

The Charitable Contribution Deduction for Individuals – To Be or Not To Be

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Jason Pesaturo
TAX 876 - Tax Policy, Fall 2008
Suffolk University
Sawyer Business School

Abstract

The charitable deduction is almost as old as the income tax itself. It is one of the most popular deductions on the individual tax return, resulting in the government having to set aside billions of dollars to fund it. Through analysis of related literature, this article seeks to discover whether the existence of the charitable deduction is actually justified. The research reveals mixed results at best, and many flaws about the deduction and nonprofit sector are highlighted. The author suggests either a major reduction in the number of organizations that are able to receive deductible donations, or the complete elimination of the charitable deduction.

Introduction

The charitable deduction is one of the oldest deductions in our income tax laws. It was signed into law in 1917, only four years after the income tax itself was established through ratification of the Sixteenth Amendment. During this time taxes were being substantially increased to help pay for World War I, but the government feared that people would give less to charity in order to pay these higher taxes; as a result the charitable deduction was introduced to lessen the cost of giving and thus partially subsidize charities, and it has been part of our tax laws ever since. Over the years it has become one of the most commonly claimed deductions on the individual tax return, with taxpayers currently claiming almost \$197 billion annually in total gifts to charity.¹ More than one million charitable organizations receive these donations, a number that is constantly growing to include a wider variety of organizations.

Many researchers have raised questions regarding the relevance of the charitable deduction under the current circumstances and, perhaps surprisingly, differing opinions have been reached in the process. After explaining the current rules and full history of the deduction, this article will explore these different opinions through related legal, political, and empirical papers that have been written. An analysis of these viewpoints is then provided by the author, which then leads to a relatively radical proposal for improving the charitable deduction. Global and ethical issues are then considered in light of the deduction.

Issue Relevance

Currently about 35% of taxpayers itemize their deductions;² of these itemizers, the vast majority (around 80%) claims the charitable deduction. It is one of the most popular tax expenditures offered by the government: in 2006 for example, it is estimated that almost \$197

¹This was the amount claimed on individual tax returns in 2006, based on IRS estimates. An overall total of \$295 billion was given to charity that year. *See* notes 2 & 4.

² Retrieved from <http://www.irs.gov/taxstats/index.html> on 10/31/2008

billion was claimed in charitable deductions, and this figure rises every year.³ As a result the government must set aside billions of dollars in its annual budget to be able to fund the deduction.⁴ When dealing with such large amounts of government spending, it is always essential to examine whether such spending is appropriate.

The IRS' definition of "charitable organization" has been greatly expanded since 1917, when the charitable deduction was first signed into law. Since then the nonprofit sector has gone from a small network of churches and other organizations that clearly provided aid to the needy (Pozen, 2006), to the current-day tally of almost one million registered public charities that are authorized to receive deductible donations.^{5 6} It is worth exploring this amplified definition of "charity", and what types of organizations are benefitting from the deduction.

Another issue, perhaps the most important of all, is that because the deduction is such an enduring part of our tax laws, I feel that politicians would be very hesitant to criticize it even if evidence showed that it was not a completely justifiable expenditure; in fact since its inception, the scope of the deduction has only been expanded.⁷ Precisely because of this tradition of allowing a deduction for charitable gifts, I think it is absolutely imperative that we take an objective look at the theories, arguments, and suggestions that have been put forth regarding its existence; only then will we be able to determine if it is still relevant today.

Analysis of Current Status

The current rules for the charitable contribution deduction for individuals are found in Internal Revenue Code (IRC) §170. Generally, individual taxpayers are allowed to deduct

³ *Id.*

⁴ Retrieved from <http://nccs.urban.org/statistics/index.cfm> on 10/31/2008

⁵ This does not include the 112,000 private foundations that also qualify under IRC §501(c)(3).

⁶ Retrieved from <http://nccs.urban.org/statistics/index.cfm> on 10/31/2008

⁷ Except in 1986 when the five-year-old nonitemizer deduction, which was always meant to be temporary, was permanently eliminated

donations of money and property to qualified organizations, and they are also allowed to deduct necessary out-of-pocket expenses incurred in providing services to such organizations. An individual taxpayer must itemize deductions to be able to take advantage of IRC §170.

Disregarding some minor restrictions, a qualified organization is one described under IRC §501(c)(3), which is any one of the following:⁸ 1) a state, U.S. possession, political subdivision of a state or U.S. possession, or the United States itself; 2) a corporation, trust, fund, or foundation organized under the laws of the United States or any of its subdivisions which is operated solely for purposes of religion, charity, science, literature, education, or the prevention of cruelty to children or animals; 3) a war veterans' organization; 4) a nonprofit volunteer fire company or civil defense organization; 5) a domestic fraternal society; or 6) a nonprofit cemetery company.⁹ Some examples of situations where contributions are not deductible include donations to specific individuals (or donations intended for the use of a specific individual), donations made with the expectation of some significant benefit, donations of time or services, and donations to political groups, for-profit organizations, and most foreign organizations.¹⁰ If a taxpayer is unsure of an organization's qualifying status, he/she can refer to IRS Publication 78, which is a comprehensive list of organizations that are eligible to receive tax deductible donations.¹¹

The deduction is generally limited to 50% of a taxpayer's adjusted gross income. Limits of 30% and 20% also apply for contributions of certain appreciated property and contributions to certain qualifying organizations, respectively.¹² Any contribution that cannot be fully deducted

⁸ IRC §170(c)

⁹ It is important to note that not all tax-exempt organizations yield a charitable deduction when they receive gifts. Other paragraphs of IRC §501(c) describe several of these organizations, which include civic leagues, labor organizations, and social clubs.

