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Generous to a Fault? Fair Shares and Charitable Giving

Miranda P. Fleischer

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Miranda Perry Fleischer*

Associate Professor and Richard W. and Marie L. Corman Scholar
University of Illinois College of Law

Abstract

Charities play a vital role in our society. In addition to enhancing pluralism, they meet many societal needs more efficiently, more creatively, and more effectively than government alone. Charities aid our poor, teach our youth, improve our health, comfort us spiritually, and enrich our cultural life. Given the charitable sector's importance and value, it is not surprising that the tax Code encourages philanthropy by allowing a deduction for charitable gifts. What is surprising is that it treats the most generous among us *less* favorably than those of average generosity. This mismatch stems from one of the most puzzling limits in the Code: the cap preventing an individual from claiming a charitable deduction greater than 50% of her income, even if she gives more than half her income to charity. As a result, someone who is generous enough to donate all her income to charity must still pay income tax.

Why limit generosity? Current literature exploring this question is scarce and shallow. The theoretical questions whether an individual who gives all her income to charity should also pay some income tax or whether the Code's current limits are an appropriate means of implementing that principle lack satisfactory answers. Only one explanation – that precluding individuals from deducting large charitable gifts serves as a crude alternative minimum tax ensuring that everyone above a certain economic income pays some tax – has gained any support at all. That explanation is insufficient. It does not answer the question of why an individual who keeps no income for herself and instead donates it all to a cause deemed worthy enough to merit a charitable deduction – such as feeding the poor, supporting educational institutions, or funding the arts – should still pay some tax.

This Article begins to answer the question—"Why limit generosity?"—by arguing that under the economic subsidy theory for the charitable deduction, internal constraints on the legislative process explain and justify a percentage-of-income limit. This Article's argument proceeds directly from the literature conceptualizing the charitable deduction as a way of overcoming market and government failure for various public goods by spurring non-profits to produce them. It suggests that limiting the charitable deduction to some portion of one's income reflects a bargain between individuals whose preferred public goods are fully funded by the government and those whose projects are only partially subsidized. This bargain is necessary to reconcile the private provision of public goods via charitable giving with our democratic legislative process.

Generous to a Fault? Fair Shares and Charitable Giving

By Miranda Perry Fleischer*

"In charity there is no excess."
-- Sir Francis Bacon, Of Goodness and Nature (1625)

I. Introduction

Charities play a vital role in our society. In addition to enhancing pluralism, private philanthropy meets many societal needs more efficiently, more creatively, and more effectively than government alone. Schools ranging from Ivy League universities to small private kindergartens teach our youth and advance knowledge. Religious organizations offer spiritual comfort to millions of Americans, while groups as diverse as neighborhood health clinics and the Gates Foundation improve the health of countless others. The Red Cross and the Salvation Army aid thousands of distressed individuals each year, while art institutions ranging from the Metropolitan Opera to neighborhood community theaters enrich the cultural life of our country.

Given the charitable sector's importance and value, it is not surprising that the tax Code encourages charitable giving by allowing a deduction for charitable donations.[1] What is surprising is that the Code treats the most generous among us *less* favorably than those of average generosity. This mismatch stems from one of the most puzzling limits in the tax Code: the cap that prevents an individual from claiming a charitable deduction greater than 50% of her income, even if she gives

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[1] I.R.C. § 170 (West 2007).

more than half her income to charity.[2] As a result, someone who generously donates all her income to charity must still pay income tax.

Neither the 50% limit nor the broad principle it represents is well-theorized Only a few scholars have explored the theoretical question whether an individual who gives all her income to charity should also pay income tax or whether the tax Code's current limits are an appropriate means of implementing that principle.[3] Those who have appear hard-pressed to find a satisfactory justification for limiting one's deduction in this manner.[4] Only one explanation – that the cap serves as a crude alternative minimum tax ensuring that everyone above a certain economic income pays some tax – has gained any scholarly traction.

That explanation is insufficient. The alternative minimum tax addresses the fact that some tax preferences allow individuals to retain substantial economic income *for their own use* that goes untaxed. This reasoning, however, does not apply to tax preferences for charitable contributions: By definition, someone who makes a charitable donation does not retain the gifted assets for her own use. The minimum tax explanation therefore does not satisfactorily answer the question whether, if an individual keeps no income for herself and instead donates

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[2] I.R.C. § 170(b) (West 2007). As explained in Section II, this 50% limit applies only to cash contributions to public charities. Limits of 30% or 20% apply in other instances, depending on the asset donated and the recipient charity. Similar limits apply to corporations: Generally, they can deduct no more than 5% of their income. While the corporate provisions are interesting and merit further study elsewhere, this Article focuses only on the individual limit.

[3] Some scholars have, however, criticized the current limits on a practical level for dampening giving by creating unnecessary complexity. C. Eugene Steurle and 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, 411-12 (1995).

[4] *See, e.g.*, Boris Bittker, *Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility, The Seventh Mortimer H. Hess Memorial Lecture*, 31 N.Y.S.B.A. REC. 159, 168-69 (1976); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 23 (2002). Only a handful of scholars have proffered explanations that they appear at least somewhat satisfied with. *See*, *e.g.*, Steurle and Sullivan, *supra* note 3, at 413-15 (suggesting that the best explanation for the cap is as a crude alternative minimum tax); Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947, 985-86 (2005) (suggesting that the limitation serves a political role by precluding the wealthy from using all their "resources . . . to fund those charitable activities that they value, at the cost of denying the federal government any control over the use of such funds.").

it all to a cause worthy enough to merit a charitable deduction – such as feeding the poor, supporting educational institutions, or funding the arts – she should still pay some income tax.

This Article is the first of two that seek to better answer whether limiting the ability of taxpayers who make substantial contributions to take a charitable deduction is justified.[5] This two-part series answers that question in the affirmative, relying on two complementary theories. The first is based on economic theory; the second is rooted in political philosophy.

This first Article articulates the economic argument, which is grounded in the existing public goods literature. That work posits that a subsidy for charitable donations is warranted because a democratic process dependent on majority preferences[6] will supply public goods at only at the level demanded by the median voter.[7] This majority, which I term the "classic majority," therefore supplies some public goods (for example, a lighthouse or national defense) but not others (perhaps a community theater). Individuals supporting the under-supplied public goods then coalesce to form what I term a "new majority" that agrees to provide partial funding (via a tax subsidy) for each other's preferred minority projects.[8] In that manner, charitable tax subsidies allow

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[5] As explained in Section II, the current subsidy is structured as a deduction that is limited to some portion of one's adjusted gross income. Another way of subsidizing charity while precluding a taxpayer from "zeroing out" her tax liability would be a credit for charitable contributions limited to some portion of her tentative liability. My goal is not to explore whether the current rule (a limited deduction rather than a limited credit) is justified, or even whether a deduction is preferable to a subsidy, but rather the broader question of whether subsidizing charitable donations while still requiring donors to pay some income tax is justified.

[6] Although I recognize that majority preferences do not always prevail due to intrinsic characteristics of our legislative system, I take the existing models in the public goods literature on the charitable deduction (which use a majoritarian model) as my starting point. *See*, *e.g.*, Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 21, 24-25 (Susan Rose-Ackerman, ed., 1986); JOHN D. COLOMBO AND MARK A. HALL, THE CHARITABLE TAX EXEMPTION 102 (1995). That literature recognizes that majority votes do not always determine political outcomes, but uses such a model for simplicity. Weisbrod, *supra* note 6, at 23; COLOMBO AND HALL, *supra* note 6, at 102. The possible role of limits on the charitable subsidy in non-majoritarian situations is explored in Section V.D.3.

[7] For an explanation of this phenomenon, see Section IV.A.1.

[8] I refer to these as "minority" projects because the classic majority voted not to fund them.

individuals whose preferences differ from the classic majority to redirect a portion of funds otherwise flowing to the federal fisc toward their preferred visions of the public good.

Two majorities now exist simultaneously: the classic majority, which has agreed to fund the lighthouse, national defense and other projects not suffering from government failure,[9] and the new majority, which has coalesced for the purpose of approving partial funding for minority-preferred projects.[10] By definition, some voters are members of both groups. How can these two majorities exist simultaneously? How do voters who are members of both majorities balance their competing interests? Current literature ignores these questions.

This Article argues that these two majorities strike a bargain (which I term the "dual-majority bargain") with each other by splitting the governmental "pie" equally:[11] The classic majority will fund the new majority's minority-preferred projects only to the extent the new majority agrees to fund the classic majority's preferred projects, and vice versa. Limiting an individual's charitable deduction to half of her income implements this bargain by ensuring that the amount of

[9] I acknowledge that many government projects would not be considered "public goods" in the economic sense. The point, however, is that the legislative process only funds projects (whether public goods or not) that do not suffer from government failure.

[10] Similarly, not all projects undertaken by non-profits constitute public goods in the economic sense. Mark A. Gergen, *The Case for a Charitable Contribution Deduction*, 74 VA. L. REV. 1393, 1398 (1988). Although the requirements of I.R.C. §§ 501(c)(3) and 170 generally ensure that their partial subsidies flow to organizations providing public goods, their contours are imperfect. *Id*; COLOMBO AND HALL, *supra* note 6, at 108. This means that not all organizations providing public goods qualify for such subsidies, and not all groups that do qualify provide public goods. *Id*. Generally speaking, however, groups qualifying for subsidies that do not provide pure public goods in the economic sense either provide impure public goods or provide some other "public benefit" to society. COLOMBO AND HALL, *supra* note 6, at 109. In other words, there are limits on which projects may receive these subsidies; one cannot qualify for a partial subsidy for just "any" project not funded by the government.

The point for my purposes is that some individuals with a differing view of what projects are good for society (including pure public goods, impure public goods, and other "public benefiting" projects) coalesce to receive partial funding for these projects. Because the literature with which I am working speaks of "public goods," however, I shall continue to use that term.

[11] As explored in Section V.C, the two majorities do not necessarily have to make the split 50/50. Splitting down the middle, however, may reflect common heuristics often observed in bargaining, even in situations where parties have unequal bargaining power (such as the Ultimatum Game). *See* note 191.

governmental subsidy to her preferred minority projects will not exceed the amount of taxes she pays to fund the classic majority's projects.[12] This bargain-saving role is, I argue, a compelling explanation for precluding a taxpayer from erasing her tax liability by making charitable contributions.

This Article proceeds as follows. Section II provides an overview of the income tax charitable deduction and the current percentage-of-income limitations. Section III explores whether the base-measurement theory for the deduction justifies limiting a given individual's deduction to some portion of her income, and concludes that at best, it does so only weakly. Section IV explains the subsidy theory for the deduction, assesses existing normative theories for precluding someone from zeroing out her tax liability by making charitable contributions, and concludes that none are satisfactory. Section V details the economic dual-majority bargain justification sketched out above. Section VI concludes.

II. An Overview of the Charitable Deduction and the Current Percentage-of-Income Limits

A charitable deduction has been part of the income tax since 1917. It allows individuals who make voluntary transfers to organizations formed for religious, scientific, literary, educational and other charitable purposes[13] to deduct such transfers from their adjusted gross income ("AGI").[14] Despite the deduction's permanent place in the tax system, no consensus exists as to its purpose. As explained in Sections III and IV, some theorists argue that the charitable deduction is

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[12] A tax credit limited to half one's tentative tax liability would have the same effect.

[13] Organizations eligible to receive tax-deductible contributions under § 170 generally are also eligible for tax-exemption under § 501(c)(3). To that end, analytical interpretations of purposes eligible for § 170 generally apply to § 501(c)(3), and vice versa. COLOMBO AND HALL, *supra* note 6, at 20. "Charitable purposes" has been broadly interpreted to include a wide variety of goals: preserving the environment, providing traditional legal aid as well as cause-oriented public interest litigation, furthering public health, supporting the arts, and so on. As a general rule, such organizations must provide some type of "community benefit" in the form of fulfilling needs unmet by the private market. John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 WASH. U. L.Q. 343, 366 (2004).

[14] I.R.C. § 170 (West 2007). Very generally, AGI represents one's net income after deducting from gross income the expenses of producing that income. *Id.* §§ 61 & 62.

necessary to measure income, while others believe that it is best characterized as a subsidy for charitable activity.[15]

Limits on the deduction have also been a permanent fixture in the tax system, although their form and severity have fluctuated.[16] Until the mid-1950's, most people were limited to a deduction equal to 15% of their income; the limit rose to 30% in 1954, where it stood until 1969.[17] Also prior to 1969, individuals whose charitable gifts and income taxes together surpassed 90% of their taxable income in eight of the ten preceding years were allowed an unlimited deduction.[18] Although intended to benefit nuns and other individuals taking a vow of poverty, the unlimited deduction had an unintended consequence: It enabled people to donate low-basis, high-appreciation property to charity and then receive an unlimited deduction based on the property's high fair-

[15] If the purpose is to subsidize charitable giving rather than measure income, a tax credit would achieve the same goal and may even be more efficient. *Compare* Jeff Strnad, *The Charitable Contribution Deduction: A politico-Economic Analysis*, at 272-76 *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 265 (Susan Rose Ackerman ed., 1986) (supporting a deduction) *with* Harold M. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, at 236 *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 225 (Susan Rose-Ackerman, ed., 1986). A tax credit would work as follows: Individuals would first compute their taxable income and tentative tax liability without regard to charitable contributions. Then, those making charitable contributions would be eligible to claim a tax credit to offset some of their tentative tax liability. MICHAEL J. GRAETZ AND DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 219-20 (5th ed. 2005).

[16] Initially, the deduction was limited to 15% of "net taxable income" with no carry-forwards for any unused deduction. This loosened somewhat in 1944, when the limitation changed to 15% of AGI (because AGI is generally larger than net taxable income, this resulted in a higher limit). It rose to 20% of AGI in 1952 and then to 30% in 1954; in 1964, carry-forwards were allowed. The current limit was codified in 1969. Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061-68 (2002).

