities. Thus, the typical state property-tax scheme grants exemption only to churches, schools, and other charitable organizations. Federal income-tax exemption extends to most types of nonprofit organizations for earnings derived from activities related to their exempt purpose; however, only charities may offer donors income-tax deductibility for contributions. Such distinctions might appear to confine the most favored "circle" of tax-benefited organizations to a small portion of the nonprofit sector. See John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 67, 68-73 (Walter W. Powell ed., 1987) [hereinafter *THE NONPROFIT SECTOR*]. Instead, "charity" historically has been broadly defined—embracing many activities that have a mutuality flavor, such as education or religion—and only a small percentage of charitable activity focuses on relief for the poor. See Brody, *Institutional Dissonance*, *supra* note 6.

15. The other two significant special tax rules for charity generally spur physical capital investment for exempt purposes: the ability to issue tax-exempt bonds and the property tax exemption.

16. C. Eugene Steuerle & Virginia Ann Hodgkinson, *Meeting Social Needs: Comparing the Resources of the Independent Sector and Government*, in *NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT* 71, 80 fig.2.3 (Elizabeth T. Boris & C. Eugene Steuerle eds., 1999) [hereinafter *NONPROFITS AND GOVERNMENT*]. Compare PRICE WATERHOUSE, *supra* note 2, pt.3, at 6 fig.2, and pt.3, at 7 n.12 (contributions have fallen from 2.2% of personal income in 1964 to about 1.75% in 1993), with James Andreoni, William G. Gale, & John Karl Scholz, *Charitable Contributions of Time and Money*, at tbl.6 (July, 1996) <<http://www.ssc.wisc.edu/~andreoni/WorkingPapers/ags-v8.pdf>> (contributions have risen from 1.79% of GDP in 1980 to 2.06% in 1992).

17. For an informal estimate of \$13.9 billion (only \$2.3 billion excluding educational institutions and hospitals), see Evelyn Brody and Joseph J. Cordes, *Tax Treatment of Nonprofit*

contribution deduction under the income tax is expected to cost the Treasury \$25.85 billion in the year 2000, the eighth-largest item in the "tax expenditure budget,"¹⁸ and the aggregate revenue loss estimate for charitable-contribution deductions under the gift and estate tax is expected to exceed \$6 billion in the year 2000.¹⁹

Accordingly, of growing importance to charities is the indirect benefit from a host of tax preferences that, deliberately or incidentally, stimulate demand for the services that charities provide.²⁰ The exclusion from workers' income for employer-provided health insurance is the second-largest tax expenditure and is projected to become the largest in 2003.²¹ While doctors and other proprietary firms benefit from health expenditures, so do hospitals, dominated by nonprofits.²² The brand-new HOPE tuition credit instantly became the twentieth-ranked tax expenditure. Designed to keep college affordable for the middle class, the credit's value, many education experts believe, will be captured by colleges and universities through higher tuition charged or lower internal aid granted. Nonprofit daycare providers benefit from the dependent-care credit. Nonprofit housing developers benefit from the low-income-housing tax credit. While the nonprofits' share of these tax expenditures cannot be quantified, the Treasury Department's estimates by

Organizations: A Two-Edged Sword?, in NONPROFITS AND GOVERNMENT, *supra* note 16, at 141, 149 tbl.4.5 (tabulations by Thomas H. Pollak).

18. The tax expenditure budget treats the income-tax exemption as part of the normal tax base. For the estimate of the contribution deduction, see ADMINISTRATION'S 2000 BUDGET, *supra* note 3, at 1200 tbl.5-3 (Major Tax Expenditures in the Income Tax, Ranked by Total 2000 Revenue Loss). In addition, because individuals can deduct their charitable contributions only if they itemize and fewer than 30% do so, a portion of the standard deduction should count, too: If the standard deduction were set too low, generous taxpayers would itemize instead. See, e.g., Andreoni et al., *supra* note 16, at 23 n.36 ("The IRS data include only itemizers, so the apparent reduction in giving as a percentage of GDP 1986 may simply reflect the fact that fewer taxpayers itemize following the 1986 tax reform.").

19. ADMINISTRATION'S 2000 BUDGET, *supra* note 3, at 1211 tbl.5-6 (Revenue Loss Estimates for Tax Expenditures in the Federal Unified Transfer Tax).

20. See Steven Rathgeb Smith, *Government Financing of Nonprofit Activity*, in NONPROFITS AND GOVERNMENT, *supra* note 16, at 177, 177 (identifying "four key ways through which government finances or encourages nonprofit activity: direct grants and contracts; fees from individuals and third party organizations; tax credits and deductions; and regulations encouraging nonprofit service delivery").

21. See Christopher Bergin, *Spending Through the Code: The Top Ten Tax Expenditures*, 82 TAX NOTES 1100 (Feb. 22, 1999).

22. In 1993, of the total \$892.3 billion in national health expenditures, \$324.2 billion (36.3%) went for hospital care, and 66% of short-stay hospital beds (651,560 out of 992,375) were nonprofit. PUBLIC HEALTH SERV., U.S. DEP'T HEALTH & HUMAN SERVS., HEALTH, UNITED STATES, 1995, at 244 tbl.119, 250 tbl.124, 231 tbl.107 (visited Sept. 7, 1999) <http://www.cdc.gov/nchswww/data/hus_95.pdf>.

"budget function" for 2000 (aside from the charitable-contribution deduction) are \$11.2 billion for education, \$2.425 billion for the dependent-care credit, and a staggering \$89 billion for health.²³

It is not difficult to identify the charitable "winners" under the tax system. As for the traditional tax rules, most of the benefits accrue to (1) charities supported by donors who itemize, or who have taxable estates; (2) charities that save, and earn exempt investment income: notably, university endowments and private foundations, although all classes of charities save;²⁴ (3) charities that borrow by issuing tax-exempt bonds: notably, hospitals and universities; and (4) under state law, charities that own real estate in high-property-tax jurisdictions (although under attack in some jurisdictions): notably, hospitals and universities.

Through the tuition tax and other subsidies described in Part B below, institutions of higher education have become the predominant incidental winners of demand-side tax subsidies. Nonprofit hospitals benefit incidentally through the exclusion for employer-provided health insurance. Of course, to identify the ultimate winners, we would have to be able to identify the individual beneficiaries of charity. However, as discussed in Part IV.A, neither private philanthropy nor demand-side tax subsidies are particularly redistributive.²⁵

Charities also depend heavily on direct governmental expenditures. To a large degree, most of the recent explosive growth in the nonprofit sector can be attributed to the "outsourcing" of federal social service spending through the nonprofit sector, either by contracting for services or by funding fees paid by clients, such as through Medicare.²⁶ While charities account for nearly

23. Figures are derived from Table 5-1 of ADMINISTRATION'S 2000 BUDGET, *supra* note 3, at 1194, and ignore \$18.7 billion for the child credit. Under similar, but not identical formulations, the staff of the Joint Committee on Taxation estimated tax expenditures (aside from the charitable-contribution deduction) at \$10.3 billion for education, \$3.4 billion for social services (ignoring \$20 billion for the child credit), and \$74.6 billion for health. See JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1999-2003, Table 1, Individuals, JCS-7-98 (Dec. 14, 1998), reprinted in 82 TAX NOTES 95 (Jan. 4, 1999) [hereinafter JOINT COMM. ON TAXATION, TAX EXPENDITURES].

24. See Thomas H. Pollak & Kathryn L.S. Pettit, *The Finances of Operating Charities, 1989-1995* tbls.21-22 (Nat'l Ctr. for Charitable Statistics, The Urban Inst.) (Nov. 10, 1997) (on file with *Tennessee Law Review*).

25. Moreover, the employees of charities are not necessarily members of a charitable class. See generally Brody, *Agents Without Principals*, *supra* note 6, at 528-32.

26. Steuerle & Hodgkinson, *supra* note 16, at 88. Noting this "outsourcing" by government, the authors caution against double-counting the level of spending on social services. *Id.* at 78 fig. 2.2, 88 (finding that the growth in nonprofit sector employment from 9.3% to 11.7% of all employment between 1977 and 1996 "is almost of the same order of magnitude as the decline in the government sector from 18.6 percent to 16.5 percent of all

6.3% of national income, more than half of their economic activity can be attributed to nonprofit hospitals and other health care providers, and almost one-fifth to institutions of higher education.²⁷ In 1992, donations represented only 18% of the average charity's revenue, and half of private individual giving goes to churches, which are nearly entirely donor-supported.²⁸ By contrast, the government directly supplied 31% of charities' support and accounted for some of the 39% of charity revenue derived from fees for services.²⁹ Thus, the recent federal discretionary budget cuts also threaten more than dollars. "Devolution" of the federal welfare system to the states is bringing two fresh challenges to charities: multiple state and local contracting authorities³⁰ and competition from newly formed for-profit service providers.³¹

A. Subsidies Based on Organizational Form

Organizational form determines the entitlement to the traditional tax benefits for charitable activity. In general, Congress provides the same tax subsidy to any nonprofit organization exempt under Internal Revenue Code section 501(c), as follows:

1. No tax on the receipt of contributions (the same is true for taxable entities).³²

employment," and attributing much of the shift to outsourcing).

While the charitable sector contains about 500,000 organizations, fewer than one-fourth spend more than \$100,000. See VIRGINIA ANN HODGKINSON ET AL., *NONPROFIT ALMANAC 1996-1997: DIMENSIONS OF THE INDEPENDENT SECTOR* 15 (1996) (1993 data). These numbers do not count churches, which are exempt from filing with the IRS. There were an estimated 341,000 churches in 1992. *Id.* at 37 tbl.1.1.

27. HODGKINSON ET AL., *supra* note 26, at 3 (national income for 1994), 7 fig.4 (sectoral division for 1992).

28. *Id.* at 190 tbl.4.2 (data include churches).

29. *Id.*

30. This multiplicity would represent an acceleration of an existing trend. See generally STEVEN RATHGEB SMITH & MICHAEL LIPSKY, *NONPROFITS FOR HIRE: THE WELFARE STATE IN THE AGE OF CONTRACTING* (1993); JULIAN WOLPERT, *PATTERNS OF GENEROSITY IN AMERICA: WHO'S HOLDING THE SAFETY NET?* (1993) (arguing that a decade of devolution and decentralization of federal programs has led to large geographic disparities in access to services because of the varying ability and willingness of states and cities to compensate).

31. See Carol J. De Vita, *Nonprofits and Devolution: What Do We Know?*, in *NONPROFITS AND GOVERNMENT*, *supra* note 16, at 213, 228-29 (noting that after health care, the next major field of competition is expected to be child welfare services).

32. I.R.C. § 501(a) (West 1998) (exemption from tax on corporations, certain trusts, etc.); *id.* § 118 (contributions to the capital of a corporation).

2. No tax on net income earned in the performance of exempt functions, such as tuition paid to a college or fees paid to a nonprofit hospital for health care. In effect, the system excludes both the gross receipts and the associated expenses.
3. No tax on investment income, such as dividends, interest, real-property rent, and royalties.³³ Taxable income does result, however, from debt-financed investments (although universities and pension funds are not taxed on leveraged real-estate investments).³⁴
4. Tax is imposed on income from a business unrelated to the organization's exempt purpose (the "unrelated business income tax," or UBIT).³⁵ Of course, in practice, the business income tax exemption varies with the purposes of particular organizations, since what is "related" to one organization might not be related to another.

In addition, two special federal tax rules apply just for section 501(c)(3) religious, charitable, and educational organizations ("charities"):

5. Charities can issue tax-exempt bonds to finance their exempt-purpose activities.³⁶
6. Donors can claim, in general, a charitable-contribution deduction for the amount of money and the value of property contributed to charities without triggering the unrealized gain.³⁷

The remainder of this section examines a few of the traditional tax subsidies in detail.

33. However, social clubs are taxed on their investment income and a charity is taxed on income (other than dividends, which the payor cannot deduct) that is received from a controlled taxable subsidiary. *Id.* § 512(a)(3), (b)(13).

34. *Id.* § 514.

35. *Id.* §§ 511-515. While the federal government and state and local governments or their instrumentalities are exempt from tax on income derived from any essential governmental function, state and local colleges and universities are subject to the UBIT. *Id.* § 511(a)(2)(B).

36. *Id.* § 103. For the requirements of qualified 501(c)(3) bonds, see *id.* § 145. See also, e.g., Sana Siwolop, *How to Support Nonprofits, and Possibly Make a Profit*, N.Y. TIMES, Jan. 11, 1998, § 3, at 4 (describing the range of section 501(c)(3) bonds).

37. I.R.C. § 170. Dues paid to trade associations and labor organizations are generally deductible under section 162 as business expenses (subject to the 2% floor under miscellaneous itemized deductions and the amount of dues used by the organization for certain lobbying and political expenditures). See *id.* §§ 67, 162(a), (e).

1. Charitable-Contribution Deduction

From its first appearance in 1917, the charitable-contribution deduction has included complicated limitations. Aside from a brief experiment in the early 1980s, nonitemizers cannot separately claim their charitable contributions.³⁸ Since 1993, itemizers with high adjusted gross income must include charitable contributions in their aggregate itemized deductions subject, in general, to a floor equal to three percent of the amount by which adjusted gross income exceeds a base (\$126,600 in 1999).³⁹

In addition, for most taxpayers, the amount they contribute represents a small percentage of what they earn in any year, but this is not necessarily true for those persons who are dissaving, such as retirees or those receiving large amounts of excluded interest income from tax-exempt bonds. The Code prevents donors from "zeroing out" their tax liability for a particular year through charitable contributions, by limiting deductions to a percentage of that year's adjusted gross income.⁴⁰ Excess amounts may be carried forward

38. The Senate version of the bill that was eventually passed as the "Taxpayer Refund and Relief Act of 1999," while not fully restoring the pre-1986-Act rule, would have allowed nonitemizers to deduct up to \$50 (\$100 on a joint return) in charitable contributions. See Grant Williams, *Tax Bill Shows Appeal of Charities*, CHRON. PHILANTHROPY, Aug. 26, 1999, at 31, 33.

39. I.R.C. § 68; Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.06 (inflation adjusted amount for 1999).

40. Obviously, the subsidy for contributions made by particular taxpayers varies with income-tax rates, and commentators observed that the percentage-of-income limits rose as tax rates rose. See Edward H. Rabin, *Charitable Trusts and Charitable Deductions*, 41 N.Y.U. L. REV. 912, 915-17 (1966) (chronicling the development of the charitable-contribution deduction). Professor Rabin cited Harry Kahn's estimate that because of rising tax rates and increasing percentage-of-income limits, the government's "share" of all charitable contributions increased from 12.2% in 1924 to 31.5% in 1956. *Id.* at 917 n.35 (citing C. HARRY KAHN, *PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX* 56-57 (1960)). More recently, because of the drop in top tax rates since 1981 (before reversing somewhat in 1993), "the generosity of the top one percent (measured by the after-tax cost of their giving) actually increased between 1979 and 1994." GERALD E. AUTEN, CHARLES T. CLOTFELTER & RICHARD L. SCHMALBECK, *TAXES AND PHILANTHROPY AMONG THE WEALTHY*, at 22 (Univ. of Mich. Tax Policy Research Working Paper Series No. 98-15), reprinted in *DOES ATLAS SHRUG: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* (Joel Slemrod ed., forthcoming 2000).

Today, simplifying greatly, the percentage limitation depends on the answer to two questions: (1) What type of section 501(c)(3) organization is the donee? and (2) Is the donation in cash or kind? If the donee is a publicly supported charity, then cash contributions may reduce the donor's adjusted gross income (AGI) by up to 50%. I.R.C. § 170(b)(1)(A). By contrast, if the donee is a private foundation, then cash contributions may reduce the donor's AGI by up to only 30%. *Id.* § 170(b)(1)(B). If instead the donor contributes appreciated capital assets, then the percentage-of-income limit is 30% for a public charity donee and 20% for a private foundation. See *id.* § 170(b)(1)(C), (D). Donations of appreciated property are generally

subject to the same rules, but unused "carryforwards" vanish after five years.⁴¹ These restrictions prompted Eugene Steuerle to observe: "Given the fact that many of the very wealthy realize only a small part of their capital income, there is only a limited income tax incentive for them to donate significant portions of their wealth to charity during their lifetimes."⁴²

Compared with an estimated \$109 billion in charitable contributions by living individuals, charitable bequests in 1998 came to an estimated \$13.62 billion.⁴³ Charitable bequests are deductible in full under the federal estate tax,⁴⁴ which includes rates that can exceed 55%.⁴⁵ In 1994, the top one percent of households (as measured by income) made over 16% of all lifetime charitable contributions, and the wealthiest 1.4% of decedents made about 86% of all charitable bequests.⁴⁶ Moreover, without an estate tax, lifetime giving would likely fall—by an estimated 12%, according to one study.⁴⁷

2. General Scope of Income Tax Exemption

Nearly every exempt organization is a creature of state law, usually organized under a state's nonprofit corporation statute. State statutes impose (in Henry Hansmann's term) a "nondistribution constraint" on nonprofit corporations: Charities may make no distributions out of profits to shareholders or members. For federal tax purposes, the Code prohibits any payment of profits to private persons except where consistent with the type of exemption,

limited to the taxpayer's basis to the extent the gain would not qualify as long-term capital gain. An election is available to deduct only basis in order to take advantage of the higher percentage limits; this election might make sense if the amount of appreciation is small. Further, for private foundations, only publicly traded securities qualify for the fair-market-value deduction. *Id.* § 170(e).

Corporate donors, generally subject to the same rules, can deduct up to 10% of gross income in any one year. *Id.* § 170(b)(2).

41. See *id.* § 170(b)(1)(B), (b)(1)(C), (d)(1)(A), (d)(2)(A).

42. Eugene Steuerle, *Charitable Giving Patterns of the Wealthy*, in *AMERICA'S WEALTHY AND THE FUTURE OF FOUNDATIONS* 205, 218 (Teresa Odendahl ed., 1987). One study found that in 1995 more than one-fourth of charitable contributions by those in the highest income class exceeded the percentage-of-income limits, and thus had to be carried forward. Auten et al., *supra* note 40, at 17.

43. AAFRC Press Release, Total Giving Increased 10.7% in 1998, Announces Giving USA (visited Sept. 6, 1999) <<http://www.aafr.org?NEWS.HTM>>.

44. I.R.C. § 2055.

45. *Id.* § 2011(c).

46. See Auten et al., *supra* note 40, at 1.

47. Gerald Auten & David Joulfaian, *Charitable Contributions and Intergenerational Transfers*, 59 J. PUB. ECON. 55, 64 (1996). See generally Steuerle, *supra* note 42 (discussing the patterns of lifetime giving and bequests).

such as the provision of strike benefits to members of a labor organization.⁴⁸ The nondistribution constraint prevents an exempt organization desiring to accumulate funds for a particular activity from raising equity capital. Rather, the organization must rely on contributions, grants, dues, retained (untaxed) earnings from "related" business activities and investment income, retained (after-tax) earnings from unrelated business activities, and borrowings.

If, as Professor Hansmann suggests, the income-tax exemption serves as a subsidy to capital formation, it nevertheless provides peculiar incentives.⁴⁹ While charities have come to be known by their "section 501(c)(3)" tax-exempt designation in the Code, the entity's federal income-tax exemption is usually the least important of its tax subsidies. The problem is that charities always have more demand for their services than they can meet, yet charities make the most of this "subsidy" by spending less on their exempt functions. After all, a dollar of receipts, whether earned or donated, effectively loses the value of exemption when the charity spends a dollar. Were the charity instead a taxable enterprise spending all of its receipts, the charity would likewise have no tax liability.

3. Unrelated Business Income Tax

In recent years, charities have found themselves caught in a vicious cycle. As federal grants plummeted in the 1980s, charities were forced to become more creative in raising revenue. This has often meant selling goods or services to the public in areas related only tangentially to the organization's

48. In 1996, Congress extended the section 501(c)(3) inurement prohibition to section 501(c)(4) social welfare organizations.

49. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax*, 91 YALE L.J. 54, 92 (1981). Professor Hansmann states:

All that is being argued here is that (1) this rationale is the *best* justification that can be given for the exemption, and (2) it is an *adequate* rationale for the exemption in that, so long as the categories of organizations that qualify for the exemption are intelligently delineated, on the whole we are probably better off with the exemption than without it.

Id. In a footnote, Professor Hansmann suggests that other devices—such as capital grants, loans and loan guarantees—"would provide a much more direct response to the problem." *Id.* at 92 n.113. Mentioning the use of such devices under the Hill-Burton program for hospitals and under the Health Maintenance Organization Act of 1973 for HMOs, Hansmann observes:

Devices of this sort might well be superior to tax exemption as a means of allocating capital to the nonprofit sector—though such bureaucratic mechanisms for distributing capital can be quite costly to administer and are subject to constraints and influences that may result in an allocation that is far from efficient.

Id. I address these last issues in Part IV, *infra*. Finally, legislation was recently proposed to permit exempt organizations to exclude from their payroll tax liability up to 30% of the first \$6,000 per worker in an effort to encourage all employers to hire welfare recipients. See Daniel Tyson, *Work Opportunity Credit May Be Extended to Nonprofit Employers*, TAX NOTES TODAY, Sept. 16, 1998, available in LEXIS, Fedtax Library, Tax Notes Today File, as 98 TNT 179-6.

original exempt purposes. Moreover, the increase in the corporate tax burden under the Tax Reform Act of 1986 increased the relative value of the nonprofit tax exemption, but only for "related" activities.⁵⁰ Thus, the charities increasingly pushed the envelope of the definition of "related."

The charities' increased and expanded activities, in turn, attracted the attention of businesses complaining of "unfair competition," and, finally, of a tax-hungry Congress. At intensive hearings in 1987 and 1988, witnesses debated issues ranging from whether the "relatedness" test should be replaced with a "commerciality" test to whether existing rules are fully enforced.⁵¹ In the end the small business lobby proved no match for the charity lobby, and the Oversight Subcommittee could not even report out a package to the full Ways and Means Committee. The debate did stimulate public awareness of existing rules, and UBIT collections subsequently skyrocketed, although the ratio of tax dollars paid to the total revenue of the sector is still infinitesimal.⁵²

50. See Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 83, 102-03 (Burton A. Weisbrod ed., 1998).

On one hand, because the UBIT parallels the corporate income tax, increasing the effective tax rate on corporate income would have reduced the incentive of nonprofits to engage in unrelated business activities if the income from such activities was actually taxed. On the other hand, raising the effective corporate tax rate could have the opposite effect of encouraging nonprofits to engage in unrelated business activities if the income from such activities was effectively tax exempt—because of either lax enforcement or cost-shifting.

Id. at 103.

51. See generally Ellen P. Aprill, *Lessons from the UBIT Debate*, 43 TAX NOTES 1105 (Nov. 27, 1989) (discussing the pros and cons of the UBIT recommendations); A.L. Spitzer, *Reform of the UBIT: An Open Letter to Congress*, 40 TAX NOTES 195 (April 10, 1989) (discussing the debate between taxable business and tax-exempt organizations).

52. Total UBIT paid by all exempt organizations—not just charities—came to \$56 million in 1986, \$132 million in 1992, and \$181 million in 1993. Margaret Riley, *Exempt Organization Business Income Tax Returns: Highlights and an Analysis of Exempt and Nonexempt Finances, 1993*, 16 STAT. INCOME BULL. 75, 75 (Spring 1997). The total UBIT paid increased 6.4% in 1994, to \$191.5 million. Margaret Riley, *Unrelated Business Income of Nonprofit Organizations, 1994*, 17 STAT. INCOME BULL. 111, 111 (Spring 1998). UBIT paid surged the following year to \$277.5 million, but only \$59 million of this came from section 501(c)(3) organizations. Margaret Riley, *Unrelated Business Income of Nonprofit Organizations: Highlights of 1995 and a Review of 1991-1995*, 18 STAT. INCOME BULL. 80, 104 tbl.1 (Spring 1999) [hereinafter Riley, *Highlights of 1995*]. The \$3.6 billion in gross unrelated business income, *id.*, represented only half of one percent of the \$663.4 in total revenue of section 501(c)(3) organizations (other than private foundations, small charities, and most churches). Cecilia Hilgert & Melissa Whitten, *Charities and Other Tax-Exempt Organizations, 1995*, 18 STAT. INCOME BULL. 105, 105 (Winter 1998-99).