¹⁰ IRC §170(c)

¹¹ However, exclusion from Publication 78 does not necessarily mean that the organization is nonqualified.

¹² IRC §170(b)

due to one of these limitations may be carried forward for five years,¹³ with the same limitations imposed on them in those subsequent years.¹⁴

The amount of the deduction allowed for donated property is generally its fair market value on the date of the contribution (Cordes, Ebel, & Gravelle, 2005); however in the case of ordinary income property (property which would result in a gain other than long-term capital gain if sold), the deduction is generally equal to the donor's basis in the property.¹⁵ Another important exception, which was enacted as part of the American Jobs Creation Act of 2004, involves the donation of cars or other vehicles which the charity later sells. The deduction allowed to the donor in this situation is generally limited to the eventual sales price of the vehicle (Herman, 2008).

Deductible out-of-pocket expenses include the cost of uniforms, overnight travel, parking fees, tolls, and car expenses.¹⁶ Regarding car expenses, a taxpayer may either deduct the actual cost of gas and oil directly connected with the charitable use of the car, or a standard mileage rate of 14 cents per mile. It is interesting to note that since the enactment of the Deficit Reduction Act of 1984, the charitable mileage rate has been set by statute,¹⁷ unlike other deductible mileage rates (e.g. medical and business) which are set by the Treasury.

Substantiation requirements differ depending on the type and amount of the charitable contribution, but in all cases the supporting documentation must be "contemporaneous".¹⁸ Until recently cash contributions under \$250 required only informal recordkeeping by the taxpayer, such as notes or a personal check register (Eileen Putman Associated Press, 2008). However

¹³ IRC §170(d)(1)(A)

¹⁴ Reg. §1.170A-10(b)(2)

¹⁵ IRC §170(e)(1)

¹⁶ Reg. §1.170A-1(g)

¹⁷ IRC §170(i)

¹⁸ IRC §170(f)(8)

with the passing of the Pension Protection Act of 2006, the IRS introduced more stringent requirements for such contributions. Now these small donations must be supported by either a bank record, a receipt from the charity, or a paystub or other documentation furnished by the donor's employer (if the donation was made via payroll deduction). Furthermore the documentation must show the name, date, and amount of the contribution.¹⁹ For contributions of \$250 or more, only a receipt from the charity or payroll documentation from the employer is acceptable.²⁰

For substantiation of noncash contributions, the IRS differentiates between values 1) less than \$250, 2) at least \$250 but not more than \$500, 3) over \$500 but not more than \$5,000, and 4) over \$5,000. For a noncash contribution less than \$250 the IRS requires that the taxpayer keeps a receipt from the charity detailing its name and location, the date of the contribution, and a reasonably detailed description of the item donated. The requirements are similar if the donation is valued between \$250 and \$500, except that the receipt must contain even more detailed information.²¹ If the donation is valued between \$501 and \$5,000 the taxpayer must obtain a detailed receipt and also provide acquisition information about the item on Form 8283, *Noncash Charitable Contributions*.²² Finally, if the donation is valued at more than \$5,000 proof of a qualified appraisal must be submitted along with Form 8283.²³

In order to deduct out-of-pocket expenses incurred while providing services to a charity, taxpayers must keep a record of their expenses or their mileage, as well as obtain a receipt from the organization detailing the specifics of the services provided.²⁴

¹⁹ IRC §170(f)(17)

²⁰ IRC §170(f)(8)(A)

²¹ *Id.*

²² IRC §170(f)(11)(B)

²³ IRC §170(f)(11)(C)

²⁴ IRC §170(f)(8)(A)

Historical Development

Beginning in 1916 major tax reforms were introduced in the United States in order to finance the costs of World War I, and these reforms were largely focused on the wealthy. In a very short period of time the income tax was transformed from a very minor source of revenue to the primary instrument of taxation for the federal government (Brownlee, 2004). However, because of concerns that these new taxes would negatively affect contributions to charitable organizations, and thus threaten the existence of such organizations, a deduction for such gifts was written into the tax code as part of the Revenue Act of 1917 (Aprill, 2001). This deduction allowed an amount of up to 15 percent of taxable income to be deducted, a limit that remained unchanged until 1944 when it was updated to apply to adjusted gross income instead of taxable income (Clotfelter, 1985).