[17] *Id.*

[18] I.R.C. § 170(b)(1)(c) (before repeal in 1969). *See also* R. Palmer Baker, Jr., *The Tax Treatment of Charitable Contribution Deductions Under the Tax Reform Act of 1969*, 20 TULANE TAX INST. 327, 328-31 (1971). Despite a 1924 Senate proposal to allow individuals who regularly contributed a substantial portion of their income an unlimited deduction, such a deduction was not implemented until 1964. As a result, the unlimited deduction was in effect only five years before repeal. Lindsey, *supra* note 16, at 1061-68. Interestingly, the legislative history of the 1924 proposal implies that taxing someone who was already benefiting society with large portions of his income seemed superfluous. The history provides that "[t]his provision is designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equaling virtually his entire income." *Id*. at 1061 n. 23.

market value relative to their income. Even though such individuals still retained substantial income for their own use, some paid no tax due to the unlimited deduction.[19] Congress repealed this targeted unlimited deduction in 1969, explicitly criticizing wealthy individuals who paid little or no tax due to the charitable deduction (even though this often stemmed from donating appreciated property, as described above, the provision's legislative history does not link the two).[20] Interestingly, the legislative history suggests that fewer than 100 individuals per year used the unlimited deduction, albeit at a cost to the Treasury of $25 million.[21]

Also in 1969, the general AGI limit was raised to its current level of 50%.[22] This limitation means that even if someone donates all her income to charity, she can only deduct up to 50% of her income in the year of the contribution. The remaining amount carries forward for five years. The general 50% limit applies to cash contributions to public charities.[23] If some of her contributions are of appreciated property or are to a private foundation,[24] more stringent AGI limitations of 30% apply. Contributions of appreciated property to private foundations are capped at 20% of AGI. Carry-forwards are allowed in those situations as well. The limits do not apply, however, if recipients of "achievement" awards such as the Nobel Prize transfer them to charity.[25]

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[19] *See* Halperin, *supra* note 4, at 24.
[20] Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550-52 (1969); Halperin, *supra* note 4, at 24..
[21] Baker, *supra* note 18, at 330.
[22] Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b)(1)(A), 83 Stat. 487, 550-51(1969).
[23] "Public charities" are the organizations that spring to mind when most people think of the words "charity" or "non-profit," for example, schools, homeless shelters, tutoring programs, churches, and the like. Such groups conduct charitable activities directly and obtain income from a range of sources, including donations from the public, dues from members, fees for services, and grants from private foundations. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 27 (8th ed. 2003). The term "public charity" is colloquial; these organizations are not a defined term by the Code.
[24] A "private foundation" (which is a defined term in § 509) is a charitable organization initially funded by a single source (such as an individual, a family, or a corporation), whose income comes from investments rather than fees for services or donations from the public, and that makes grants to other charities instead of conducting its own charitable activities. *Id*. at 274.
[25] I.R.C. § 74(b) (West 2007). Specifically, § 74 excludes from gross income "prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement" that are transferred to charity. Excluding from gross income funds that would otherwise be taxable renders the limits inapplicable.

Although the limits' legislative history suggests that they were intended to target a small number of wealthy taxpayers,[26] the limits apply across all income levels and on a larger scale than one might suspect. In 2003, approximately 500,000 returns included charitable deductions carried-forward from previous years.[27] The amount of these previously-unusable, carried-forward deductions that were usable in 2003 year totaled over $25.5 billion,[28] comprising about 18% of all individual income tax charitable deductions claimed in 2003. That amount exceeds the amounts of charitable bequests ($18.2 billion) and corporate giving ($11.1 billion) for 2003 and approaches the level of foundation giving for that year ($26.8 billion).[29]

What is surprising is the extent to which the limits apply to taxpayers at all income levels. Of the roughly 500,000 returns claiming a carried-over deduction in 2003, over 191,000 returns (about 38%) showed an AGI under $25,000. An additional 214,000 returns (roughly 43%) reflected an AGI between $25,000 and $100,000. Just over 89,000 returns (almost 18%) showed an AGI between $100,000 and $1,000,000; and only about 6,500 returns (approximately 1.3%) had an AGI greater than $1,000,000.[30] Because AGI reflects only current income and not accumulated wealth, it is likely that some of the generous lower-income taxpayers who carry-forward charitable deductions have substantial wealth yet little current income.[31] It is also likely, however, that others

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[26] *See* Section IV.B.4.

[27] MICHAEL PARISI AND SCOTT HOLLENBECK, INDIVIDUAL INCOME TAX RETURNS 2003 at 44, tbl.3 (2005), *available at* http://www.irs.gov. Due to the manner in which the IRS reports data, the amount of carried-over deductions claimed in a given year is a more accessible way of measuring the limits' impact than trying to ascertain the amount of deductions *not* claimed in a given year because of the limits. To be sure, however, this data does not illuminate how many contributions in a given year were not made at all due to the limits.

[28] *Id*.

[29] GIVING USA 2006 at 204.

[30] Author's calculations based on data at p. 44, Table 3 of PARISI AND HOLLENBECK, *supra* note 27.

[31] Looking at estate tax data sheds light on the interplay between accumulated wealth and income. David Joulfaian, an economist at Treasury, recently conducted a ten-year panel study of individuals dying between 1996 and 1998 that showed that a fair number of individuals with estates over $1,000,000 (in 1997 dollars) had mean AGIs lower than $1,000,000 for the ten years before death. Of such decedents, for example, approximately 1% had a mean AGI below $50,000; just over 2% had a mean AGI between $50,000 and $100,000; about 8% had a mean AGI between $100,000 and $200,000. Approximately 18% had AGIs between $200,000 and $500,000; and 19%

of these lower-income taxpayers do not have substantial accumulated assets and are not what most people would consider "wealthy."[32]

In the wake of Hurricane Katrina, these limits were temporarily lifted for contributions made between August 28, 2005 and December 31, 2005.[33] Although prompted by the hurricane, the Act removed the 50% AGI limitation for cash contributions to any public charity--whether engaged in hurricane relief or not. The Act's legislative history suggests that Congress's concern was two-fold: First, it wanted to spur giving to hurricane relief groups. In addition, Congress wanted to assist other charities susceptible to donor fatigue (from both the hurricane and the December 2004 tsunami) and to a potential drop in donations from rising gas prices and fears of an economic downturn.[34] One year later, in the Pension Protection Act of 2006, Congress again temporarily lifted the limits in narrow circumstances: The Act excludes from income IRA distributions made in 2006 and 2007 directly to charitable recipients of up to $100,000.[35] (Excluding such distributions from the retiree's income renders the AGI limits inapplicable.)

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had AGIs between $500,000 and $1,000,000. The remaining 47% had mean AGIs over $1,000,000. *See* DAVID JOULFAIAN, CHARITABLE GIVING IN LIFE AND DEATH 22 tbl.3 (2000), *available at* http://ssrn.com. It is therefore likely that at least some extremely charitable individuals with low AGIs have some accumulated wealth.

[32] The Treasury study also shows, however, that mean AGI tends to rise with estate size. *Id.* Thus, it is also quite likely that some extremely charitable individuals with low AGIs *do not* have much accumulated wealth and who are what we might consider lower- or middle-class. Unfortunately, more detailed information on these taxpayers—such as to which organizations they give, and why might someone with an AGI of only $50,000 give more then $25,000 in a year—is unavailable.

[33] Katrina Emergency Tax Relief Act, H.R. 3768, 109th Cong. (2005) ("KETRA"). The Act also temporarily repealed the then 3% phase-out of itemized deductions in § 68 for charitable contributions, and lifted the corporate limit from 5% to 10% (but only for contributions to hurricane-related charities).

[34] Statements of Representatives Mark Souder and John Hayworth in Congressional Record for Katrina Emergency Tax Relief Act, H.R. 3768, 109; Stephanie Strom, *Hurricane Tax Break Spurs Triple Projected Donations*, N.Y. TIMES, Apr. 21, 2007, at A9.th Cong. (Sept. 15, 2005), *available at* http://www.govtrack.us; Holly Hall, *A Special Katrina-Inspired Tax Break Produced Mix Results for Charities*, 18 CHRONICLE OF PHILANTHROPY at 18 (Jan. 26, 2006).

[35] Pension Protection Act of 2006, H.R. 4, 109th Cong. § 1201 (2006) (amending § 408(d)).

Unfortunately, it is too early to estimate, even roughly, whether these provisions will have a long-term impact on giving.[36] Early and unofficial data suggests that KETRA spurred $11 billion in charitable donations, costing the Treasury more than $3 billion—far greater than the estimated cost of $819 million.[37] However, anecdotal evidence suggests that while KETRA may have encouraged some gifts that otherwise would have gone unmade, it also simply shifted some giving planned for 2006 or later into 2005, as donors fulfilled pledges early or otherwise sped up giving to utilize the temporary provision.[38] In the past, short-term increases in giving due to temporary favorable tax provisions have been followed by short-term drops when the favorable provisions disappear, resulting in no real increase in overall gifts.[39] Many experts thus do not anticipate a long-term increase in giving from KETRA.[40] At passage, however, the Joint Committee estimated KETRA's revenue effect between 2006 and 2015 from lifting the limits and the 3% phase-out to be over $861 million dollars.[41] It is unclear what this suggests. One on hand, it may indicate that an increase in otherwise unmade gifts was expected. On the other hand, it may reflect an expectation that donors previously unable to deduct the full amount of

[36] For KETRA, this is so because gifts made in 2005 will appear on returns due as late as August of 2006, and a lag time exists between filing due dates and the IRS's release of statistics from a given set of returns. According to Melissa Brown, the editor of Giving USA, the IRS has indicated that it will not release final data on 2005 charitable giving until the fall of 2007. Telephone Interview with Melissa Brown (Jan. 8, 2007). For the Pension Protection Act, this is because the provision does not expire until the end of 2007, meaning that many gifts eligible for the provision have not even been reported to the IRS yet.

[37] Stephanie Strom, *Hurricane Tax Break Spurs Triple Projected Donations*, N.Y. TIMES, Apr. 21, 2007, at A9.

[38] GIVING USA 2006 at 67. It appears that large charities that reached out to their donors about KETRA's provisions (such as Princeton, Haverford, and the ACLU) were the main beneficiaries of KETRA's largesse. Holly Hall, *Time Short for Using New Tax Breaks to In crease Charitable Gifts*, 17 CHRON. OF PHILANTHROPY, Oct. 13, 2005, http:// www.philanthropy.com/free/articles/v18/i01/01001001.htm.

[39] GIVING USA 2006 at 124.

[40] For example, Patrick Rooney, the director of research at Indiana University's Center on Philanthropy, opined that "People are using these special incentives to pay off pledges early and make other gifts they were planning on making over the next several years. While there's no question that the Katrina tax break had a positive short-term impact, I don't know that anyone thinks that this means charity will increase dramatically over the next several years." Strom, *supra* note 37, at A9.

[41] JOINT COMMITTEE PRINT JCX-68-05, KATRINA EMERGENCY TAX RELIEF ACT OF 2005, 109TH CONG., ESTIMATED REVENUE EFFECTS TO H.R. 3768 (Comm. Print Sept. 21, 2005).

their gifts (even with the carry-forwards) would now be able to take a full deduction (meaning that overall giving was not necessarily expected to increase). Regardless of these provisions' ultimate impact, however, many in the charitable community believe that the AGI limits dampen giving.[42]

III. Base-Measurement and Limiting the Charitable Deduction

In exploring whether to limit someone's ability to reduce her tax liability to zero by making charitable donations, several possibilities exist. This Article explores the possibility that features intrinsic to the tax Code or to the legislative subsidy process justifies such a limit.[43] Determining whether the limits are justified based on the internal logic of the Code or the subsidy, however, requires understanding *why* the Code allows charitable deductions the first instance. Two rationales, detailed below, predominate in justifying the deduction: the base-measurement theory and the subsidy theory.[44] I argue that if one subscribes to the base-measurement theory, limiting a given individual's charitable deduction to some portion of her income is only weakly justified. If, however, one believes that the subsidy theory justifies the deduction, then percentage-of-income limits on the subsidy are strongly justified on economic theory grounds.

A. The Base-Measurement Theory for the Deduction

The base-measurement theory, first articulated by Professor William Andrews,[45] suggests that a deduction for charitable transfers is necessary to measure income accurately. Starting from the Haig-Simons

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[42] See, e.g, Strom, *supra* note 37, at A9. (one fund-raising consultant predicted that KETRA might spur as much as $10 billion in charitable gifts).

[43] A second possibility, of course, is that a reason extrinsic to the Code and the subsidy' process justifies a limit. As explained in the Conclusion, the second part of this series argues that limiting the subsidy granted any given individual is also justified on political theory grounds extrinsic to tax policy.

[44] My goal in this Article is not to critique or justify these rationales for the charitable deduction in the first instance. Rather, my goal is to assess whether, under each theory for the deduction, a limit based on what portion of AGI one's donations comprise is normatively justified.

[45] William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

definition of the ideal income tax base[46] as accumulation plus consumption,[47] Andrews argued that personal consumption (and therefore income) should not include amounts expended by an individual for charitable purposes.[48] In other words, such expenditures should be excluded from the ideal income tax base.

As explained by Andrews, "consumption" for purposes of measuring taxable income should include only the "private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others."[49] Charitable contributions, he reasoned, deflect resources away from private use and toward common goods "whose enjoyment is not confined to contributors nor apportioned among contributors according to the amounts of their contribution."[50] Under this reasoning, because any benefit the donor receives is necessarily shared by others, a charitable contribution should not constitute consumption.[51] In a similar vein, Boris Bittker has argued that charitable contributions have such a high moral value that they should be ignored when determining the amount of income at the voluntary disposal of the taxpayer—in other words, that they should not constitute consumption due to that high moral value.[52] To these ends,

[46] That is, what most scholars believe to be the purest definition of what should constitute "income" for purposes of levying an income tax in accordance with ability to pay. Although the Code departs from this ideal in many important respects, it is often used as a benchmark against which to measure various aspects of our current system. *See*, *e.g*., GRAETZ AND SCHENK, *supra* note 15, at 89-91 (5th ed. 2005).

[47] ROBERT M. HAIG, THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS, IN THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921), *reprinted in* AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup eds., 1959); HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

[48] Andrews, *supra* note 45, at 344-75.

[49] *Id*. at 346.

[50] *Id.* For example, "a wealthy man cannot purchase and enjoy the sound of a new church organ without conferring a benefit on his fellow parishioners . . . .[and] attendance at church on a particular Sunday, use of the town library, or listening to a symphony orchestra broadcast will not immediately prevent someone else from doing the same thing." *Id.* at 357-58. Modern economic terminology refers to such goods as "public goods;" Gergen, *supra* note 10, at 1397, and for that reason, some scholars have re-characterized Andrews's argument as simply another argument for subsidizing public goods. *See id.* at 1416.