James Hines expresses skepticism of the UBIT figures: "Since unrelated business income is self-reported, and since nonprofit organizations are virtually never audited by the IRS,

Purely as a matter of comparative advantage and economies of scale and scope, the types of unrelated businesses most attractive to an exempt organization will be ones that make use of the organization's exempt-purpose assets, including labor.⁵³ This type of unrelated business activity accordingly can be economically efficient.⁵⁴ To minimize tax, however, the organization will seek to allocate as many as possible of the costs of such "dual-use" assets to the unrelated activity.⁵⁵ Indeed, most UBIT returns report net losses,⁵⁶ and the IRS has had fierce difficulties in reallocating deductions.⁵⁷ In the late 1980s, the Oversight Subcommittee also considered limiting deductions for dual-use assets, such as requiring use of marginal instead of pro-rata cost to determine net unrelated business income.⁵⁸ Economist Richard Sansing

organizations have incentives to misreport any otherwise-taxable activities as being either related to charitable purpose, and therefore exempt from tax, or else unprofitable due to large deductions from income." JAMES R. HINES, JR., *NONPROFIT BUSINESS ACTIVITY AND THE UNRELATED BUSINESS INCOME TAX* 25 (National Bureau of Economic Research Working Paper No. 6820, 1998).

53. See Cordes & Weisbrod, *supra* note 50, at 100 (footnote and table omitted):

In each of the industries we found, as hypothesized, that (1) additional gross income from *untaxed* activity had a positive, statistically significant, and substantial effect on total compensation [paid], and (2) additional income from *taxed* (UBIT) activity had no significant effect on total compensation. It seems, not surprisingly, that nonprofits are selecting unrelated commercial activities that use the same inputs required for the mission-related activities, so that the marginal costs of added unrelated activity are essentially zero.

54. See, e.g., *id.* at 103 ("It may encourage nonprofits to use existing resources to expand the output of ancillary goods that, without differential taxation, would be profitable to produce, but which would not be produced because of nonprofits' aversion to profit-making activities."). But see J. Gregory Dees, *Enterprising Nonprofits*, HARV. BUS. REV., Jan. 1998, at 54, 56-57 (suggesting that nonprofit managers are not so reluctant: "Commercial funding is particularly attractive because it is unrestricted: owners of a commercial enterprise can use excess revenues for whatever purposes they like, whereas the use of grants and donations to nonprofits is often restricted to particular projects and purposes.").

55. See Cordes & Weisbrod, *supra* note 50, at 102:

Most, if not all, of the labor-compensation costs reported on UBIT returns reflect not true costs of the activities but only allocation of fixed costs that would have been incurred even were there less or no unrelated business activity. This does not imply any illegalities, but it does raise questions about accounting rules for joint-cost allocation between taxed and untaxed activities.

56. In 1995, 9,903 section 501(c)(3) organizations reported gross unrelated business income of \$3.6 billion and associated deductions of \$4.6 billion; only 3,187 charities owed income tax. Riley, *Highlights of 1995*, *supra* note 52, at 104 tbl. 1.

57. In *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), the Service lost an attempt to allow the university deductions only for the marginal (variable) costs of renting out a hockey stadium. The Treasury regulations permit an allocation of dual-use expenses on "a reasonable basis." Treas. Reg. § 1.512(a)-1(c) (1998).

58. To be precise, the proposal sketched the following rule for dual-use assets: An exempt organization could deduct the "marginal costs of the activity; allocable share of straight-line depreciation; and allocable share of general and administrative expenses (including overhead), to the extent that a direct nexus to the unrelated activity can be established." Idle

observes that such reform could produce efficiency gains as well: "If the exempt organization is permitted to allocate a portion of its common costs to the taxable activities constrained only by the reasonableness standard in the Treasury Regulations, then in practice UBIT generally will fail to deter economically inefficient investments by exempt organizations."⁵⁹

4. Bond Finance

In 1968, Congress codified the privilege of charitable, religious, and educational organizations to issue tax-exempt bonds; according to the legislative history, "The Conference recognizes that section 501(c)(3) organizations typically perform functions which government would otherwise have to undertake."⁶⁰ The income exclusion for interest earned on tax-exempt bonds is notoriously inefficient: Because the demand by issuers cannot be satisfied by bondholders taxed at the highest marginal rate, the interest rate offered has to be high enough to attract those taxed at lower rates. Since the interest rate subsidy is based on an average of the different marginal rates of the bondholders, the amount of tax revenue lost is greater than the savings to the issuers.⁶¹ In 1978, the Treasury Department recommended that tax-exempt bonds be replaced with taxable bonds, supplemented by a direct government payment to those then entitled to issue tax-exempt bonds.⁶²

time would be allocated to the exempt function. See *Spreadsheet Used by Ways and Means Oversight Panel During UBIT Discussions* (May 24, 1988), TAX NOTES TODAY, May 25, 1988, available in LEXIS, Fedtax Library, Tax Notes Today File, as 88 TNT 111-22.

59. Richard Sansing, *The Unrelated Business Income Tax, Cost Allocation, and Productive Efficiency*, 51 NAT'L TAX J. 291, 301 (1998). Professor Sansing also observes that if the unrelated business results in nondeductible lost opportunity costs (such as decreased donations because of donors' distaste for excessive commercialism), then the UBIT could inefficiently deter activity. *Id.* at 293. Compare Professor Aprill's observation that much of the debate during the late 1980s concerned not unfair competition but rather "the nature of the exemption itself." Aprill, *supra* note 51, at 1106-07. For example, the proposal to create price limits for UBIT-free sales by museum gift shops "indicates a Congressional judgment that at some point it is not appropriate for an exempt cultural and educational institution to sell goods for profit." *Id.*

60. John Copeland & Gabriel Rudney, *Federal Tax Subsidies for Not-for-Profit Hospitals*, 46 TAX NOTES 1559, 1566 n.28 (Mar. 26, 1990) (quoting H.R. REP. NO. 99-841, at 687 (1986)).

61. *Id.* at 1568.

62. *Id.* at 1573 & n.63 (citing U.S. DEP'T OF TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM (Jan. 30, 1978)). Professor Kaplow suggests that the opposition of state and local government officials to this proposal suggests that they prefer tax subsidies to direct subsidies, "perhaps because they are less likely to be cut as part of deficit-reduction efforts." Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 486 n.201 (1996).

5. State Tax Subsidies

Large subsidies to charities also occur at the state level, such as property-tax and sales-tax exemptions. In contrast to the income-tax exemption—and like the bond subsidy—these are input subsidies, reducing the costs of operation.

*B. Demand-Side Tax Incentives: The Case of Education*⁶³

The federal government uses demand-side tax subsidies to stimulate the purchase of a variety of services, many of which are provided by nonprofit organizations. For convenience, this article narrows the discussion to the set of tax expenditures for higher education, which are expected to cost (not counting \$3 billion for deductible donations to education) about \$11.2 billion in 2000.⁶⁴ As a separate matter, the federal government spends funds directly on Pell and other grants and on work-study programs, and it facilitates the ability of students to borrow against future income through the federally guaranteed student-loan program.⁶⁵ While the grant programs concentrate on students from low-income families, the student-loan program guarantees both means-tested subsidized loans and non-means-tested unsubsidized loans.⁶⁶ In 1997, the federal government spent about \$1.6 billion in campus-based aid, which disproportionately benefits students at private, nonprofit institutions.⁶⁷

63. See Evelyn Brody, *The Tax Treatment of Education After the Taxpayer Relief Act of 1997*, 78 TAX NOTES 1549 (Mar. 23, 1998); JOINT COMM. ON TAXATION, OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO TAX AND SAVINGS INCENTIVES FOR EDUCATION, JCX-12-99 (Mar. 2, 1999) [hereinafter JOINT COMM. ON TAXATION, TAX AND SAVINGS INCENTIVES FOR EDUCATION] (visited Sept. 8, 1999) <<http://www.house.gov/jct/x-12-99.htm>>.

64. ADMINISTRATION'S 2000 BUDGET, *supra* note 3, at 1194 tbl.5-1, lines 69-82 (excluding line 80, the child credit, and line 81, the charitable-contribution deduction). Similarly, for an analysis of tax subsidies provided for health care, see JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND ON FEDERAL TAX PROVISIONS RELATING TO HEALTH CARE 40-42, JCX-26-98 (Apr. 22, 1998).

65. See Brody, *Student Loans*, *supra* note 6, at 494-99.

66. STAFF OF JOINT COMM. ON TAXATION, ANALYSIS OF PROPOSED TAX INCENTIVES FOR HIGHER EDUCATION 9-15, JCS-9-97 (Apr. 15, 1997).

67. CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS 179, DOM-46 (Mar. 1997) ("Eliminate Federal Funding for Campus-Based Student Aid.") The federal government also provides funds for higher education in the form of research and development contracts, which include an allocation for university overhead. *Id.* at 205, DOM-62 ("Reduce the Overhead Rate on Federally Sponsored University Research"). Federal spending for elementary and secondary education programs came to \$22 billion in the 1995-96 school year. *Id.* at 174, DOM-43 ("Reduce Funding for Elementary and Secondary Education Programs"). A variety of other programs provide funds for the disadvantaged, bilingual education, safe and drug-free schools and Head Start.

Specifically, the Code contains:⁶⁸ an exclusion for qualified scholarships for tuition and related expenses;⁶⁹ two tuition tax credits, a HOPE credit for the first two tax years of college and a Lifetime Learning Credit in all later years;⁷⁰ a limited interest deduction for education loans;⁷¹ an interest exclusion

68. The Joint Committee also categorizes the following items as education tax expenditures: the parental personal exemption for students aged 19 to 23; the exclusion of interest on state and local government student loan bonds, and on bonds for private nonprofit educational facilities; and the deduction for charitable donations to educational institutions. JOINT COMM. ON TAXATION, TAX EXPENDITURES, *supra* note 23. Gene Steuerle notes the incompleteness of the tax expenditure budget: "For instance, the true value of much of public education is understated because there is no tax expenditure estimate of its cost." Gene Steuerle, *The Tax Expenditure Budget: Use With Care*, 78 TAX NOTES 1051, 1051 (Feb. 23, 1998).

In addition, services performed by students for educational institutions qualify for an exemption from FICA tax. I.R.C. § 3121(b)(10) (West 1998); *see also* Rev. Proc. 98-16, 1998-5 I.R.B. 19, 20 (Feb. 2, 1998).

69. I.R.C. § 117. As a separate matter, no income results to students who attend public colleges and universities, whose tuition is generally priced below that of private institutions. Recent years have seen a "gentrification of public colleges" as nearly 25% of families with income over \$200,000 send their children to public institutions. *See* Peter Passell, *Affluent Turning to Public Colleges*, N.Y. TIMES, Aug. 13, 1997, at B7 (describing a study by Michael McPherson and Morton Shapiro called the "Student Aid Game").

70. I.R.C. § 25A. The HOPE credit is 100% of the first \$1,000 of tuition and 50% of the next \$1,000 (*i.e.*, the maximum credit is \$1,500) *per student* enrolled at least half-time in the first two taxable years of college. *Id.* § 25A(b)(1). The Lifetime Learning Credit is 20% of the first \$5,000 of tuition (*i.e.*, the maximum credit is \$1,000) increasing to \$10,000 in 2003 (*i.e.*, the maximum credit will be \$2,000), *per tax return*. *Id.* § 25A(c)(1). The credits—which are not refundable—phase out at modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). *Id.* § 25A(d)(2)(A)(ii). The HOPE credit (but *not* the Lifetime Learning Credit) and the income ranges will be indexed for inflation beginning in year 2002. To claim the credit for a student other than the taxpayer or the taxpayer's spouse, the student must be the taxpayer's dependent (any amounts paid by the dependent are treated as paid by the taxpayer).

71. Section 221 of the Code allows an above-the-line interest deduction for up to \$1,000 in 1998 (increasing by \$500 increments annually to \$2,500 after year 2000) for student loans in the first 60 months of repayment, phasing out for borrowers with modified AGI between \$40,000 and \$55,000 (\$60,000 to \$75,000 on a joint return). *Id.* § 221(a), (b). Income ranges, but not the cap, will be adjusted for inflation beginning in 2003. *Id.* § 221(g)(1)(A), (B). The Clinton administration's Year 2000 Budget proposes eliminating the 60-month requirement. *See General Explanations, supra* note 4, at 19. Similarly, the Taxpayer Refund and Relief Act of 1999, vetoed in September 1999, would have repealed the 60-month limit, increased the beginning of the income phase-out from \$40,000 to \$45,000 for a single taxpayer, and provided married couples with twice the limit of a single taxpayer; effective after December 31, 1999, these changes would have cost a total of \$2.6 billion in forgone tax over 10 years. *See* JOINT COMM. ON TAXATION, SUMMARY, *supra* note 4; JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS, *supra* note 4.

for Education Savings Bonds used for tuition;⁷² an unlimited gift-tax exclusion for tuition payments;⁷³ deferral of income from participation in a qualified state tuition program;⁷⁴ exclusion for the cancellation of certain student loans if the student undertakes certain public-service employment;⁷⁵ an education "IRA";⁷⁶ and an exclusion for \$5,250 of employer-provided education assistance.⁷⁷ Nearly all of these rules reflect Congress's desire to provide a subsidy for higher education, rather than the proper tax treatment for investments in income-producing human capital.⁷⁸

72. I.R.C. § 135(a) (phasing out, in 1999, at modified AGI between \$53,100 and \$68,100 (\$79,650 and \$109,650 for joint returns)); Rev. Proc. 98-61, 1998-52 I.R.B. 18, § 3.07.

73. I.R.C. § 2503(e).

74. *Id.* § 529(a). The distributee (beneficiary student) recognizes income as distributions are made, under the annuity basis-recovery rules of Code section 72—that is, contributions are recovered ratably over the period of distributions. The distributed amounts may qualify the beneficiary for the education tax credits.

75. *Id.* § 108(f).

76. *Id.* § 530. Contributions are not deductible, but withdrawals will be tax-free if used for tuition and related expenses and, if the beneficiary is enrolled at least half-time, room and board. *Id.* § 530(b)(1). No contribution may be made after the designated beneficiary reaches 18, and any balance must be paid out when the beneficiary reaches age 30 (with unspent earnings subject to a 10% penalty because they are not used for educational purposes) or transferred to an educational IRA benefiting a related beneficiary. *Id.* § 530(b)(1)(A)(ii). Annual contributions are limited to \$500—for all accounts covering a particular person. Contributions phase out for contributors with modified AGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for joint returns). *Id.* § 530(c)(1)(A), (B). However, a higher-income relative could give \$500 a year to the child, who could then make the contribution. In addition, taxpayers may make penalty-free withdrawals from true IRAs if the money is used for higher education (room and board as well as tuition).

77. *Id.* § 127(a)(2). This provision expires May 31, 2000. *Id.* § 127(d). President Clinton's year 2000 budget proposes extending this exclusion for one year to apply to undergraduate courses beginning before June 1, 2002, and also extending the exclusion to graduate education (effective for courses beginning after June 30, 1999 and before June 1, 2002). See *General Explanations*, *supra* note 4, at 14. The vetoed Taxpayer Refund and Relief Act of 1999 would have extended the exclusion for employer-provided educational assistance through 2003, at an aggregate cost of \$1.4 billion. See JOINT COMM. ON TAXATION, SUMMARY, *supra* note 4; JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS, *supra* note 4.

78. See generally Brody, *Student Loans*, *supra* note 6. For guidance on the recent provisions, see I.R.S. Notice 97-60, 1997-46 I.R.B. 8 (describing the 1997 Act education provisions). See also Proposed Treas. Reg. REG-116826-97, 64 Fed. Reg. 3257 (Jan. 21, 1999) (qualified education loan interest deduction); Proposed Treas. Reg. REG-106388-98, 64 Fed. Reg. 794 (Jan. 6, 1999) (education credits); Proposed Treas. Reg. REG-106177-97, 63 Fed. Reg. 45019 (Aug. 24, 1998); I.R.S. Notice 98-59, 1998-49 I.R.B. 16 (information reporting obligations of educational institutions under Code section 6050S); I.R.S. Notice 98-46, 1998-36 I.R.B. 21; I.R.S. Notice 98-7, 1998-3 I.R.B. 54 (information reporting on education loans); I.R.S. Notice 97-73, 1997-51 I.R.B. 16; I.R.S. Notice 97-57, 1997-43 I.R.B. 8 (education IRAs); I.R.S. Notice 97-53, 1997-40 I.R.B. 6 (IRA withdrawals for education); I.R.S. Notice 97-52, 1997-38 I.R.B. 20.

In Congress's decision to limit federal domestic discretionary spending, it appears that tax expenditures do not count so long as they are part of a revenue-neutral package.⁷⁹ However, using the tax system this way again reveals the weaknesses (or, perhaps, the hidden strengths) of doing indirectly what Congress lacks the will to do directly. While education experts unanimously advocate the benefits of increased spending earlier in the educational process,⁸⁰ higher education spending represents the most likely candidate for tax expenditures because college costs are the first educational expenses *directly* paid for by taxpayers (ignoring private elementary and secondary schools⁸¹). Additionally, as explored generally in Part IV, a direct

79. See Gene Steuerle, *Will Performance Measures Raise the Status of Tax Expenditures?*, 78 TAX NOTES 939, 940 (Feb. 16, 1998) ("A number of educational incentives last year were put into the tax code simply because they stood a better chance as tax cuts of getting through the legislative process."); cf. Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1177 (the 1985 Graham-Rudman-Hollings Act was designed to reduce discretionary spending that exceeded certain caps, but had no effect on tax expenditures).

80. See *Brookings Panel Discusses Education Tax Cut Proposals*, TAX NOTES TODAY, June 30, 1997, available in LEXIS, Fedtax Library, Tax Notes Today File, as 97 TNT 125-96 [hereinafter *Brookings Panel*] (it was the consensus of the Brown Center on Education Policy of the Brookings Institution, meeting on May 28, 1997, that "early childhood, elementary, and secondary education, rather than post-secondary education are the areas most in need of additional investment").

81. A bill that Senator Coverdell sponsored would have temporarily expanded the education IRAs by increasing the annual contribution limit from \$500 to \$2,000, and by broadening the definition of qualifying expenses to include certain elementary and secondary expenses at a public, private or religious school (such as tuition, tutoring, computers, transportation, and uniforms). See Proposed Education Savings and School Excellence Act of 1998, H.R. 2646, 105th Cong. (1998). The President vetoed the bill, objecting to Congress's decision to

divert limited Federal resources away from public schools by spending more than \$3 billion on tax benefits that would do virtually nothing for average families and would disproportionately benefit the most affluent families. . . . Moreover, the bill would not create a meaningful incentive for families to increase their savings for educational purposes; it would instead reward families, particularly those with substantial incomes, for what they already do.

Clinton Letter to House Announcing Veto of Coverdell Education Bill, TAX NOTES TODAY, July 30, 1998, available in LEXIS, Fedtax Library, Tax Notes Today File, as 98 TNT 141-38. Democratic members fear undermining support for the public-school system. As President Clinton additionally explained in his veto letter, "More than 70 percent of the benefits would flow to families in the top 20 percent of income distribution, and families struggling to make ends meet would never see a penny of the benefits." *Id.*

Conservatives, by contrast, do not accept that, if parents want to send their children to private schools, those parents nevertheless must continue to support the public school system as well as pay the private school tuition with after-tax dollars. Overlaid on this fundamental debate is the specific fear—constitutionally based or otherwise—that governmental financing of church schools compromises the religious community or the secular community or both. This

expenditure program is better than a tax expenditure at targeting benefits, verifying participants' eligibility in advance, and offering predictable amounts of benefits.⁸² Finally, critics would have preferred that "any new federal resources for higher education focus on existing aid programs rather than on new tax policies."⁸³

On efficiency grounds, little evidence exists to suggest that these educational provisions will actually increase enrollments, as opposed to reward those who planned to attend college anyway.⁸⁴ The administration considered the \$40 billion tax cost of these revenue provisions to satisfy its campaign promise of a middle-class tax cut.⁸⁵ Moreover, institutions of higher education can capture the benefit by raising tuition or by offsetting internal financial aid (or both).⁸⁶ Tuition inflation is primarily a concern for the HOPE

proposed expansion of the education savings accounts re-emerged in the now-vetoed Taxpayer Refund and Relief Act of 1999; proposed to be effective after December 31, 2000, the provision was estimated to cost more than \$3.5 billion in forgone tax through 2009. See JOINT COMM. ON TAXATION, SUMMARY, *supra* note 4; JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS, *supra* note 4.

82. See *infra* notes 233-317 and accompanying text.

83. *Brookings Panel*, *supra* note 80. The horrendous complexity of these new rules results from a myriad of differences among them, notably: different income-eligibility phaseouts (the credits cut off at a much lower income than the education IRA); different bases (the HOPE credit is per student, while the Lifetime Learning Credit is per taxpayer return); different creditable expenses (the credits, generally, are measured against tuition, while the IRAs and state tuition programs can also be applied against room and board); different dollar ceilings, which might increase in later years (but no ceiling beyond "reasonable" for state tuition programs); and different credit rates for the HOPE credit (100% of the first \$1,000 and 50% of the next \$1,000) and the Lifetime Learning Credit (20% of the first \$5,000, which doubles to \$10,000 in 2003). See generally Kenneth R. Miller, *How Are New Tax Benefits, Old Tax Burdens Affecting Colleges and Universities?*, 21 EXEMPT ORG. TAX REV. 187, 188-89 (Aug. 1998) (speech of an associate general counsel at Yale University).

84. The college participation rate of children in families with income less than \$22,000 is 60%, but nearly 90% for those from families with income over \$65,000. *Unofficial Transcript of W&M Hearing on Education Tax Incentives in Clinton's Budget* (Mar. 5, 1997), TAX NOTES TODAY, Mar. 12, 1997, ¶ 960, available in LEXIS, Fedtax Library, Tax Notes Today File, as 97 TNT 48-82 (testimony of James Appleberry, president of the American Association of State Colleges and Universities) [hereinafter *W&M Hearing*].

85. Deputy Treasury Secretary Lawrence Summers testified at a Congressional hearing: "I do not think there is any question that this program is going to benefit a very, very large number of families who would have sent their kids to college anyway and I think that is appropriate because this is, after all, a middle class tax relief program." *Unofficial Transcript of Finance Committee Hearing on Education Tax Proposals*, TAX NOTES TODAY Apr. 23, 1997, ¶ 344, available in LEXIS, Fedtax Library, Tax Notes Today File, as 97 TNT 78-37 [hereinafter *Finance Committee Hearing*].

86. President Clinton had proposed a 100% credit for the first \$1,500 of tuition—the average annual tuition at a public two-year college—thus making "grades 13 and 14" as free as lower schooling. However, critics charged that without a student "co-pay" schools with lower

credit: For the twenty-percent Lifetime Learning Credit, the affected juniors, seniors, and graduate students bear eighty percent of the cost, so schools will have more difficulty raising tuition (although more expensive schools benefit from the larger tuition base).⁸⁷ At institutions where the net price that students pay varies a great deal from the "sticker price" because of internal aid, the school can capture the value of the tax credits without raising tuition by reducing internal grants.⁸⁸ After all, the creditable expenses would fall dollar-for-dollar by the scholarship. For tuition of \$1,000 or less, the only cost to the affected student would be the time value of benefiting from the tax credit (via refund or reduced withholding).

Commentators have hotly debated who wins and who loses from these education tax expenditures.⁸⁹ Critics derided the 1997 increase of \$300 in the

tuition would simply raise tuition to this level. Under the act, the first two years of college tuition up to the first \$1,000 is "free" for all qualifying students, because the first \$1,000 of tuition is creditable dollar for dollar. Thus, two-year state schools with low tuition—California, for example, charges \$365 a year at two year-public institutions—can grab federal dollars at no cost to many (if not most) of their students. See Martin A. Sullivan, *Clinton's Proposed Tuition Breaks Raise Questions on Several Fronts*, 73 TAX NOTES 1257, 1259 (Dec. 16, 1996). Michael McPherson and Morton Schapiro characterized the Clinton proposals as "an intergovernmental transfer": "the proposed federal revenue loss through these tax cuts of around \$7 billion per year is the same order of magnitude as the reduction in real support of public higher education by state governments during the 1990s," and "would partly create an environment that encourages further withdrawal of state support." Michael S. McPherson & Morton Owen Schapiro, *Financing Undergraduate Education: Designing National Policies*, 50 NAT'L TAX J. 557, 564 (1997). David Breneman, dean of the Curry School of Education, University of Virginia, pointed out the attractiveness of the tax credit as an additional resource to state governors and legislators setting public school tuition. *Finance Committee Hearing*, *supra* note 85, ¶ 548. See, for example, a description of the Massachusetts plan for community college tuition in Richard Chacou, *Board Trims Its Plan for Free Tuition*, BOSTON GLOBE, Sept. 23, 1997, at A11 (reducing tuition in light of federal tax credits).