Major changes to the tax code were introduced during World War II as well, marked by a broadening of the tax base and a reduction of the personal exemption; by the end of the war, 74 percent of the population was subject to the income tax (Aprill, 2001). This of course meant that more tax returns were being filed than ever before, and in response Congress introduced the standard deduction as a simplification measure as part of the Individual Income Tax Act of 1944 (Aprill, 2001). This eliminated the need for a charitable deduction for many taxpayers, which nonprofit organizations saw as a threat to their existence. They and other critics felt that the availability of a charitable deduction to all taxpayers was both fair (that is, income given to charity should not be taxed) and incentivizing (that is, the existence of the deduction gave taxpayers more of a reason to donate to charity), and that the new standard deduction created a tax system where a donor and non-donor were treated exactly the same. Supporters of the bill felt that the need for simplification far outweighed the fairness argument, and also that people

did not need a deduction as an incentive to give to charity (Aprill, 2001).

Over the next 25 years, the charitable deduction limits were updated from time to time: to 20 percent of adjusted gross income in 1952, to 30 percent in 1954 for certain charities, and finally to the current limit of 50 percent as part of the Tax Reform Act of 1969 (Clotfelter, 1985).

One other provision of the Act of 1969, a provision still in effect today, was the limit imposed on donations of ordinary income property.²⁵ This limit essentially limits the deduction for donations of self-created works of art, manuscripts, letters, and memorandums to the donor's basis,²⁶ which in most cases is the cost of materials (a nominal amount). This provision was enacted partly in response to the abuses of Presidents Lyndon Johnson and Richard Nixon in deducting inflated fair market values for the donations of certain letters and papers written while they held office (Dean, 2003).

In Nixon's case, his deduction of \$576,000 on his 1969 tax return for donated vice-presidential papers was one of many issues that raised red flags with outside observers, which curiously had escaped suspicion with the IRS. In fact, the IRS was accused of giving Nixon special treatment for not initially questioning his large deduction. Eventually, after two IRS audits and an investigation by the Joint Committee on Taxation, Nixon's deduction was reduced by \$482,018. Furthermore, he was found to have backdated the deed of gift so that his donation appeared to have met the cut-off date for deducting fair market value (Samson, 2005).

The next major event in the history of the charitable deduction came from the 1981 Economic Recovery Act (ERTA), which called for a deduction for nonitemizers to be phased in gradually until 1986, when a full deduction would be allowed for that year only. After 1986 the deduction would be eliminated, and data would be reviewed to see what the effects of the

²⁵ IRC §170(e)(1)(A)

²⁶ Reg. §1.170A-4

nonitemizer deduction actually were. The rationale was that the new law might stimulate giving to charitable organizations, which would enhance their ability to provide services that the government would otherwise have to provide (Aprill, 2001).

ERTA was implemented as planned during the 1980s, but the Tax Reform Act of 1986 did not extend the deduction for nonitemizers, as the goals of the 1986 Act shifted toward fairness and simplicity of the tax laws. Similar to the Act of 1944, the standard deduction was used as a way to meet these goals (in this case, substantial increases to the standard deduction amounts). And just as in 1944, critics saw the new law as a threat to charitable organizations: not only was the nonitemizer deduction being eliminated, but the increase to the standard deduction amounts as well as other tax law changes decreased the number of people who would be itemizing, which in turn meant fewer people would be claiming a charitable deduction.

In more recent years, even though both Presidents Clinton and George W. Bush supported a reinstatement of the nonitemizer deduction, no major changes or effects to the charitable deduction have occurred since the 1986 Act (Aprill, 2001).

Related Literature – Legal Papers

Arguments in favor of the charitable deduction

Several theories have been proposed as justification for the charitable deduction. One of the most popular theories is the “subsidy theory” or “efficiency theory” (Gergen, 1988). This is based on the idea that charities provide certain goods and services that society feels should be equally available to all citizens at no charge. Clearly, giving to these charities helps them to provide such goods and services; thus government subsidy through the deduction is warranted since it will encourage giving. Hochman and Rodgers (1977) extended the theory and suggested that a tax credit available to all taxpayers (that is, nonitemizers as well) would be an even better

subsidy than a deduction.

The question of whether private giving is better than direct government subsidy has been addressed by Burton Weisbrod (1975). His argument is that private giving allows more charities to benefit, since smaller groups can decide to give to lesser-funded organizations of their choice (smaller organizations that may be overlooked by government). Also, proponents have said that the deduction is economically efficient since the amount of donations going to charities is more than the amount of revenue the government loses by offering the deduction (Aprill, 2001).

Another popular theory justifying the charitable deduction is the “tax base theory” (Andrews, 1972). This says that amounts given to charity should not be taxed since they are not part of an individual’s personal consumption or accumulation of wealth. This idea seems to support the original intention of the income tax, which was to reduce private consumption and accumulation of wealth in order to free resources for public use (Brownlee, 2004).