[51] Andrews, *supra* note 45, at 344-75.

[52] Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 46-49, 58-59 (1972). *See also* Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 628 (1990) (arguing that charitable transfers should be exempted from tax due to their altruistic nature).

some tax theorists believe that allowing a deduction for charitable contributions is necessary to define the income tax base.[53]

B. Base-Measurement and Percentage-of-Income Limits

If a charitable deduction helps define the ideal income tax base, perhaps a limited deduction (rather than an unlimited one) most accurately measures income. This section explores two alternative conceptions of measuring income under which precluding a taxpayer from zeroing out her tax liability might be justified.

1. Measuring Consumption

Perhaps precluding someone from reducing her taxable income to zero by making charitable deductions reflects a notion that charitable transfers involve some element of personal consumption and therefore should not be completely excepted from tax. This rationale is initially plausible: Giving is voluntary, and donors choose to make donations instead of purchasing wine or vacation homes or whatever else it is on which they spend their money. It is thus possible that donors treat charitable giving as another voluntary consumption expenditure. This notion is buttressed by the fact that donors receive a variety of benefits in return for giving. Some are intangible, such as the "warm glow" that accompanies a good deed, the signaling of wealth to one's community, or membership in certain social circles.[54] Other benefits are more tangible, like the ability to enjoy an opera, attendance at a benefit party, nicer facilities at their children's school, and the like.[55]

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[53] *See, e.g.,* Andrews, *supra* note 45, at 344-75; John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 VA. TAX REV. 229, 233 (1984). As explained in note 15, *supra*, by definition, a deduction (as opposed to a credit) is used to determine the appropriate tax base. In contrast, after the tax base has been determined and tentative tax computed, credits are then used to adjust one's tax liability. Although a deduction and a credit each ultimately lower the taxes actually owed, as a technical matter, a deduction is the appropriate means of defining the tax base. GRAETZ AND SCHENK, *supra* note 15, at 219-20. To that end, this Section III looks only at a charitable deduction and a limit on that deduction based on one's AGI.

[54] *See*, *e.g*., Gergen, *supra* note 10, at 1408, 1430; John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 670-73 (2001); Eric Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 WIS. L. REV. 567, 574-77 (1997).

[55] Colombo, *supra* note 54, at 67; McNulty, *supra* note 53, at 236. JAMES J. FISHMAN AND STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 876-79

If charitable giving includes an element of consumption, then some limits on charitable deductions should apply.[56] This conclusion, however, does not justify an AGI limit that prevents someone from zeroing out her tax liability via charitable contributions. For several reasons, so doing is an ineffective means of reflecting that charitable transfers may contain elements of consumption.

First, it makes little sense to tie the amount of a transfer that is treated as consumption to the portion of one's AGI that it represents.[57] Let's use the existing 50% limit as an example, although the reasoning would apply with equal force to any other percentage limit.[58] Tying deductibility to AGI in this manner creates the following paradox: Someone who contributes 49% of her income to charity can deduct the full amount; no portion of her gifts is treated as consumption. In contrast, once an individual donates more than half her income to charity, an increasingly larger portion of her contributions is treated as consumption.[59] While donations may have different elements of consumption depending on the taxpayer's motives and the intangibles

(3d ed. 2006) (quoting GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR, REPORT OF THE [FILER] COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 107-111 (1975)).

[56] *See* Bittker, *supra* note 4, at 165; Mark Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 849-51 (1979) (criticizing Andrew's contention that charitable giving is not consumption in part because donors receive deference, respect, and attention); Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679, 707 (1988) (conceptualizing an ideal income tax as taxing the power to consume and concluding that spending cash or property on charitable purposes "represents a clear personal benefit to the donor"); STANLEY S. SURREY AND PAUL R. MCDANIEL, TAX EXPENDITURES 21 (1985); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 375-77, n.169 (1989); Strnad, *supra* note 15, at 278-86.

[57] Steurle and Sullivan, *supra* note 3, at 409.

[58] I emphasize my goal is to explore whether—as a *general* matter—the deduction should be limited to some portion of income and not whether the existing limit as currently structured is justified. My criticism is of using *any* percentage of AGI as a baseline, not of using 50% per se.

[59] To illustrate: If a donor contributes 60% of her income to charity, she can deduct five-sixths of the transfer (an amount equal to 50% of her AGI). Only one-sixth of her transfer is treated as non-deductible consumption. If she instead contributes 75% of her income to charity, she can deduct only two-thirds of the transfer. In that situation, twice as much of her transfer – one-third – is treated as non-deductible consumption. Under this reasoning, the same $100,000 transfer has differing elements of consumption based on what percentage of a donor's AGI it represents.

received in return, it is unlikely these are tied to the ratio of the size of the gift to AGI.

One might argue that the greater percentage of your income you donate, the more you value charitable giving, and therefore, your donations have a larger element of consumption than those of someone who donates a smaller share of her income. But this explanation fails on both a theoretical and practical level. On a theoretical level, it contradicts common understandings of marginal utility. These principles suggest that as contributions increase, the utility derived from each additional contribution decreases, thus contradicting the idea that increased contributions demonstrate increased consumption value.

This "increasing consumption element" justification for the cap is also problematic on a practical level. The Code is rife with dual-character receipts or expenditures that simultaneously contain elements of personal consumption and of non-consumption, such as employee fringe benefits, work expenses like clothing and commuting, and so on. Generally, the Code does not differentiate consumption and non-consumption on any type of basis unique to the taxpayer in question. Dual-nature expenses and receipts, for administrative ease, are generally treated one of three ways: (1) as all consumption (commuting), (2) as no consumption at all (most fringe benefits), or (3) the same portion of a given transaction is treated as consumption for all individuals (business meals). The Code, in other words, generally determines the treatment of such transactions according to the type of transaction, rather than the taxpayer's characteristics.

For these reasons, tying deductibility to the portion of a donor's AGI that a gift comprises is an inaccurate method of measuring consumption. Moreover, the existence of other types of limits that would better measure the amount of consumption in a charitable gift further suggests that precluding someone from zeroing out her taxable income via the charitable deduction cannot be justified on that ground.[60] Two types of such potential limits exist. First, limiting deductibility to

[60] Obviously, much more can be said about whether and how to structure limits on the charitable deduction that are designed to differentiate the consumption and non-consumption elements of a donation. My goal is neither to critique that goal, nor to propose a structure for so doing. I make these observations by way of contrast to illustrate how a limit based on the portion of AGI that a donation represents fails to do so.

some flat percentage of each contribution (much like allowing a deduction of 50% for business meals)[61] would reflect the idea that any charitable contribution contains both consumption and non-consumption elements simultaneously, regardless of how many other contributions a donor makes, her AGI, or the portion of her AGI represented by any given contribution.

Second, such a limit would likely differ based on the charitable recipient. For example, it is likely that giving to an opera you regularly attend, to your child's college, or to the local museum in exchange for a wing with your name on it has a greater element of consumption than giving to a soup kitchen or tutoring center across town. Simply limiting one's deduction to some portion of one's income in and of itself treats all charities equally, however, further suggesting that ferreting out consumption does not satisfactorily justify such a limit.[62]

2. Moral Theory

Alternatively, percentage-of-income limits might be tied to the notion that we have a moral duty to contribute to charity.[63] As a starting point, many religions hold that we have a duty to help those less fortunate, as do many secular conceptions of distributive justice.[64] Bittker (among others) has argued that this moral duty should preclude taxing charitable transfers, on the theory that the involuntary nature of a required tithe or other charitable gift means that it is not consumption.[65]

If required transfers are not consumption, one might argue that additional transfers above and beyond what is required *are* voluntary and therefore should be considered consumption. This distinction, coupled

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[61] I.R.C. § 274(n) (West 2007).

[62] As explained in Section II, the current rules impose lower percentage limits on contributions to private foundations as opposed to public charities (though they do not differentiate among public charities). As my goal is not to justify the exact structure of the current AGI limits but rather to answer the general question of whether the deduction should be limited to some portion of AGI, the initial sections of this Article set aside these types of distinctions. After having justified as a general matter such a limit, however, Section V.D.1 addresses whether different limits are justified.

[63] I thank Bill Klein for this suggestion.

[64] For a readable account of these philosophies, *see* DANIEL M. HAUSMAN AND MICHAEL S. MCPHERSON, ECONOMIC ANALYSIS, MORAL PHILOSOPHY, AND PUBLIC POLICY 99-133, 174-212(1996).

[65] Bittker, *supra* note 52, at 46-49, 58-59.

with the obligations we have to the broader community in addition to our church or our own personal philosophy, might suggest the following: That a certain percentage of your income is "God's"[66] money—not the government's—on moral grounds and therefore shouldn't be taxed, but anything beyond that is fair game for taxation. Under this reasoning, a limit based on what percentage of AGI a donation represents might be justified as reflecting the contours of one's moral duty to give to charity. It is possible, however, that such a limit would be lower than 50%, perhaps 10% to reflect traditional tithing requirements.

This line of reasoning, however, is problematic on two levels. First, it assumes that all charitable organizations have equal moral worth, glossing over *why* a moral duty to give exists in the first instance. For example, if religious tithing is required to support one's place of worship or because of a duty to help the poor, then such donations have more moral weight than donations say, to the opera. It is likely that—regardless of whatever moral philosophy one subscribes to—the philosophy in question would count some charities as morally superior to others.[67] For the reasons outlined in Section IV.B.2, *infra*, percentage-of-AGI limits are an inexact means of differentiating among the worthiness of various charities.

Second, this type of limit favors some types of moral philosophies over others. For example, philosophies stemming from organized religions often have set rules about "how much" giving is required (such as tithing 10% of one's income).[68] In contrast, many secular moral philosophies are much less specific. They tend to speak in vague terms such as "having a duty to ensure equality of welfare by giving to the poor," but generally do not specify what that duty entails.[69] Indeed, long-standing debates about the best mechanisms for implementing these general philosophies exist.[70] It is therefore

[66] Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 588-89 (1998).
[67] For a fuller exploration of how various accounts of distributive justice would each shape the contours of the charitable deduction, *see* Miranda Perry Fleischer, *Charitable Justice* (working paper on file with author).
[68] *See generally* Adam Chodorow, *God's Income Tax: What Jewish Tithing Practices Can Teach Us about Tax Reform* (March 10, 2006), available at SSRN: http://ssrn.com/abstract=889960, for a description of Jewish tithing requirements.
[69] *See* HAUSMAN AND MCPHERSON, *supra* note 64, at 99-133, 174-212.
[70] For example, many justify the estate tax on the grounds that moral philosophy requires ensuring that everyone has an "equal opportunity". Tax scholars debate,

impossible to know what amount of giving is required of individuals subscribing to these secular philosophies—and therefore where any percentage-of-income limit should be set. Tithing requirements are not helpful in this situation, for using them would favor religious over non-religious philosophies. Therefore, although a case can be made that although moral duty might justify percentage-of-income limits as a theoretical matter, practical considerations suggest that moral duty is not the strongest justification for such limits.

IV. The Subsidy Theory

Turning away from the base-measurement theory, this Section analyzes whether limiting the charitable deduction to some portion of one's income makes sense under the subsidy theory.[71] It argues that such a limit is not justified under any of the reasons that other tax scholars have previously suggested, forcing us to turn elsewhere for a justification. Such a limit cannot be justified as reflecting a desire to limit the private production of various public goods for reasons related to the goods in question or to prevent the wealthy from engaging in tax shelters. Instead, I argue that under the economic theory for the deduction, such a limit is compelled by the structure of our legislative process.

Under the subsidy theory, even if charitable transfers should be taxed in a pure Haig-Simons world, a deduction is justifiable as a tax expenditure to subsidize charitable activity.[72] A variety of arguments

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however, what that means in terms of actually structuring an estate tax. *See, e.g.,* ERIC RAKOWSKI, EQUAL JUSTICE 43-148, 149 (1991); David G. Duff, *Taxing Inherited Wealth: A Philosophical Argument*, 6 CAN. J. L. JURIS. 3, 45-57 (1993); Anne Alstott, *Equal Opportunity and Inheritance Taxation* at 5-12 (Feb. 17, 2007), available at SSRN: http://ssrn.com/abstract=944978.

[71] I reiterate that my goal is not to critique the subsidy theory. Rather, my goal is to determine whether, accepting that theory as a given, one can justify limiting the amount of subsidy granted to a given taxpayer based on her income (and ultimately, her tax liability). Similarly, my goal is not to favor either a deduction or a credit. Because the current subsidy is structured as a deduction, however, my argument largely focuses on a deduction limited to some portion of one's AGI. What follows, however, would apply with equal force to a credit limited to some portion of one's tentative tax liability.

[72] The deduction subsidizes charity in the following manner. Imagine a taxpayer in the 35% bracket who donates $100 to charity and receives a $100 deduction. This deduction reduces her tax bill by $35, meaning that she transferred $100 to charity at a net cost to her of $65. The government has subsidized her transfer to the tune of $35. By lowering the price of making charitable gifts, the subsidy is thought to increase

abound as to why subsidize charity. The more recent (and probably more accepted) explanation is grounded in economics: Quite generally, it theorizes that subsidizing charities is necessary to assist them to provide public goods that would otherwise be under-produced due to market and governmental failures.[73]

The more traditional explanation is that subsidizing charities is "good" because of the benefits they provide. Some theorists focus on the fact that charities relieve the government of burdens it would otherwise have to bear (for example, poverty relief). Others emphasize the role charities play in providing creative and diverse solutions to society's problems, or in offering alternative viewpoints in the arts and culture. Lastly, some scholars highlight the role that non-profits play in countering governmental power and enhancing pluralism.[74]

Although traditionalists rarely couch their explanations as such, their rationales are grounded in the ideas of public goods: Saying that the charitable sector does good things is arguably a non-economic way of saying that a strong and vibrant charitable sector is a public good in and of itself. Further, many of the good things traditionalists wish to subsidize –such as the arts and poverty relief--are public or quasi-public goods. Thus, the traditional and economic explanations for subsidizing charity do not differ as much as they initially seem to.[75] To that end,

taxpayer's incentives to make them. Gerald E. Auten, Charles T. Clotfelter, and Richard L. Schmalbeck, *Taxes and Philanthropy Among the Wealthy in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 392 (Joel B. Slemrod ed., 2000). This increased giving in turn enhances the scope and activity of the charitable sector. This subsidy can also be characterized as a "matching grant" from the government, which matches each taxpayer's donation with a grant equal to 35% of that gift. From that perspective, taxpayers can be thought of as individually directing the allocation of federal funds. Saul Levmore, *Taxes As Ballots*, 65 U. CHI. L. REV. 387, 405 (1998); Bittker, *supra* note 52, at 39; Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 379-80 (1972). Giving a taxpayer a 35 cent credit for every dollar donated has the same effect: In that case, a taxpayer who gives $100 to charity would receive a $35 credit with which to offset her tax bill, subsidizing her transfer to the tune of $35.