87. *Brookings Panel*, *supra* note 80.

88. See Jay Starkman, Letter to the Editor, 80 TAX NOTES 971 (Aug. 24, 1998) (enclosing a "Dear Parent" letter from a private pre-collegiate school requiring families receiving financial assistance in the form of reduced tuition to remit to the school the families' per-child tax credits). But see Margie Fishman, *U. Unveils Trustee Scholarship Financial Aid Awards*, DAILY PENNSYLVANIAN (Univ. of Pa.), Mar. 24, 1998, at 1 (visited Sept. 6, 1999) <<http://dailypennsylvanian.com>> ("According to [University of Pennsylvania Associate Vice President for Finance Frank] Claus, the majority of Ivy League schools already subscribe to a policy of dismissing the tax credit in awarding aid.").

89. Lawrence Gladieux's written testimony stated:

If the country really can afford something approaching \$30-\$40 billion in additional resources to expand access to higher education over the next five years, surely it would be better invested in Pell and other grant, loan, and work-study programs. Existing aid programs are not just for the very poor. They help low- and, yes, middle-income students based on need, and they get the dollars to students when tuition bills are due, not months later in a tax refund.

maximum Pell grants (for a total annual \$3,000), when compared with the value of the tax credit for middle-class taxpayers.⁹⁰ Because of the offset against creditable expenses for Pell grants and other scholarships—and the nonrefundability of the education credits—the HOPE and Lifetime Learning Credits will not benefit lower-income taxpayers.⁹¹ Of course, redistribution need not be the goal of a tax subsidy if the “positive externality” the government seeks to subsidize is aggregate social benefit.⁹²

From a tax policy perspective, perhaps the most alarming of the recent education tax provisions is an exemption for the inside build-up of a

College Board Policy Official's Testimony at W&M Hearing on Education Tax Provisions in Budget Proposal, TAX NOTES TODAY, Nov. 6, 1997, ¶ 12, available in LEXIS, Fedtax Library, Tax Notes Today File, as 97 TNT 44-51.

90. Economist Thomas Kane charged: “Now, if you look at the proposal, there’s \$300 in it for the Pell Grant—lowest income Pell Grant recipients; and on the other hand, there’s the \$2,800 tax benefit for somebody in the 28 percent tax bracket who’s attending an expensive, private institution.” *W&M Hearing*, *supra* note 84, ¶ 597 (referring to the original Clinton deduction proposal for up to \$10,000 tuition).

When the Lifetime Learning Credit fully phases in, it will be worth up to \$2,000 (not to mention the values of the other education provisions). With the income caps on eligibility for most of the 1997 Act education provisions, the benefits will cease at a variety of AGIs—which are much higher than the \$28,000 cutoff (for a family of 4) for Pell Grants. David Breneman testified at the Ways & Means hearing:

I think another way to think about a tax credit—which I’m sure has been in all of our minds—is whether you’d like to see this credit turned into a direct expenditure program, having exactly the same features as the credit. I submit that a . . . direct \$1,500 credit to families of incomes up to \$80,000 and then I guess ratably reduced below that, doesn’t strike me as the kind of direct expenditure program most of us would support.

Id. ¶ 646.

91. See *Brookings Panel*, *supra* note 80, ¶¶ 3-4 (recommending, among other things, that the education credits should be independent of the student’s Pell grant award, that credits should be refundable, and that credits should not be extended to graduate studies; and to encourage families to save for college, policy makers should lessen the disincentives for calculating family contributions in student aid formulas). Note that as originally proposed, Clinton’s tax credit would have been refundable. See *CRS Analyzes Clinton’s Tuition Tax Credit and Deduction*, TAX NOTES TODAY, July 18, 1996 (reprinting Bob Lyke, *Tuition Tax Credit and Deduction: Issues Raised by the President’s Proposals* (CRS, July 3, 1996)), available in LEXIS, Fedtax Library, Tax Notes Today File, as TNT 140-42.

92. JOINT COMM. ON TAXATION, TAX AND SAVINGS INCENTIVES FOR EDUCATION, *supra* note 63, at 18 (“If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.”). The Joint Committee adds:

The distinction between education as investment and education as consumption is not important to the efficiency/externality rationale for providing a subsidy to education, as externalities can arise from either consumption or investment. However, the distinction . . . is important to the equity rationale . . . , as the equity rationale generally is based upon education as an investment in future earning potential.

Id. at 19.

"qualified State tuition program" (distributions are taxed to the distributee).⁹³ This innocuous-sounding category now represents a multi-billion dollar industry whose lobbyists have completely mowed down federal resistance. Before Congress enacted section 529 in 1996, the IRS asserted that only prepayment tuition plans backed by the full faith and credit of the state could enjoy exemption on their investment income. Since the 1996 Act, the number of state programs has exploded. According to the web site of the College Savings Plans Network, 41 states have adopted some type of plan, 22 of which became effective in 1998 or 1999.⁹⁴ While these programs are poised to become universal, this is not necessary; in the race to the bottom, most plans offer portability of benefits to out-of-state schools.

Qualified state tuition programs threaten to become the next big individual tax shelter. No federal income limit applies to participation.⁹⁵ While the federal rules do not set specific dollar limits on plan contributions, they do require the qualified program to adopt safeguards against "excess" contributions.⁹⁶ Proposed regulations provide a safe harbor limit: The total contributions may not exceed the amount actuarially estimated to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest-cost institution covered by the program.⁹⁷ In addition, the program must impose "a more than de minimis penalty on the earnings portion of any distribution."⁹⁸ However, the proposed regulations provide a surprisingly lenient safe-harbor penalty of ten percent

93. See generally A.L. Spitzer & Christopher E. Houston, *The New QSTPs: Not Your Grandparent's State Tuition Plan*, 82 TAX NOTES 867 (Feb. 8, 1999).

94. Go to <<http://www.collegesavings.org/>>, click on "Your State," and follow links to the various states' web sites, describing their plans. In addition, some states, such as Virginia and New York, offer deductibility against state income for plan contributions up to specified dollar limits. College Savings Plan Network (visited Sept. 5, 1999) <<http://www.collegesavings.org/default.htm>>.

95. In response to a question of whether the middle class as well as the wealthy are signing up, a representative of the College Savings Plan Network testified:

It is primarily across the board, in the middle income area. We find that almost 45 percent of the enrollees in many States are grandparents that are able to purchase this for their grandchildren and present them at their first birthday party with a certificate with the State seal on it, and curlicues all around it, and say, honey, this is your college education, it is paid for.

Finance Committee Hearing, *supra* note 85, ¶ 605 (statement of the Hon. Marshall G. Bennett, Treasurer, State of Mississippi). The 1997 Act also amended the gift tax treatment so that these gifts would qualify for the annual \$10,000 exclusion (and indeed can be so averaged over a 5-year period), although they are not eligible for the unlimited gift tax exclusion for tuition payments under § 2503(e). See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(c), 111 Stat. 846.

96. I.R.C. § 529(b)(7).

97. Prop. Treas. Reg. § 1.529-2(i)(2), 63 Fed. Reg. 45,028 (Aug. 24, 1998).

98. Prop. Treas. Reg. § 1.529-2(e)(1), 63 Fed. Reg. 45,027 (Aug. 24, 1998).

of the earnings portion of the distribution.⁹⁹ Under this rule, many taxpayers could still come out ahead from funding the plan in an early year and obtaining a refund in a later year.

One also wonders about the political risks to states from adopting these plans. The statute prohibits a contributor or beneficiary from having the power to direct investment of the program.¹⁰⁰ Depending on the program, the account might not cover the cost of future education. Even in those states that do not formally guarantee full coverage, political forces might constrain the state from raising tuition above what families expect.¹⁰¹

Recently, private colleges have been complaining that section 529 unfairly discriminates against private educational institutions. In order to "preserve a level playing field," section 111 of the proposed Taxpayer Relief Act of 1998 would have permitted private institutions of higher education to establish qualified prepaid tuition programs, and such a proposal was recently repropoed.¹⁰² Of course, to the extent that middle- and upper-income families are the predominant users of prepaid tuition plans for state schools, they will benefit even more from plans for expensive private schools.¹⁰³ A bill vetoed in September 1999 contained a proposal to convert the deferral regime of qualified state tuition programs into an exclusion regime.¹⁰⁴

99. *Id.* § 1.529-2(e)(2)(ii).

100. I.R.C. § 529(b)(5).

101. One group of education experts described the variety of ways in which states could impose plan burdens on future generations:

If the earnings of pre-paid tuition plans are insufficient to cover the increased costs of higher education, non-plan participants may be faced with even higher tuitions, state taxpayers may be asked to provide state institutions with increased subsidies, or the quality of the education provided by institutions with large numbers of pre-paid students may erode.

See Brookings Panel, supra note 80, ¶ 11.

102. The vetoed Taxpayer Refund and Relief Act of 1999 contained such a provision. *See* JOINT COMM. ON TAXATION, SUMMARY, *supra* note 4.

103. *See* Fred Stokeld, *Exempt Organizations Find Relief in House Tax Bill*, 81 TAX NOTES 28, 29 (Oct. 5, 1998) (describing observation of Edward Elmendorf of the American Association of State Colleges and Universities).

104. The Taxpayer Refund and Relief Act of 1999 would have excluded from income distributions made from qualified state tuition plans after December 31, 1999. *See* JOINT COMM. ON TAXATION, SUMMARY, *supra* note 4. Presumably the fairly modest budget estimate reflects the long transition period before beneficiaries start attending college. *See* JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS, *supra* note 4 (estimating \$1.1 billion in lost tax, including from the changes to the student loan interest deduction described in note 71, *supra*, over the next 10 years).

III. FROM INCREMENTAL TO FUNDAMENTAL TAX REFORM

Pressures for a range of tax reforms could produce a range of consequences to charities. This article now considers reforms both deliberate and incidental to the tax treatment of charity, beginning with the charitable-contribution deduction and ending with fundamental tax reform.

A. "Overt" Subsidies

1. Making the Contribution Deduction More Efficient and Fair

a. The "Upside-Down Subsidy"¹⁰⁵

Over the years, the charitable-contribution deduction has been attacked as inefficient. Private philanthropy raises two independent efficiency concerns. First is the efficiency of private giving itself: whether donations are being wasted or even misused by particular charities. This article focuses on the second aspect, the efficiency of the tax subsidy: whether a dollar of foregone taxes induces at least an *extra* dollar of donations.¹⁰⁶

Many theories exist to explain why people give to charity, some of which I have explored elsewhere.¹⁰⁷ Apparently tax considerations are not paramount. After all, philanthropy long preceded the enactment of the federal income tax, and no income-tax subsidy is available to the 70% of individual taxpayers who claim the standard deduction. Studies have found incomplete "crowd-out" of a particular donor's giving as charities obtain revenue from other sources, suggesting that donors give because of social pressures other than (only) to support an identifiable need.¹⁰⁸ For example, James Andreoni

105. Stanley Surrey coined this term to describe the effect of deductible (or excludible) tax expenditures. See Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 392-97 (1970).

106. Martin Feldstein, *The Income Tax and Charitable Contributions: Part II—The Impact on Religious, Educational, and Other Organizations*, 28 NAT'L TAX J. 209, 218 (1975): A price elasticity of exactly one implies that the amount of giving responds to changes in price in such a way that the *net* cost to the individual donor is unaffected by the price. . . . The "efficiency" of the incentive is thus 100 percent, i.e., 100 percent of the revenue forgone by the Treasury is a net addition to the receipts of the donee. [However, w]ith a price elasticity absolutely less than one, a decrease in the price of giving raises the gross gift by less than the net cost to the Treasury.

Id.

107. See generally Brody, *Charitable Endowments*, *supra* note 6 (considering desire for perpetual endowments).

108. Christopher Jencks, *Who Gives to What?*, in THE NONPROFIT SECTOR, *supra* note

posits a "warm glow altruist"¹⁰⁹ whose satisfaction increases with the value of the gift to the charity, and others suggest that giving sends a social signal either that a certain level of giving to a particular charity is expected of those in the group,¹¹⁰ or simply of one's wealth or income.¹¹¹ Under these models, giving may even be excessive.¹¹²

What does the motive for giving have to do with tax policy? If the policy behind the charitable-contribution deduction is to spur donations, then tax subsidies are wasted on donations that would have been made anyway. The combination of exemption and the contribution deduction, as William Vickrey observed long ago, "seems to be much more an expression of the general predilection in this country for privately organized and controlled philanthropy rather than a significant stimulus to *net* giving."¹¹³ In addition, a dollar-for-dollar inducement is not enough: "if the community felt it were

14, at 321, 326-28 (describing the noneconomic determinants of philanthropic giving); Richard Steinberg, *The Theory of Crowding Out: Donations, Local Government Spending, and the "New Federalism"*, in PHILANTHROPIC GIVING 143, 154 (Richard Magat ed., 1989) (crowding out is only partial). See also discussion *infra* Part IV.C.3.

109. See, e.g., James Andreoni, *Giving With Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 J. POL. ECON. 1447, 1447 (1989); James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm Glow Giving*, 100 ECON. J. 464, 469 (1990).

110. See JERALD SCHIFF, CHARITABLE GIVING AND GOVERNMENT POLICY 9-10, 16 n.12 (1990) (describing the "demonstration effects" identified in Martin Feldstein & Charles T. Clotfelter, *Tax Incentives and Charitable Contributions in the United States*, 5 J. PUB. ECON. 1 (1976), and commenting that "as the level of giving by others increases, it may take larger donations to 'buy' prestige and the like via giving, and spending on such goods may rise").

111. See Amihai Glazer & Kai A. Konrad, *A Signaling Explanation of Charity*, 86 AM. ECON. REV. 1019, 1019-20 (1996). Noting that "[i]mpressing former college roommates who may live in other parts of the world, may require a notice in the alma mater's alumni magazine," Glazer and Konrad described the cliff effect of donations when the charity publicizes giving by dollar ranges. *Id.* at 1021 (stating that in "[t]he 1993-1994 report of the Harvard Law School Fund . . . 980 people contributed in the category of \$500-\$999. Contributions of exactly \$500 would constitute 93 percent of the total raised in this category"). By contrast, the authors comment, a theory of giving in which the donor cares only about the charity's level of outputs would provide a smoother curve of donations. *Id.*

112. See *id.* at 1019 ("[C]onspicuous consumption may be banned by social norms when charitable donations are not.") (footnotes omitted); see also LESTER M. SALAMON, PARTNERS IN PUBLIC SERVICE: GOVERNMENT-NONPROFIT RELATIONS IN THE MODERN WELFARE STATE 46-48 (1995) (discussing "philanthropic particularism," "philanthropic paternalism," and "philanthropic amateurism").

113. William Vickrey, *One Economist's View of Philanthropy*, in PHILANTHROPY AND PUBLIC POLICY 31, 56 (F.G. Dickenson ed., 1962), reprinted in WILLIAM VICKREY, PUBLIC ECONOMICS 500, 525 (Richard Arnott et al. eds., 1994). Vickrey concluded: "The unacknowledged and haphazard array of subsidies that result from present special tax privileges call for replacement with more uniform and explicit arrangements that can be brought into line with desirable public policy." *Id.*

worth \$1 in revenue to obtain an additional dollar of the benefits produced by charitable contributions, it would simply purchase the good that charity finances through direct government spending."¹¹⁴

The contribution deduction has been attacked as unfair as well as inefficient, because "[t]he amount of public funds which a private person can allocate [to charity] depends on his marginal tax bracket and hence his income position and wealth generally."¹¹⁵ As Richard Murgrave and Peggy Musgrave commented: "A philosopher-economist might observe that the opportunity cost of virtue falls as one moves up the income scale."¹¹⁶ In addition, those taxpayers most likely to itemize their personal deductions are homeowners who claim home mortgage interest expenses and property taxes, or those living in areas that adopt high state and local income taxes, namely, the more wealthy.¹¹⁷

The fairness problem, though, relates to the efficiency problem. In effect, a deduction affords rich donors a greater proportionate subsidy in order to induce them to give more. Indeed, while studies have found a wide range of responses to the tax price of giving, they suggest that the deduction is efficient only for higher-income taxpayers.¹¹⁸ After all, low-bracket taxpayers' after-

114. Harold M. Hochman, *Comments*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 297, 298 (Susan Rose-Ackerman ed., 1986) [hereinafter *ECONOMICS OF NONPROFIT INSTITUTIONS*]. Hochman states:

The reason all of this is so troubling is that so much of both the academic and the policy discussion of the tax treatment of charitable contributions has been couched in terms of the price elasticity issue and has assumed, implicitly or explicitly, that an elasticity of -1 has some special normative significance.

Id.

115. STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 225 (1973). At a time of a 70% top tax rate, Professor Surrey observed:

It is clear, then, that our colleges, insofar as such support through "gifts" is concerned, are really receiving nearly all of the support from the Government with the "donors" providing very little of their own funds and instead "voting" through the deduction these appropriations of Government funds to the colleges.

Id. at 227.

116. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 348 (4th ed. 1984).

117. See Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 682, 691 (1988-89).

118. See Martin Feldstein, *The Income Tax and Charitable Contributions: Part I—Aggregate and Distributional Effects*, 28 NAT'L TAX J. 81, 95, 90 (1975) (finding price elasticities generally greater than one; projecting that eliminating the charitable-contribution deduction would cause moderate-income taxpayers to reduce gifts by 24% and high-income taxpayers to reduce gifts by 75%; and explaining the lower-than-expected price elasticity at the very high end: "At these very high income levels, adjusted gross income is a less adequate measure of economic income and wealth is a more important influence on giving."); CHARLES T. CLOTFELTER, *FEDERAL TAX POLICY AND CHARITABLE GIVING* (1985) (finding a price elasticity of -1.3 for a rise in the price of giving); Bruce Robert Kingma, *An Accurate*

tax price of donations is close to the before-tax price (and for non-itemizers, these are the same thing). Thus, gifts to charities supported by high-income donors are expected to fall off more than gifts to, say, churches, when the price of giving increases.¹¹⁹ However, William Randolph recently suggested that even high-bracket taxpayers might really just be time shifting—making contributions in years when tax rates are highest, rather than changing their lifetime amount of giving.¹²⁰

To improve the efficiency of the contribution deduction, theorists have proposed a floor under deductible donations that is equal to a low percentage of adjusted gross income.¹²¹ As described in Part II.A, a floor now exists

Measurement of the Crowd-Out Effect, Income Effect, and Price Effect for Charitable Contributions, 97 J. POL. ECON. 1197, 1204 (1989) (finding a price elasticity of -0.43 for contributions to public radio). Also see Andreoni et al., *supra* note 16, at 24-25:

Our central estimate of the own-price elasticity of monetary gifts is -0.35, which is considerably smaller than most published estimates . . . [but] is comparable to recent estimates by Randolph (1995) and is consistent with the fact that the time series pattern of contributions exhibits a stable upward trend over the 1980s, a period of significant reductions in marginal tax rates.

119. See Feldstein, *Uncharitable Contributions: Part II*, *supra* note 106, at 218 (finding an absolute price elasticity of only 49% for religious giving, and price elasticities for other giving of greater than 100%). "For gifts to educational institutions, the estimated price elasticity implies that small price reductions have an efficiency of 223 percent, i.e., for every dollar of revenue forgone by the Treasury, educational institutions receive an additional \$2.23." *Id.* (footnote omitted). Professor Feldstein estimated that if the charitable-contribution deduction were eliminated, gifts to religious organizations would fall between 7% and 21%, gifts to educational institutions would fall between 48% and 65%, gifts to hospitals would fall between 41% and 62%, gifts to health and welfare organizations would fall between 22% and 23%, and all other charities would see a fall between 25% and 46%. *Id.* at 221 tbl.4. See also Clotfelter & Schmalbeck, *supra* note 2, at 216 tbl.6-4 (showing charitable contributions for 1992 by type of recipient—religion, higher education, and other—by income class).

120. See William C. Randolph, *Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions*, 103 J. POL. ECON. 709, 724-25, 735 (Aug. 1995) (estimating a transitory price elasticity of between -2.27 and -1.55 and a permanent price elasticity of between -0.51 and -0.08).

121. See RICHARD GOODE, *THE INDIVIDUAL INCOME TAX* 174-75 (1964); MUSGRAVE & MUSGRAVE, *supra* note 116, at 348 n.25 (suggesting a 3% floor); U.S. DEP'T OF TREASURY, *supra* note 3, at 69-70 (proposing a 2% floor). The Congressional Budget Office recently estimated that a 2% floor "would completely disqualify the charitable deductions of about 17.6 million taxpayers in 2000 and reduce allowed deductions for roughly another 16.1 million." CONGRESSIONAL BUDGET OFFICE, *supra* note 3, at 229, REV-05. However, other authors have stated that to

rationalize a floor in terms of efficiency, one must argue that activities financed by individuals having deductions lower than the floor generate no positive external effects, or that at least the benefit the floor generates by precluding subsidies to truly private goods offsets the harm it inflicts by stifling contributions to activities with positive external effects.

under the aggregate of all the itemized deductions of high-income taxpayers.¹²²

Alternatively, Paul McDaniel and others have proposed remedying the upside-down subsidy by replacing the itemized deduction with a tax credit or direct outlay.¹²³ Because of the different types of charities favored by high-income and low-income taxpayers, though, a tax credit of, say, 25% would not only redistribute benefits from taxpayers with higher marginal rates to those with lower marginal rates, but also "may result in certain activities, such as education, health care, and the arts, bearing the additional burden nominally imposed on the higher-income contributors. Other activities, such as religion and welfare, might be more likely to benefit from the tax savings given to lower-income contributors."¹²⁴

Other proposals—recently, as part of proposed major tax reform—advocate repealing the charitable-contribution deduction without a replacement.¹²⁵ In the 1970s, the Treasury Department described a model to repeal

Harold M. Hochman & James D. Rogers, *The Optimal Tax Treatment of Charitable Contributions*, in *ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 114, at 224, 240. In addition, they argue that to the extent the deduction is based on charities' provision of external benefits, it should be extended to nonitemizers. *Id.* at 239.

122. See *supra* note 39 and accompanying text.

123. See Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 *TAX L. REV.* 377 (1972); Paul R. McDaniel, *Study of Federal Matching Grants for Charitable Contributions*, in 4 *FILER COMM'N RESEARCH PAPERS*, *supra* note 12, at 2417, 2417-19, 2426 (proposing a sliding credit, based on the percentage of income that the taxpayer donates, made out of a fund appropriated by Congress to replicate the current amount of the deduction tax expenditure; thus, "on a progressive matching grant schedule, a person in the 70 percent bracket who contributes 5 percent of his income to charity will trigger the same percentage matching federal grant as does a 14-percent-bracket taxpayer who contributes 5 percent of his income to charity."); see also David A. Good & Aaron Wildavsky, *A Tax By Any Other Name: The Donor Directed Automatic Percentage Contribution Bonus, A Budget Alternative for Financing Government Support of Charity*, in 4 *FILER COMM'N RESEARCH PAPERS*, *supra* note 12, at 2389, 2394 (describing a direct expenditure substitute for the charitable contribution deduction, in which new committees other than the tax-writing committees would decide the size of the governmental appropriation).

124. DAVID BRADFORD & U.S. TREASURY TAX POLICY STAFF, *BLUEPRINTS FOR BASIC TAX REFORM 88* (2d ed. 1984) [hereinafter *BLUEPRINTS*] (when a 25% credit would have been revenue-neutral); see also Feldstein, *Uncharitable Contributions, Part II*, *supra* note 106, at 222 tbl.5 (estimating that substituting a 30% tax credit for the contribution deduction—although noting that only a credit of 20% would be revenue neutral—would cause an increase in gifts to religious organizations of between 11% and 23%, a decrease in gifts to educational institutions of between 19% and 22%, a decrease in gifts to hospitals of between 8% and 9%, an increase in gifts to health and welfare organizations of between 20% to 21%, and an increase in gifts to all other charities of between 17% and 38%).