Other theories provide additional reasons for the deduction (Gergen, 1988): people who give to charity are less well-off than they were before they gave, and thus should be taxed less than someone who used their income for private consumption; the deduction serves as a reward for unselfish behavior; giving to charity is an admirable form of self-expression that deserves encouragement; charitable causes are good and therefore should be supported in any way possible; and in a perfect society we would do more of whatever charities do.

Arguments opposed to the charitable deduction

Several arguments have been put forth that are opposed to the charitable deduction, both the current version and the idea of extending it to taxpayers who do not itemize. The evidence for the subsidy theory has been called into question by many economists who have looked at the incentive effect of the deduction (Aprill, 2001). They believe that, even though taxpayers do

find some incentive in being able to deduct charitable donations, previous studies overstated that effect by using flawed data and unproven assumptions. In fact a 2006 Christian Science Monitor article refers to a survey which found that, contrary to earlier research,²⁷ 51.7% of taxpayers earning \$200,000 or more a year would not change their charitable behavior if the deduction were eliminated, and that only 38.1% of these high-income taxpayers would “somewhat decrease” their giving. Also, taxpayers earning \$20,000 or less (who are probably not itemizing and thus not benefitting from the deduction) actually donate a higher percentage of their income than do high-income taxpayers. In addition to the tax effects, factors such as identifying with a charitable purpose, wanting to make a difference, and the feeling of satisfaction are all important reasons why taxpayers donate (Trumbull, 2006).

With regard to the tax base theory, many analysts point out that giving to charity is a voluntary act, unlike paying medical bills or property taxes, and thus is a discretionary use of income. Furthermore, some of these donations actually benefit the donor (such as donations to churches), and so can be considered a form of personal consumption (Aprill, 2001). Andrew Chamberlain (2005) looks at the deduction from a historical perspective and adds that the original intention of the charitable deduction was to serve as a subsidy to charities, not as an aid to taxpayers in calculating a proper tax base.

Those who argue for the fairness of allowing nonitemizers to deduct donations have also been met with opposition. People who reject this fairness argument point out that everyone can itemize if they so choose; no taxpayer is legally prevented from itemizing and claiming his/her donations. The decision to claim the standard deduction is a purely economic one. Furthermore, the standard deduction is purposely inflated to account for a given amount of deductible charitable gifts, and that offering a nonitemizer deduction would effectively allow taxpayers to

²⁷ Clotfelter (1985), for example

double count their donations (Aprill, 2001).

Arguments against the idea of fairness have also been applied to the current deduction in the Internal Revenue Code. Since it is a deduction and not a credit, the amount of benefit to a taxpayer is based on his/her marginal tax rate; furthermore because it is an itemized deduction, and because those who itemize tend to be middle- and upper-income taxpayers (Cordes et al, 2005), charities supported by these taxpayers are benefitted more than charities supported by lower-income taxpayers who do not itemize. The idea of offering a credit instead of a deduction can also be criticized since, for example, a taxpayer in the highest tax bracket would only have to donate \$35 to receive a \$35 benefit, whereas under the current rules this taxpayer has to donate \$100 to receive the same \$35 benefit; consequently, this may lead to taxpayers donating less. Also, unless the credit was a refundable credit, it still would not equally benefit low-income taxpayers who pay little or no tax (Aprill, 2001).

Another concern for extending the deduction to nonitemizers is the administrative cost. Not only will the Code need to be amended, which would add complexity even if some kind of floor were not introduced,²⁸ but the already-existing problem of inaccurately reported donations (usually to the taxpayers' benefit of course) would potentially become an even bigger problem (Aprill, 2001). Typical nonitemizers are lower-income taxpayers who donate relatively small amounts to charity, and it is these smaller deductions that are the hardest to police, even with the new substantiation requirements mentioned above.²⁹

Other arguments against the deduction are: considering that giving to charity is and should be a selfless act, the idea of rewarding taxpayers monetarily seems to tarnish their philanthropy; even though donating is a high form of self-expression, other such forms of

²⁸ The idea of a floor, whereby only donations above a certain amount would be deductible, has been proposed by supporters of the nonitemizer deduction, for example President Clinton (Aprill, 2001).

²⁹ IRC §170(f)(17)

expressing oneself are not afforded a tax deduction; and given the liberal rules under which organizations are anointed with §501(c)(3) status (discussed next), it is not necessarily true that in a perfect world we would do more of what charities do (Gergen, 1988).

Qualifying under IRC §501(c)(3)

When the charitable deduction was first enacted in 1917, it was intended to serve as a subsidy for charitable organizations; it was assumed that these organizations would be hurt by the expansive World War I tax regime. Back then, the nonprofit sector was much smaller and was mostly made up of churches and charities that clearly provided aid to the poor; since then however, Congress has expanded the deduction significantly by raising adjusted gross income limits and granting §501(c)(3) status to a much wider array of organizations (Pozen, 2006).