[73] *See generally* notes 9-10; Section IV.A.

[74] THERESA ODENDAHL, CHARITY BEGINS AT HOME 234 (1990); LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 11-13 (2d ed. 1999) *in* FISHMAN AND SCHWARZ, *supra* note 55 at 44; Bittker, *supra* note 52, at 39.

[75] *See also* Colombo, *supra* note 13 at 367 (2004) (arguing that reinterpreting the "community benefit" test for tax-exemption to focus on whether an organization

much of what follows addresses both strands of the subsidy theory simultaneously.

A. The Foundations of the Subsidy Theory

The subsidy theory for the deduction[76] has three foundational blocks: (1) an economic analysis of the role of charities in relation to for-profits and the government; (2) an explanation of the need for a subsidy to assist charities in fulfilling that role; and (3) the decision that the tax system is the best method of providing that subsidy. These foundations are addressed below.

1. Non-Profit Institutions, Market Failure, and Government Failure

As mentioned above, both the traditional and the economic explanation of the subsidy theory rest on the idea that the charitable sector *generally* provides public goods.[77] This is so because classic economic theory suggests that the market will undersupply public goods[78] due to free-riding and positive externalities.[79] Either the good

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increases a given population's access to services unavailable through the private markets bridges the traditional and economic subsidy arguments).

[76] This theory, which scholars use to explain the existence of both the charitable deduction and the tax-exempt status of charitable organizations, seeks to explain as a general matter the existence of tax subsidies for charitable activity. To that end, it would apply with equal force if the subsidy for donations was structured as a credit instead of a deduction.

[77] To be sure, not every organization eligible under § 170 to receive deductible gifts provides public goods (or even impure ones), and not all organizations providing public goods are eligible to receive deductible contributions. See note 10.

[78] As explained by Mark Gergen, "Two qualities define a public (or collective) good: one person's consumption of the good does not reduce its availability to others (i.e., the good is nonrival or in joint supply); and no one can be excluded from the good (i.e., the good is nonexclusive). To be public, a good need not be purely nonrival and nonexclusive. It is sufficient that the cost of excluding an individual is greater than the marginal cost of supplying the good to her as an additional user. It is then cheaper to supply the good freely than to charge each user for it." Gergen, *supra* note 10, at 1397.

[79] Gergen explains that this is so because "[s]ome people will refuse to pay for a good and rely on others to sustain it. Their refusal discourages more conscientious people from giving, because even conscientious people may not want to be taken advantage of by freeriders or they may despair of the possibility of successful collective action. The undiscouraged still may undergive because they undervalue collective goods, something that is easy to do because there is no market to set a price for the good." *Id.* at 1398; see also Weisbrod, *supra* note 6; COLOMBO AND HALL, *supra* note 6, at 101

remains undersupplied, or the government or non-profit sector remedies the market failure. Often, the government overcomes the market failure in question by "coerce[ing] 'purchase' by everyone via the power of taxation."[80] As explained below, however, in some instances the government cannot or purposefully will not remedy the market failure.[81] In that case, non-profits step in to help.

Existing literature suggests that government will remedy a market failure by funding a given public good at close to optimal levels if demand for that good is relatively homogenous (meaning that most voters demand roughly similar amounts of the good).[82] This argument first assumes that "governmental decisions in a democracy are roughly shaped by the desires of the majority of the electorate"[83] and that the median voter determines the level at which government supplies a given public good.[84] It concludes that if demand for the good is relatively homogenous, then the median voter's demand for the good closely mirrors that of voters on each extreme. In such cases, if the government supplies "enough" of a good to satisfy the median voter, it will be very close to supplying "enough" to satisfy most other voters. Little unmet demand remains.[85]

In contrast, the government will be unable to overcome a market failure when demand for a given public good is heterogeneous (that is,

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("If I know that Sarah next door will pay to support the PBS program I watch, there is no need for me to pay, as well, because once PBS sends out the signal, I can watch "for free").

[80] BURTON A. WEISBROD, THE NONPROFIT ECONOMY 20 (1988); COLOMBO AND HALL, *supra* note 6, at 101. This coerced purchase precludes free riding and ensures that individuals do not under-purchase public goods with large positive externalities. Once the government has thus coerced the purchase of a public good, it can either provide the public good directly (for example, TANF), or subsidize others to do so (for example, by granting a charitable deduction for donations to groups like soup kitchens).

[81] As explained below, I believe the instances where the government *cannot* remedy the market failure illustrate the application of the economic strand of the subsidy theory and the instances where the government *will not* remedy the market failure illustrate the more traditional subsidy theory.

[82] Weisbrod, *supra* note 6, at 21; COLOMBO AND HALL, *supra* note 6, at 101-113; Gergen, *supra* note 10, at 1403.

[83] COLOMBO AND HALL,, *supra* note 6, at 102 (citing Buchanan and Tullock, Weisbrod).

[84] I recognize that the majoritarian, median-voter framework described above is only one possible description of the democratic process. *See* note 6. *See* Section V.D.3. for an analysis of this issue using a non-median-voter framework.

[85] COLOMBO AND HALL, *supra* note 6 at 102; Weisbrod, *supra* note 6, at 22-26.

the amount each voter demands varies). This is so because if the government supplies enough of the public good to satisfy only the median voter, it will fall short of satisfying the "high-demand" minority.[86] I shall term this "accidental" governmental failure. The high-demand minority, failed by both the market and the government, must seek another solution to meet their demands.[87] One solution is the non-profit sector: Individuals who demand more of a given public good than the government can or will produce are thus often moved to donate time and money to non-profits to produce the good at a satisfactory level.[88]

Some readers might object here to the existing model on the grounds that the median-voter model is flawed. I acknowledge this objection, and briefly explore other models in Section V.D.4. At this point, however, what is important to take away from the model is that the government, for some reason, cannot overcome a market failure. As Professors Colombo and Hall have noted, the conclusion that high-demanders turn to non-profits in the face of government failure does not depend on *why* a government failure occurred.[89]

In fact, the term "government failure" may sometimes be a misnomer. This "failure" may not always be bad: In some cases, provision by a non-profit may be preferable to governmental provision. Maybe the non-profit sector provides the good more efficiently or more creatively than the government.[90] Perhaps voters wish to avoid sullying the good in question with the taint of coerced government funding, preferring the more morally pure halo of altruistic funding and production.[91] Or maybe voters recognize the importance of a strong non-profit sector that can serve as a check on government power and enhance

[86] That is, those who demand more of given good than the median voter. COLOMBO AND HALL, *supra* note 6, at 102; Weisbrod, *supra* note 6, at 22-26.
[87] COLOMBO AND HALL, *supra* note 6, at 102; Weisbrod, *supra* note 6, at 26-32.
[88] COLOMBO AND HALL, *supra* note 6, at 102; Weisbrod, *supra* note 6, at 30.
[89] COLOMBO AND HALL, *supra* note 6, at 102-103.
[90] *Id.* For example, even voters who support traditional governmental anti-poverty programs such as TANF may also recognize the value in having charities provide supplemental mechanisms for reducing poverty, such as Dress for Success. Sometimes charities may implement alternative ways to reduce poverty that the government did not think of, or sometimes charities may implement similar activities in a more efficient or appealing manner.
[91] COLOMBO AND HALL, *supra* note 6, at 102-03; Atkinson, *supra* note 52.

pluralism.[92] Lastly, sometimes the government *cannot* produce the good in question for constitutional or other reasons, as is the case with churches and other charities producing religious goods.

In such situations, voters may refuse to fund a public good—even at levels supported by the median voter and even if demand is fairly homogenous—on purpose. In other words, the refusal of government to provide the public good may stem not from shortcomings in the majoritarian process, but from reasoning and deliberation. I shall term this "purposeful" government failure.

2. The Role of Tax Subsidies

In both situations described above, governmental refusal to provide the desired public goods leads to production by the non-profit sector. But why are charities then subsidized by the government? If high demanders could not convince the government fully to fund the good (accidental government failure), why would the government agree to subsidize *any* of it? Alternatively, if high demanders could have obtained full government funding but chose to forego such funding (purposeful government failure), why ask for any subsidies? And why implement the subsidy through the tax system? Existing literature provides the following explanations.

a. Subsidies and "Purposeful" Government Failure

Let's start with the latter. Recall that purposeful government failure occurs when an affirmative decision is made to have the non-profit sector rather than government provide a given public good. Unfortunately, the same free-rider and externality problems that inhibit provision of these goods by the market also plague charities, making it difficult for the charitable sector to fulfill the role envisioned for it by traditionalists. Thus, it is necessary to help charities overcome these problems without polluting the attributes that make them preferable to government in the first instance.

Enter the charitable deduction: By lowering the cost of supporting such institutions, free rider problems decrease.[93] By the same

[92] ODENDAHL, *supra* note 74, at 234; Salamon, *supra* note 74, at 44.
[93] Hochman and Rodgers, *supra* note 15, at 225. See note 72 for an explanation of how the subsidy reduces the costs of giving. Non-profits also use a variety of additional

token, since the tax subsidy depends upon independent acts by non-governmental actors, all the benefits of non-governmental provision are saved.[94] In this manner, the charitable deduction is a product of purposeful government failure.[95]

b. Subsidies and "Accidental" Government Failure

What about the case of accidental government failure? In the median voter model conceptualized by existing literature, why would the median voter agree to partial funding of goods for which she refused to provide full funding?

Basic economic theory suggests one answer. As the price of a good decreases, the amount demanded increases. By replacing full funding of a public good with only partial funding via the deduction, cost is reduced and the amount demanded by the consumer/voter will increase.[96] The median voter will thus be willing to partially subsidize the good at greater levels than she would be willing to fully subsidize it. In other words, she receives some benefit from increased production of the good in question – enough to pay a little more for it via a tax subsidy, but not enough to pay for all of it.[97]

A similar rationale is that the subsidy represents a bargain among various taxpayers with minority interests.[98] The median voter may agree to provide partial subsidies for public goods from which she receives no direct marginal benefit *so long as* she receives something in return—partial funding for other public goods from which she will receive a benefit. In other words, disparate high-demanding minority groups coalesce to form a majority that agrees to provide partial funding for each other's projects.

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tools to reduce the free-rider problem, such as social pressure, donor recognition, appeals to altruism and the like.

[94] COLOMBO AND HALL, *supra* note 6 at 102-103; Hochman and Rodgers, *supra* note 15, at 226; Halperin, *supra* note 4, at 7. A tax credit would also have both of these characteristics.

[95] Many of the benefits describes in more detail in section IV.A.2.c. would also apply here.

[96] The same would hold true if the subsidy were structured as a tax credit.

[97] COLOMBO AND HALL, *supra* note 6, at 108; Weisbrod, *supra* note 6, at 36.

[98] COLOMBO AND HALL, *supra* note 6, at 108; *see also* Levmore, *supra* note 72, at 404; McDaniel, *supra* note 72, at 390-91.

Professors Colombo and Hall have expressed tax-exemption for charities in such terms:

> opera lovers are not willing to pay the full cost of the government studying ruffled grouse and vice-versa; but many ruffled-grouse lovers wouldn't mind paying a little for more opera, and many opera lovers wouldn't mind paying a little for a bit of ruffled-grouse studying, especially if the bargain results in each group getting some help for its own preferred interest. Because everyone who has a particular interest subject to government failure benefits from exemption, and because virtually all segments of society either have such an interest or directly benefit from such an interest . . . exemption becomes a method for government to assist *all* of society in providing goods and services that the market cannot provide . . . and which the government cannot fully provide directly because of structural deficiencies in the democratic system.[99]

Although Colombo and Hall were addressing subsidization via tax exemption, the same reasoning applies to subsidization via the charitable deduction (or credit). It also bears noting that the above explanation is not meant to explain what actually motivated Congress to implement the deduction or what actually transpired when Congress did so. Rather, the theory's proponents believe that it helps illuminate the continued existence of tax subsidies for charities: Taxpayers implicitly recognize and post hoc ratify the bargain it represents.

c. Subsidies and Taxes

A question remains: Why provide the bargained-for subsidy via the tax system instead of governmental grants? As an initial matter, using a deduction or credit means that individual taxpayers (instead of the legislature) decide which charities receive the subsidies and how large the subsidies should be.[100] Tying the subsidy to the preferences of

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[99] COLOMBO AND HALL, *supra* note 6, at 108 (emphasis in original).

[100] Halperin, *supra* note 4, at 7. This is because a deduction (or a credit) acts like a matching grant: When a taxpayer contributes $100 to a given charity and receives a $35 deduction, she and the government are now partners in the contribution. Her donation has triggered a $35 "match" from the government, and she is now responsible

individual taxpayers has several benefits. On a political level, this removes the decision about which projects to partially subsidize from the legislature, thus shielding those decisions from the vagaries of the legislative process and diminishing the prospect of further government failure.[101] The matching grant aspect, moreover, means that the charities that receive the most donations (that is, the most support from individual taxpayers) receive the largest subsidies. This allows the subsidies to reflect the electorate's enthusiasm for given charities, which might not happen if the legislature[102] determined how much of a subsidy each charity could receive.[103] Moreover, the matching grant is triggered only by an affirmative sacrifice on the part of the taxpayer (someone who makes a $100 donation and receives a deduction is, even after the $35 drop in her tax bill, still out of pocket $65).[104] Perhaps this spurs taxpayers to think more carefully about which projects they fund and to develop other commitments to those projects, such as volunteering.[105]

This structure also has economic benefits. Namely, it helps allocate the costs of funding a given charitable good among taxpayers in accordance with how much each values that good.[106] High-demanders

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for allocating $35 of federal funds to the charity of her choice. Giving a taxpayer a $35 credit has the same effect.