125. Meanwhile, the political process continues. The Independent Sector recently called for restoring the charitable-contribution deduction for nonitemizers, although only a 50% deduction for the excess over \$500:

Nonitemizers contributed an estimated \$25 billion in 1996. They are, by any measure,

the deduction as a proxy for not taxing the charities' beneficiaries.¹²⁶ This would conform the tax treatment of charitable giving to the tax treatment of private giving. We recently had a preview of the possible effects of repeal. Legislation enacted in the 1980s slashed the top individual tax rate from 70% to 50% in 1981, and then to 28% in 1986.¹²⁷ At the same time, the 1986 act simplified the tax system for more individuals by increasing the standard deduction so that fewer taxpayers would itemize. As a result, the percentage of itemizers fell from 38% to 28%. When the charitable-contribution deduction for nonitemizers was also allowed to expire in 1986, many taxpayers saw their price of contributing a dollar increase to \$1. Studies found that predictions of drastic contribution falloffs failed to predict taxpayer response. Donations increased overall and at every income level except the highest, where the fall in donations was smaller than predicted.¹²⁸

b. The Fair-Market-Value Deduction

Tax planners and charities themselves have long understood the additional tax benefit to donors from making charitable contributions with appreciated property instead of with cash—more than one-third of charitable contributions from taxpayers with at least \$1 million in income comes in the form of property.¹²⁹ Current law permits a deduction against ordinary income for the full fair

middle and lower income taxpayers and yet they give generously to charitable causes. The media often focuses public attention on large gifts but these modest income Americans deserve recognition every bit as much for their unsung philanthropy.

Group Seeks Archer's Support for Letting Nonitemizers Claim Charitable Contributions, TAX NOTES TODAY, Mar. 18, 1998, available in LEXIS, Fedtax Library, Tax Notes Today File, as 98 TNT 52-13; see also note 38, *supra*.

126. See BLUEPRINTS, *supra* note 124, at 87-88 ("If the donor reduces his contributions by the amount of the additional tax he pays, the donor indirectly shifts the tax burden to the beneficiaries.").

127. The top rate subsequently increased to 31% in 1990 and to 39.6% in 1993.

128. See Gerald E. Auten, James M. Cilke & William C. Randolph, *The Effects of Tax Reform on Charitable Contributions*, 45 NAT'L TAX J. 267, 280 tbl.7 (1992). The authors note that the price of giving appreciated property increased even more in 1986, when the unrealized appreciation became an item of tax preference under the alternative minimum tax. *Id.* at 271 tbl.2. This rule was modified in 1990 and repealed in 1993. See also *id.* at 280 tbl.7 (showing that between 1979 and 1989, the average contribution (in 1991 dollars) by taxpayers with pre-tax income of \$1 million or more increased from \$133,837 to \$136,258, and the average contribution by taxpayers with between \$200,000 and \$1 million in income increased from \$11,104 to \$11,696); Charles Clotfelter, *The Impact of Tax Reform on Charitable Giving: A 1989 Perspective*, in DO TAXES MATTER? THE IMPACT OF THE TAX REFORM ACT OF 1986, at 203 (Joel Slemrod ed., 1990).

129. Auten et al., *supra* note 40, at 17.

market value of the property, including the amount of unrealized gain.¹³⁰ The Treasury Department and scholars have long criticized this tax treatment as inefficient and unfair.¹³¹ However, such a conclusion depends on which rule is the norm.

The sale or other disposition of property usually is a "realization" event, and gain or loss must be recognized unless an explicit nonrecognition rule can be found in the Code; however, neither gifts nor bequests constitute taxable events.¹³² Assume, for example, that you own a Picasso painting that you purchased for \$100,000. Over the years it has hung over your living room fireplace. After 20 years of enjoyment, you donate the painting, now worth \$3 million, to the Art Institute of Chicago. Should you be permitted a deduction for \$100,000 or \$3 million? Should you be taxed on the \$2.9 million of appreciation? Under current law, you deduct \$3 million, subject to annual limits based on your income level, and the gift is not a realization event. If, instead, the gift *is* a realization event, you would have \$2.9 million of gain, and the same \$3 million deduction. In effect—ignoring the not-insignificant tax rate difference between an "ordinary" deduction and a "capital" gain¹³³—your gift would amount to the original \$100,000 basis. Under the latter approach, from a tax point of view, neither your 20 years of enjoyment of the painting nor the increase in its value would have occurred.

Should we distinguish "unenjoyable" assets from "enjoyable" ones? That is, should we have one rule for stock and another for paintings? In one

130. This deduction is subject to the percentage-of-income limits described, *supra* note 40. The 1986 Tax Reform Act required the untaxed appreciation to be treated as an item of tax preference under the alternative minimum tax. The charities (particularly the museums) protested relentlessly, and Congress repealed the preference in 1993. See Editorial, *A Small Price for Big Art*, N.Y. TIMES, Aug. 21, 1993, at A12. But see Albert Buckberg, *Escape from Taxation: Artworks as Tangible Personal Property and Exemption from Minimum Tax*, 60 TAX NOTES 125 (July 5, 1993).

131. See U.S. DEP'T OF TREASURY, *supra* note 3, at 72-74 (proposing that the deduction for donations of property would be limited to the lesser of fair market value or the inflation-adjusted basis). But see THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 27 (May, 1985) (dropping the proposal).

132. The Code contains no non-recognition rule in the case of gifts, whether gifts to individuals or gifts to charity. However, such a rule implicitly exists because section 1015 provides that the donee takes the same basis in the property that the donor had immediately before the gift. Similarly, death is not a realization event, although any pre-death appreciation permanently escapes the income tax because of the fair-market-value-basis rule of section 1014.

133. Thanks to the Taxpayer Relief Act of 1997, the top statutory rate on ordinary income (39.6%) is essentially twice as high as the most favorable tax rate on long-term capital gains (generally 20% for assets held more than 18 months). I.R.C. § 1(a), (c), (h). Moreover, a "collectible" like a painting would be subject to a top tax rate of 28%, making it an even more desirable charitable gift than stock, because the price of giving versus selling is lower. In general, only basis may be deducted for contributions of property the sale of which would give rise to ordinary income or short-term capital gain. But see *id.* § 170(e)(3), (4), (6).

respect, Congress thinks so.¹³⁴ Section 170(e)(5) provides that a contributor of publicly traded stock to a private foundation can deduct its fair market value, while only the basis of most other property contributed to a private foundation is deductible. However, the reason that Congress treats publicly traded stock more favorably than other assets donated to foundations has nothing to do with whether the donor could obtain current consumption benefits from the asset. Rather, given that donors generally control their foundations, Congress mistrusts the valuation placed by donors of artwork and gems, as well as stock in closely held businesses,¹³⁵ contributed to foundations.¹³⁶ Publicly traded stock, by definition, can be valued simply by looking at the stock tables of any major newspaper. Indeed, the real tax disparity between "unenjoyable" assets and "enjoyable" assets lies with our failure to impute income to owners of usable assets.¹³⁷

Given that Congress is unlikely to change the law to impute recognition of gain on transfers by gift and to impute income on consumer durables, would

134. *Id.* § 170(e)(5).

135. As a separate matter, the Tax Reform Act of 1969 adopted divestiture rules, requiring foundations to dispose of control stock in companies owned by their disqualified persons. *Id.* § 4943 (taxes on excess business holdings).

136. 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 AM. J. TAX POL'Y 399, 425 (1995) ("By limiting the availability of the full value deduction to stock traded on an established securities market, Congress [in 1984] avoided particular concerns about the valuation of donated property (such as artwork or real estate) which had motivated the adoption of the basis limitation in 1969.") (citing STAFF OF THE JOINT COMM. ON TAXATION, SUMMARY OF H.R. 13270, TAX REFORM ACT OF 1969, at 77 (1970)).

137. Economists have long lamented the distortions created by an income tax system that does not tax owners on the imputed rental value of housing and consumer durables. See BLUEPRINTS, *supra* note 124; DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 206-07 (1986). This omission has nothing to do with charitable contributions, but it does explain how the tax treatment of donations of all appreciated assets could be conformed. Compare publicly traded stock and a Picasso painting. If you own stock and decide to keep the dividends received each year, you would include them in your ordinary income. You would bear a similar tax burden if the law imputed income to you each year equal to the rental value of the Picasso painting. Of course, such a valuation would not be easy; because of both the valuation problem and the liquidity problem (where would you find the cash to pay the tax on all your consumer durables?), our tax system looks the other way.

A corporate charitable contribution that would otherwise have been made by a shareholder raises the issue of whether the amount is a disguised dividend (taxable to and deductible by the shareholder, but not deductible by the corporation). But see Linda Sugin, *Theories of the Corporation and the Tax Treatment of Corporate Philanthropy*, 41 N.Y.L. SCH. L. REV. 831, 875 n.180 (1997) (discussing Private Letter Ruling 81-52-094, which approved a plan—apparently Berkshire Hathaway's—that permitted shareholders to designate the charitable beneficiaries of the corporation's largesse). Professor Don Leatherman of the University of Tennessee College of Law suggested to me that the dividend tax avoidance is even worse if the corporation makes a donation of appreciated property.

repealing the fair-market-value deduction be a necessary and acceptable second-best solution? Such a solution would have little appeal until Congress also eliminates the basis step-up at death, because donors could still reduce taxable estates by the fair market value of bequeathed appreciated property.¹³⁸

2. Piecemeal Repeal of Exemption for Certain Commercial Activities

Congress might repeal exemption for organizations in identified industries that no longer warrant subsidy.¹³⁹ The list of previously tax-exempt organizations includes building and loan associations and Blue Cross/Blue Shield, organizations that initially performed charitable services but "grew up" into overly commercial enterprises.¹⁴⁰

Recent years have brought similar change to the character of nonprofit hospitals. While contributions to hospitals remain large in absolute dollars, they represent less than three percent of nonprofit hospital revenue.¹⁴¹ Proprietary hospitals can now earn satisfactory returns, thanks primarily to the third-party payment systems funded by both Medicare and Medicaid and by the tax expenditure for employer-provided health insurance. Evidence suggests that nonprofit hospitals provide a level of charity care comparable to that provided by for-profit hospitals.¹⁴² Indeed, in the early years of Medicare and Medicaid, the Internal Revenue Service (IRS) issued a revenue ruling under which nonprofit hospitals entitled to exemption have few specific

138. Recently estimating that limiting the charitable-contribution deductions to basis would raise more than \$17 billion over 10 years, the Congressional Budget Office commented: "Indisputably, however, the current provision encourages people to donate their appreciated assets, such as stock or art, to eligible activities rather than leave them to their heirs at death, when any gains also escape income tax . . ." CONGRESSIONAL BUDGET OFFICE, *supra* note 3, at 228, REV-04.

139. See BRUCE HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* (6th ed. 1992); James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (Sept. 14, 1987); Carolyn Wright, *Commerciality Doctrine Poses Substantial Threat to EOs*, TAX NOTES TODAY, Nov. 15, 1996, available in LEXIS, Fedtax Library, Tax Notes Today File, as 96 TNT 53-6. To the extent charities enter into partnerships with taxable persons, the issue is entwined with the fear of prohibited private benefit. See *Housing Pioneers v. Commissioner*, 65 T.C.M. (CCH) 2191 (1993), *aff'd* 58 F.3d 401 (9th Cir. 1995); *Redlands Surgical Serv. v. Commissioner*, 113 T.C. No. 3, 1999 U.S. Tax Ct. LEXIS 29 (July 19, 1999); PLR 97-36-039 (June 9, 1997); Simon, *supra* note 14, at 91-92 (citing repetitive efforts by courts to remove "commercial hue").

140. See I.R.C. § 501(m) (repealing exemption of organizations engaged in commercial-type insurance, such as Blue-Cross/Blue Shield in 1986, and TIAA-CREF in 1997); *cf. id.* § 501(f) (exempting the Common Fund, which makes investments in securities on behalf of educational institutions).

141. Clotfelter & Schmalbeck, *supra* note 2, at 214 & tbl.6-3 (1993 percentage).

142. See, e.g., David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, 23 J. CORP. L. 741, 758-59 (1998).

obligations to the community.¹⁴³ As the IRS struggles with the private-benefit implications of "whole hospital joint ventures" and "joint operating agreements" with proprietary partners,¹⁴⁴ extending the commerciality logic might require simply revoking the exemption of nonprofit hospitals.¹⁴⁵ Moreover, as a strategic matter, the charitable sector might consider supporting such a move in order to protect the rest of the sector from health care's pervasive and highly visible commercial taint.

3. The Diminishing Role of Contributions and the "Now" Aspect of Charity

Since 1969, Congress has taken the position that contributors perform the important role of overseeing charities. In theory, only when contributors are few does the Code impose specific rules to limit activities. For example, private foundations must annually pay out for charitable purposes at least five percent of the net value of their investment assets.¹⁴⁶ However, the statute deems the three largest segments of the charitable world—churches, schools, and hospitals—not to be private foundations, and for other charities, government grants and fees for services can count toward the public-support test.¹⁴⁷ Non-private foundations, usually called "public charities," have no obligation to expend funds currently for exempt purposes.¹⁴⁸

143. Rev. Rul. 69-545, 1969-2 C.B. 117; see also *Eastern Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974), *vacated and remanded on other grounds*, 426 U.S. 26 (1976) (plaintiffs lacked standing). In 1956, the Treasury had proposed regulations under section 501(c)(3) that would have limited the definition of "charitable" to "organizations for the relief of poverty, distress, or other conditions of similar public concern." Prop. Treas. Reg. § 1.501(c)(3)-1(b), 21 Fed. Reg. 464 (1956). A 1956 revenue ruling required that a hospital "must be operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able to and expected to pay." Rev. Rul. 56-185, 1956-1 C.B. 202. The regulations finalized in 1959, however, defined "charitable" in its "generally accepted legal sense" as developed in the common law. Treas. Reg. § 1.501(c)(3)-1(d)(2) (1960). Revenue Ruling 69-545 revoked the "financial ability" standard of Revenue Ruling 56-185 and adopted a "community benefit" standard for nonprofit hospitals.

144. Rev. Rul. 98-15, 1998-12 I.R.B. 6; Carolyn D. Wright & Fred Stokeld, *Joint Venture Revenue Ruling Gets High Marks, With Some Reservations*, 78 TAX NOTES 1220 (Mar. 9, 1998). See generally Charles A. Bruder, *Charting the JOA Waters: Joint Operating Agreements, Tax-Exempt Health Care Entities, and a Proposed Safe Harbor*, 18 EXEMPT ORG. TAX REV. 227 (Nov. 1997); Vicky Tsilas, *Whole Hospital Joint Ventures: Do Exempt Organizations Really Know What They're Getting Themselves Into?*, 17 EXEMPT ORG. TAX REV. 273 (Aug. 1997).

145. See generally John H. Goddeeris & Burton A. Weisbrod, *Why Not For-Profit? Conversions and Public Policy*, in NONPROFITS AND GOVERNMENT, *supra* note 16, at 235.

146. I.R.C. § 4942 (taxes on failure to distribute income).

147. *Id.* § 509(a).

148. The corporate "accumulated earning tax" does not apply to exempt organizations. See Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 7 n.15

However, Congress might want, in return for its subsidy, to ensure not just that a charity performs good deeds, but also good deeds within a certain period of time after it receives donations or earns income. Ironically, though, entity-level income-tax exemption encourages charities to save in order to maximize the value of their exemption. Thus, charities suffer from a peculiar lock-in effect: They are loath to spend money because they lose the compounding benefit of the untaxed investment income and related business profits. For the same reason that taxable investors do not want to sell capital assets or retirees want to defer drawing down their pensions, the current tax system deters charities from doing good now. I have estimated that investment assets held in the charitable sector exceed \$500 billion,¹⁴⁹ of which just over a third is held in private foundations.¹⁵⁰

For the many reasons that I have discussed elsewhere, in the absence of tax considerations, charity saving usually does not make "business" sense, if by business we mean the charitable purposes of the organization. After all, because a charity cannot distribute profits to shareholders, it must eventually spend its funds on good deeds,¹⁵¹ and the intergenerational arguments for charity saving do not hold up.¹⁵² I believe that the taste for perpetual charitable endowments and other forms of charity wealth preservation persist as the happy coincidence of donors' desire for immortality for themselves and

(1990). Instead, a "commensurability" test applies: to retain its tax-exemption, a charity must conduct a level of charitable activities commensurate with its resources. *See* Rev. Rul. 64-182, 1964-1 C.B. 186 (known as the Field Foundation ruling) (an organization whose primary source of income was from the rental of a large commercial office building operated primarily for an exempt purpose if its contributions and grants to other charities resulted in "a charitable program commensurate in scope with its financial resources"); *see also* Gen. Couns. Mem. 38,742 (June 3, 1981) (stating that "the commensurate-in-scope test must be applied carefully and specifically to the individual facts and circumstances of a particular case"). Moreover, reinvesting earnings to build endowment can be compatible with a charitable program. *Id.* The commensurability test is not well understood, and is infrequently applied. *See* Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, U. HAW. L. REV. (Bishop Estate Symposium Issue, forthcoming 1999).

149. Brody, *Charitable Endowments*, *supra* note 6, at 887.

150. *Id.* (using 1993 figures); *see* Debra E. Blum & Marina Dundjerski, *Foundations' Endowment Explosion*, CHRON. PHILANTHROPY, Feb. 26, 1998, at 1 (the endowments of 121 big foundations grew from \$103.3 billion in 1996 to \$126.5 billion in 1997); *see also* Debra E. Blum & Marina Dundjerski, *Despite Gains in Assets, Many Funds Stick to the Legal Minimum for Giving*, CHRON. PHILANTHROPY, Feb. 26, 1998, at 10 ("Most foundations, however, regard 5 per cent as a maximum. Foundation officials who favor such a strategy say it is the only way to protect an institution's corpus and grant-making ability over time—through stock-market fluctuations and varying inflation rates."). One congressional staffer suggested that Congress might revisit the 5% payout rule for foundations, but no such proposal has emerged. *See* Fred Stokeld, *Hill Staffers Report the Latest on Exempt Organization Issues, Charitable Deduction for Stock Gifts*, 16 EXEMPT ORG. TAX REV. 729 (May 1997).

151. *See* Brody, *Agents Without Principals*, *supra* note 6.

152. *See* Hansmann, *supra* note 148.

for their cultural beliefs, the professional staff's desire for employment and authority, and society's apparent desire for narrowly controlled investment capital.¹⁵³

Unfortunately, it would not be easy to design a requirement for operating charities to attain a meaningful minimum level of current spending or plans for spending. If the goal were to tax the profit from operations but not to tax donations, a charity with even a low level of donative support could stack earned income and investment income first against exempt-purpose expenses, and claim to be saving only out of donations.¹⁵⁴ (Such an opportunity would be available under the Clinton administration's Year 2000 Budget proposal to tax the investment income of trade associations, except for earnings on amounts set aside for charitable purposes.¹⁵⁵) A sense of the difficulties of designing a tax on "overfunded" exempt organizations can be gathered from a proposal with the following features:

1. *Taxable income* would equal net income, measured by (i) the sum of receipts from contributions and grants, investment income, and gross receipts, minus (ii) the sum of expenditures for grants made, related business expenses, administrative expenses, capital expenditures for related purposes, and set-asides for identified related projects.
2. *Tax rates* could be the corporate rates (under Code section 11). Alternatively, the organization could apply a flat rate based on the assumed blended rates of the organization's beneficiary class. For example, the rate would be zero for a charity that feeds the homeless and 39.6% for an opera company that performs primarily for upper-bracket taxpayers. This latter alternative has obvious administrative problems, but the rule applies the theory that the tax on the entity serves as a proxy for the untaxed benefits received by the individuals. Another alternative would apply a flat rate of tax with a large zero bracket amount (for

153. See Brody, *Charitable Endowments*, *supra* note 6.

154. Cf. John Copeland, *Some Suggestions for Revision of Tax-Exempt Organization Rules*, 51 TAX NOTES 911, 919 (May 20, 1991) (stating that a minimum distribution requirement "is not very practical for colleges, hospitals, and other operating and fee-charging organizations. A formula would have to be developed to prevent the attribution of the spending of all endowment income on exempt functions while retaining any net gain from fee-charging operations.").

155. Compare the current rules for set asides by social clubs, I.R.C. § 512(a)(3)(B), and by private foundations, I.R.C. § 4942(g)(2).

Should we retain the UBIT, *see infra* Part III.B.1.c., we would want to prevent an exempt organization from reducing income derived from an unrelated business by losses from a related activity. Otherwise, we would be reinstating the "destination of income" test for exemption: that income is exempt because it is used for an exempt purpose. Thus, we would need two baskets, one for the income and expenses of the unrelated activities and one for all other receipts and expenditures.

example, \$1 million) or a percentage of untaxed income (for example, five percent of taxable income, or, if larger, \$100,000).

3. *Problems with fluctuating income* could be handled various ways. First, we could allow generous carrybacks and carryforwards of losses. Second, we could permit a "rainy day" fund to accumulate tax-free that provides, say, an additional deduction for the average of the last three years' annual expenditures, perhaps increased by an inflator.

4. *Accounting rules* would have to be designed. Would we need a dollar or time limit for multi-year contributions and dues, investments, and expenditures? Should we apply discount factors? Should portfolio assets be marked to market each year?

5. *Constitutional constraints* might require us to adopt special rules or exemptions for two classes of exempt organizations, churches and state governmental entities (and their subdivisions and instrumentalities).¹⁵⁶

In lieu of such a complex regime, a proposal for a low rate of tax on just net investment income has some appeal. Such an investment tax, however, raises its own fairness and efficiency issues.

B. "Covert" Subsidies

1. Corporate/Shareholder Integration

a. Current Law and Effects

The United States's classical two-tier corporate income tax has long troubled public finance scholars as inefficient¹⁵⁷ and out of step with the tax

156. See JOINT COMM. ON TAXATION, IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS OF REPLACING THE INCOME TAX, JCS-4-96 (Apr. 30, 1996) (prepared for a May 1, 1996 hearing of the Ways and Means Committee), available in LEXIS, Fedtax Library, Tax Notes Today File, as 96 TNT 87-15 (May 2, 1996) [hereinafter JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS]. The Committee staff states that

it is uncertain whether a Federal consumption-based tax imposed directly on States—as opposed to a tax imposed on identifiable consumers of goods and services under the same general rules applicable to all businesses, but merely collected by the State—would be a valid, nondiscriminatory tax under the doctrine of intergovernmental tax immunity as interpreted in the modern era.

Id. ¶ 172 (footnote omitted).

157. More recently, Gene Steuerle suggested that the "penalty from inclusion of more than is appropriate in the regular tax base" be treated as a "negative tax expenditure"; he used

system of our major trading partners. Under U.S. tax law, corporate income is taxed first at the corporate rate, and then dividends paid are taxed again at the shareholders' rates.¹⁵⁸ By contrast, interest paid by a corporation is deductible by the corporation, but includible in the recipients' income at the recipients' rates. Accordingly, we (simplistically) think of dividends as taxed twice and interest as taxed once.¹⁵⁹

However, where the stockholder or bondholder is a tax-exempt entity, the formula results in one level of tax (at the paying corporation's rate) on dividends paid and no tax on interest paid.¹⁶⁰ The fact that exempt investors bear one fewer level of tax than taxable investors do is part of what it means to be "tax exempt" under current law. Nevertheless, the single level of tax collected on returns to equity held by exempt stockholders, and the absence of tax on the returns to debt held by exempt bondholders, frustrates some policy makers. The question is of considerable financial importance, primarily because of the financial wealth held by the largest segment of exempt organizations—the qualified pension funds.¹⁶¹ A 1990 estimate by the U.S. Treasury Department pegged the level of exempt holdings at about 37%

as an example "the double taxation of income earned through a corporation." Steuerle, *The Tax Expenditure Budget*, *supra* note 68, at 1051.

158. The retained earnings are effectively taxed at capital gains rates when the shareholders sell their stock. Note that if the shareholder were itself a regular corporation, it could claim a dividends-received deduction (DRD), ranging from 70% (for portfolio investments) to 100% (for an 80%-owned subsidiary). I.R.C. § 243(a). In general, the theory behind the DRD is that corporate earnings should be taxed twice, but not more than twice, and intercorporate dividends should not (much) add to the tax initially paid by the earning corporation and eventually paid by the ultimate individual shareholder. A charity, of course, has no shareholders to whom to make distributions.