Today, we have a system where the rules for deductibility are anything but clear-cut and consistent; Pozen describes them as a “labyrinthine web”. For example, there are certain nonprofit organizations that do not operate much differently from for-profit organizations (hospitals are probably the best example); however giving to one yields a deduction while giving to the other yields no deduction (Colombo, 2004). Gergen (1988) considered it “ludicrous” that certain nonprofits such as singing groups, sports museums, and jazz festivals were given such a distinction in the tax code.³⁰ Such organizations, he explained, have other methods of support that are available, and gifts to them are not purely philanthropic since the donor usually receives a benefit.

As a remedy, Colombo (2004) suggested a new “access test” that must be met in order to

³⁰ In the court system, some decisions on nonprofit status have been straightforward, while others have been a little more complicated. An example of the former is *Bob Jones University*, 83-1 USTC ¶9366 (USSC 1983), in which a private school had its nonprofit status discontinued because of its racially discriminatory policies. An example of the latter is *The Fund for Anonymous Gifts*, 97-2 USTC ¶50,710 (U.S. District Court, D.C. 1997), in which tax-exempt status was denied for a fund that allowed its donors to make decisions on how donations were invested and subsequently distributed to charities.

qualify for nonprofit status: if the organization “enhances access” to qualifying services for under-served populations,³¹ then it should be considered a nonprofit organization. He supports his proposal by indicating that some IRS rulings and tax court decisions regarding an organization’s nonprofit status have actually referred to this idea of access.

Related Literature – Political Papers

General problems with the charitable deduction

Political analysis has revealed various problems with the deduction. Chamberlain and Sussman (2005) explored whether the charitable deduction is economically justified, and found several issues with it. They pointed out that the deduction shifts part of the cost of charitable giving onto government, and thus onto society as a whole. This means that some of us are subsidizing other taxpayers’ charitable objectives, objectives with which we may not agree. They also found that a growing number of charitable organizations are actually “charitable” in name only, existing primarily to promote and support certain political views and ideologies, or to compete with very similar for-profit companies. Organizations like these are clearly not within the spirit of IRC §501(c)(3). Other organizations are supported largely by government contracts and grants, and thus can be considered quasi-government agencies. In fact, contrary to popular belief, most charitable organizations receive a large portion of their revenues from service fees and government support, instead of from donor contributions (Blackwood, Wing, & Pollack, 2008).

When we look at charitable donations of \$50 million or more, we find that a vast majority go to universities, private foundations, hospitals, and art museums (Strom, 2007). All of these organizations are tax-exempt and are qualified to receive deductible donations. However, these organizations do not have the central purpose of serving the most disadvantaged people in a

³¹ IRC §170(c)

society, and so the question of whether such gifts should be considered philanthropy arises. In fact, less than 10% of charitable giving in America goes toward basic human needs like shelter, food, and medicine for the poor, and the wealthiest taxpayers (those most likely to itemize and claim a charitable deduction, as well as receive the greatest benefit from it due to their tax bracket) typically donate less to these causes than other taxpayers (Strom, 2007).

Suggestions on improving IRC §170

One aspect of the charitable deduction laws that has received considerable attention lately is IRC §170(i), which states that the deductible mileage rate for charitable miles is 14 cents. This is the only deductible mileage rate that is frozen in the Internal Revenue Code, which requires congressional action to change it. With gasoline prices currently at an all-time high, lobbyists of both major political parties feel it is time that §170(i) be amended to allow the Treasury the freedom to set the charitable mileage rate to better reflect current and future economic conditions. One such lobbyist, Senator Charles Grassley of Iowa, stated that some volunteers may decide to donate less of their time since driving a car is more expensive than ever (WebCPA Staff); and in fact, Grassley's comments are warranted: a recent article in a Maryland community newspaper reported that the Meals on Wheels program, which provides home-delivered meals to people in need, has in fact lost volunteers because of high gas prices. Amending the law would bypass the troublesome step of congressional involvement, and raising the charitable mileage rate could encourage more people to volunteer their time (Robbins, 2008).

Another section of the law that has been given attention is IRC §170(e)(1)(A), which effectively limits the charitable deduction to cost basis for contributions of self-created works of art, compositions, manuscripts, and the like. As mentioned before, this limit was put into place to try to prevent further abuses similar to those committed by Presidents Lyndon Johnson and

Richard Nixon. However since the limit covers a broad range of self-created works, writers, musicians, and artists who would otherwise claim a legitimate deduction of fair market value are left to deduct the nominal cost of supplies. Creative input is effectively ignored, and as a result these writers, artists, and musicians have stopped contributing their works and instead are either selling them to private bidders or simply holding onto them. When this happens, the public loses out on access to such works, which has an adverse effect on our cultural heritage (Dean, 2003).

Not only is §170(e)(1)(A) unfair to serious artists, writers, and musicians, it also leaves us with another odd situation: while a creator of an artistic work is limited to deducting cost basis, a collector who acquires the same work of art and donates it is allowed to deduct its full fair market value (Dean, 2003). This seems to violate the principle of horizontal equity, since creators are not given the same incentive to donate as collectors. However, if a self-created work is donated after death, then fair market value is allowed as a deduction from estate taxes. The law clearly encourages these individuals to donate their works after death, which deprives society of the creator's valuable participation in answering questions and providing information about his/her motives and inspirations (Association of Art Museum Directors, 1999).