[101] Some readers may wonder why the legislature would purposely choose to delegate decision-making in this way. Professor Saul Levmore offers two explanations. The pessimistic view is that perhaps Congress conducted a rough cost-benefit analysis and decided that the benefits of having non-profits lobby for favors were outweighed by the costs of favoring some charities over others. The optimistic view is that the deduction is a "pre-commitment" to discourage rent-seeking that otherwise might occur. Levmore, *supra* note 72, at 408.

[102] Or some agency (such as the IRS) to whom Congress delegated that decision-making authority. One could imagine a situation, for example, where charities applied for federal grants from some central administrative agency. Such decisions also might not reflect the populace's enthusiasm. Of course, that agency could look at the level of donations received as a way of gauging support. That, however, leads us back to the merits of using the tax system – so doing would have the same effect and be more administratively convenient.

[103] Levmore, *supra* note 72, at 398-99, 404-405.

[104] The same holds true if she instead were to receive a $35 credit.

[105] *Id.* at 427, 411; Halperin, *supra* note 4, at 8.

[106] *See* Gergen, *supra* note 10, at 1400-1406 (summarizing the works of Jeff Strnad and Hochman and Rodgers on this point). This approximates what economists call a Lindahl solution, in which a collective good is funded at the level where the marginal benefits received by both contributors and non-contributors alike equals their respective marginal costs (in the form of voluntary contributions and cost-shifting from taxes that support the subsidy, respectively). *Id*; Hochman and Rodgers, *supra* note 15, at 228. Economists disagree, however, as to whether a tax deduction or a tax credit is

pay "more" by making charitable contributions. Low-demanders pay "less." Because they demand less, they do not contribute directly, but because they do receive some small benefit, the tax system forces them to make a smaller payment indirectly.[107] In contrast, if the government raised taxes on all citizens to provide direct grants to charities, it is quite likely that very few people's taxes would rise in proportion to how much they valued the charitable good now subsidized.[108]

On the other hand, routing the subsidy through the tax system may have some downsides. Some might argue that requiring a financial sacrifice from a taxpayer before allowing her to direct federal funds is tantamount to a "poll" tax requiring payment before voting.[109] Others question the fact that since the current subsidy is structured as a deduction, higher-bracket taxpayers receive more of a "match" per dollar than other taxpayers, and that non-itemizers receive no match at all.[110] Lastly, maybe this structure is undemocratic in that fewer citizens are able to influence the allocation of federal funds in this manner than via conventional voting, since far fewer individuals claim itemized charitable contributions on their tax returns than vote.[111] Maybe setting

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preferable on efficiency grounds. *Compare* Strnad, *supra* note 15, at 272-276 (supporting a deduction) *with* Hochman and Rodgers, *supra* note 15, at 236 (supporting a credit).

[107] For a discussion of whether it is morally "fair" to force low-demanders to partially subsidize such goods, see Gergen, *supra* note 10, at 1401 n. 27. Here, the bargain is "fair" because everyone has either the possibility of channeling federal funds to his or her project *or* the possibility of benefiting from others' projects as a recipient of charitable goods and services.

[108] Gergen, *supra* note 10, at 1402.

[109] Levmore, *supra* note 72, at 406.

[110] *See* Sections IV.B.1 and 2. It may be, however, that non-itemizers implicitly benefit from the bargain as recipients and patrons of non-profit organizations. See, e.g., Strnad, *supra* note 15, at 269; Bittker, *supra* note 52, at 55. (Unless any credit was refundable, individuals with no tentative tax liability would similarly receive no "match" from the government. For a discussion of refundable tax credits, *see generally* Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006)).

[111] Levmore, *supra* note 72, at 405. Approximately 80 million people, for example, voted in the 2002 mid-term elections. FEDERAL ELECTION COMMISSION, FEDERAL ELECTIONS 2002 (2002), http://www.fec.gov/pubrec/fe2002/pgcong.htm. In contrast, approximately 40 million tax returns reflected an itemized charitable deduction. (This could represent more than 40 million people, however, as some of those returns represent joint returns from married couples. INTERNAL REVENUE SERVICE, INDIVIDUAL INCOME TAX RETURNS, PRELIMINARY DATA, 2002, S.O.I. BULL. 15 (Winter 2004), *available at* http://www.irs.gov/pub/irs-soi/02inplim.pdf.

limits on the ability of a taxpayer to take a charitable deduction addresses some of these potential concerns.[112]

B. The Subsidy Theory and Existing Explanations for Percentage-of-Income Limits

Although the works discussed above help justify a tax subsidy for charitable contributions as well as explore its potential flaws, none attempt to justify limiting that subsidy based on one's income (in the case of a deduction) or tax liability (in the case of a credit).[113] This Section analyzes existing theories for such a limit under the subsidy rationale and finds that they do not hold up under scrutiny, requiring us to look elsewhere for any potential justification. (Although the goal of this Article is not to justify the existing percentage-of-income limits as such, looking at their history and what other scholars say about them sheds light on whether some such limit is justified.)

1. Protecting Progressivity

One common justification for the current limits—based on their *intended*[114] target of high income donors—is that they answer the recurring criticism that the charitable deduction adversely affects progressivity because it is worth more to a higher-bracket taxpayer than a lower-bracket one.[115] This raises the question whether precluding a

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[112] Structuring the subsidy as a refundable credit would equalize the match given to all charitably-inclined citizens, regardless of their tax bracket. It would not, however, address the other criticisms levied at the deduction.

[113] I do not mean this as a criticism of the subsidy theory itself or of those scholars, who were simply asking fundamental questions that requiring analysis before any further scrutiny of the deduction's details could occur. For example, Weisbrod, Colombo and Hall were addressing whether to have a subsidy in the first instance. Levmore asked whether that subsidy should flow through the tax system, and Strnad, Hochman and Rodgers questioned whether that subsidy should be a deduction or a credit.

[114] Although the limitations technically apply to taxpayers in all brackets, the legislative history suggests that they were intended to curb the extent to which the wealthy benefit from the charitable deduction. *See*, e.g., H.R. REP. NO. 91-413, *as reprinted in* 1969-3 C.B. 200, 234; S. REP. NO. 91-552, *as reprinted in* 1969-3 C.B. 423, 474; JOINT COMMITTEE ON TAXATION, TAX REFORM ACT OF 1969, 91ST CONG., 1ST SESS., EXPLANATION OF H.R. 13270, at 76 (1970).

[115] I thank participants at the 2006 Junior Tax Scholars' Workshop for this suggestion. *See also* MARILYN E. PHELAN AND ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 376 (2003) ("The reason for annual limitations on the amount of a charitable contribution deduction relates to our progressive tax system and the worth of

donor from zeroing out her tax liability by making charitable deductions might protect progressivity. Perhaps so doing reflects the view that under the traditional subsidy theory, any such subsidy must not adversely affect progressivity in order for it and the non-profit sector to play the positive role envisioned by its proponents. Or perhaps such a cap might reflect a view under the economic subsidy theory that certain voters are willing to fund others' pet projects only so long as the overall progressivity of the tax system is not impaired.

As an initial matter, there is no reason to preclude a taxpayer from zeroing out her liability for this reason if the subsidy is structured as a credit instead of a deduction.[116] This is so because credits have equal value to all taxpayers: A tax credit of $1 reduces the taxes of both a low-bracket and a high-bracket taxpayer by $1, regardless of their marginal rates. Non-refundable credits, of course, do not benefit taxpayers without any tentative tax liability. However, any given credit could be made refundable, thus benefiting such individuals.[117]

Protecting progressivity, therefore, plausibly justifies an AGI limit only if the subsidy is structured as a deduction. This is so because the criticism that the deduction hurts progressivity stems from the "upside down effect" inherent in any deduction: Because deductions reduce taxable income, they are worth more to higher-bracket taxpayers than lower-bracket taxpayers. To illustrate, imagine the following hypothetical rate structure:

If taxable income is over:	But not over:	The tax is:
$0	$50,000	10% of the amount over $0
$50,000	$150,000	$5,000 plus 25% of the amount over $50,000
$150,000	No limit	$30,000 plus 50% of the amount over $150,000

Now imagine three taxpayers, *Alex*, *Bonnie* and *Christine,* who each make a $100 donation. *Alex* is in the 50% tax bracket; his donation

aggregating deductions in one year as opposed to spreading such deductions over many years.").

116 For additional arguments favoring a credit *see* Hochman and Rodgers, *supra* note 15.

117 Batchelder, Goldberg, Jr., and Orszag, *supra* note 110, at 23.

reduces his tax bill by $50. Compare *Bonnie*, who is in the 25% bracket: Her deduction is worth only $25. *Christine*, who is in the 10% bracket, is even worse off. Her taxes drop by only $10 for every $100 that she contributes to charity. Taxpayers in higher brackets thus receive more of a subsidy than those in lower brackets. For this reason, many scholars feel that this upside down effect undermines progressivity.[118] Perhaps by limiting the deduction available to high-bracket taxpayers in any given year, AGI limits protect progressivity.[119]

This is a poor justification for AGI limitations for several reasons. Let's use the existing 50% limit as an example, although the reasoning would apply with equal force to any other percentage limit. First, such a limit applies only to the extent a taxpayer's charitable contributions exceed 50% of her AGI (or at whatever other fraction of AGI the limit is set). To continue the previous example, if *Alex*, *Bonnie* and *Christine* each contribute less than 50% of their income, exactly the same amount of progressivity results both with and without the limits: *Alex's* benefit is twice that of *Bonnie* and five times that of *Christine*.[120]

Second, even when this type of limit does apply, it will not always limit the magnitude of the upside down effect. This is because a limit based on what portion of AGI a contribution represents applies to taxpayers in all brackets.[121] If *Alex*, *Bonnie*, and *Christine* each give all their income to charity, *Alex* still receives the greatest tax benefit and

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[118] *See*, *e.g.*, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR, REPORT OF THE [FILER] COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 109 (1975); McDaniel, *supra* note 72, at 383; Kelman, *supra* note 56, at 833 n.7, 856-58; SURREY, PATHWAYS TO TAX REFORM at 21, 36; Gergen, *supra* note 10, at 1405. *But see* Griffith, *supra* note 56, at 363; Strnad, *supra* note 15, at 271-72.

[119] At this point, some readers may begin to wonder, "So what? What's wrong if the charitable deduction isn't progressive?" Two criticisms of the upside-down effect predominate. The first is that charities favored by the rich are over-funded, a concern addressed in Section IV.B.2. The second criticism is that the wealthy are not paying "enough" tax relative to their true ability to pay. As explored in Section IV.B.4, this concern is really about minimum tax issues. I address the concept of the upside down subsidy separately, however, because so many other commentators levy it, without more, as a criticism of the deduction.

[120] Although I reiterate that my focus is on a general limit on the subsidy given to any specific taxpayer and not on the current limits as such, the application of the current limits illustrates this point: As currently structured, they affect only about one-fifth of donors claiming a charitable deduction, meaning that they have no effect on progressivity 80% of the time. *See* Section II.

[121] *See* Section II.

Christine still receives the least. In that case, all that AGI limits do is cut in half the amount of the subsidy each taxpayer receives.[122] This decreases the nominal amount of *Alex's* benefit compared to *Christine's* (instead of benefiting 40 cents per dollar more than *Christine*, now he only benefits 20 cents more per dollar) but not its proportional magnitude. He still benefits five times as much as she does.[123]

This type of limit diminishes the proportional magnitude of *Alex's* benefit only if he is the only taxpayer affected by it. Assume, for example, that *Alex* donates all his income to charity and *Christine* donates only half her income. In that case, the proportional benefit that he enjoys compared to *Christine* diminishes (before, his benefit was five times as large as hers, now it is only two-and-a-half times as large).[124] Even then, however, this kind of limit does not erase the upside down effect.[125]

[122] Of course, if the limit was something other than 50%, it would reduce each taxpayer's benefit by some other fraction. The same reasoning applies, however.
[123] To illustrate, imagine that before applying the charitable deduction, *Alex's* income was $300,000, *Bonnie's* was $100,000, and *Christine's* was $50,000. After applying the charitable deduction and the AGI limitation, *Alex* reduces his income from $300,000 to $150,000 and his tax bill from $105,000 to $30,000. *Bonnie's* income decreases from $100,000 to $50,000 and her tax bill from $17,500 to $5,000; *Christine's* income drops from $50,000 to $25,000 and her tax bill decreases from $5,000 to $2,500. This means that *Alex's* $300,000 contribution cut his tax bill by $75,000. Put another way, his contribution received a 25% subsidy from the government. *Bonnie's* $100,000 contribution cut her tax bill by $12,500, resulting in a 12.5% subsidy by the government of her donation. *Christine's* $50,000 contribution reduced her tax bill by only $2,500 – a subsidy of only 5%. With or without an AGI limitation, *Alex* receives a benefit that is five times as large as the benefit that *Christine* receives
[124] Let's first assume that *Christine* (still with an income of $50,000) contributes half her income to charity. Because the limits don't apply in that event, she can deduct her entire $25,000 contribution. Her tax bill drops from $5,000 to $2,500; she receives a tax benefit of 10 cents for every dollar contributed. Next, assume that *Alex* contributes all his $300,000 income to charity, thereby triggering an AGI limit. In the year of contribution, he can deduct only half this amount, reducing his taxable income from $300,000 to $150,000 and his tax bill from $105,000 to $30,000. He now receives a $75,000 tax cut for making a $300,000 contribution, or a tax benefit of 25 cents for every dollar contributed.
[125] The existing limits as currently structured are even worse on this score. When incomes fluctuate over time, the current carry-forwards exacerbate the upside-down effect by essentially allowing income averaging. By prohibiting full use of the deduction in *Year 1*, the limitations preclude that deduction from soaking up income taxed at lower marginal rates. Instead, any deduction that is carried-over comes off the

Limits based on what portion of AGI a contribution represents thus protect progressivity only in very narrow circumstances and only in a limited manner. Because they apply only when donations exceed the specified percentage of income, they often do not impact progressivity at all. Moreover, even when triggered, the limitations merely dampen, and do not erase, the upside down effect. Even if the charitable subsidy is structured as a deduction, protecting progressivity is a poor rationale for limiting the deduction to some portion of income. The best remedy for the upside down effect, as several scholars have thoughtfully suggested, would be to replace the deduction with a credit.[126]

2. Limiting the Subsidy of "Rich People's" Charities

A similar potential rationale for limiting the subsidy available to any given donor also stems from the current provision's intended targeting of the wealthy:[127] Perhaps the AGI limit minimizes the governmental subsidy of charities favored by the wealthy,[128] either as part of an affirmative decision about what a proper charitable sector should be or as part of the bargain about which charities to subsidize. This idea stems from the well-documented fact that wealthier taxpayers generally—but not always—donate to different types of charities than other taxpayers. The former tend to favor colleges and universities, health institutions, and cultural institutions such as museums. In contrast, lower-income givers generally favor churches and other religious organizations, federated campaigns, and social service organizations.[129]

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top of the donor's highest marginal rate in the year used. Steurle and Sullivan, *supra* note 3, at 412.

