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DEFENDING THE CHARITABLE DEDUCTION

The tax deduction for charitable contributions is one of the many ping pong balls being lobbed back and forth across the deficit debate table in Washington. While we are aware of the government's fiscal predicament, our perspective on the issue has been forged by many working days knee-deep in the financial and other challenges facing exempt organizations. From this vantage point we see no compelling reason to curtail the deduction, and in these pages we make the case that any attempt to pick the pockets of organizations in the philanthropic sphere will be self-defeating and should be resisted.[1]

Private Fiduciary vs. Political Control over Assets

We believe it is misguided to target the charitable deduction because both governmental and charitable revenue must be used for a public purpose or benefit. Accordingly, we submit that the underlying policy question is who should control the expenditure of monies which must be so used: donors and the governing boards of the charities to which they choose to make contributions, or elected officials and the administrative agencies which operate under their purview. Our contention is that the public benefits more from revenue directed by private donors and managed by private governing boards, because both are proximate to the mission, and the judgments of board members are tethered to enforceable fiduciary duties of loyalty and care. In contrast, governmental officials are far removed from the mission, and, because they are not fiduciaries, their judgments are too prone to the seductions of the ballot box. Let us put our case in perspective by looking at the history and the law, and then providing some analysis and detail to support our position.

The Evolution of the American Philanthropic Sector

The history begins with the decision of the Founding Fathers to leave behind the monarchies and aristocracies of Europe and to lay the groundwork for new cultural institutions based in part on the Constitutional rights to form private associations (create charities) and to own and control property (make donations).[2] These rights have been exercised to create and to fund organizations designed to address common or community needs – needs not addressed as well (or at all) by the private and governmental sectors. Many of these institutions were started by parents and motivated community members – and had names that sound oddly out of place today

[1] As always, we invite readers to share their opinions with us at nonprofit@rrlawpc.com. Also, we realize that many people will give despite limits on deductibility. However, limits on the deduction will certainly not enhance charitable giving.

[2] There are many types of voluntary associations, both for profit and non-profit. A business partnership or corporation is a type of association. Non-profit associations include labor unions, political parties, trade associations and private clubs. Our discussion is limited to "associations" which are "charitable" as defined under Section 501(c)(3) of the Internal Revenue Code and to which donors may make deductible contributions under Section 170 of the Code.

(such as the *Connecticut Asylum at Hartford for the Instruction of the Deaf and Dumb*). Over time, they have evolved and expanded and now include hospitals, colleges, museums, little leagues, parent-teacher organizations, homeless shelters, food pantries and social service agencies (among others). The terms "independent" or "intermediate" are used to describe the philanthropic sector because of the cultural space it occupies – half way between the governmental sector and the private for-profit sector.[3]

The American Charitable Tax Compact

The federal income tax in its current form did not exist until after the 1913 ratification of the 16th Amendment to the Constitution (which gave Congress the power to impose an income tax). The exemption for charitable organizations was included in Revenue Acts in 1913 and 1916, and a deduction for contributions to charitable organizations was added in the Revenue Act of 1917. However, favored tax treatment for charities has historical and legal roots that run much deeper in our culture than the federal income tax. In this regard we note a May 2, 2012 story in *The Wall Street Journal* about Brown University's agreement to increase its voluntary payments to the financially troubled City of Providence, Rhode Island. The story began with the following line: *"An agreement dating back to Colonial times provides that Brown University is 'freed and exempted from all taxes.'"*

Over the years we have read many scholarly publications critical of the deduction (and the exemption), which typically argue that there is nothing in the legislative history of the 1913-1917 statutes articulating a policy rationale sufficient (in the minds of the critics) to justify tax favored treatment.[4] These folks may have their analysis backwards. We wonder if the exemption and deduction language was added to these early statutes to make it clear that the new income tax did not trump the unwritten part of the American "social contract" (*previously unwritten because it was so well understood)* that charitable organizations should not bear the same tax burden as the private sector (the exemption), and that citizens should be encouraged to support them (the

[3] We found an interesting article on the importance of intermediate institutions in, of all places, the April 4, 2012, edition of the newspaper *China Daily* (*Relaxed NGO Registration to Boost Growth of Civil Society).* China – with a massive governmental sector and a nascent private sector – is still trying to figure out what it wants to be. The article suggests an emerging awareness about the need for robust institutions in the middle space of the Middle Kingdom. The article discusses a "major policy shift" by the government of Guangdong province, meant to ease the "cumbersome registration" process of NGOs (non-governmental organizations, or what we call nonprofits). As the article puts it: "This latest Guangdong policy shift can be seen as a breakthrough because it simplifies local civil groups' registration process, and fosters local civil society growth…Such a shift is long overdue. With the Internet penetration into more households and daily lives, the information flow has increased exponentially in recent years. It has become harder for social tensions to be ignored or suppressed by powerful interests or some local governments. Civil groups allow the disadvantaged to be heard and provide a 'safety valve' through which tensions can be eased. Such groups could either act as a mechanism to communicate with higher authorities, or can alleviate issues directly."