Related Literature – Empirical Papers

The price and income effects of taxes on giving

Many empirical studies on the interactions between charitable giving and taxes used data that covers the late 1970s through the mid- to late 1980s, a period of time during which two major tax reforms were introduced (the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986). This allowed researchers to focus on the opposing forces of the price and income effects, and how changes in each of them affected giving (Clotfelter, 1985; Auten, Sieg, & Clotfelter, 2002; Barrett, 1991; Barrett, McGuirk, & Steinberg, 1997; Randolph, 1995). The

price effect refers to the incentive created by the deduction, which lowers the “price” of giving: for example if a donor’s marginal tax rate is 25 percent, one dollar donated reduces taxes by 25 cents, which means the donation only “cost” the donor 75 cents. On the other hand the income effect refers to the disincentive to give caused by having to pay taxes, which reduces disposable income; stated another way, if a donor can deduct his donations, he will have more income at his disposal and will be inclined to donate more (Barry, 1996).

The empirical work most often cited with regard to taxes and giving is that of Charles T. Clotfelter (1985). He concluded that income tax laws, namely the charitable deduction, standard deduction, and tax rate schedules, have important effects on charitable behavior, with the deduction being the most important. Specifically, he found that the price effect had more influence on giving than did the income effect, and the net effect of the charitable deduction was that it did stimulate giving.

More recent empirical work seems to support Clotfelter’s findings. One study found that a current increase to the cost of giving causes taxpayers to shift giving into a future year, while a current decrease causes them to donate more in the current year. As expected, knowledge of future price increases also causes taxpayers to give more in the current year (Barrett, 1991). Another study focused on the temporary and permanent nature of price and income effects, and found that permanent effects had more of an impact on giving than did temporary effects, and that the most important tax policy consideration for charitable giving was the permanent price effect. Based on these findings, the reduction of marginal tax rates in the 1980s probably resulted in less charitable giving (Auten et al, 2002).

However, other studies have come to different conclusions about the price and income effects. Kevin S. Barrett (along with other researchers) reexamined his 1991 study referenced

above and also reviewed other credible studies, and concluded that the price effect is actually weaker than was originally thought (Barrett et al, 1997). Another study also found that the price effect was significantly smaller than previously thought, while the income effect was significantly larger (Randolph, 1995). Joulfaian and Rider (2004) took a different approach and discredited all previous studies that used self-reported data, indicating that taxpayers can intentionally or unintentionally report incorrect amounts on their tax returns, which would result in miscalculations of the true price and income effects on charitable giving.

Other Conclusions

Clotfelter (1985) also found that tax policy affects the distribution of contributions as well as the level of contributions, since certain donors at various income levels tend to donate to similar organizations. For example a tax policy change for high-income earners will tend to affect donations to colleges, art museums, and private foundations; similarly, eliminating the deduction would affect gifts by wealthy taxpayers the most.

Another of Barrett's (1991) findings was that donors are somewhat habitual: all things being equal, what they did in the prior year has some effect on what they do in the current year. He also concluded that government subsidization of taxpayers' charity is an efficient way to stimulate giving; thus the deduction should not be restricted or eliminated, and furthermore extending it to nonitemizers makes sense as well.

However in his later study (Barrett et al, 1997) the findings suggested that the deduction may not be efficient for the Treasury; in other words, that the resulting increase in donations caused by the stimulating effect of the deduction may not be greater than the lost revenue caused by the existence of the deduction.

Proposal

I have presented various opinions, studies, and suggestions that have been considered in the vast literature on the charitable deduction and the nonprofit sector. I will now assess these perspectives and give my proposal on how to improve our tax system in this area.

With regard to the deductible mileage rate for charity, I do not see any justification for it to be set by statute, requiring more political action than other deductible mileage rates to change it. The charitable mileage rate, like other deductible mileage rates, is an area of the tax law that needs to be updated frequently as the cost of driving changes. With the mileage rates for business, medical, and moving purposes currently at 58.5 cents, 27 cents, and 27 cents, respectively,³² clearly the 14-cent rate for charitable mileage is in dire need of an update.

Concerning IRC §170(e)(1)(A), which limits the deduction of donated self-created works to the cost of materials, I do not feel that it is fair to put all self-created works in the same category. For example, Brad Pitt's autograph is clearly not as culturally valuable as a painting or musical composition; however IRC §170 would treat donations of these two items by their creators exactly the same. For the artistic value alone, amendments to the Code (which have been suggested by such organizations as the Association of Art Museum Directors (1999)) should be seriously reconsidered.