[126] *See*. *e.g*., Hochman and Rodgers, *supra* note 15, at 236. This is so because credits have equal value to all taxpayers: A tax credit of $1 reduces the taxes of both a low-bracket and a high-bracket taxpayer by $1, regardless of their respective marginal rates. Non-refundable credits, of course, do not benefit taxpayers with no tax liability. Any given tax credit could also be made refundable, however. Batchelder, Goldberg, Jr., and Orszag, *supra* note 110, at 28-29.

[127] I reiterate that although my goal is not to justify the existing AGI limits, looking at their history may shed light on the broader question of whether taxpayers should be precluded from zeroing out their tax liability by making charitable contributions.

[128] I thank participants in the 2006 Junior Tax Scholars' Workshop for this suggestion.

[129] Auten, Clotfelter and Schmalbeck, *supra* note 72, at 403-06; ODENDAHL, *supra* note 74, at 49.

Why might limiting the subsidy of "rich people's charities" be desirable? Perhaps this desire reflects a belief that such organizations are less worthy of a subsidy because they lack a strong redistributional component.[130] Alternatively, maybe it stems from a belief that the institutions and projects favored by the wealthy—even if as socially worthy as those favored by the non-wealthy—are already sufficiently funded or perhaps even over-funded, rendering a subsidy unnecessary or even inefficient.[131]

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[130] Subsidizing charity is often justified on the grounds that it helps redistribute income downward. ODENDAHL, *supra* note 74, at 232 (citing ROBERT A. DAHL, DILEMNAS OF PLURALIST DEMOCRACY: AUTONOMY VS. CONTROL 6, 47, 83 (New Haven: Yale University Press 1982). Not all charitable transfers do so equally, however. On some level, gifts to Ivy League schools primarily benefit the wealthy students who comprise much of the student bodies, and gifts to art museums primarily benefit the upper and upper-middle class individuals who patronize such institutions. Because health organizations are not required to offer charitable care other than open emergency rooms, such gifts may also lack a redistributive element. Colombo, *supra* note 13 at 348. This is not to suggest that such contributions do not benefit the non-wealthy at all: Elite schools provide scholarships, a passion for art is not limited to the wealthy, and all of society benefits from medical and scientific advances. While fully assessing the redistributional element of such charitable contributions is outside the scope of this Article, it is not a stretch to suggest that many charitable donations by the wealthy do little to benefit the non-wealthy. See Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. (forthcoming 2007), available at http://ssrn.com/abstract=904229, for a more detailed exploration of which types of charitable transfers contain redistributive elements. Moreover, much evidence exists that charitable dollars tend to stay "close to home" with respect to the socio-economic status of those benefiting from a given charitable donation. *See*, *e.g*., ROB REICH, *Philanthropy and Its Uneasy Relation to Equality* at 27-49 in TAKING PHILANTHROPY SERIOUSLY: BEYOND NOBLE INTENTIONS TO RESPONSIBLE GIVING at 27-49 (William Damon and Susan Verducii, eds.); ODENDAHL, *supra* note 74; Auten, Clotfelter and Schmalbeck, *supra* note 72, at 397-400, 406.

[131] There is some evidence, for example, that capital projects in educational and arts organizations are over-funded, and that many university endowments are much larger than necessary to achieve their goals. Gergen, *supra* note 10, at 1409; Colombo, *supra* note 13, at 657; Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 22 (1990); *The University of Raising Big Money*, N.Y. TIMES, Oct. 21, 2006; John Hechinger, *When $26 Billion Isn't Enough*, WALL ST. J., Dec. 17, 2005, at 1. It might also be desirable to target subsidies to charities providing public goods that would not be provided absent a subsidy due to market and governmental failure. Gergen, *supra* note 10, at 1398; COLOMBO AND HALL, supra note 6, at 109. If operas, hospitals, and art museums would exist at optimal levels without a subsidy, then why subsidize them? Perhaps, then, limiting the ability of the taxpayers most likely to fund these projects and institutions is a roundabout attempt to remedy remedying an inefficient or unnecessary subsidization of them.

These desires do not, however, provide a coherent normative justification limiting a donor's charitable subsidy to some portion of her AGI (if a deduction is used) or her tentative tax liability (if a credit is used). Assuming that there is some merit to treating "rich people's charities" less favorably than other charities—and that workable distinctions could be drawn between such charities—such a limit is an ineffective means of implementing that principle for several reasons.

First, although there is often a link between donor income and the charities favored, there are numerous exceptions. Trying to limit the subsidy given to a particular set of charities by targeting the donors who tend to support them is both under- and over-inclusive. In addition to reducing the incentives of wealthy individuals who desire to benefit the opera, it would also reduce those of wealthy donors who want to support a local social service agency. Similarly, it would leave untouched the incentives of the non-wealthy who desire to support the ballet or some other less-favored "rich person's charity."[132]

Second, even assuming that the size of a donor's income is a workable proxy for the charities benefited, limiting the subsidy based on the percentage of a donor's AGI a gift represents (instead of limiting a donor's ability to take a deduction based on her absolute AGI) is ineffective.[133] A percentage-of-income limit, in and of itself, applies to taxpayers in all brackets.[134] Thus, they affect the incentives of a low-bracket taxpayer to donate a large portion of his income to the Salvation Army or his church as much as those of a high-bracket taxpayer to donate a similar share of his income to Harvard or the opera.[135]

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[132] Thinking about other ways to adjust the size of the subsidy given to various charities is useful to show how an AGI limit fails to do so: If we think certain charities should be treated less favorably than others, a more exact solution would be to vary the size of the allowable deduction (or credit) based on the nature of the recipient charity, not the donor's income or tax liability. I offer these suggestions merely by way of comparison; my goal here is not to propose a new structure for the charitable deduction that could differentiate among various types of charitable transfers.

[133] The same holds true if the subsidy were a credit limited to a percentage of tentative tax.

[134] *See* Section II.

[135] Again, comparing the current limits to other possibilities is useful to show how a percentage-of-income limit fails. A much more direct way of limiting the subsidy given to high-income donors would be to impose limits once a donor's AGI exceeds some absolute limit (instead of imposing limits once a gift exceeds some portion of the donor's AGI). A similar structure could be applied if the subsidy was a credit, looking

Moreover, even as applied to wealthy donors, percentage-of-income limits do a poor job of minimizing the subsidy given to charities favored by the wealthy.[136] Take the current 50% limit as an illustration. It applies only to the extent a donor makes gift exceeding half her income,[137] leaving most gifts by such donors untouched.[138] When it does apply, it treats the same $1,000,000 gift to the ballet differently depending on what portion of the donor's AGI the gift represents. If a donor with an AGI under $2,000,000 makes such a gift, some of the deduction is disallowed. But if a donor with an AGI larger than $2,000,000 makes the same gift, all of it is deductible. This means that sometimes, the wealthiest of the wealthy receive a *greater* subsidy for their gifts—which is not what one would expect if the limits were meant to limit the subsidy granted to such individuals.[139]

3. Backstopping the Preference for Donations of Appreciated Property

It is also plausible that precluding a taxpayer from zeroing out her income via charitable donations is justified to offset the preference given to donors of appreciated property.[140] With some exceptions,[141] donors can contribute property containing substantial unrealized gain, receive a deduction based on the property's fair-market value, and use that deduction to reduce taxable income from other sources (such as

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at a donor's tentative tax liability relative to some absolute cut-off, rather than looking at what portion of her tax bill her charitable credit represented.

[136] If the subsidy were a credit, the same reasoning would apply to a credit limited to a portion of tax liability.

[137] Or exceeding whatever other percentage of income (or tax liability) was agreed upon. My criticism is of using any percentage, not of using 50%. Even if the general AGI limit was something other than 50%, the same reasoning described above would apply.

[138] Given that donors plan around the limits, perhaps some given to such charities simply doesn't take place. If so, then the limits would have some impact on the amount of subsidy given to such charities.

[139] The same argument would apply if the subsidy were structured as a credit limited to some portion of one's tax bill.

[140] See text surrounding notes 18-20; Andrews, *supra* note 45, at 373 (suggesting that the limits minimize this preference but acknowledging that they are a "crude way" of so doing); Halperin, *supra* note 4, at 23-25 (suggesting that this preference influenced the repeal of the unlimited deduction but concluding that limits would be unnecessary if unrealized gains were not deductible).

[141] For examples, donors of tangible personal property unrelated to a recipient charity's exempt purpose are limited to a deduction equal to basis.

salary income). Because of the realization requirement, this puts donors of appreciated property in a better position than donors of cash. Maybe limiting the subsidy to some percentage of income or tax liability erases this preference.

To illustrate the preference given to donors of appreciated property, compare *Diane*, who receives a salary of $1,500, with *Ed*, who receives a salary of $600 but also owns stock (with a basis of $100) that appreciates by $900 during the year (to a fair market value of $1,000). Economically, both are in the same position; each is better off to the tune of $1,500. Due to the realization requirement, however, *Diane*'s taxable income is $1,500, while *Ed's* is only $600. He will, however, pay tax on the unrealized appreciation when he sells the property, thus putting him roughly in the same position as Diane (and making the Treasury whole) when viewed over time. (Of course, *Ed* has enjoyed the time value of money in the meantime and will likely enjoy preferential rates when he sells.)

Now imagine that *Diane* contributes $1,000 cash to charity and can deduct that full amount. Her taxable income drops to $500 (resulting in a tax bill of $175, using a flat 35% rate for illustration). Compare *Ed*, who donates his stock with a FMV of $1,000 and a basis of $100. If he can deduct the full fair market value, he ends up with no taxable income in the year of donation, owes no tax that year, and never catches up with *Diane* since he has divested himself of the property before realizing any gain from it. Not only is *Ed* never taxed on the unrealized gain from the property donation, now he is not taxed on his salary income (which he kept and lived off of). And if he had other income as well, some of that would be offset by the portion of the donation exceeding his salary income.[142]

Limiting donors to some portion of their AGI does not, however, put *Ed* on equal footing with *Diane*. First, this type of limit applies to donors of cash as well as property. If, for example, a 50% limit applies to both *Ed* and *Diane*, the following happens: Based on her $1,500 AGI,

[142] Throughout this discussion, the same distortions would result if the subsidy was a credit limited to some portion of tax liability and *Ed*'s credit was based on the full fair market value of his donation. Although the mechanics would be different, the credit would still enable *Ed* to offset tax on some of his salary income, and limiting *Ed*'s credit based on its relation to his tax liability would simply lessen, not erase, the preference given to him over *Diane*.

Diane can only deduct $750 of her $1,000 cash contribution. This gives her taxable income of $750 and a tax bill of $262.50. Based on his AGI of $600, *Ed* can only deduct $300 of his $1,000 contribution. This gives him taxable income of $300 and a tax bill of $105. The relative preference given to *Ed* has lessened, but has not disappeared. *Ed* will still never catch up to *Diane*, since he gave away the property and will never realize gain from it.

Even limiting *Ed* to a smaller percentage of his AGI than cash donors does not solve this problem. Take, as an example, the existing rule limiting taxpayers like *Ed* to 30% of their AGI. In that situation, *Ed* would only be able to deduct $180 of his contribution. His taxable income would be $420 and his tax bill would be $147, which is still lower than *Diane*'s tax bill. Applying different limits to *Ed* and *Diane* minimizes the preference, but does not erase it.[143]

The only way fully to erase the preference is either to (1) limit *Ed*'s deduction to his basis[144] or (2) allow him a FMV deduction but force *Ed* to realize and recognize gain upon donating appreciated property.[145] In both situations, *Ed* would have taxable income of $500, thus putting him on equal terms with *Diane*.[146]

That each of these two alternatives erase the preference given to donors of appreciated property more thoroughly and more directly percentage-of-income limits suggests that this goal, standing alone, may not be the best justification for these limits. Given that such limits do reduce the preference somewhat, however, this goal may still provide some—but just not sole—support for precluding a taxpayer from zeroing out her tax liability via charitable gifts.

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[143] Andrews, *supra* note 45, at 373.
[144] In that situation, he would have gross income of $600 from his salary, less a $100 deduction (the amount of his basis), yielding taxable income of $500. If a credit was in place, this preference would be erased by calculating the credit with respect to the property's basis and not its fair market value.
[145] Here, *Ed*'s gross income would be $1,500 ($600 salary plus $900 gain from the property) and he could take a $1,000 deduction (the FMV of the property), giving him taxable income of $500. Alternatively, if a credit was used, Ed's gross income (and his tentative tax bill) would increase due to realization but his credit would be calculated on the full value of the property.
[146] *See*, *e.g.*, Halperin, *supra* note 4, at 24-25 (arguing that "trading an unlimited deduction for constructive realization would substantially improve the equity of the tax system").

4. A Crude Alternative Minimum Tax

Of all the existing normative rationales for limiting someone's charitable deduction to some portion of income, the notion that so doing serves as an alternative minimum tax has the most scholarly support.[147] This support stems both from dissatisfaction with other potential justifications and from the legislative history of the existing caps.[148]

First, as Steurle and Sullivan have noted, almost every other existing justification for limiting the deduction based on how much of one's income a donation represents ends up in the same place: reflecting, on some level, a desire to make sure that people do not spend "too much" money on charitable projects instead of paying taxes. For example, criticism of the upside down effect of the deduction often reflects a concern that the wealthy are not paying "enough" tax relative to their ability to pay.