159. The level of the corporate tax depends on the amount of corporate income given preferential tax treatment.

160. See also Michael J. Graetz, *The Tax Aspects of Leveraged Buyouts and Other Corporate Financial Restructuring Transactions*, 42 TAX NOTES 721, 722 n.1 (Feb. 6, 1989) ("Professor [Lawrence] Summers estimates that 'the total average tax rate on the interest income of corporate bondholders is only about seven percent,' and he concludes that for 'every dollar of corporate interest paid, the government loses about 27 cents.'"). The Treasury Report cites a Congressional Research Service estimate that the total effective federal income tax rate on corporate debt was 20%, compared with 48% for equity. REPORT OF THE DEP'T OF THE TREASURY ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 6 & n.14 (Jan. 1992) [hereinafter TREASURY INTEGRATION REPORT] (citing Jane G. Gravelle, *Corporate Tax Integration: Issues and Options* (CRS 1991)).

161. The primary tax subsidy to qualified retirement savings is the permanent tax exemption of investment earnings; like any other inside build-up, investment returns compound pre-tax. The fact that the participant pays tax on the nominal amount of each distribution merely reflects the time value of the tax savings on the deduction (or exclusion) of the original (pre-tax) contribution. A secondary subsidy is the effect of lower tax rates after retirement, because generally contributions are made in the participant's high-tax years and distributions are made in the low-tax retirement years.

of corporate equities and 46% of corporate debt, although only a minuscule percentage represented holdings by nonprofit organizations.¹⁶² As of 1995, nonprofit organizations (not just charities, but excluding churches) held 4.24% of total corporate and foreign bonds and 3.54% of corporate equities.¹⁶³

b. Integration or a Broad Investments Tax?

Traditionally, the goal of corporate/shareholder "integration" has been to tax income at the shareholders' rates, that is, the corporation becomes fiscally transparent. The practical difficulty with charities in this picture is that, unlike other entity investors, the income is not eventually going to flow through to any individual investors.¹⁶⁴ Yet this is equally true under current law. Accordingly, passing through the benefits of integration to charities would mean preserving their current *relative* subsidies compared with taxable investors. If after integration taxable investors would bear one level of tax on corporate income instead of the two levels under current law, then preserving charities' relative subsidies in integration would mean that corporate income allocable to exempt shareholders should not be taxed at all (instead of the one level under current law).¹⁶⁵ Moreover, the traditional integration inquiry does

162. TREASURY INTEGRATION REPORT, *supra* note 160, at 68 tbl.6.1. The bulk of this, 28% of corporate stock and 44% of corporate debt, was held by pension funds; nonprofit institutions such as charities held only 4% of stock and 1% of corporate bonds.

163. In addition, nonprofits held 1.83% of mutual fund shares. Percentages are derived from the 1995 figures reported in Board of Governors, Federal Reserve Sys., *Flow of Funds Accounts of the United States: Flows and Outstandings First Quarter 1999* (June 11, 1999): L.100.a (Nonprofit Organizations) (nonprofits held \$119.7 billion in corporate and foreign bonds, \$295 billion in corporate equities, and \$33.9 billion in mutual fund shares); L.212 (Corporate and Foreign Bonds) (total of \$2,823.6 billion); L.213 (Corporate Equities) (total of \$8,331.3 billion); L.214 (Mutual Fund Shares) (total of \$1,852.8 billion).

164. By contrast, it is easier, although not trivial, to identify the specific beneficiaries of pension funds.

165. As an administrative matter, however, the "shareholder allocation" method would most likely be accomplished by corporate-level payment of tax, with gross-up of the distribution by and imputation of the credit to the shareholders (somewhat like wage withholding). Then, for taxpayers in lower brackets than the withholding rate, the credit could act either as a collection device or as a final tax, depending on whether the shareholder tax credit is refundable. A model that uses a gross-up and credit can preserve the current relative subsidies of tax-favored investors by allowing all shareholders to claim a refund of any portion of the shareholder credit not used to reduce tax. Alternatively, the model could selectively deny the benefits of integration by making the credit refundable only to certain types of shareholders (for example, to individuals but not to insurance companies, or to charities but not to trade associations). These distinctions do not, however, derive from the decision to integrate, but rather result from a (conscious or implicit) re-examination of the underlying tax exemptions or subsidies of these investors.

Moreover, the rate of return earned by an exempt investor could actually be less than the rate earned by a taxable investor. This would happen under a mechanism that uses, say, a 34%

not reach the treatment of debt, and so the relative burdens on debt would stay the same as current law (still zero tax on interest paid to exempt bondholders, compared with the single level of tax on interest paid to taxable bondholders).¹⁶⁶

However, as indicated by the subtitle of its 1992 corporate integration report, the Treasury Department stated a goal of "taxing business income once." Moreover, the Treasury posited that all corporate income should be taxed at the same rate.¹⁶⁷ This schedular approach ignores the various characteristics of the investors in taxing an investor's share of corporate income, and thus would equalize the tax burden on corporate equity investments by taxable and tax-exempt investors. Tax-exempt shareholders would lose in relative but not absolute terms: They would forfeit their advantage over taxable shareholders, but earn the same return as they do under current law (assuming the corporate tax rate is not changed). Integration's elimination of one level of tax simply passes them by when the level of tax being removed is the shareholder's. In the end, the Treasury recommended adopting a dividend-exclusion model, effectively putting exempt organizations on a par with taxable investors with respect to distributed corporate income.¹⁶⁸

In truth, revenue concerns led the Treasury to recommend "that a level of taxation . . . of corporate equity income allocated to investments by the tax-exempt sector be retained under integration."¹⁶⁹ Richard Goode uses even

withholding rate and makes the difference nonrefundable to exempt investors but refundable to taxable investors, or under a mechanism that uses, say, a 28% withholding rate and makes the difference refundable to a 15% investor. (Thus, in the first case, a taxable investor in a 0%, 15%, 28%, or 31% bracket gets back the difference, but an exempt investor's income bears the full 34% tax.) As George Yin observed: "This suggestion raises a policy question of whether it is appropriate to tax zero-bracket shareholders on corporate-source income at a higher rate than, say, 15%-bracket shareholders." George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431, 466 (1992). One group identified the propensity of zero-rate shareholders to churn their holdings (because they bear no tax cost), and the lack of support for transactions excise taxes, as a reason to make "the credit . . . fully refundable for dividends collected with respect to securities held for three years or longer and only 50 per cent. refundable for dividends collected on securities held for one to three years." Competitiveness Policy Council, *Lifting All Boats: Increasing the Payoff from Private Investment in the U.S. Economy* (Sept. 14, 1995), TAX NOTES TODAY, Sept. 20, 1995, available in LEXIS, Fedtax Library, Tax Notes Today File, as 95 TNT 184-35. Without discussing the inconsistency, the Treasury recommended that exempt investors be denied a refundable shareholder credit, but that refunds be allowed to low-bracket individual shareholders.

166. Eliminating the corporate tax would make stocks relatively more attractive than debt compared with current law, for exempt investors as well as for taxable investors.

167. TREASURY INTEGRATION REPORT, *supra* note 160, at 12-13.

168. *Id.* at 70 (also noting that it does not favor a dividends-paid deduction, which "would eliminate the current corporate level tax on distributed earnings on equity capital supplied by tax-exempt investors").

169. *Id.* ("Finally, continuing to tax equity investments by the tax-exempt sector avoids the revenue loss that would result if such investments were completely tax-exempt.").

harsher terms: "The report's favorable evaluation of dividend exclusion appears to be motivated not only by its simplicity . . . but by the relatively low priority the authors give to fairness as usually interpreted and their emphasis on ensuring that nontaxable shareholders will not benefit from integration."¹⁷⁰

However, in a world of readily constructed derivative financial products, attempts to deny the benefits of integration to exempt shareholders would be difficult to accomplish.¹⁷¹ In his 1969 study, considering the same question, Charles McLure suggested that the value of integration will be capitalized into share prices, to the advantage of all sellers including exempt sellers; moreover, "[t]echnical devices, such as selling the right to receive dividends to taxable individuals or organizations" will allow exempt shareholders to circumvent the scheme.¹⁷² He wondered whether "it would be preferable simply to extend the benefits to tax-exempt organizations and avoid the socially wasteful shuffling of portfolios and legal maneuvers that denial of benefits would stimulate."¹⁷³

Tax exemption, and each of the other special treatments described in Part II, serves policy goals. To the extent that integration would significantly impinge on these goals, policy makers have to decide which policy trumps: integration or tax-exemption. It would be logical instead to pass through the benefits of integration and use this opportunity to craft any appropriate limits on the underlying exemption subsidy. After all, the objectionable behavior of exempt organizations is not that they buy stock as opposed to other investment assets. If zero is too low a rate of tax on an exempt organization's investment income, then Congress can select another rate.¹⁷⁴

170. Richard Goode, *Integration of Corporate and Individual Taxes: A Treasury Report*, 54 TAX NOTES 1667, 1668 (Mar. 30, 1992).

171. See ALVIN C. WARREN, JR., A.L.I. REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 166 (Mar. 31, 1993).

[I]t is not even certain that the benefit of the shareholder credit could be denied exempt investors, who would be free to sell their shares to taxable investors who could use the credit. Exempt investors interested in the investment attributes of stock might then be able to replicate the return on such investments by using the developing set of derivative instruments that mimic the performance of corporate stock.

Id. (footnote omitted); see also Yin, *supra* note 165, at 466 ("[A]s a practical matter, some zero-bracket shareholders might be able to obtain the benefit of the credit by selling their stock to low-bracket shareholders just prior to a distribution, thereby foiling Treasury's plan.") (footnote omitted).

172. CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 170 n.53 (1979). The conference discussion of this study produced additional examples of portfolio shifts: The charity could invest in convertible debentures, the charity could be the beneficiary of a trust which held the stock and would be entitled to dividend relief, and the charity could retain shares but sell the right to receive dividends (for which the taxable buyer would be eligible for dividend relief). *Id.* at 237.

173. *Id.* at 170.

174. Policy makers and the public might feel less compelled to preserve a zero tax rate

At the end of its discussion of exempt shareholders, the Treasury advocated an approach that would impose a low uniform tax rate on all investment income earned by tax-exempt organizations, with the rate set to "achieve overall revenues equivalent to those currently borne by corporate capital supplied by the tax-exempt sector."¹⁷⁵ The study determined that a revenue-neutral tax rate would be "in the range of six to eight percent depending on the prototype."¹⁷⁶

c. Corporate Integration and the Unrelated Business Income Tax

The Treasury report stated that neutrality requires denying the benefits of integration to tax-exempt shareholders "if UBIT remained in place for noncorporate investment."¹⁷⁷ "Indeed," the study concluded, "anti-abuse rules might be required to preclude tax-exempt organizations from avoiding UBIT altogether simply by incorporating their unrelated businesses."¹⁷⁸ But why would a UBIT be necessary in an integrated world?¹⁷⁹

The Treasury's view of the UBIT is consistent with its view that Congress would want to tax charities' return to unrelated business capital once, regardless of whether the activity is conducted directly or as an investment in

for pension funds. (However, if it were determined that qualified plans should have *no* relative tax advantage over nonqualified plans, there would be no incentive to establish qualified rather than nonqualified plans, with the loss of the currently desirable anti-discrimination requirements that ensure coverage of lower-compensated employees). Pension plans, though, would undoubtedly sweep up the charities in their large wake. Moreover, it is not obvious whether charities as a whole should enjoy lower rates than pensions. It could be argued that the "right" rate for some charities (such as private universities) is higher than for some pensions (such as for blue-collar workers). Moreover, in categories where the rationale for charity exemption has changed, complete repeal of the exemption is consistent with integration—for example, as discussed above, perhaps the profits of a nonprofit hospital should be taxed once, at the full corporate rate.

175. TREASURY INTEGRATION REPORT, *supra* note 160, at 71 & n.13; cf. MCLURE, *supra* note 172, at 173.

The question then arises of what the proper treatment of dividends paid to tax-exempt organizations should be. There can be no categorical answer without some prior decision as to whether tax-exempt status makes sense. But if tax-exempt status is deemed sensible, the answer is clear. Gross-up and credit should be allowed under the imputation method, and no dividend tax should be levied under the dividend-paid deduction. If it is felt that such a solution goes too far, then a special income tax should be levied on the income of such organizations. But such a tax should not be limited to dividend income. It would be more sensible to tax all income at the chosen rate.

176. TREASURY INTEGRATION REPORT, *supra* note 160, at 71 (footnote omitted).

177. *Id.* at 70.

178. *Id.*

179. The Treasury's CBIT proposal left other portfolio shifts available: Rents, royalties, and deductible/excludible financing arrangements by exempt investors would remain relatively attractive compared to the treatment of taxable investors.

a proprietary corporation.¹⁸⁰ In other words, "exemption" would cover just related business activity. Extending the traditional view of corporate integration, however, the tax imposed on an exempt organization's unrelated business income should also be repealed.¹⁸¹ The UBIT shores up the corporate-level tax, so once the corporate tax is eliminated there no longer remains a justification for the UBIT. It is not "unfair" for an exempt organization to compete with an *untaxed* corporation, even if that corporation has taxable shareholders.¹⁸² The owners' tax rates have no effect on the enterprise's costs of operations. Otherwise, under such an argument, any individual investor who would pay tax on corporate income at less than the 39.6% top rate could be considered "tax-favored." On what theory do we remove the tax from General Motors and place it instead on the General Motors Pension Plan?

On the other hand, should policy makers adopt the theory that all business income must be taxed once (including business activities conducted by tax-exempt entities through passive investments), why preserve the distinction between related and unrelated business activities? If in general the nature of the activity as "business" requires taxation, then why should society not want to tax the profit from nonprofit hospital services, higher education, and even social services? It is this issue we turn to shortly, in Part III.B.2: the desirability of adopting uniform tax treatment for all economic activity.

180. The legislative history to the 1950 legislation creating the UBIT emphasized that the goal of the UBIT is to prevent unfair competition. See Treas. Reg. § 1.513-1(b) (1998). Where goods or services are provided by a *taxable* corporation of which an exempt organization is a shareholder, the fact that the shareholder pays no tax on its dividends does not create unfair competition. By excluding dividends from the UBIT, the system thus collects one level of tax on either the taxable subsidiary or the unrelated business activity conducted directly by the exempt organization. Cf. Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 608 (1989).

181. Applying current law, to the extent the corporation earns income which if earned directly by an exempt investor would be subject to the unrelated business income tax, the exempt investor's share would be taxable. The conduit theory of integration strives to tax both distributed and retained earnings at the shareholders' rates. Where that rate is zero, there is no tax on corporate-source income. In addition, if there is no corporate tax, there should be no UBIT for activities conducted directly by the exempt organization. Thus, under a conduit model, only if the incidental corporate tax is removed in a way that does not subject the exempt investors' share of corporate income to UBIT would the *relative* subsidies exempt investors currently enjoy over taxable investors be maintained.

182. See MCLURE, *supra* note 172, at 236:

Certainly most firms would say that it would be totally unfair to have to compete with corporations whose stock is owned in large part by tax-exempt organizations. Though the same complaint could be levied against a corporation owned by low-income shareholders, the likelihood of substantial ownership by shareholders in low marginal tax brackets would be substantially greater for tax-exempt organizations and the reasoning underlying the tax on unrelated business income much more compelling.

Note first, however, that extending the definition of "business" to nonprofit activities related to an organization's exempt purpose would simplify the law but not necessarily increase tax revenues. Many related business activities lose money. If related and unrelated businesses are treated the same, the exempt organization could reduce net income from an unrelated business by the loss from the related business. It could also be expected that money-making commercial businesses would find their way into the hands of exempt organizations conducting money-losing related activities. In effect, this could represent a return to the prior era when a for-profit business owned by a tax-exempt organization itself enjoyed tax-exemption under the "destination of income" test.

d. Exempt Organizations as Tax-Shelter Partners

Prospects for the United States to integrate its corporate and shareholder taxes are dim. Indeed, the Clinton Administration's Year 2000 Budget contains a surprisingly forceful attack on "corporate tax shelters," in order to preserve the corporate tax base from a slew of recent investments designed to minimize tax at little economic risk. One of the proposals imposes penalties on the investment banks and other promoters designing these products.

One sleeper proposal would tax income from "corporate tax shelters involving tax-indifferent parties."¹⁸³ As described in the Budget:

The Federal income tax system has many participants who are indifferent to tax consequences (e.g., foreign persons, tax-exempt organizations, and Native American tribal organizations). Many corporate tax shelters have tax-indifferent participants who absorb taxable income generated by the shelters so that corresponding losses or deductions can be allocated to taxable participants. The proposal would provide that any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable. The proposal would be effective for transactions entered into on or after the date of first committee action.¹⁸⁴

Congress has previously enacted rules to reduce the tax benefits of depreciation deductions from "tax-exempt use property," and to prevent taxable parties in real estate partnerships with certain tax-exempt partners from allocating deductions disproportionately to the taxable partners.¹⁸⁵ In

183. OFFICE OF MANAGEMENT AND BUDGET, FY 2000 BUDGET, ANALYTICAL PERSPECTIVES, Ch. 3 (Federal Receipts), available in LEXIS, Fedtax Library, Tax Notes Today File, as 1999 TNT 23-72 (Feb. 4, 1999), ¶ 179.

184. *Id.*

185. I.R.C. § 168(h) (providing for longer-than-normal useful lives for depreciable property leased to a tax-exempt entity, or owned by a partnership having an exempt partner if the allocations are not "qualified"); *id.* § 514(c)(9)(E) and Treas. Reg. § 1.514(c)-2 (1996)

addition, an anti-"earnings-stripping" rule denies a deduction for certain interest paid to related exempt persons.¹⁸⁶ Such targeted rules, however, fail to stem other forms of tax-advantaged transactions with exempt organizations. According to the Treasury Department's explanation of the Year 2000 Budget:

Many corporate tax shelters involve a timing mismatch or separation of income or gains from losses or deductions that is exploited through the use of tax indifferent parties. In these transactions, the tax indifferent party absorbs the income or gain generated in the transaction, leaving the corresponding loss or deductions to the taxable corporate participants. Tax indifferent parties often agree to engage in such transaction in exchange for an enhanced return on investment or for an accommodation fee. Corporate taxpayers should not be entitled to buy the special tax status of tax indifferent parties. Imposing a tax on the income allocated to tax indifferent parties should limit the sale of their special tax status and, thus, their participation in corporate tax shelters.¹⁸⁷

The practical tax result would depend on the type of tax-indifferent party. For example, any income allocated to an exempt organization would constitute unrelated business income.¹⁸⁸ The Administration estimates that it can save \$830 million over the next five years in lost tax revenue from this single proposal.

No legislative language exists for this proposal, and so it is hard to gauge its potential impact. Nor do we know the extent to which university endowments and private foundations have been engaging in these activities. Nevertheless, until a precise definition of "corporate tax shelter" becomes available, such a proposal will have a chilling effect on particularly aggressive investment practices.

2. Flat Tax and Other Substitutes for the Income Tax

Recent years have seen a flurry of proposals for tax reform even more fundamental than corporate integration. While reform approaches differ and descriptions are only sketchy, the proposals have in common a goal of

(permitted allocations in leveraged real estate partnerships having institutions of higher education or pension trusts as partners).

186. I.R.C. § 163(j) (if debt exceeds 60% of the paying corporation's capitalization, a deduction is denied for net interest expense paid or accrued in excess of 50% of the corporation's taxable income to exempt related persons). The basic idea is to deprive the paying corporation of a deduction for what are economically disguised dividends; the primary target of the proposal was related foreign payees.

187. *General Explanations*, *supra* note 4, at 104.

188. The proposal makes all participants of the corporate tax shelter jointly and severally liable so that if, for example, the tax-indifferent party is a foreigner protected by a treaty or a Native American tribal organization, the tax would be collected from the other parties. *Id.* at 104-05.

imposing taxes on ultimate consumers of goods and services. Moreover, the proposals aim for simplicity—at least in these early days, before the political process has had a chance to work its will. Major consequences of reform would include removing the distinction between corporate and noncorporate businesses, exempting returns to invested capital, repealing itemized deductions and taxing fringe benefits, flattening tax rates, and reaching most consumption, including that of governments and nonprofit institutions.

These proposals would radically change the current tax subsidies enjoyed by exempt organizations.¹⁸⁹ Superficially, most of the proposals appear to exempt charities. On closer inspection, however, we find that each of the various components of tax-favored treatment to charity would take a blow. Most visible is the elimination of the charitable-contribution deduction. Other aspects of the proposals would remove the relative tax advantages of charities: By excluding all taxpayers' investment income, the charities would be relatively no better off (as just described in the discussion of corporate integration),¹⁹⁰ and charities could no longer attract buyers of lower-interest bonds.¹⁹¹ The proposals that would apply tax to inputs purchased by charities

189. See, e.g., CONGRESSIONAL BUDGET OFFICE, THE ECONOMIC EFFECTS OF COMPREHENSIVE TAX REFORM (July 1997) <<http://www.cbo.gov/showdoc.cfm?index=36&sequence=0&from=1>> [hereinafter CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS]; CONGRESSIONAL BUDGET OFFICE, THE POTENTIAL EFFECTS OF TAX RESTRUCTURING ON TAX EXEMPT AND OTHER NONPROFIT INSTITUTIONS (CBO Paper Feb. 1997); PRICE WATERHOUSE, *supra* note 2; JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156; Robert Carroll, Thomas S. Newbig, & Kathleen Nilles, *Impact of Structural Tax Reform on Nonprofit Organizations*, 67 TAX NOTES 1785 (June 26, 1995); Clotfelter & Schmalbeck, *supra* note 2; see also Fred Stokeld, *Exempt Organizations Ponder Life Under National Sales Tax*, 71 TAX NOTES 292 (April 15, 1996).

190. William Gale describes "a potentially important loophole in the business tax base" of the reform proposals. William G. Gale, *The Kemp Commission and the Future of Tax Reform*, 70 TAX NOTES 717, 724 (Feb. 5, 1996). Because receipts from sales of goods and services would be taxed, but not interest received, businesses would have an incentive to engage in transactions with entities not subject to the business tax ("households, governments, foreigners"), to label as "'interest income' as much cash inflow as possible," and to label as deductible "purchases" of goods and services "as much of their cash outflow as possible." *Id.* & n.9 (citing Charles E. McLure, Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption* 25 (May 11, 1995) (conference paper, Hoover Institution on War, Revolution & Peace) (concluding that the taxation of business income in the flat tax "contains unacceptable opportunities for abuse")).

191. By eliminating taxation of interest income, the proposals would "wipe out the distinction between taxable and tax-exempt bonds, thus raising the cost of financing for nonprofits and state and local governments." CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS, *supra* note 189, ch. 4, at 11. "In addition, the Gibbons VAT proposal would include interest earnings from tax-exempt bonds in net income to determine assessments on taxpayers with income above \$75,000." *Id.* However, the "USA tax would retain a preference for tax-exempt bonds by excluding the interest from such bonds from the cash income of individuals, while permitting the purchase of bonds to qualify as tax-exempt saving." *Id.*

would remove exemption from all but their "value added" to goods and services,¹⁹² and would require complex accounting and filing obligations to boot. Reform would eliminate the tax-free treatment of fringe benefits, including health insurance, provided to workers. Finally, the proposals in general would collect a single level of tax on a whole host of "commercial" charitable services, notably health care.

While the variety of proposals can quickly overwhelm the casual observer, in their details each produces somewhat different threats to nonprofits. Essentially, four models have emerged: (1) the National Retail Sales Tax;¹⁹³ (2) the Value-Added Tax ("VAT");¹⁹⁴ (3) the Flat Tax;¹⁹⁵ and (4) the Unlimited Savings Allowance ("USA") Tax.¹⁹⁶

The National Retail Sales Tax contains no general individual-level tax; rather, tax would be collected on business sales to customers of goods (other than financial assets) and services (other than dues, contributions, and payments to qualified not-for-profit organizations).¹⁹⁷ The Value-Added Tax

192. Under current law, however, to the extent that the corporate income tax is passed on to customers, charities and governments already bear tax on their purchases.

193. See H.R. 2001, 106th Cong. (May 26, 1999). A competing sales tax proposal, the FAIRTAX, has also emerged. See Robert S. McIntyre, *The 23 Percent Solution?*, N.Y. TIMES, Jan. 23, 1998, at A21.