The price and income effects of the charitable deduction were examined, and based on the literature presented their impacts are at best ambiguous. I think Joulfaian and Rider (2004) make a good point about self-reported data being unreliable, especially when it comes to the charitable deduction. In fact, a recent article on Forbes.com describes a study which suggested that wealthy people are the most serious violators of misreporting information on their tax returns, mostly because their income sources (rents, capital gains, and partnership income, for

³² Retrieved from <http://www.irs.gov/newsroom/article/0,,id=184163,00.html> on 10/24/2008

example) tend to be easier to conceal (Novack, 2008).

The tax base theory is considered one of the major justifications for the charitable deduction, and on its face it seems to make sense: money and property given as charitable donations were not used for private consumption, and thus should not be part of the tax base. However, other forms of consumption not used for private enjoyment could be considered just as worthy. For example, if I give \$1 to a homeless person while passing him on the street, I am not allowed to deduct that \$1; however, this act is just as selfless as giving that same \$1 to the Pine Street Inn, which is a charitable organization.³³ Because of the existence of the deduction, we can never know for sure if a taxpayer's charity is selfless since he/she is receiving a benefit, up to 35 percent of the gift itself. Even for taxpayers who do claim the deduction however, they must feel some sense of morality or decency when making their donation, which I feel should be enough of a benefit to motivate them to donate. The Christian Science Monitor (2006) article mentioned earlier, which suggested that elimination of the deduction may not affect charitable giving for a majority of high-income earners, seems to provide the statistics to support this claim.

I think it is also important from a subsidy theory point of view that taxpayers who do not benefit from the deduction (specifically those earning \$20,000 or less) donate a higher percentage of their income than those taxpayers who do benefit from the deduction. This indicates that factors other than the charitable deduction may be motivating these people to donate. Also, records indicate that only 12.3 percent of public charities' revenues came from private donations in 2005, while over 70 percent came from service fees and government grants (Blackwood, Wing, & Pollack, 2008). Clearly, the deduction is no longer a needed subsidy for charitable organizations.

Because charity is part of the Code, it is not surprising that many strategies have been

³³ According to IRS Publication 78

developed to maximize tax savings through donations. Tom Herman (2008) suggested “shopping around among charities” for organizations with favorable donated-car policies. Guidance like this is also offered by Schwab Charitable, which advertises on their website that their mission is “to increase charitable giving in the United States by offering advantageous ways to give,” as well as “a strategic approach to philanthropy.”³⁴ Ideas like these are clearly not promoting selflessness through giving, and to me are contrary to the spirit of true charity; but this is exactly the type of charitable behavior that the Code has created.

Back in 1917 when the income tax was new and the nonprofit sector was small, a deduction for charitable giving was probably justifiable. If the nonprofit sector were as small today as it was back then, the argument favoring a deduction to help subsidize charities might still be valid. However, it is not a valid argument in 2008. Due to the lax qualifications for becoming a §501(c)(3) charity, the number of such organizations has exploded in the last 91 years (currently almost 958,000 public charities exist),³⁵ which now includes such causes as quilting organizations (Madoff, 2008), university golf teams, puppet theaters, and even an organization established after Hurricane Katrina to help sadomasochists replace certain “belongings” they had lost in the storm (Strom, 2007). Dictionary.com defines charity as “generous actions or donations to aid the poor, ill, or helpless”,³⁶ but the IRS’ definition of charity is apparently much more flexible.

Due to the expansion of the number and types of nonprofit organizations over the years, the definition of the term “nonprofit organization” itself has evolved into an almost meaningless designation; nowadays it seems more like a technicality of the law to be considered nonprofit. This expansion of the industry has created a system where “deductibility sets charities apart as

³⁴ Retrieved from <http://schwabcharitable.org/> on 10/24/2008

³⁵ Source: National Center for Charitable Statistics (NCCS), found at <http://nccs.urban.org/>

³⁶ Retrieved from <http://dictionary.reference.com/browse/charity> on 10/24/2008

our legal system's most favored breed of nonprofit organization" (Pozen, 2006).

Based on my analysis of the issues I have discussed in this section, I propose much stricter guidelines for organizations qualifying under IRC §501(c)(3). I feel this is the best way to deal with the problems that exist with the current charitable deduction. The nonprofit sector needs to be whittled down to resemble what it was in 1917 when the deduction was originally introduced - organizations that truly and clearly assisted the poor, sick, needy, or provided for the general welfare of society. After such a change if high-income taxpayers still want to donate huge amounts of money to charity, I can justify allowing them to deduct up to 50 percent of their adjusted gross income.

If for whatever reason the number of nonprofit organizations cannot be reduced in this manner, then I believe the deduction should be eliminated from the Code. For one, it seems to help high-income taxpayers the most, who I suspect do not really need the benefit of the deduction. Furthermore, even if elimination of the deduction were to affect charitable giving in a major way, based on the statistics it seems that charities do not rely on such giving as a major source of funding.

However I must admit that even though I see one of these two proposals as necessary, I realize that they are unlikely to occur since they would negatively affect too many people and/or businesses. Paring down the nonprofit sector still allows for some subjectivity when deciding what organizations qualify under §501(c)(3), and it is "some" subjectivity over a long period of time that has created the enormous number of charitable organizations in the current system. Also, the deduction has been part of the income tax laws for so long that I do not think any politician would ever attempt to abolish it. The very idea of deducting charitable donations

seems to be protected as a traditional and almost sacred part of the Code, even if in reality this simple concept is much more complex under the surface.