The legislative history of the current caps also supports this alternative minimum tax idea. As mentioned in Section II, before 1969, an unlimited income tax charitable deduction was allowed under certain conditions. When Congress repealed this allowance,[149] it emphasized the unfairness of "allow[ing] a small number of high-income persons to pay little or no tax on their income."[150] The House Report explained that "Ours is primarily a self-assessment system. If taxpayers are generally to pay their taxes on a voluntary basis they must feel that these taxes are fair. Moreover, only by sharing the tax burden on a fair basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers."[151] The Senate Report echoed these concerns,[152] as did the

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[147] *See*, *e.g.*, MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 190 (10th ed. 2005) (the "limit shows that Congress was unwilling to permit the very rich to reduce their taxes to zero by turning over their entire incomes to charity and living out of savings."); FISHMAN AND SCHWARZ, *supra* note 55, at 714 ("The limitations reflect a judgment that no taxpayer should completely avoid federal income tax by making charitable contributions"); Steurle and Sullivan, *supra* note 3, at 414 (the cap "most likely is meant to address concerns analogous to those used to motivate a minimum tax--namely, no taxpayer should be able to eliminate his or her entire tax liability through a combination of deductions, credits, and exclusions, no matter how meritorious their purpose.").

[148] Steurle and Sullivan, *supra* note 3, at 408.

[149] Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550-52 (1969).

[150] H.R. REP. NO. 91-413, *reprinted in* 1969-3 C.B. 200, 234.

[151] *Id*. at 200.

Joint Committee's Explanation, which noted that "it appeared that the charitable contributions deduction was one of the two most important itemized deductions used by high-income persons, who paid little or no income tax, to reduce their tax liability."[153]

While this justification is sounder than other existing rationales, it does not go far enough. It does not address what, exactly, is unfair about allowing an individual to donate all of his income *to charity* instead of paying tax. The rationale behind the AMT is the concern that in its absence, some individuals could retain substantial economic income for their *own use* that would go untaxed due to tax preferences incentivizing activities deemed beneficial to society.[154] For example, one oft-repeated justification for the AMT's passage in 1969 was a Mrs. Dodge, who received $1 million of untaxed income from tax-exempt municipal bonds.[155] While the preference for tax-exempt bonds[156] is thought to subsidize state and local government activity (thereby benefiting society), it also directly benefits the individual holders of such bonds, who receive the income tax-free.[157] As such, a preference for some municipal bonds is disallowed in the AMT.

Many other preferences available under the regular tax system but not available under the AMT also directly benefit the taxpayer claiming the preference (while benefiting society at large). For example, § 179 expensing and accelerated depreciation both spur investment activity (benefiting society) but also benefit the taxpayer in question by

[152] S. REP. NO. 91-552, *reprinted in* 1969-3 C.B. 423, 423, 474.
[153] JOINT COMMITTEE ON TAXATION, TAX REFORM ACT OF 1969, 91ST CONG., 1ST SESS., EXPLANATION OF H.R. 13270, at 76 (1970).
[154] *See* MICHAEL J. GRAETZ AND EMIL SUNLEY, MINIMUM TAXES AND COMPREHENSIVE TAX REFORM, IN UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 385 (1988), quoted in GRAETZ AND SCHENK, *supra* note 15, at 771 ("[T]he enactment of a minimum tax . . . is an admission that the U.S. income tax involves trade-offs among competing objectives. Congress wants to use income tax provisions to encourage particular investments or activities and to promote certain societal goals. At the same time, it wants to ensure that the income tax burden is distributed generally in accordance with taxpayers' abilities to pay.").
[155] GRAETZ AND SCHENK, *supra* note 15, at 768.
[156] I.R.C. § 103 (West 2007).
[157] To be sure, the benefit is less than it first appears due to tax capitalization, *see generally* Boris Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, in* THE ECONOMICS OF TAXATION (Henry Aaron and Michael Boskin, eds. 1980), but such holders still receive income from the bonds free of federal income tax.

offsetting otherwise taxable income retained for personal use. To preclude a taxpayer from fully offsetting such income in that manner, the AMT disallows § 179 expensing and requires the use of a less-accelerated depreciation schedule. The AMT thus targets tax preferences that, while benefiting society, still enable individuals to shelter income that they actually retain and use for their own benefit. At root, it is the fact that individuals retain untaxed income for their own benefit that triggers AMT concerns, not the use of a deduction in and of itself.[158]

In contrast, true charitable contributions do not benefit the donor the same way the tax preferences described above do. By definition, if you give money to charity, you do not retain it for your own use:[159] A complex web of rules that apply to both public charities and private foundations are designed to prevent taxpayers from (1) creating "sham" charities that benefit donors and other private individuals instead of the community at large and (2) reaping personal gain even from charities that do benefit the public.[160] As with any anti-abuse rule, however,

[158] That said, in some respects, the tax preferences mentioned above share one characteristic with the charitable deduction: It could be argued that in all cases, the taxpayer is being rewarded with a deduction for doing something "good" with his money (be it helping charity, spurring investment, or assisting localities). To that end, the argument in Section V of this Article may also apply to justify limits on other tax preferences as well. For example, perhaps the AMT's disallowance of accelerated depreciation reflects a compromise among various groups with different preferences concerning the level of business subsidies. Alternatively, the arguments in Section V of this Article may justify expanding the AMT to cover charitable donations (as an alternative to limiting the charitable deduction, standing alone). Although this Article concludes that these arguments counsel for percentage-of-AGI limits on the deduction as opposed to other types of stand-alone limits within the charitable deduction provisions, it does not assess the relative merits of implementing these theories within the charitable deduction versus within the AMT.

[159] As explained in Section IV.B.3., *infra*, allowing donors of appreciated property to deduct the full FMV of such property allows them to use a deduction to offset income that they actually retain for their own benefit. Although the AMT briefly disallowed a charitable deduction for untaxed appreciation in the mid-1980s, it contains no such remedy today. And, as explained in Section IV.B.3, while precluding a donor's ability to deduct the full fair market value of appreciated property may well be a valid goal, AGI limits are an ineffective means of reaching that goal.

[160] *See*, *e.g*., I.R.C. § 170(c)(2)(C) (precluding a deduction for contributions to public charities in which the net earnings inure to the benefit of private individuals); *id*. § 501(c)(3) (requiring "no private inurement" to maintain tax-exempt status); *id*. § 4958 (imposing an excise tax on public charities and individuals engaging in acts of private inurement deemed not severe enough to warrant loss of exemption); *id.* § 4941 (imposing very strict limitations on transactions between private foundations and their founders and donors).

organizations and taxpayers sometimes purposefully evade these rules, allowing donors to reap direct benefits from charities to which they have contributed. In fact, such abuses likely motivated the enactment of both the AMT and substantial reforms of the rules governing charities in the 1969 Tax Reform Act. Such abuses cannot, however, justify using percentage-of-AGI limits today as a means of taxing individuals who retain otherwise exempt income for their own benefit: To the extent that the current anti-abuse rules allow manipulation by taxpayers, they should be tightened. Alternatively, if the rules are clear but simply ignored, the rules should be more stringently enforced. Limiting a donor's ability take a deduction based on the percentage of income the gift represents is an overbroad means of remedying such abuses.

Keeping these anti-abuse rules in mind and viewing the purposes of an alternative minimum tax in the light described above, the question of what is unfair about an allowing an individual who does not retain income for her *own* use but instead donates it *all to charity* to pay no income tax still remains. If someone retains no income and donates it all to a cause that, by benefiting society, is deemed worthy enough to merit a charitable deduction in the first instance – such as feeding the poor, supporting educational institutions, or funding the arts – why should she still pay income tax? Two recurring answers are explored below.

a. Benefit Theory

One oft-mentioned possibility is that everyone should pay some tax because everyone benefits from certain goods provided by the government: roads, sidewalks, national defense, fire protection, and so on.[161] The problem with this argument, however, is that there is generally no link between taxes paid and benefits received. On a theoretical level, it is hard to determine how much someone benefits from the government. Take police protection. Do all citizens benefit equally? Do the poor benefit less, because the property protected is worth less? Or do they benefit more, because they are unable to afford private security?[162] On a more administrative level, there is no attempt

[161] I thank Amanda Frost, Clare Huntington, and David Zaring, among others, for this suggestion.

[162] *Compare* Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 451-55 (1952) *with* Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 491-97 (1987).

to match taxes paid with benefits received. My taxes fund the fire department regardless of whether I ever call them; if I did call them, they would respond without regard to whether or how much tax I had paid. Without more context, then, the argument that everyone should pay some tax because everyone benefits from government does not justify limiting the extent to which a given individual can receive a deduction (or credit).[163] Our tax system is based on ability to pay, not benefits received.

b. Optics

A second oft-mentioned possibility is that it just "seems unfair" to allow some individuals to escape taxation completely—even if they retain no income for their own use.[164] Perhaps precluding taxpayers from zeroing out their tax liability by making charitable gifts can therefore be justified on the grounds of optics: Allowing someone to pay no tax (regardless of the reason) "undermines public confidence in the tax system by inducing widespread perceptions of tax inequity."[165] This perception of unfairness might encourage more taxpayers to find every-increasing ways of avoiding taxes by engaging in tax shelters or simply not reporting income.[166] (This argument is, of course, a second justification for alternative minimum taxes, but with different implications than the justifications discussed above in Section IV.B.4.)

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[163] At this point, some readers may argue that all citizens benefit from the provision of public sidewalks (for example), and if enough citizens did not pay any tax, then public sidewalks might be under-funded. This argument basically restates the proposition that public sidewalks are subject to free-rider problems in the market, thus requiring government taxation to overcome this problem. The possibility that the government may lack enough funds to pay for the sidewalks leads to the dual-majority bargain proposed in Section V. Other readers may argue that the benefit theory is not predicated on the purchase of specific public goods by a taxpayer, but rather on the purchase of "civilization." Therefore, since everyone benefits in some fashion or another, everyone should pay something. Again, however, this raises the question of why, if you are already "paying" for civilization by giving all your money to a charity that provides some type of social good, should you pay again in the form of taxes? The next Article in this series answers that question.

[164] I thank Lee Fennell for urging me to give this argument weight.

[165] GRAETZ AND SUNLEY, *supra* note 154, quoted in GRAETZ AND SCHENK, *supra* note 15 at 771.

[166] GRAETZ AND SCHENK, *supra* note 15 at 28; *see generally* JEFFREY H. BIRNBAUM AND ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH (1987) (detailing the passage of the Tax Reform Act in 1986, done in large part to fight such happenings).

As with the traditional alternative minimum tax argument, however, this reasoning does not go far enough. It does not address what, exactly, *seems* unfair about not taxing individuals who have voluntarily donated all their income to a cause that by definition benefits the general public (just as tax monies do). Such individuals are benefiting society just as much (if not more) than individuals who do not contribute to charity but pay taxes.[167] What, precisely, is unfair about allowing such individuals to pay no income tax? Again, traditional tax policy arguments for a minimum tax do not answer this question.[168] The next Section seeks to do so.

V. A Better Tax Policy Justification: The Dual-Majority Bargain

A more compelling rationale for precluding charitable donors from zeroing out their tax liability with their gifts can be found by revisiting the economic strand of the subsidy theory in the context of our political system. This Section does just that. As previously described, the subsidy theory conceptualizes charitable tax subsidies as a bargain among various voters to overcome simultaneous market and government failures.[169] As detailed below, I suggest that limiting the subsidy for donations is a necessary second bargain (what I call the "dual-majority bargain") that enables the initial bargain to hold: Limiting the deduction is the classic majority's way of making sure that its priorities in the democratic process are funded even if they agree to partially subsidize minority projects via the deduction.[170] (The same holds true regardless of whether the subsidy is structured as a deduction or a credit).

Focusing on this reason for limiting the subsidy granted to any given charitable donor provides a better tax policy justification for this

[167] Take two taxpayers with incomes of $100,000. The first makes no donations, and pays $35,000 in tax, which, broadly speaking, benefits the public. If the second donates all her income to charity, then she pays $100,000 (far more than the first taxpayer!) toward projects that also, broadly speaking, benefit the public.
[168] As Boris Bittker has argued, "[i]f a taxpayer contributes 100 per cent of his income to charities, it is preposterous to suggest his character will suffer if he does not pay "some" amount in taxes. For those who fear that we will be unable to carry on as a nation if everyone adopts the practice of giving of all of his income to charities, I suggest there are greater dangers on the fiscal horizon to which they could turn their attention with profit. BITTKER, *supra* note 52 at 62.
[169] *See* Section IV.A..
[170] As explored later, the idea of wanting to make sure the government has enough money left to fund its own priorities may also be relevant under some strands of the traditional subsidy theory. *See infra* note 217.

type of limit than those rejected above. As a matter of the subsidy's structural logic, limiting one's deduction based on what portion of one's income it represents[171] is at least as good as, and likely better, than other possible limits in achieving this goal. As a matter of broader tax policy goals, however, such a limit balances two goals that are sometimes in tension: (1) maximizing the subsidy given to charity and (2) addressing the unfairness resulting from allowing some individuals to fund only their preferred vision of the public good and none of the vision of the public good set by their fellow citizens in the democratic process.

A. Limiting Generosity to Uphold the Bargain That Makes the Charitable Deduction Possible: the "Dual-Majority" Bargain

My argument that precluding taxpayers from zeroing out their taxable income via charitable gifts is justified stems directly from existing literature discussing the bargain among minority taxpayers who coalesce to create a majority for purposes of approving a tax subsidy in the first instance.[172] Recall that Colombo and Hall posited that opera lovers would be willing to work with ruffled-grouse lovers so long as they were repaid in kind. Once opera lovers and ruffled-grouse lovers strike this bargain and form a new majority willing to approve partial subsidies via the charitable deduction,[173] two majority groups simultaneously exist. The "classic majority" represents the majority in which the median voter approves the lighthouse or national defense or other projects not subject to government failure. The "new majority" represents the new group that has coalesced to help fund each others' pet projects.[174] By definition some voters are members of both majorities simultaneously.

Another bargain must now be struck between these two majorities (or voters who belong to both majorities must weigh their

[171] Or limiting a credit based on what portion of one's tax bill it represents.
[172] *See* Section IV.A.
[173] I reiterate that this theory does not attempt to explain what actually happened in Congress when it implemented the deduction. Rather, this theory attempts to justify the continued existence of a deduction or other subsidy: People allow it to continue because they implicitly recognize they will lose something if it is repealed.
[174] I acknowledge that in some instances, preferences other than those of the majority may control the legislative process. Because existing literature uses a majoritarian model, I use that as my starting point. I explore other possible models in Section V.D.3.

competing desires), and this bargain is represented by limiting the subsidy for charitable donations. The classic majority will agree to subsidize the opera or the ruffled-grouse, but only if the new majority also agrees to contribute something to the lighthouse or national defense.[175] Existing literature ignores this second bargain, which I term the "dual-majority bargain."