[4] As an example of the academic debate, we note an article in the October 2005 edition of the *Indiana Law Journal* entitled "The Community Income Theory of the Charitable Contributions Deduction." The author (Johnny Rex Buckles of the University of Houston Law Center) supports the charitable deduction, while noting the academic controversy which has encircled it: "Notwithstanding its longevity, this charitable contributions deduction has been a controversial feature of federal income tax statutory law for decades. The deduction has been criticized as inequitable, inefficient, politically suspect as tax expenditure, and, in general, fundamentally inconsistent with a comprehensive income tax base."

deduction).[5] We suggest that the doubters need only look as far as the local homeless shelter (or the discussion below) to find clarity.

Analysis and Conclusions

First, there are some basic tax principles to keep in mind when thinking about these issues. Charitable money (donations) and government money (taxes) are both derived from the private sector and both must be used for public purposes. Charitable organizations, governments and governmental units are all exempt from taxation; contributions to any of them are entitled to a federal income tax deduction.[6]

Second, a charitable donation is a voluntary expression of the will of the donor as to the mission to be supported and the persons to control its use (that is, the institution and its governing board). In contrast, tax revenue is mandatory and is expended as directed by our public officials. Tax revenue can be used for any public purpose (guns or butter) determined by the government. Donated revenue can only be used for those public purposes which are charitable.

Third, government does not have a constitutional obligation to provide for charity. It does so only as a matter of legislative grace. This is an important and often overlooked point. How often have you heard someone say something to the effect that "if the exempt sector didn't do it the government would have to do it." The point is that the government would do "it" only if the government had the desire (the votes to pass the legislation) and the resources (enough tax revenue) to do so. From this perspective we contend that the charitable deduction compact protects the people from Congress – and Congress from itself – by providing alternative mechanisms to direct charitable resources where they are needed.

Fourth, we think this unwritten American Charitable Tax Compact is best interpreted as devolution of the power to private citizens to allocate resources for public charitable purposes on a partially tax-favored basis.[7] In other words, perhaps the people who earned the money in the first place have a worthy idea or two about a good public purpose for its use. In this sense, the deduction is a further manifestation of the democratic principles upon which the Founding Fathers chose to establish the Republic: let the people make some public fiscal decisions on their

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[5] The unwritten nature of this part of American law does not dilute its significance. England has existed as a nation a lot longer than the United States, yet its constitution is not contained in a single written document and includes unwritten sources (such as royal prerogatives and parliamentary constitutional conventions) in addition to centuries of statutes, court decisions, international treaties and the like – including *Magna Carta* which was signed in the year 1215.

[6] People do not usually think of the government in this context, but Section 170(c) of the Internal Revenue Code, which defines "contribution," provides that taxpayers can deduct voluntary contributions to "a State, a possession of the United States, or the United States or the District of Columbia...."

[7] To the extent deductible, contributions are only partially "tax favored." A deduction reduces income taxes only to the extent of the donor's marginal tax rate (a 28% rate means a $280 reduction for a $1,000 gift), and is not a dollar for dollar credit (which would reduce taxes by $1,000 in the above example). Moreover, there are other limits on the deduction based on the Adjusted Gross Income of the donor and the nature of the organization receiving the gift (private foundations are less favored than public charities).

own. Congress is not the font of all wisdom, and not all allocations of charitable revenue need be funneled through its filters.

Finally, as we said at the outset, there are massive differences between the dynamics of (a) donors and the private charitable associations they support, and (b) government and the agencies through which it exercises its will. The former are inevitably closer to the mission – whether it is the donor to a human services agency whose children were cared for there, or the religiously motivated individuals whose calling is to care for the homeless or the addicted – or the board members who attend monthly board, budget and business meetings and whose attention, when making decisions, is bound by the fiduciary obligation to act only "in the best interests" of the organization. Government agencies awarding grants and contracts are bureaucratic organizations and do not, as such, have the same passion for the mission as do the volunteers running the annual golf tournament or participating in a walkathon. In our nonprofit practice we have seen elected officials willing to subordinate their pledges of support to nonprofit organizations to different interest groups with more pull at the voting booth.

We believe that both the government and the charitable sector play vital and important roles, and that the existing system creates a reasonable balance of power and resources that is not in need of fixing at this time.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel.

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