Global Considerations

Today's nonprofit sector is becoming more globally interconnected than ever before (Pozen, 2006), and I feel our tax policies on the charitable deduction ought to reflect this trend, or at the very least they ought to recognize it in some way. For example, no deduction is allowed for a donation made directly to a foreign charity; however, a donation made to a domestic charity is deductible even if the gift is then passed on to a foreign charity (assuming the donor did not mandate this result and that the domestic charity has total control over the use of the gift) (Pozen, 2006). This part of IRC §170 seems very narrow and outdated in relation to the globalized nonprofit sector. Furthermore, as I have alluded to organizations that have been given §501(c)(3) status for reasons that are unclear, I am sure that some foreign charities are worthier of such a distinction.

On the other hand, expanding §501(c)(3) to include foreign charities means that we must consider the argument put forth by Chamberlain and Sussman (2005): allowing a deduction for gifts to these organizations means that taxpayers would be subsidizing part of the cost of these gifts. This issue occurs in our current system with charities like the Bill and Melinda Gates Foundation. This organization receives billions of dollars every year in donations, and that money primarily goes toward improving the lives of poor people in less-developed countries. Even though this is seemingly a worthy cause, polls have repeatedly shown that Americans have mixed feelings about using tax dollars for foreign aid (Strom, 2007).

Ethical Considerations

Howard Gardner (2007) defines ethics as the ability to think abstractly about one's role as

a worker and/or citizen and to conceptualize the nature of those roles; it is also the capacity to reflect on how someone does or does not successfully embody those roles. He sees “good work” as evidence of an ethical mind; that is, work that is excellent in quality, responsible in its effects on the surrounding community, and attractive or pleasing. With regard to the charitable deduction, I think both taxpayers and the IRS need to be ethical in their roles, but of course this does not always occur, as I will now discuss.

Donations of capital gain property, such as shares of stock or real estate, have the double benefit of allowing a deduction of fair market value, as well as allowing the donor to avoid paying tax on the capital gain he/she has realized (which could be millions of dollars in some cases). As if this double benefit weren’t enough, a new study shows that top corporate executives made large donations of their company’s stock to their family foundations just before the stock had a significant decline in market value. Some of these executives may have also backdated their donations in order to maximize their charitable deduction (Yermack, 2008). Since they are top executives, they usually have knowledge of forthcoming market value changes in their company’s stock; however insider trading laws do not apply to these charitable gifts, and so these executives are able to take advantage of this loophole.

Recently in Texas a Tax Court Summary Opinion was given to Daniel and Ruth Gomez, who were contesting a disallowed charitable deduction of almost \$6,900 that they had claimed on their 2005 tax return.³⁷ The taxpayers seemed to have sufficient documentation to establish that they had in fact made the contributions; in fact, the Summary Opinion included language indicating that the judge did not question the fact that the contributions were made. The reason that the IRS denied the deduction, a decision which was upheld by the Tax Court, was that the letter from the charitable organization was dated in 2008 and thus was not “contemporaneous”,

³⁷ *Gomez*, TC Summary Opinion 2008-93

as is required by law.³⁸

In both of these cases, even though the letter of the law appears to have been followed, I think it is debatable whether the parties acted ethically. I personally believe Gardner's definition of good work was not met in either case: executives taking advantage of a loophole, and the IRS exploiting a technicality of the law, are not examples of excellent work; executives being selfish, and the IRS possibly having a negative effect on future charitable donations in such a blatant manner, are not examples of responsible work; and neither the executives nor the IRS have done work that is pleasing to others. In this sense, the corporate executives did not fulfill their roles as business leaders and as taxpayers, and I do not feel the IRS fulfilled its role as a government agency; furthermore, I feel it was the spirit of charity that was overlooked in both instances.

Conclusion

Through examination of related legal, political, and empirical papers, as well as global and ethical concerns, this article has shown that views on the charitable deduction are anything but unanimous. While some arguments are in favor of the deduction, and even for its extension to nonitemizers, other views are in direct opposition. The theories that justify the existence of the deduction have all been criticized with equally convincing arguments, and valid suggestions for the improvement of the deduction have also been proposed.

This author feels that one of the biggest problems with the deduction is the enormous pool of organizations that are qualified under IRC §501(c)(3), many of which provide no assistance to the poor, sick, or needy. Allowing such organizations to receive deductible gifts is not in line with the original intention of the deduction. This huge expansion of §501(c)(3) has created a charitable deduction that is so far removed from what it should be that the definition of "charitable organization" is almost meaningless today. For there to be a true deduction for

³⁸ IRC §170(f)(8)(A)

charitable gifts, the nonprofit sector needs to be scaled down significantly; otherwise, the charitable deduction needs to be abolished.

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