194. Curiously, "[t]he one system that [American reformers] have chosen to ignore is the one system that's used by virtually every other country in the world that has consumption taxation, and that is, of course, the credit invoice method of value-added taxation." *Edited Transcript of the May 15, 1998 ABA Exempt Organizations Committee Meeting*, 21 EXEMPT ORG. TAX. REV. 35, 54 (1998) (comments of Hank Gutman for panel on "The Fundamentals of Fundamental Tax Reform").

195. ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995); H.R. 2060, 104th Cong. (July 19, 1995) (Cong. Army); and S. 1050, 104th Cong. (July 19, 1995) (Sen. Shelby).

196. Referred to by the Joint Committee as a "cash flow" tax, the USA Tax Act of 1995 was introduced by Senators Sam Nunn and Pete Domenici. See S. 722, 104th Cong. (April 25, 1995). Of these four proposals, only the Flat Tax would also replace the estate tax; the USA Tax would also offset the payroll taxes. For a comparison of the basic features of the proposals, see Henry J. Aaron & William G. Gale, *Introduction* to ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM, *supra* note 2, at 6-14. Eliminating the estate tax actually reduces the incentive to make lifetime gifts as well as bequests to charity. Clotfelter & Schmalbeck, *supra* note 2, at 218.

One should not confuse the Nunn-Domenici proposal with President Clinton's Year 2000 Budget proposal to provide a government subsidy for private saving by lower-income shareholders, also called—no doubt deliberately—USA (but standing for Universal Savings Accounts).

197. This last provision basically covers section 501(c)(3) charities, section 501(c)(4) social welfare organizations, and section 501(c)(6) civic leagues. PRICE WATERHOUSE, *supra* note 2, pt. 2, at 6-7. Goods or services provided in connection with a contribution or payment of dues would be treated as a taxable transaction in an amount equal to the fair market value of the goods or services provided. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT

would collect tax on business sales minus the cost of inputs purchased from other businesses. The Flat Tax is the same as the Value-Added Tax, except that it would permit businesses to deduct wages paid and pension plan contributions; individuals would then pay a single-rate tax on their wages and pension income (but not on their interest, dividends, and capital gains). The purpose of bifurcating the tax on compensation is to tailor personal exemptions to household size.¹⁹⁸ At the individual level, the USA Tax retains the basic structure of current law (with a credit for payroll taxes), but would allow deductions for non-pension saving and would tax consumption (even from savings above \$50,000 of old wealth). The proposal would deny deductions for state and local taxes, but would allow all taxpayers, not just itemizers, to deduct mortgage interest, charitable contributions, and a limited amount of tuition. At the business level, the USA tax would adopt a value-added tax as well as a credit for payroll taxes.

Eliminating the deduction for state and local taxes increases the relative burden on public sector goods and services.¹⁹⁹ Similarly, most proposals would eliminate the charitable-contribution deduction (although some uncomfortable politicians deliberately left this aspect of their plans ambiguous).²⁰⁰ The authors of the Flat Tax, Robert Hall and Alvin Rabuska, unapologetically declare:

ORGANIZATIONS, *supra* note 156, ¶ 143. Payments for health care would be taxable, but, under an explicit exclusion, payments for tuition (but not room and board) to both for-profit and nonprofit providers would be exempt because payments for "general primary, secondary or university-level education and fees for job-related training courses are . . . treated as purchased to produce taxable property or services." PRICE WATERHOUSE, *supra* note 2, pt. 2, at 7. Applied research, but perhaps not basic research, would appear to be exempt under the same theory. *Id.* Special rules would apply to property or services purchased for a dual use. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶ 70.

198. See CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS, *supra* note 189, ch. 2, at 8. ("In effect, with the same tax rate on the business and wage portion of the tax, a bifurcated VAT is an ordinary VAT with an implicit refund that would depend on a family's size and wage earnings."). Similarly, the "X-Tax" proposed by David Bradford would be a bifurcated VAT with graduated rates applied to the wage tax. *Id.* at 9.

199. See also MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 210 (1997) ("The uniform opposition of governors and mayors was an important—perhaps even decisive—factor in dissuading President Nixon from proposing a value-added tax as a partial substitute for Social Security and corporate income taxes in the early 1970s.").

200. The Kemp Commission ducked the issue of this itemized deduction (as well as the deduction for home mortgage interest), perhaps out of self-interest. See Gale, *supra* note 190, at 720 ("While theoretical purity might call for eliminating the charitable contributions deduction, the commission may have found this a difficult stance to maintain in light of the fact that the commission itself filed for tax-exempt status, so that contributions to the Kemp commission could be tax-deductible."). The courts, however, upheld the IRS's denial of section 501(c)(3) exemption to the commission on the ground that it was too closely linked to advocacy for legislative change. *Fund for the Study of Econ. Growth & Tax Reform v. IRS.*, 161 F.3d 755 (D.C. Cir. 1998).

Churches have nothing to fear from tax reform and, like most people and institutions, would have much to gain from better economic conditions brought about by reform. Despite their dominant position in gifts, churches are not the leaders in fighting a tax reform that denies deductions. Instead, institutions serving the absolute economic and social elite—universities, symphonies, opera companies, ballets, and museums—are protesting the loudest. No compelling case has ever been made that these worthy undertakings should be financed by anyone but their customers. A glance at the crowd in any of them will tell you that it is perverse to tax the typical American to subsidize the elite institutions. . . .

Tax reform will be a tremendous boon to the economic elite from the start. After all, those with high salaries will benefit directly and immediately from the reduction in the tax rate from 39.6 percent to 19 percent. Those with lightly taxed business income stand to benefit more indirectly in that their economic activities are severely distorted by the devices and activities they have adopted to avoid taxes. Freed from these distortions, they may well become better off even though they are paying more taxes. For both groups, removing tax deductions from their favorite cultural activities is a reasonable price to pay. With substantially higher after-tax incomes among their customers as well as donors, universities and other institutions will make up part or perhaps all of the ground they will lose when tax deductions disappear.²⁰¹

The USA Tax proposal is the least harmful to the charitable sector; indeed, it is the only proposal that would *lower* the price of charitable contributions (because nonitemizers could claim them, and more income would be subject to taxation at higher rates).²⁰² The USA Tax also would continue the deduction for the fair market value of donated appreciated property.²⁰³ As a separate matter, the USA Tax would permit families to deduct up to \$2,000 for each family member (capped at \$8,000 in the aggregate) each year for postsecondary education and training.²⁰⁴

As the Hall and Rabushka quote suggests, in estimating the effects that the various proposals will have on giving, economists try to ascertain whether the "income effect" of higher after-tax income available for donation will dominate the "substitution effect" of shifting expenditures to other uses once

201. HALL & RABUSHKA, *supra* note 195, at 100.

202. See PRICE WATERHOUSE, *supra* note 2, pt. 3, at 20.

203. This concerns Clotfelter and Schmalbeck, who observe:

But this provision raises a serious issue: investment assets purchased after the USA tax is in effect will have a zero tax basis. Allowing any deduction at all for the contribution of such property would produce a double deduction—once when the funds to buy the asset were saved, and a second time when the asset was contributed to a charitable organization. Clotfelter & Schmalbeck, *supra* note 2, at 227.

204. CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS, *supra* note 189, ch. 2, at 11.

the price of giving rises.²⁰⁵ Most are not hopeful. Clotfelter and Schmalbeck calculate that the Armey-Shelby Flat Tax, which denies the deduction for charitable contributions, would result in a 10% drop in donations by individuals, while the USA Tax, which retains the deduction, would produce an 11% increase.²⁰⁶ The Price Waterhouse study estimates that had a 21% Flat Tax been in place in 1996, charitable giving by individuals would have been \$71 billion instead of \$104 billion, and repeal of the estate tax would have cost another \$3 billion in lost contributions; by contrast, the USA Tax could have increased individual giving by as much as \$34 billion.²⁰⁷ A Heritage Foundation study, though, estimates that contributions by individuals to charity, particularly religious congregations, would rise by about 3.8% under a 17% Flat Tax without a charitable contribution.²⁰⁸

As a threshold matter, talk of fundamental tax reform provides an opportunity to re-examine the economic inefficiencies of applying different tax schemes to the three sectors. Consider, for example, the following discussion by the Congressional Budget Office (CBO), which expresses doubt about the universal distinctiveness of public and nonprofit service provision:

Taxing government services is . . . hard because they are seldom financed by user fees that reflect their true cost. The same is true for the services that nonprofit organizations provide. Proper treatment under a retail sales tax would be to tax government and nonprofit provision of goods and services. Otherwise, those goods and services would be subsidized relative to private production, and there would be incentives to allocate more economic resources toward the government and nonprofit sectors. Such an

205. See *supra* Part III.A. (providing estimates of the elasticity of giving).

206. Clotfelter & Schmalbeck, *supra* note 2, at 230.

207. PRICE WATERHOUSE, *supra* note 2, pt. 2, at 4. Because the proposals are designed to be roughly revenue neutral, Price Waterhouse notes, the importance of the income effect is lessened in the aggregate. *Id.* pt. 3, at 19. "Giving will decrease 19 percent for each 10 percent increase in the price of giving. This effect swamps increases in giving as a result of increases in income. On average, a family will give about 3 percent more to charity when its income increases by 10 percent and about 3 percent less when its income decreases by 10 percent." *Id.* pt. 1, at 3.

Price Waterhouse concedes that its estimates of the price elasticity of charitable giving are at the high end of studies and its estimates of the income elasticity for charitable giving are low. *Id.* pt. 3, at 28. Using other estimates produces a 24% decline rather than a 32% decline in giving under the Flat Tax, and a 23% increase rather than a 33% increase under the USA Tax. *Id.* pt. 3, at 29. Because of the lack of data on contributors' basis in donated property, Price Waterhouse could not account for changes in the level of non-cash giving, which "may be seriously understating the total price effect of non-cash gifts." *Id.* pt. 3, at 46. Finally, the study did not address the difference between permanent and transitory responses to tax restructuring, so their "results may overstate the long-term reactions to tax reform." *Id.* pt. 3, at 23.

208. John S. Barry, *How a Flat Tax Would Affect Charitable Contributions* 12-13 (Heritage Foundation Backgrounder, Nov. 7, 1996); see also HALL & RABUSHKA, *supra* note 195, at 100-01 (discussing the rise in donations in the 1980s despite the increase in the price of giving after Congress in 1981 and 1986 slashed the top rate from 70% to 50% and then to 28%).

outcome can be acceptable when governments and nonprofit organizations provide certain public goods, such as education or charitable services, that have spillover benefits to everyone. But it is a problem when the goods and services provided compete directly with those of for-profit firms.²⁰⁹

Given the difficulties, however, in ascertaining identifiable transactions to tax, the CBO suggests that "the best that can be done is to have governments and nonprofit groups value resources at the same prices as the private sector by taxing sales from businesses to those entities."²¹⁰

The staff of the Joint Committee on Taxation expresses the issue more theoretically: "One of the most fundamental issues in attempting to measure the value of governmental and nonprofit activities is when should government and nonprofit entities be regarded as producers of goods and services and when should they be treated as consumers?"²¹¹ If the goal of the tax system is to tax "the value added with respect to all final goods and services in the economy, then value added by government and nonprofit labor and capital resources should be subject to tax."²¹² By contrast, if governments and nonprofits are treated as consumers of self-supplied services,²¹³ then sales to

209. CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS, *supra* note 189, ch. 2, at 6.

210. *Id.*

211. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶ 154. In a footnote, the Joint Committee on Taxation notes that McDaniel and Surrey generally treat governments and charities as ultimate consumers, except to the extent they sell commercial-type goods and services to identifiable customers. *Id.* n.67. See PAUL R. MCDANIEL & STANLEY S. SURREY, INTERNATIONAL ASPECTS OF TAX EXPENDITURES: A COMPARATIVE STUDY 92 (1985):

However, where government acquires items which it then resupplies to final, identifiable customers in transactions which are, or can be, carried out by private businesses, the final burden of the tax should not rest with government, but instead should be passed on to the actual consumers

. . . Where such organizations are operating in a non-profit way to purchase and provide goods to individuals in the society who probably cannot or would not acquire such items from a for-profit business, it is appropriate to treat the charitable organization as the consumer and impose the tax burden on it.

Id. But, concluded McDaniel and Surrey, "[w]here the charitable organization carries out for-profit activities which do, or can, compete with those of private entrepreneurs the tax should not be borne by the organization but by the consumers of its products." *Id.* at 93. The Joint Committee's footnote concludes by describing Canada's intermediate approach in its goods and services tax: "Under the GST, charities are treated as consumers with regard to most of their services, which are VAT-exempt; however, charities also are treated as quasi-businesses and are allowed a 50-percent input credit." JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, at n.67.

212. *Id.* ¶ 165. ~

213. Self-supplied services escape tax because of difficulties of monitoring and valuation. *Id.* ¶ 167. The JCT worries about a system that would tax "a barn built under the auspices of a church or other entity, but tax only the materials if the same barn is built by an informal group

governments and nonprofits would not be inputs in a business activity of theirs.²¹⁴ The Joint Committee suggests bringing the federal government into the system as well; by not doing so, "the Federal Government would look smaller or more efficient than it otherwise might, and would appear smaller than State and local governments that might undertake some of the same activities"²¹⁵

No country with a transactions tax treats all consumption uniformly. European-style VATs typically reduce tax on "necessities" such as education, health care, food, and clothing,²¹⁶ either by removing the tax on the value added at the retail stage (but not the tax on the retailer's inputs) or by zero-rating (exempting tax on sales and providing the seller with a refundable credit of the VAT paid on purchases). "Since nonprofit organizations are typically exempt from consumption tax in Europe, they still pay tax on their inputs."²¹⁷ However, a system that taxes some activities while exempting others would require allocating inputs between the taxable and the exempt activities. "Aside from the administrative complexities and record keeping costs imposed on nonprofit organizations from the allocation system, the taxing authority

of neighbors," and quotes McDaniel and Surrey, who would exclude only an "activity customarily carried on by individuals in and around their own households." *Id.* n.73 (quoting MCDANIEL & SURREY, *supra* note 211, at 77). A business transfer tax introduced in 1994 by former Senators Boren and Danforth would have fully subjected charities to tax only for their unrelated business income (other than debt-financed income). See S. 2160, 103d Cong. (May 26, 1994). The bill would have imposed a partial tax on charities (as well as governments) to the extent of the estimated fair market value of their self-consumption of goods and services. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶ 179, 214. *Id.* ¶ 166.

The National Retail Sales Tax reflects this approach in its treatment of certain qualified not-for-profit organizations by taxing sales to such organizations, but not taxing their sales (other than UBIT-type activities or sales of commercially available goods or services) and by exempting wages paid by such organizations, as well as contributions, gifts, and similar payments they receive, from tax.

Id. Also, by not imputing income to volunteers, a consumption tax system that denies the charitable-contribution deduction would make donations of time relatively less costly. *Id.* ¶ 196; Andreoni et al., *supra* note 16, at 21.

215. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶ 175. The study notes the National Retail Sales Tax proposal includes the Federal government. *Id.* ¶ 176.

216. Professors McDaniel and Surrey characterized these exemptions as tax expenditures, treating expenditures for education and health care as consumption under arguments similar to those that deny a business-expense deduction for investments in human capital under the income tax. MCDANIEL & SURREY, *supra* note 211, at 81, 88.

217. Carroll et al., *supra* note 189, at 1788. "For example, exemption of hospital services to consumers would not remove tax collected from manufacturers of hospital supplies." Aaron & Gale, *supra* note 196, at 7.

also has to bear additional compliance costs because taxpayers have an incentive to allocate expenses to taxable production to offset tax."²¹⁸

The National Retail Sales Tax would allow charities to exempt purchases only to the extent used to produce taxable goods and services. Specifically, notes Price Waterhouse, exemption would apply only "if [charities] receive payments in any form for the purchase of property or services that are not substantially related to the organization's exempt purpose *or that are commercially available*."²¹⁹ This study concludes that such a test "will have the effect of making most program service revenue taxable because there are commercial counterparts to most charitable services"—including "such traditional charitable activities as child care, family counseling, health care, and the publication of scholarly and religious works, all of which have for-profit equivalents."²²⁰ Under a "commercially available" test, Price Waterhouse asks: Do goods and services have to be the same or merely similar? Do differences in quality or price affect availability, and if so, how? Is distance a factor in determining availability? And how is a sale at less than fair market value taxed?²²¹

As for the Value-Added Tax, even if Congress exempts governments and nonprofits from their own value added to goods and services, these entities would still pay tax on the value of their purchases from businesses.²²² Moreover, by permitting taxable enterprises to expense invested capital, a consumption tax reduces the relative value of tax-exemption, because

218. Carroll et al., *supra* note 189, at 1792 (comparing the New Zealand model, which imposes the VAT on nonprofit organizations but exempts production of certain goods and services, with the European and Canadian model, which generally exempts nonprofits but taxes certain activities).

219. PRICE WATERHOUSE, *supra* note 2, pt. 2, at 7. An entity currently exempt under sections 501(c)(3)-(6), (8) and (10) could apply for an exemption certificate from the appropriate state tax administrator to cover property or personal services acquired for resale or used in the production of taxable property or services, including goods or services provided in return for contributions or dues. JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶ 73.

220. PRICE WATERHOUSE, *supra* note 2, pt. 2, at 7. This study also notes that the proposal contains none of the present law UBIT exceptions for activities run by volunteers, rental income, and sales of donated merchandise. *Id.* pt. 2, at 7-8.

221. *Id.*; see also JOINT COMM. ON TAXATION, IMPACT ON TAX-EXEMPT ORGANIZATIONS, *supra* note 156, ¶¶ 184, 185 (discussing difficulties of ascertaining whether it is possible to purchase certain goods and services on an individual basis, and the effect of similar, but not identical, goods or services being provided commercially).

222. See CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS, *supra* note 189, ch. 2, at 7-8. Note that private foundations—which essentially act as conduits by receiving donations and investment income—would see little direct effects from a consumption tax, but could fund less activity in the future. See also Clotfelter & Schmalbeck, *supra* note 2, at 213.

expensing is the equivalent of exempting the return on the asset from tax.²²³ For the Flat Tax, though, the CBO observes: "Because wage payments account for a large portion of the value added attributable to governments and nonprofit organizations, a bifurcated VAT provides generally consistent treatment for those institutions and private businesses."²²⁴ However, the Flat Tax would tax fringe benefits paid to workers, by denying deductions to businesses and by imposing a tax on nonprofits, thus raising all employers' costs of labor compared with current law.²²⁵ Price Waterhouse notes that the value of employee health and medical insurance, free parking, spousal travel, and tax-exempt housing averages about four to five percent of the expenses of educational organizations.²²⁶

The Armey-Shelby Flat Tax proposal would exempt governments and nonprofits from the business tax, except for their unrelated business activities.²²⁷ However, the Flat Tax would limit the nonprofit exemption to charities, while imposing business taxes on transfers of property or the provision of services by all other nonprofits,²²⁸ "even if such activities are substantially related to what historically has been considered to be the exempt purposes of these organizations."²²⁹ The USA Tax would go further, denying exemption to certain charities, notably child-care centers and educational organizations that undertake policy analysis (*e.g.*, think tanks).²³⁰ It is unclear

223. Another way to say this is that capital will generally become relatively less expensive than labor for taxable businesses. See CONGRESSIONAL BUDGET OFFICE, *ECONOMIC EFFECTS*, *supra* note 189, ch. 4, at 1.

224. *Id.* ch. 2, at 9.

225. This mechanism would overtax the fringe benefits of low-wage workers, who, had they instead received cash compensation, would have seen their total income covered by the large personal exemption. David Cutler, *Comment*, to Jonathan Gruber & James Poterba, *Fundamental Tax Reform and Employer-Provided Health Insurance*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM*, *supra* note 2, at 163-64. The USA Tax would instead include the value of fringe benefits in the employees' income. While avoiding one overtaxation problem, this approach raises the difficult problem of allocating and valuing individual workers' fringe benefits.

226. PRICE WATERHOUSE, *supra* note 2, pt. 2, at 11.

227. CONGRESSIONAL BUDGET OFFICE, *ECONOMIC EFFECTS*, *supra* note 189, at 9. The USA Tax contains a similar scheme, although it is not clear how much of current law would be retained. See S. 722, 104th Cong. § 301 (Apr. 25, 1995). Price Waterhouse comments: "The bill delegates to the Treasury Secretary the authority to answer these questions, but this leaves some question about the treatment of such income streams as income from activities that are not regularly carried on, from royalties, from passive rental activities, from research . . ." PRICE WATERHOUSE, *supra* note 2, pt. 2, at 4. Any consumption tax that retains the UBIT should repeal UBIT treatment for debt-financed income. See JOINT COMM. ON TAXATION, *IMPACT ON TAX-EXEMPT ORGANIZATIONS*, *supra* note 156, n.94.

228. See Clotfelter & Schmalbeck, *supra* note 2, at 226.

229. See JOINT COMM. ON TAXATION, *IMPACT ON TAX-EXEMPT ORGANIZATIONS*, *supra* note 156, ¶ 131.

230. PRICE WATERHOUSE, *supra* note 2, pt. 3, at 5.

whether such charities should include gifts and membership dues in their calculation of taxable receipts.²³¹

In sum, while fundamental tax reform is driven by the desire to take returns to capital out of the tax base, the overall tax structure determines the form in which subsidies can be delivered. A consumption tax would subsidize activities rather than organizations.²³² However, with the notable exception of the USA Tax, the current form of these proposals would radically limit the direct and indirect tax subsidies provided to charities, without using the tax savings for anything other than reducing tax rates across the board.²³³

IV. REPLACING TAX SUBSIDIES WITH DIRECT EXPENDITURES

As I described in Part II, Congress uses a combination of direct expenditures and both supply-side and demand-side tax expenditures to deliver subsidies to charities.²³⁴ In 1966, marveling at the growth in federal direct expenditures for education, science, welfare, health, and art, Edward Rabin urged: "With these new direct federal contributions should come a new determination that the indirect federal contribution via the tax deduction should be at least as effectively and wisely spent as the direct contribution."²³⁵

The possible reforms raised in Part III would alter not only the form of subsidy but also the size and distribution among taxpayers of varying income classes. After all, to identify a "tax expenditure" is not necessarily to identify a target for extinction, but rather to identify an indirect government spending program that might continue—perhaps in a radically altered and stripped-down form—as a direct spending program.²³⁶ Thus, this part takes the question of reform to the final step by examining what substitute programs might look like.

231. *Id.* n.5 (citing to Alliance USA, *Unlimited Savings Allowance (USA) Tax System*, 66 TAX NOTES 1482 (Special Supp., Mar. 13, 1995)).

232. Eric Toder, remarks at the author's Georgetown University Law Center Tax Policy Workshop (Oct. 9, 1998). If fundamental reform retains an income tax on high-income taxpayers, the charitable-contribution deduction could also be retained. Ken Gideon, remarks at the same workshop.

233. *Cf.* Kaplow, *supra* note 62, at 486 n.201 (In the 1986 tax reform debate, state and local government officials strongly opposed the suggested repeal of the deduction for state and local taxes, the savings from which "were to be used entirely to finance reduced tax rates, rather than being channeled into increased grants.").

234. *See supra* Part II.

235. Rabin, *supra* note 40, at 936-37.

236. Alternatively, the tax law could be simplified but the complexity shifted to another policy instrument, such as regulation. *See* Stanley L. Winer & Walter Hettich, *What Is Missed If We Leave Out Collective Choice in the Analysis of Taxation*, 51 NAT'L TAX J. 373, 378 (1998) ("Special interest groups that lose favored tax treatment may succeed in obtaining relief through new regulatory measures. Forced simplicity in one policy area may thus lead to greater complexity elsewhere.").

Converting from tax subsidies to direct subsidies raises three issues:

- (1) Can a direct expenditure program always be designed?
- (2) Are there constitutional impediments where churches are involved?
- (3) What political issues are raised, and would the form of subsidy likely produce different results?

As I write this final part, I recognize that feelings run hard on this subject. One study describing the history of tax subsidies for charity concluded:

Having come this far and having achieved so much under a tax system which encourages private philanthropy, it would be a disaster if we were at this late date to decide to junk the present system in favor of some untried scheme of direct government subsidy or operation of all charity.²³⁷

A. *Can It Be Done?: A Mixed Approach*

Welfare reform has focused attention once more on an old idea: delivering social services through vouchers. The basic idea builds on the notion of consumer sovereignty. Other forms of vouchers have existed for some time, including Pell grants and Medicare payments. In most cases, there is no overarching social requirement that everyone be able to purchase from the same provider, the government.²³⁸ Instead of providing particular services directly, the government could issue chits to those who demand them.²³⁹ The holders then could determine where best to spend that chit. The theory goes that competition among providers for these chits will ensure the best results for all. As Milton Friedman wrote in 1962: "The subsidization of institutions rather than of people has led to an indiscriminate subsidization of all activities appropriate for such institutions, rather than of the activities appropriate for the state to subsidize."²⁴⁰

237. Kenneth Liles & Cynthia Blum, *Development of the Federal Tax Treatment of Charities*, 39 LAW & CONTEMP. PROBS. 6, 56 (1975).

238. For a counter-example, consider that in public primary and secondary education, universality is itself an asserted social good.

239. Cf. Susan Rose-Ackerman, *Social Services and the Market*, 83 COLUM. L. REV. 1405, 1406, 1420 (1983) ("Proxy shopping"—paying for services for the needy if the provider has enough unsubsidized clients—"can be superior to a voucher plan when the needy are less effective shoppers than are unsubsidized customers."). See generally William H. Simon, *Social-Republican Property*, 38 UCLA L. REV. 1335 (1991).

240. MILTON FRIEDMAN, CAPITALISM AND FREEDOM 100 (1962).

As discussed above, some of the current tax subsidies, such as the tuition tax credits, can be described as vouchers.²⁴¹ Some might even view the charitable-contribution deduction as a voucher, because it provides the same governmental financial benefit (for taxpayers in the same marginal tax bracket) for contributions of a given amount regardless of the chosen charity.

This is not to say that conversion of tax subsidies to direct outlays would be easy. In 1973, Professor Surrey declared: "It seems clear that if higher education, the arts, and some other philanthropic activities are to continue to play the role we desire for them, there must be a considerable enlargement of Government aid."²⁴² He considers why we do not simply increase the amount of direct aid we already provide, and repeal the contribution deduction:

If we can work out the ways to accomplish this aid and still maintain the requisite degree of independence for the institutions involved, then we could of course let these methods of far larger support absorb the portion of support that currently depends on tax deduction. But could we through direct expenditure programs duplicate the present tax expenditure system under which any type of charity, whatever its function and size, can get some federal assistance as long as some persons choose to make contributions to it? Should we want to duplicate it?²⁴³

Of course, uniform treatment for all charities need not be the goal. Some types of subsidies for social services might most fairly, efficiently, and administrably be supplied via direct consumer vouchers usable with providers of any legal form; others might be better supplied as grants to providers; and still others might be supplied under the current tax-subsidy regime.

Recent years have brought a revolution in the types and extent of commercial activities undertaken by nonprofits, as well as an influx of proprietary enterprises into traditionally nonprofit fields, such as hospital care and higher education.²⁴⁴ As Russell Hardin recently observed of public goods: "Technically speaking, there may be no good of any political or economic significance that is inherently subject to non-exclusion. Indeed, the technology of exclusion is a growth industry with frequent innovation."²⁴⁵ Notably, under the 1996 welfare overhaul bill, "the word 'nonprofit' was deleted from

241. DAVID F. BRADFORD & DANIEL SHAPIRO, *THE ECONOMICS OF VOUCHERS*, at 17 (National Bureau of Econ. Research Working Paper No. 7092, Apr. 1999), *reprinted in* *VOUCHERS AND RELATED DELIVERY MECHANISMS: CONSUMER CHOICE IN THE PROVISION OF PUBLIC SERVICES* (C. Eugene Steuerle et al. eds., forthcoming 2000).

242. SURREY, *supra* note 115, at 232 (footnote omitted).

243. *Id.* (footnotes omitted). In reviewing the arguments made by the universities for retaining existing tax incentives to giving, Surrey characterized the arguments as "a statement of the need for financial assistance rather than reasoned support for the unfairness and inefficiencies in the present tax expenditure." *Id.* at 379 n.86.

244. See generally Brody, *Institutional Dissonance*, *supra* note 6.

245. Russell Hardin, *Economic Theories of the State*, in *PERSPECTIVES ON PUBLIC CHOICE* 21, 27-28 (Dennis C. Mueller ed., 1997).

an old section of child welfare law," permitting proprietary firms to enter into contracts for such institutional care as orphanages.²⁴⁶

Moreover, we can easily conceive of vouchers for health care, education, and welfare benefits, but subsidies for public goods such as art collections might need to be made to the provider rather than to the consumer. Other examples are environmental activities, public radio and television,²⁴⁷ and scientific and medical research, all with free-rider problems. Of course, constitutional limitations preclude making direct payments for religious purposes, so Congress would likely wish to leave churches under the current tax regime.²⁴⁸ Thus, a combination of input and output subsidies could be applied to the nonprofit sector. However, opportunities or traps might arise if a tax subsidy scheme exists for certain types of *entities*, but a voucher subsidy scheme exists for certain types of *activities*.

B. Constitutional Considerations

In the 1997 case *Camps Newfound/Owatonna, Inc. v. Town of Harrison*,²⁴⁹ the Supreme Court suggested that even though a tax-exemption provision discriminating against charities serving nonresidents would violate the Commerce Clause, Maine could have offered "direct financial support to parents of resident children" who wanted to attend summer camp, and "[t]hough we have not had the occasion to address the issue, it might also be permissible for the State to subsidize Maine camps directly to the extent that they serve residents."²⁵⁰ Of more central constitutional concern to nonprofits,

246. Nina Bernstein, *The High Cost of No Intentions*, N.Y. TIMES, May 11, 1997, at D5. See generally, e.g., Brody, *Institutional Dissonance*, *supra* note 6; Barbara Ehrenreich, *Spinning the Poor Into Gold*, HARPER'S, Aug. 1997, at 44 (participation of businesses in privatization of welfare). For reasons totally unrelated to assisting nonprofits, however, special-interest groups have blocked plans to give proprietary firms a major role in administering social service programs. Privatizing welfare services would cost state employees their jobs, and, at the behest of public-employee unions, the Clinton administration put the brakes on a Texas plan to enter into a \$2 billion contract with Lockheed Martin Corporation and Electronic Data Systems Corporation. See Sam Howe Verhovek, *Clinton Reining in Role for Business in Welfare Effort*, N.Y. TIMES, May 11, 1997, at A1; William D. Hartung & Jennifer Washburn, *Lockheed Martin: From Warfare to Welfare*, NATION, Mar. 2, 1998, at 11.

247. Although to the extent that television signals are supplied via cable, free rider problems would be avoided. See Mark P. Gergen, *The Case for a Charitable Contribution Deduction*, 74 VA. L. REV. 1393, 1444-45 (1988).

248. Note that most contributions to churches come from individuals who do not itemize their deductions, and so do not benefit from the charitable contribution deduction, although itemizers also make significant gifts to churches. State property-tax exemption is another matter.

249. 117 S. Ct. 1590 (1997).

250. *Id.* at 1601 n.16. The brief for the petitioners was more explicit in asserting that Maine has reasonable and adequate alternatives to a discriminatory tax exemption:

of course, is the First Amendment. Because direct subsidies for religious services remain beyond the constitutional pale, tax exemption remains the only permissible form of state support for religion. Moreover, whether tax subsidies could constitutionally be treated the same as direct payments has been the subject of much debate.²⁵¹ In a case upholding property-tax exemption for churches as part of a broad, neutrally applied scheme, the Supreme Court viewed tax exemption as the state's "simply abstain[ing] from demanding that the church support the state";²⁵² but the plurality opinion in a later case striking a sales-tax exemption limited just to religious publications declared that "[e]very tax exemption constitutes a subsidy that affects nonqualifying taxpayers, forcing them to become 'indirect and vicarious donors.'"²⁵³ But can the constitutional distinction between tax subsidies and direct subsidies be maintained?²⁵⁴ On the other hand, if Congress repeals

The tax exemptions, for example, could be replaced with vouchers to residents for use at licensed camps, nursing homes, or other covered establishments. Or payments could be made directly to the institutions to defray residents' fees. There could be no constitutional objections to such measures, any more than to granting scholarships to residents.

Petitioner's Brief on the Merits, *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 117 S. Ct. 1590 (1997) (No. 94-1988), available in LEXIS, Fedtax Library, Tax Notes Today File, as 96 TNT 195-29 (Oct. 4, 1996), ¶ 62. See also Edward A. Zelinsky, *Are Tax "Benefits" Constitutionally Equivalent to Direct Expenditures?* 112 HARV. L. REV. 379, 387-88 (1998).

251. Compare Boris I. Bittker, *Churches, Taxes and the Constitution*, 78 YALE L.J. 1285 (1969) (base-defining theory of exemption), with Donna D. Adler, *The Internal Revenue Code, the Constitution, and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making*, 28 WAKE FOREST L. REV. 855, 864 (1993) ("Once a provision that appears in the Internal Revenue Code is identified as a tax expenditure, the same policy debates and constitutional standards that apply to direct spending programs should be applied to evaluate the tax expenditure provision."), Stephen B. Cohen, *Exempt Status for Segregated Schools: Does the Constitution Permit Lower Standards for Tax Benefits than for Direct Grants?*, 17 TAX NOTES 259 (Oct. 25, 1982), and E.C. Lashbrooke, Jr., *An Economic and Constitutional Case for Repeal of the I.R.C. Section 170 Deduction for Charitable Contributions to Religious Organizations*, 27 DUQ. L. REV. 695, 717 (1989) ("The majority in *Walz* completely misunderstood or deliberately misconstrued the tax expenditure concept when it drew a distinction between a direct money subsidy and a tax exemption."). See generally Zelinsky, *supra* note 251.

252. *Walz v. Tax Comm'n*, 397 U.S. 664, 675 (1970).

253. *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 14 (1989).

254. Commerce Clause theorists believe that the distinction may be maintained on political-process grounds. (Indeed, Justice Harlan's concurring opinion in *Walz* focused on political-process differences.) See Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 442-43 (1996).

Tax incentives, unlike cash subsidies, are typically independent of the annual appropriation process and are authorized as a standing part of the tax code. As a result they are less politically visible—indeed, their actual costs are often unknown—and they

exemption for all charities except churches, an Equal Protection argument might be raised.²⁵⁵

Recently, the constitutional debate has reversed because of the apparent permissibility of direct expenditures to religious organizations for secular services.²⁵⁶ That is, if direct payments are permissible, is it impermissible to discriminate *against* faith-based providers? In 1996, Congress replaced the old welfare system (Aid to Families With Dependent Children) with a new system of block grants to the states for the design and operation of their own welfare programs, consistent with federal requirements that the needy become self-sufficient (Temporary Aid to Needy Families, or TANF).²⁵⁷ TANF contains "Charitable Choice" rules, under which, if a state wants to arrange for purchase-of-service contracts with private providers rather than supply the

do not have to compete with other demands on state resources in the appropriation process. Moreover, their magnitude is not typically fixed by the legislature, like the cost of ordinary government programs, but rather is determined by the extent to which taxpayers make use of them. These factors suggest the need for stricter external constraints on tax incentives than on direct subsidy programs.

Id.; see also Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789, 869 (1996) ("[C]onsideration of a [direct] subsidy forces the mind of the public body to consider most pointedly the cost and consequences of moving forward." (citing Dan T. Coenen, *Business Subsidies and the Dormant Commerce Clause*, 107 YALE L.J. 965 (1998))). But most tax scholars have a harder time seeing the distinction. See Adler, *supra* note 251; Cohen, *supra* note 251; Lashbrook, *supra* note 251; see also Mark P. Gergen, *The Selfish State and the Market*, 66 TEX. L. REV. 1097, 1134 (1988) ("The balance of these [efficiency, administrative, and respect-for-tradition] concerns argues for per se rules prohibiting many impure subsidies, such as buy-, hire-, and sell-local laws and laws requiring private businesses to prefer state citizens, but allowing pure subsidies, such as cash grants and tax breaks.").

Professor Zelinsky believes the two camps have been speaking past each other because they are asking different questions: "'What is the particular recipient receiving?' is a different inquiry than 'What and to whom is the government giving?'" Zelinsky, *supra* note 250, at 411. This article considers political-process issues in Part IV.C, *infra*.

255. Churches initially were exempted from UBIT, amid worries of the constitutionality of the special treatment. Churches today enjoy reduced oversight: They need not file with the IRS for recognition of tax exemption, nor must they file annual returns. They are subject to special protection in the event of a dispute with the IRS under the Church Audit and Procedure Act. I.R.C. § 7611.

256. See *Agostini v. Felton*, 117 S. Ct. 1997 (1997) (New York may send special education teachers into parochial schools); see also Peter Applebome, *Parochial Schools Ruling Heartens Voucher Backers*, N.Y. TIMES, June 25, 1997, at B6. In the 1999-2000 Term, the Court will decide whether a general program to provide educational materials—including equipment such as computers—violates the Establishment Clause to the extent it includes parochial schools. *Helms v. Picard*, 151 F.3d 347, 365 (5th Cir. 1998), *cert. granted sub nom. Mitchell v. Helms*, 119 S. Ct. 2336 (June 14, 1999).

257. Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105 (codified at 42 U.S.C. § 601 to § 679b (Supp. III 1997)).

services directly, then the state must allow not just secular charitable and proprietary firms to bid for contracts, but also religious organizations.²⁵⁸ Faith-based organizations that win state contracts need not alter their form of internal governance or remove religious symbols or icons, but if a recipient of benefits objects to the religious character of the provider, the state must provide the recipient with an "accessible" alternative (but not necessarily a religious one). If, however, the state chooses to set up a voucher program, and the recipient chooses to redeem the voucher with a faith-based organization, then the restrictions on the use of sectarian instruction do not apply.

Assuming the constitutionality of charitable choice is upheld, it is too early to tell the extent to which churches (as opposed to their social-service affiliates) will be inclined to offer or support state-desired services.²⁵⁹ Neither side is rushing toward state purchases of services from faith-based organizations.²⁶⁰ The practical solution to fears of "excessive entanglement" appears

258. *Id.* § 104 (codified at 42 U.S.C. § 604a). For a history of Charitable Choice, see Randy Frame, *God in a Box? "Charitable Choice" Church-State Antipoverty Partnerships*, CHRISTIANITY TODAY, Apr. 7, 1997, at 46. The originator of the provision, Professor Carl Esbeck, has written extensively about it. See, e.g., Carl H. Esbeck, *A Constitutional Case for Governmental Cooperation with Faith-Based Social Service Providers*, 46 EMORY L.J. 1, 4-5 (1997):

When the dispute is over a welfare program in which faith-based social service providers desire to participate, the neutrality principle requires government to follow a rule of minimizing the impact of its actions on religion, to wit: all service providers may participate in a welfare program without regard to religion and free of eligibility criteria that require the abandonment of a provider's religious expression or character.

259. See, e.g., De Vita, *supra* note 31, at 223-24:

[C]ongregations are selective in the types of services that they are willing to offer or support. Programs for preschool children were most popular, with 51 percent of congregations indicating that they would be receptive to increasing services for children. Youth (43 percent) and elderly (42 percent) programs followed. Much further down the list (ranking eleventh) was expanding services to welfare recipients. Only 12 percent of congregations in the study expressed an interest in expanding this type of outreach program. See also JOHN MCCARTHY & JIM CASTELLI, RELIGION-SPONSORED SOCIAL SERVICE PROVIDERS: THE NOT-SO-INDEPENDENT SECTOR 6 (n.d.) (Aspen Inst. Nonprofit Sector Research Fund Working Paper):

[F]inancial capability is only one part of the problem. Even if the money were to miraculously appear, religious institutions lack the administrative capacity to replace the safety net: (1) There is no organized structure at the national, state, or local level for creating the massive new infrastructure that would be required for administering a large amount of new funds and programs; (2) Religious institutions lack the resources to hire and train additional staff and volunteers; and (3) Religious institutions lack the experience to replace the safety net.

260. See Richard C. Reuben, *The Welfare Challenge: States Face Tough Choices and Lawsuits Under New Act*, A.B.A. J., Jan. 1997, at 34, 35 ("Despite their efforts [to avoid legal landmines], the states may have to face an unpleasant fact: The devolution of power includes the devolution of liability.").

to take the form of separately incorporated entities, created by churches to provide the compensated social services.²⁶¹

C. *Would It Be Done?: Political Considerations*

Now we come to the political and practical differences between tax subsidies—including voucher-type tax subsidies—and direct grants.

1. Political Participation

Defenders of the charity income-tax and property-tax exemptions assert that exemption differs in an important political way from an equivalent system of direct grants. Over a century ago, while defending Harvard's property-tax exemption before the Massachusetts legislature, university president Charles Eliot contested the view that an institution's tax exemption "is the same thing as to grant it money directly from the public treasury. This statement is sophistical and fallacious." In a declaration often quoted by charities, Eliot described how a zero rate of tax removes charities from the political arena:

261. The Center for Public Justice and the Center for Law and Religious Freedom offers "A Guide to Charitable Choice", which states, in part:

A religious organization may choose to form a separate 501(c)(3) corporation to carry out federally funded programs. Separate incorporation may facilitate control of the use of federal funds and shield the main organization from some federal employment laws. Separate incorporation will also shield the main organization from fiscal audits of the use of the federal funds. (However, the Charitable Choice provision allows an organization to limit audits simply by establishing a separate account to receive and disburse the federal funds.)

Center for Public Justice, *A Guide to Charitable Choice* (visited Sept. 8, 1999) <<http://cpjustice.org/~cpjustice/CGuide/ccqanda.html>>.

Robert Wuthnow has found:

Forming separate nonprofit organizations permits churches to cooperate more easily with other congregations, restricts the churches' financial and legal liabilities, and permits overburdened clergy to attend to their own work while nonprofit professionals operate the service programs. Many faith-based nonprofits were initiated by clergy councils or interested individuals three decades ago during the initial expansion of the Great Society programs and now have strong expertise in delivering services that few individual congregations could match. . . . Perhaps because of their accumulated expertise, these nonprofits, rather than churches themselves, have been the most active participants in new government-nonprofit partnerships in Texas, Mississippi, Michigan, and Maryland where early efforts to experiment with Charitable Choice programs were initiated.

Robert Wuthnow, *Clash of Values: The State, Religion, and the Arts*, in NONPROFITS AND GOVERNMENT, *supra* note 16, at 283; see also De Vita, *supra* note 31, at 222 ("Currently, more than half of the revenues of Lutheran Social Services and Catholic Charities come from government grants and contracts. At least in the field of human services, there is a long-standing tradition although sometimes overlooked alliance between government and large faith-based organizations that provide social services to the needy.").

The exemption method is comprehensive, simple and automatic; the grant method, as it has been exhibited in this country, requires special legislation of a peculiarly dangerous sort, a legislation which inflames religious quarrels, gives occasion for acrimonious debates, and tempts to jobbery. The exemption method leaves the trustees of the institutions fostered untrammelled in their action, and untempted to unworthy arts or mean compliances.²⁶²

Similarly, with regard to the charitable-contribution deduction, Richard Goode wrote: "In my judgment, it is fortunate that Congress does not feel it necessary to scrutinize deductions for contributions as regularly and carefully as it examines appropriations or attach the same conditions to the two."²⁶³ Specifically: "The appropriations process is not well suited to the nourishment of new or unpopular ideas or minority tastes; the usual procedures for handling public funds would often be cumbersome or worse in this area."²⁶⁴ Dr. Goode concluded that "[a] considerable amount of waste and personal gratification of donors to questionable philanthropies may not be too high a price to pay for decentralized control and flexible operations of the worthy organizations and activities."²⁶⁵

But does a subsidy delivered through the tax system really insulate charity from the political process? After the Tax Reform Act of 1969, in which

262. CHARLES WILLIAM ELIOT, VIEWS RESPECTING PRESENT EXEMPTION FROM TAXATION OF PROPERTY USED FOR RELIGIOUS, EDUCATIONAL AND CHARITABLE PURPOSES 392 (1874), quoted in CHAUNCEY BELKNAP, THE FEDERAL INCOME TAX EXEMPTION OF CHARITABLE ORGANIZATIONS: ITS HISTORY AND UNDERLYING POLICY (1954), reprinted as Appendix to John P. Persons, et al., *Criteria for Exemption Under Section 501(2)(3)*, in 4 FILER COMM'N RESEARCH PAPERS, *supra* note 12, at 1909, 2025-38.

In the 1950s and 1960s—in reaction to Congressional investigations of those family-dominated, grant-making charities known as "private foundations"—the charities reiterated the value to the body politic of a tax-supported yet independent philanthropic sector. As the Rockefeller Foundation's legal counsel observed in 1954:

The essence of the advantage of this system is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and choices of private givers. The donors determine the direction of their own funds, and the distribution of "tax savings" as well. . . . Since all of these operations are out of the hands of government under the exemption and deduction statutes, the beneficiary organizations receive their governmental aid without having to petition for it.

Belknap, *supra*, at 2039.

263. GOODE, *supra* note 121, at 170-71.

264. *Id.* at 171 (footnote omitted). In a sign of the times, Dr. Goode noted "only one political control on the deductibility of contributions: it is denied for contributions to organizations that are registered as communist-action organizations or that have been directed to register as such by the Subversive Activities Control Board." *Id.* (footnote omitted).

265. *Id.*

charities experienced bruising—but only partial—assaults to their blanket exemption, Stanley Surrey observed:

The philanthropic institutions, having a vested interest in preserving an unfair and inequitable tax system, must defend the existing abuses and inequities and oppose their correction—they must defend the exemption of the appreciation element in the gifts, must oppose allocation of deductions [between taxable and exempt income], must keep a watchful eye on the unlimited deduction for charitable contributions under the estate and gift taxes, and so on. College presidents must appear before Congressional committees and sit in Senators' anterooms as lobbyists alongside the oil company executives, the oil investors, the hobby farmers, and the real estate operators—all pressing their claims that the special provisions of the tax system applicable to *their* activities should not be changed and contending that the national interest will be adversely affected by any change. One wonders whether college presidents relish the role or comprehend that many legislators and Government officials believe that some of the presidents are not even aware of the role itself.²⁶⁶

Recently, Nancy Knauer wrote of the successful lobbying activities of the charitable sector—both on the legislative side and the administrative side—in defeating proposals that threatened tax regimes favorable to charities.²⁶⁷ Moreover, the demand-side tax subsidies described in Part II are strongly supported by the benefited charities, notably institutions of higher education, which actively comment during the regulatory process as well.

2. Effectiveness of Direct and Indirect Subsidies

In contrast to vouchers in the form of tax subsidies, governmental subsidies in the form of direct outlays have the virtue of fiscal transparency. The public fails to equate the tax expenditure to revenue that flows into the federal fisc and is then reallocated to the charities of the taxpayers' choice. In short, the government does not get credit for this financial support, and charities often assert that they receive no public funds.²⁶⁸

266. SURREY, *supra* note 115, at 228.

267. Nancy J. Knauer, *How Charitable Organizations Influence Federal Tax Policy: "Rent-Seeking" Charities or Virtuous Politicians?*, 1996 WISC. L. REV. 971.

268. See, e.g., Letter from Linda K. King, Secretary and Chairman, Government Affairs Committee, United Ostomy Association, in SUBCOMMITTEE ON OVERSIGHT, COMM. ON WAYS & MEANS, WRITTEN COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX, 100th Cong., 2d Sess. 846 (Apr. 21, 1988) (Comm. Print WMCP: 100-30) ("The United Ostomy Association, like many other voluntary health organizations, depends largely on dues from its members, or on contributions raised through a variety of fund raising efforts. (We are not, and have never been, the recipient of federal, state, or local financial assistance.)").

The relative advantages and disadvantages of using tax subsidies and direct outlays are thoroughly discussed in the Clinton administration's 1999 Budget, which announces that, pursuant to the Government Performance and Results Act of 1993, the Treasury Department is beginning to measure the performance of the various tax expenditures, "and to compare their effectiveness with outlay, regulatory and other tax policies as means of achieving objectives."²⁶⁹

The 2000 Budget report begins with the advantages of tax expenditures. First, tax expenditures can be used effectively "when the benefit or incentive is related to income and is intended to be widely available."²⁷⁰ Second, tax expenditures can make use of the "existing public administrative and private compliance structure for the tax system."²⁷¹ Third, tax expenditures "help simplify the tax system, as where they leave certain income sources untaxed."²⁷² Fourth, tax rules "implicitly subsidize certain activities," although "the beneficiaries experience reduced taxes that are offset by higher taxes (or spending reductions) elsewhere."²⁷³ Finally, the availability of a wide range of tax expenditures tools—"e.g., deductions, credits, exemptions, and deferrals; floors and ceilings; and phase-ins and phase-outs, dependent on income, expenses, or demographic characteristics (age, number of family members, etc.)"—"means that tax expenditures can be flexible and have very different distributional and cost-effectiveness properties."²⁷⁴

Next, the administration describes the limitations of tax expenditures. First, they add complexity in some cases, "which can raise both administrative and compliance costs."²⁷⁵ Second, because "the income tax system does not gather information on wealth," tax subsidies cannot be tailored by this attribute.²⁷⁶ Third, "the tax system may have little or no contact with persons who have no or very low incomes, and incentives for such persons may need to take the form of refunds."²⁷⁷ Fourth, tax expenditures "do not enable the

269. PRESIDENT'S FISCAL 1999 BUDGET, ANALYTICAL PERSPECTIVES VOLUME, ch. 5 (Feb. 2, 1998), reprinted in 78 TAX NOTES 911, 934 (Feb. 16, 1998). The administration, which also discussed the use of regulations as a fiscal tool, cautioned that this assessment process is in its infancy. In its 2000 Budget, the administration illustrated policy objectives that employ multiple approaches: "Minimum wage legislation, the earned income tax credit, and the food stamp program are examples of programs that utilize regulatory, tax expenditure, and direct outlay approaches, respectively, in order to improve the economic welfare of low-wage workers. Their relative strengths and weaknesses have merited significant attention." ADMINISTRATION'S 2000 BUDGET, *supra* note 3, at 1208.

270. *Id.* at 1207 (footnote omitted).

271. *Id.*

272. *Id.*

273. *Id.*

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.* at 1207-08.

same degree of agency discretion as an outlay program."²⁷⁸ Finally, "tax expenditures tend to escape the budget scrutiny afforded to other programs."²⁷⁹ As a separate matter, two different groups may be involved. For example, in its section setting forth the issues for particular "budget functions," the Treasury comments: "Evaluation of charitable activities requires consideration of the beneficiaries of these activities, who are generally not the parties receiving the tax reduction."²⁸⁰

The report then enumerates the advantages of outlay programs. First, direct expenditures are effective "where direct government service provision is particularly warranted" (such as maintaining the armed forces or administering justice).²⁸¹ Second, outlays can be "specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a return."²⁸² Third, "[o]utlay programs may also receive more year-to-year oversight and fine tuning, through the legislative and executive budget process."²⁸³ Finally, many spending programs (including credit programs "and payments to State and local governments, the private sector, or individuals in the form of grants or contracts") provide "flexibility for policy design."²⁸⁴

The report describes the limitations of outlay programs, starting with a less direct reliance "on economic incentives and private-market provision than tax incentives."²⁸⁵ Second, "[s]pending programs . . . require resources to be raised via taxes, user charges, or government borrowing."²⁸⁶ Finally, "spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures."²⁸⁷

Several aspects of the administration's analysis can be disputed. In his study of the tax reform process in the 1990s, Daniel Shaviro asserts "that one oft-heard criticism of tax preferences—that they are enacted without receiving the kind of public scrutiny given direct expenditures—misses the mark."²⁸⁸ Citing John Witte, Professor Shaviro agrees that "scrutiny is not really the issue: many tax preferences are extensively discussed, frequently revised, and subject in general to a level of scrutiny and a process of deliberation quite

278. *Id.* at 1208.

279. *Id.*

280. *Id.* at 1210.

281. *Id.* at 1208.

282. *Id.*

283. *Id.*

284. *Id.*

285. *Id.*

286. *Id.*

287. *Id.*

288. Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 63 (1990).

comparable to that typical of spending programs."²⁸⁹ Indeed, contrary to the prevailing belief that tax expenditures result from pressures of narrow interest groups,²⁹⁰ Professor Witte, writing in 1985, found that the largest tax expenditures have two traits in common: "They are mass-based provisions that affect large numbers of individual or corporate taxpayers, and they are of long-standing: only four of seventeen originated in the postwar period."²⁹¹ On Witte's list of "big ticket" tax expenditures is the charitable-contribution deduction.²⁹² This deduction has been modified numerous times, particularly the percentage-of-income limits and the rules for property donations, consistent with Witte's additional findings that "many provisions, once enacted, are modified,"²⁹³ and that provisions affecting "the well-off, reflecting the political controversy that surrounds them, are changed much more often [than those affecting the middle class], but rise and fall as the political winds shift."²⁹⁴

Moreover, Witte disputes the assertion that direct expenditure decisions are made with greater deliberation than tax provisions. He reviews the lessons learned from recent studies of the budget process: "that such detailed decisions are almost always the work of committees; that line-item rather than program categories persist; and that to save time and avoid political conflict, the basic incremental 'formula' is to begin with last year's outlays and marginally adjust those figures."²⁹⁵ While new programs might receive greater debate, Witte found that "often new program legislation only provides general policy outlines, assigning more detailed authority to a specific agency, which

289. *Id.* (citing JOHN WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 311, 328-29 (1985)).

290. WITTE, *supra* note 289, at 285 ("[I]t is incorrect to perceive the tax expenditure system as primarily a method of distributing hidden benefits to very narrow and highly organized groups. If it were, it might be much easier to deal with, and reform crusades might be more effective.").

291. *Id.* Tax expenditures need not serve a subsidy function: "The use of special provisions ... allows the government to achieve a higher degree of politically desirable differentiation among taxpayers, while standardizing the definition of tax bases across individuals." Walter Hettich & Stanley L. Winer, *The Political Economy of Taxation*, in *PERSPECTIVES ON PUBLIC CHOICE: A HANDBOOK* 481, 490 (Dennis C. Mueller ed., 1997) (footnote omitted). Nevertheless, "[s]ince individual legislators do not take into account the full social cost of the programs delivered on behalf of their constituents, the overall budget is inefficiently large, as are the number and size of tax-expenditures." *Id.* at 502.

292. WITTE, *supra* note 289, at 286-87 tbl.13.2.

293. *Id.* at 290.

294. *Id.* at 320; *see also id.* at 350-51 tbl.16.5, 352 (discussing the results of a poll in which a majority of respondents opposed deductions for *nonitemized* charity giving). "It is ironic, but perhaps illustrative of the intense political pressure to expand tax expenditures," that the charity deduction for *nonitemizers* was enacted in the 1981 tax bill. *Id.* at 352 (allowed to sunset the year after Witte wrote).

295. *Id.* at 328.

then constructs programs that become subject to the normal budgetary review."²⁹⁶

The economist Estelle James identifies an agreement to disagree (or, perhaps, a "you support my cause and I'll support yours" agreement) as "the heart of why we use the indirect tax subsidy method rather than direct subsidies (in the form of grants)" to support charities:²⁹⁷

I think one of the reasons why we use the indirect tax subsidy approach is that we are a very heterogeneous society. As such, we find it difficult to agree on which functions to subsidize. We could give a lot of examples of organizations where people would greatly disagree whether this was a "public good" or a "public bad." We avoid making these choices explicitly by decentralizing our decision-making. We say, for example, that people vote for an organization by donating to it. Under the indirect tax subsidy approach, that donation is automatically matched by the government in the form of some kind of tax deduction. As we start to exclude or include, to "fence in" or "fence out" certain functions, we are going to have to make explicit collective choices rather than implicit individualistic choices. This may be a much more difficult process—so we simply avoid it by choosing the indirect tax subsidy approach instead of the direct subsidy approach.²⁹⁸

Thus, Dr. James finds that "[t]he activities that continue to depend on donations and tax subsidies are, by definition, those where people disagree about their relative value."²⁹⁹

One way to depoliticize direct-subsidy decisions, John Witte suggests, is to delegate authority "to administrative bodies and executive agencies."³⁰⁰ However, Professor Shaviro properly observes that solving the legislative problem only leads to an administrative one: "[Witte's] proposal may raise concerns about elitism versus popular government as well as the danger that interest groups will 'capture' the new decision-makers."³⁰¹ Similarly, John Simon observed: "The tax allowance method has at least the virtue that it does

296. *Id.*

297. See Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 830-31 (1988-89) (comments of Estelle James). See also Simon, *The Tax Treatment of Nonprofit Organizations*, *supra* note 14, at 94-95:

Despite the breadth and depth of the tax system's shadow . . . it has not yet appeared to affect the autonomy and health of the vast majority of nonprofit organizations. In part that happy result flows from the rather remarkable self-denying ordinance under which Congress and the IRS have lived: refusing, for the most part, to seek programmatic control, that is, declining to intervene into the substantive decisions of nonprofit institutions and their donors.

298. Hansmann, *supra* note 297, at 831 (comments of Estelle James).

299. *Id.* at 832.

300. WITTE, *supra* note 289, at 382.

301. Shaviro, *supra* note 288, at 114-15.

not call upon the government to play an active role in singling out the chosen few."³⁰² In the area of medical research, Gerard Brannon and James Strnad suggested using programs of government grants with allocation decisions made by a private group of certified doctors, "rather the way the government left decisions about wheat price supports and crop controls to a vote of interested farmers."³⁰³

By contrast, Professor James recognizes the situations in which the direct subsidy approach has advantages: "It allows the government to decide which organizations should be subsidized. It also permits the government to decide how much to subsidize each function. This indirect tax mechanism that we now use denies government these important decision making powers."³⁰⁴ As Louis Kaplow mentioned in his recent study of the deduction for state and local taxes, one of the consequences of tax expenditures is limited political oversight and reallocation of authority to the tax committees of Congress: "For example, whenever there is general tax reform involving changes in rates and the standard deduction, the magnitude of the subsidy changes. This requires adjustments in other, more direct grant programs—which are under the jurisdiction of different committees from those considering the tax reform."³⁰⁵

3. Crowd-Out Considerations

The shrewd Harvard president Charles Eliot a century ago also recognized how a hidden subsidy avoids the risk that direct government expenditures will "crowd out" private contributions:³⁰⁶

The exemption method is emphatically an encouragement to public benefactions. On the contrary, the grant method extinguishes public spirit. No private person thinks of contributing to the support of an institution which has once got firmly saddled on the public treasury. The exemption method fosters the public virtues of self-respect and reliance; the grant method leads straight to an abject dependence upon that superior power—

302. John G. Simon, *Charity and Dynasty Under the Federal Tax System*, 5 PROBATE LAWYER 1, 82 (1978) (discussing the charitable-contribution deduction).

303. Brannon & Strnad, *supra* note 12, at 2378. See also *id.* at 2385 ("In general, in the area that we designate as charity, it is our judgment that there is too little scope for the opinion of the people benefited as to whether the services proffered provide greater utility than some other services that could be offered.").

304. Dr. James comments that the very growth of "commercialized" nonprofits can be traced to the growth of "insurance and entitlement programs" such as Medicare and Medicaid. Hansmann, *supra* note 297, at 831 (comments of Estelle James).

305. Kaplow, *supra* note 62, at 485-86.

306. See HARVEY ROSEN, PUBLIC FINANCE 379 (4th ed. 1995) ("In general, whether a tax expenditure or a direct subsidy is more effective depends on the amount of crowding out that occurs, and on how responsive the demand for the preferred item is with respect to its after-tax price. The issue must be examined on a case-by-case basis.").

Government. . . . The exemption is wholesome while the direct grant is, in the long run, pernicious.³⁰⁷

Actually, the general constancy of individual charitable contributions as a percentage of income is a puzzle, given an expected "crowding out" effect from increased government expenditures not just on funds transferred directly to charities but as spending on all social services.³⁰⁸ Part of the explanation has been discussed in Part III.A, which set out different theories of giving, but the result is to call into question the efficacy of the charitable-contribution deduction.³⁰⁹

In addition, the absence of dollar-for-dollar crowd-out can be explained by the fact that donative charities and government do not necessarily serve the same constituencies. As Jerald Schiff illustrates: "if the 'good' that a donor is interested in providing is income redistribution to poor Catholics in New Orleans, it may be cheaper for the individual to do so by donating to a charity that serves this specific group rather than relying on government"³¹⁰

Moreover, crowd-out of donations need not be the fate of a government spending program even where the government and charity provide the same good. Susan Rose-Ackerman suggests how governments can design a direct subsidy program that will stimulate rather than reduce private giving: by using matching grants; by offering improved monitoring that increase donor confidence in the charity; by providing the charity with enough funds so that donations can be used to realize scale economies; and by pushing charity managers to adopt policies favored by donors.³¹¹ By contrast, she points out

307. BELKNAP, *supra* note 262, at 2039 (quoting Charles Eliot).

308. Burton Abrams and Mark Schmitz describe both the substitution effect (that government spending lowers the need for additional contributions, and hence the potential donor's willingness to substitute another expenditure) and the income effect (that potential donors taxed to finance the government expenditures will have less disposable income from which to make contributions). Burton A. Abrams & Mark D. Schmitz, *The Crowding-Out Effect of Governmental Transfers on Private Charitable Contributions*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 114, at 303, 304-05. In the aggregate, they find, "a one dollar increase in governmental transfers lowers private charitable contributing by approximately 28 cents." *Id.* at 309.

309. See also Kevin Stanton Barrett, Anya M. McGuirk & Richard Steinberg, *Further Evidence on the Dynamic Impact of Taxes on Charitable Giving*, 50 NAT'L TAX J. 321, 329 (1997) ("[I]f our point estimate captures the true price elasticity, then tax deductions are efficient only if crowding out exceeds 40.5 percent.").

310. SCHIFF, *supra* note 110, at 8. Dr. Schiff concludes that "there is no reason to expect government social welfare spending to influence giving to, for instance, the arts or universities." *Id.* at 74-75.

311. However, Dr. Schiff points out that "[i]f consumers have a low regard for government . . . then the receipt of a government grant may actually decrease giving to an organization." *Id.* at 37. He continues:

On the other hand, support for a particular charity may act as a seal of approval, not just

that the "more closely fixed-sum government grants substitute private gifts, the more likely is a fall in donations."³¹²

4. Distributional Issues

A direct-expenditure program requires up to four separate determinations: someone (who?) has to decide to give some amount (how much?) to someone else (whom?) for some purpose (what?). Public acceptance can depend on the perceived distributional consequences, which in turn can depend on the form of the payment. For example, if we give "opera vouchers" for anyone who wants to see the Metropolitan Opera, then handouts to the mink-coat set might not last a single season.³¹³ Alternatively, if the government gave opera companies (whether for-profit or nonprofit³¹⁴) a grant based on the number of admissions, then the distributional consequences might not be so obvious. Because the charities supported by the more affluent may succeed in blocking such a change, David Good and Aaron Wildavsky suggest buying off the "elite institutions" in order to induce reform.³¹⁵

As just discussed, demand-side subsidies are generally more efficient than those based on organizational form, simply because legislators are then forced to identify the public good being supplied, and can target the level of subsidy

for that organization, but for all organizations engaged in similar activities. For instance, government support for one cancer group may be viewed by donors as an indication that cancer research, in general, has a high "pay-off" to society.

Id.

312. Susan Rose-Ackerman, *Do Government Grants to Charity Reduce Private Donations?*, in *ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 114, at 313, 325.

313. Compare the Supreme Court's suggestion in *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 117 S. Ct. 1590 (1997), that Maine could distribute subsidies to residents to send their children to camp, *supra* note 250 and accompanying text.

314. One might argue that a for-profit opera company will be unlikely to form. But then one should not be surprised when a successful Broadway production of "Porgy and Bess" asks for its share of the handout. Defining "opera" is the least of the problems faced by the arts under current law and under this proposal. Some commentators cannot defend the current subsidy to the arts, because of concerns of elitism and failure to provide a charitable benefit. See, e.g., Gergen, *Case for Charitable Contribution Deduction*, *supra* note 247, at 1410.

315. See Good & Wildavsky, *supra* note 123, at 2413:

Just as there are no free lunches, there is no painless way to deprive people of things they should never have had But the beneficiaries have gotten used to being benefited. Our "inequity" is their "security." The problem, then, is how to move them from a position they know to be bad to one we believe to be better without threatening their future. That is why we recommend a "buy-out" of the affected interests to permit a voluntary transfer from an unjust and illegitimate method—the income tax write-off—to a just and legitimate one—the donor directed automatic percentage contribution bonus. By, in effect, insuring potential losers against loss, by giving them time to see if, in fact, they might not actually do better for themselves, we might facilitate the emergence of an integrative solution. Virtue would, at long last, become its own reward.

accordingly.³¹⁶ However, public good need not equate to redistribution. Much of governmental social-service spending—like much of charitable activity—extends to the general public, rather than requires means-testing.³¹⁷ Instead, for both charities and the government, the asserted “public good” being supplied is, say, “good health” or “an educated populace.”

5. State Level Concerns

The charitable sector fears that any erosion in their basic federal tax exemption will tempt states to remove benefits as well. Many charities actually enjoy a relatively small federal tax benefit, which, after all, depends on the entity's earning net income, receiving contributions, or issuing tax-exempt bonds. Rather, the largest benefit for exemption can often be the property tax exemption, a matter of state and local law.³¹⁸

As a separate matter, because of the uneven internal distribution of the property-tax-exemption burden, states could make transfer payments to their urban centers to compensate for taxes forgone on local charitable property.³¹⁹

316. Compare Brannon & Strnad, *supra* note 12, at 2362:

The statement made by charitable organizations that they fulfill public “needs” is tainted with considerable *hubris*. We can say with complete objectivity that charities change the allocation of resources. It is quite acceptable to say also that some of these resource allocations are in the public interest. However, one would expect on the basis of probability alone that some charitable activities would work out against the public interest in the sense of spending money in ways that produce less aggregate utility than would have occurred if contributors had spent the money on themselves in the first place.

317. In general, private charity is less capable than government to provide relief for the poor, in terms of both sheer dollars and comprehensive and fair coverage. Brannon and Strnad would even cut off tax subsidies to charities that engage in these activities:

We can concede that private charity in the form of poor relief serves some social function. It is, however, a blind alley as to achieving any kind of decent solution to the poverty problem. If people want to do it, fine. It does not seem incumbent on society to subsidize these efforts. Society's money would be better used in comprehensive programs.

Id. at 2379.

318. Some municipalities do look beyond the federal tax exemption and conduct an independent examination of entitlement to property-tax exemption. Most notably, courts in Utah and Pennsylvania, for example, have upheld the determination of the local authority to strip nonprofit hospitals of their property tax exemption, on the ground that they are not serving the poor and therefore are not “charitable.” See generally Brody, *Of Sovereignty and Subsidy*, *supra* note 6 (also discussing recent Pennsylvania legislation).

319. Laws in a couple of states already require the state to make these payments, subject to appropriation, but actual payments have fallen far short not just of the tax otherwise due but also of the legislated amounts. See, e.g., REPORT OF CONNECTICUT PROPERTY TAX REFORM COMMISSION (1995), available in LEXIS, Fedtax Library, State Tax Notes File, as 95 STN 34-11 (Feb. 21, 1995) (payments “are at a fraction of the payment that would be made if an equally valued use of another type with no exemption were substituted”); Karen Pallarito, *Conn., R.I. Subsidies Lessen Demand to Justify Tax Status*, MODERN HEALTHCARE, Oct. 8, 1990, at 45

As a 1977 study prepared for the Commission on Private Philanthropy and Public Needs (popularly known as the "Filer Commission") observed: "[S]ince state payments would go to the locality rather than to the institution, there would be no interference by the state in the activities of the tax-exempt recipients," thus avoiding "several of the serious pitfalls that have effectively stood in the way of proposals to do away with the tax-exempt device and to replace it with a program of direct state subsidies to the recipient institutions."³²⁰

V. CONCLUSION

Professors Clotfelter and Schmalbeck characterize charities as unintended casualties in the debate over fundamental tax reform.³²¹ I am not so sure. The current convoluted and interwoven system of supply-side and demand-side tax subsidies for charity might not have been intended at the outset, but its growth and shape has kept pace with the increasing visibility and increasingly commercial character of the charitable sector. Recent calls to "tear the income tax up by its roots" will not lead, as many congressional Republicans hope, to the end of the income tax by 2001.³²² Moreover, any major tax reform, once

(Rhode Island's payments to compensate for local concentrations of exempt hospitals and colleges "vary depending on action by the Legislature and haven't reached the full [legislated] 25%"). For an analysis of such an approach, see Rebecca S. Rudnick, *State and Local Taxes on Nonprofit Organizations*, 22 CAP. U. L. REV. 321, 340-42 (1993). Professor Rudnick suggests that "the execution of such a logical plan would require much administrative expansion and would open the door to new questions of equity." *Id.* at 340-41. For example, she identifies such difficulties as

[t]he need for a proper and regular assessment of the exempt property, the need to determine the proportion of the exemption that state residents outside of the locality must bear, . . . and the question of whether wealthier local areas should benefit from the subsidies to the same extent as poorer ones.

Id. at 341.

320. L. Richard Gabbler & John F. Shannon, in *The Exemption of Religious, Educational, and Charitable Institutions from Property Taxation*, in 4 FILER COMM'N RESEARCH PAPERS, *supra* note 12, at 2556.

321. Professors Charles Clotfelter and Richard Schmalbeck observed: "The tax reform plans we examine do not appear to have nonprofit organizations as intended targets. However, like bystanders at a gunfight, nonprofits have a good chance of being hit." Clotfelter & Schmalbeck, *supra* note 2, at 237.

322. By a vote of 219 to 209, the House of Representatives approved a proposal to sunset the entire Internal Revenue Code as of December 31, 2001. See 144 CONG. REC. H 4678 (daily ed. June 17, 1998); see also *Former IRS Commissioners' Letter to Archer and Roth on Tax Code Termination* (Mar. 19, 1998), TAX NOTES TODAY, Mar. 23, 1998, available in LEXIS, Fedtax Library, Tax Notes Today File, as 98 TNT 55-67 (Nine former Internal Revenue Commissioners strongly oppose a proposal to sunset the Internal Revenue Code—except for Social Security and Medicare—by December 31, 2001 "without first specifying what the replacement tax system would be."). In a list of only four identified uncertainties, they asked:

it makes its way through the political process, would more closely resemble our complex economy (and our complex tax code) than the simple models now being discussed.³²³ (Indeed, even the 1999 Republican presidential candidates have been campaigning for expanded charity provisions under the income tax.³²⁴) However, each wave of discussion makes it more acceptable to question the appropriateness of charity tax subsidies.

Targeted tax reform could focus on the continuing desirability of charity treatment for particularly "commercial" activities such as hospital care. If policy makers are unhappy with the high level of savings engaged in by charities—notably private foundations and university endowments—they could adopt a low-level tax on investment income. Most threatening, fundamental reform could so alter the structure of the tax system that subsidies based on organizational form would no longer be practicable. Congress would then have to consider providing subsidies for particular activities, regardless of whether those activities are conducted by nonprofit or proprietary organizations. From a public finance perspective, the "charitable sector" could largely become an historical relic.

"How would this uncertainty affect the commitment of major contributors to educational and other charitable causes?" *Id.* See generally William G. Gale, *Tax Reform Is Dead, Long Live Tax Reform*, 74 TAX NOTES 909 (Feb. 17, 1997).

323. See GRAETZ, *supra* note 199, at 258-59. John Witte, writing a dozen years ago about similar calls for fundamental reform, charged:

There is nothing, absolutely nothing in the history or politics of the income tax that indicates that any of these schemes have the slightest hope of being enacted in the forms proposed. In fact, if the past is any guide, [changes,] whether radical proposals . . . or more modest changes of an incremental variety, are very likely to aggravate the problem over the long run. People and institutions have memories; reforms in one political period are likely to be followed by counterattacks on the tax system in another. . . . The main result has been more complexity, which in turn provides more numerous and less visible targets for those seeking specialized tax relief in a later period.

. . . The answer is not to reform the tax system or even to seek immediate policy remedies, but rather to alter the political process to prevent even further regression . . . so as to retard and stabilize change.

WITTE, *supra* note 289, at 380 (citation omitted); see also Winer & Hettich, *supra* note 236, at 378 ("We may expect democratic tax systems to be complex tax systems.").

324. See Jennifer Moore & Grant Williams, *Charity: A Campaign Front-Runner*, CHRON. PHILANTHROPY, Aug. 12, 1999, at 24 (describing views of Republicans Lamar Alexander, George W. Bush, Elizabeth Dole, and Dan Quayle, and of Democrats Bill Bradley and Al Gore; perhaps surprisingly, the descriptions of all of the Republican candidates, but neither of the Democratic candidates, mentioned tax incentives).