Without that second bargain, high-demanders could substitute completely their view of the public good for that initially set by the classic majority in the traditional democratic process. A cap on the subsidy for charitable donations ensures that such individuals may have government subsidize their view of the public good, but only if, in return, they also subsidize the goods demanded by the classic majority. Without the cap, the bargain among the two majorities might falter, and the newly-formed majority that has agreed to subsidize each other's minority projects might unravel.[176]

To take an extreme example, imagine a society in which a "new majority" has approved a charitable deduction (or credit) under the bargaining model described above. Next, assume that two diseases exist in this society, *A* and *B*. *Disease A* kills only a handful of people each year; *Disease B* kills thousands. Majoritarian preferences as determined by the median voter (the classic majority) will likely fund governmental research on *Disease B*, but not *Disease A*. Now suppose the wealthiest member of this society, *Francie*, has a brother who suffers from *Disease A*, and *Francie* accordingly makes a large donation to a charity to fund research on *Disease A*.[177]

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[175] For a discussion of this reasoning in the context of non-majoritarian models of the legislative process, s*ee* Section V.D.3.

[176] My theoretical model of the dual-majority bargain – like the existing theoretical model of the first bargain justifying the deduction's existence – does not attempt to explain what actually happened in Congress when limits were passed. I offer this theory as a justification for the continued existence of *some* type of limit on how much any given individual can reduce his her tax liability by making charitable contributions (albeit not necessarily the current 50% of AGI limit): Both majorities implicitly recognize that allowing individuals to zero out their taxable income by making charitable contributions may have consequences that they fear.

[177] This is, of course, an extremely stylized example. Some readers may prefer to think of *Disease B* as representing all of the projects not suffering from government failure that the classic majority agrees to fund, and *Disease A* as representing other projects that *Francie* believes better contributes to the public good broadly speaking (whether such projects, as explained in note 10, are true public goods, impure public goods, or other projects providing a public benefit).

Giving *Francie* an unlimited deduction allows *Francie* to undercut the preferences of the classic majority: theoretically, she could pay no taxes at all and thus fund none of the research on *Disease B*.[178] If *Francie's* tax revenues would otherwise comprise a substantial portion of the community's revenue, this would drastically reduce revenue available to fund research on *Disease B*.[179] *Francie* could thus over-ride the preferences expressed by the classic majority to fund research on *Disease B*. If that were possible, it is unlikely that enough members of the classic majority would join those individuals seeking partial subsidies for minority projects to form the new majority.[180]

A cap on the deduction[181] allows both majorities to exist simultaneously. The classic majority agrees to subsidize activities that it does not prioritize (*Disease A*), but only if individuals whose preferences are partly subsidized (that is, members of the new majority) also agree to support the majority's preferences (*Disease B*) by paying some tax.[182] This bargain-preserving role justifies the need somehow to prevent taxpayers from zeroing out their tax liability by making charitable gifts.

B. Focusing on the Dual-Majority Bargain Extends Previously Insufficient Justifications for AGI limits to a Satisfactory Level

Focusing on the dual-majority bargain better answers the questions unresolved by existing justifications for precluding someone from zeroing out her tax liability via charitable gifts. Recall that Section

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[178] That is, fund none of the government projects desired by the classic majority.

[179] Due to the distribution of the tax burden, this is not an impossible scenario. In 2002, for example, the top 10% of taxpayers paid over 62% of federal income taxes. GRAETZ AND SCHENK, *supra* note 15, at 22. It may be unlikely, however, given the government's ability and propensity to borrow to finance deficit spending.

[180] The same is true if the subsidy was a credit not limited to some fraction of *Francie*'s tentative tax liability.

[181] Or credit.

[182] Although the model I have set forth to this point envisions the classic majority as being comprised of individuals voting to fund government projects directly, some members may also be individuals who derive other indirect subsidies from the tax system (for example, real estate developers who benefit from the many tax breaks for housing, *see* Roger Lowenstein, *Who Needs the Mortgage Interest Deduction?*, N.Y. TIMES MAGAZINE, March 5, 2006 at 78) and for that reason have a stake in ensuring that funds flow to the classic majority (without such funds, they would receive no subsidy).

IV.B. argued that many of those justifications – for example, the notion that the limits might enhance progressivity or serve as an alternative minimum tax—were not satisfying because those explanations did not answer the further question of *why* those goals matter. Why make sure the rich pay "enough" tax even if they make large charitable gifts? Why make sure everyone pays some tax in addition to making donations that fund public goods? The optics argument explored in IV.B.4.b. took a stab at answering those questions: Because it seems unfair. As previously argued, however, this justification, standing alone, still does not go far enough: Why, exactly, does not taxing people who donate all their income to charity seem unfair?

Thinking about the dual-majority bargain helps answer these questions. The problem solved by that bargain was the fact that an unlimited charitable deduction (or credit) would allow some individuals to fund only their preferred vision of the public good and none of the government's vision of the public good. Taken to an extreme, this could leave the government without enough revenue for its own projects. Viewed through this framework, those previously-unsatisfactory justifications for limiting the charitable subsidy can be recast as variations on two themes: (1) ensuring the government has enough revenue to fund its own priorities and (2) precluding individuals with minority preferences from undermining the preferences of the majority. It is not enough that everyone contributes to the public good broadly speaking. Rather, everyone must pitch in to fund what the government prioritizes so that individuals with the ability to make large donations cannot undercut the legislative process and leave the government's projects under-funded.

The hearings for the 1969 reforms that repealed the unlimited deduction reflect this concern. It appears that some legislators were concerned about the ability of wealthy people, through charitable contributions that completely erased tax liability, to supplant governmental decisions about which goods and services should be provided to the public at large and instead insert their own decisions about what should be provided. For example, one legislator arguing for the caps bemoaned the fact that the wealthy could control what services are to be provided while "the great mass of the American people … have to pay for what the great, large, big Government decides are the services they are going to render."[183] Another argued that he was "really concerned over the ability of a few individuals to actually appropriate what I would call Federal funds, because these funds have been short-circuited from the Treasury and are under the control of these few wealthy individuals who decide which goods and services should be provided."[184]

This illuminates what the optics argument is really about: Even if wealthy individuals contribute to society through charitable contributions, their choice to give to charity in lieu of paying taxes could leave the government without enough funds for its own projects. It is the ability to single-handedly over-ride the preferences of one's fellow citizens that seems unfair.[185] Precluding an individual from zeroing out her tax liability via charitable contributions ensures that everyone contributes something to what their fellow citizens deem good and prevents them for undermining the decisions made in the legislative process. Of course, whether or not one views that ability as actually unfair turns on one's political philosophy. The next article in this series will argue that liberal democratic theory also justifies this kind of limit and that allowing some individuals to opt out completely would, as a matter of political theory, be unfair and is inconsistent with our democratic structure.

C. Implementing the Dual-Majority Bargain

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[183] *Hearings Before the Committee on Ways and Means on Tax Reform*, 91st Cong., 1st Sess., Part 4 of 15, at 1571 (1969) (statement of Rep. Byrnes in Feb. 26-27, 1969 hearings).

[184] *Id.* at 1577 (Statement of Representative Utt).

[185] *See also* Buckles, *supra* note 4, at 985-86 ("But for [the AGI' limitations, a wealthy taxpayer could avoid paying taxes by donating all of her income the charity and living off of her savings. …To allow all of the resources of the wealthy to fund those charitable activities that they value, at the cost of denying the federal government any control over the use of such funds, may simply be politically unacceptable to governmental policymakers"); George F. Break, *Charitable Contributions Under the Federal Income Tax: Alternative Policy Options*, *in* SPECIAL BEHAVIORAL STUDIES, FOUNDATIONS AND COPORATIONS, 3 [FILER COMMISSION] RESEARCH PAPERS at 1521, 1524 (1977) (suggesting that limits on the charitable deduction may be justified because "permitting [some privileged individuals] to contribute only to their own privately chosen public goods while everyone else has to contribute to collectively chosen public goods is an option of dubious merit" but declining to analyze whether limits such as the AGI limits are an adequate constraint).

Identifying the need for a dual-majority bargain, however, does not necessarily justify—as a matter of the deduction's structural logic—limiting the deduction to some portion of the donor's AGI.[186] Three types of limits might, as a structural matter, ensure that the classic majority maintained enough funds for its own projects: (1) AGI limits, (2) caps on the portion of each contribution that is deductible, or (3) absolute dollar ceilings on the amount a given individual could deduct in a given year.[187] Thus, percentage-of-income limits are justified as a means of implementing the dual-majority bargain only if they are the most appealing of these three options to those involved in the bargain.

A simple analogy helps illustrate the pros and cons of each of these three limits. What the two majorities are really bargaining about is how to split the governmental "pie" that is available to fund public goods. The pie is comprised of two ingredients: (1) taxes received by the government for projects it conducts directly and (2) the subsidy given to charitable projects via foregone revenue from the charitable deduction.[188] At some point, the two majorities reach an agreement about what share of the pie each receives, and for administrative reasons, this will likely be expressed in a fraction: Maybe one side gets 1/3 and the other 2/3, maybe one side gets ¼ and the other ¾, or maybe they agree to split the pie equally.

Let's assume, for illustration, that the two majorities agree to an equal, 50/50 split. This division provides a simple model, and although it is not inevitable, it is quite plausible.[189] Here's why. As a starting point, recall that in describing the initial bargain for the charitable deduction, Colombo and Hall posited that opera lovers are willing to "scratch the backs" of ruffled grouse lovers so long as the favor is returned.[190] Arguably, that initial bargain among the minority taxpayers

[186] Or limiting one's charitable credit based on the portion of a donor's tentative tax liability that it represents.
[187] If the subsidy were via a credit rather than a deduction, the parallel limits would be (1) a credit limited to some portion of tentative tax liability, (2) percentage caps on the portion of a given contribution that was creditable, or (3) absolute dollar ceilings on the amount of credit any given individual could use in a given year.
[188] Or the foregone revenue if the subsidy were a credit.
[189] *See infra* note 191.
[190] COLOMBO AND HALL, *supra* note 6, at 108.

who coalesce to form the new majority is maintained over time only if the back-scratching is roughly equal.[191]

Similar reasoning plausibly applies to the second bargain between the classic and new majorities that leads to a limited deduction.[192] In that interaction, a feasible, attractive, end point is that each majority bargains for the possibility of an equal amount of government funding for its preferred projects.[193] The classic majority agrees to the partial subsidies desired by the new majority, and vice versa, but only if they split the available subsidies equally. With respect to charitable gifts, this means that individuals with strong minority interests can have their project subsidized up to the point where that subsidy equals the amount they pay in taxes which fund the classic majority's projects (such as the lighthouse), but no more.[194] Returning to our previous example, *Francie* is allowed to take a charitable deduction

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[191] I acknowledge that an equal, 50/50 split is not necessarily the only result that will enable the bargain to hold. Although a 50/50 split is somewhat arbitrary, it does accord with many people's intuitions about what is fair, which in turn affects their bargaining approaches. To that end, a 50/50 split is a convenient number that people often resort to when reaching a compromise. Several experiments relating to rational choice and behavioral economics demonstrate this, as does some empirical evidence on actual bargaining situations. One such experiment is the ultimatum game, which involves two players. The first is given some amount of money, perhaps $10 or $20. She proposes a split of that sum to the other player, who either accepts or rejects her offer. If the second player accepts the offer, the money is split as proposed. If the second player rejects the offer, neither walks away with anything. Rational choice suggests that the first player should propose a split clearly in her favor: the reasoning is that even if she only offers the second player a few dollars, the second player is better off accepting and getting a small amount of money rather than rejecting and getting nothing. Despite this reasoning, the proposal seen most often in participants is a 50-50 split. Russell B. Korobkin and Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics,* 88 Calif. L. Rev. 1051, 1135 (2000). Similarly, empirical studies of cropsharing farming contracts between landlords and tenants in places ranging from Illinois to India show that a 50-50 split is most common, regardless of the bargaining power of each party and the underlying economic features of the transactions. H. Peyton Young and Mary A. Burke, *Competition and Custom in Economic Contracts: A Case Study of Illinois Agriculture,* AM. ECON. REV. 559, 560-562 (2001). One plausible explanation is that choosing an "easy" fraction (such as 50-50) is attractive. *Id*. at 561-62.

[192] Or that would lead to a limited charitable credit.

[193] For the classic majority, the funding comes from tax revenue that funds the projects approved by the median voter. For the new majority, the funding comes in the form of reduced taxes due to the charitable deduction (or credit).

[194] For the reasoning just described, a 50/50 split is not the necessary endpoint for this bargain, either, although it is a plausible one.

of $100 (funneling $35 to *Disease A*) so long as she pays taxes on $100 (funneling $35 to *Disease B*).[195]

This means that a bargain has been struck whereby the new majority is allowed to use half the pie for its pet projects, but no more. The other half must go to the government to fund its projects. Of course, members of the new majority might choose to forego some or all of their half of the pie, but the key is that they have bargained for the option to have half the pie.

The question then becomes, what type of limit best ensures that the new majority can obtain as much of its bargained-for half of the pie as it desires?[196] As explored below, AGI limits better protect that bargain than per-transfer limits or per-taxpayer ceilings on the deduction.[197]

1. Per-Taxpayer Dollar Ceilings and the Dual-Majority Bargain

Applying a dollar ceiling on any given individual's deduction splits the pie down the middle only in extremely narrow circumstances.[198] To illustrate, first think about the pie in the aggregate, as comprised of the gross personal income tax revenue collected in a year, without regard to any single taxpayer's contributions. Imagine that the total AGI of all the taxpayers in this simplified world would be $3,000,000, yielding a pie of approximately $1,000,000 (using a flat 35% rate for simplicity and rounding).[199] This means that after a bargain to split the pie equally has been struck, the new majority should get up to $500,000 in subsidies for its projects.

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[195] If the subsidy were structured as a 35 cent credit for every dollar donated to charity (which would be comparable to a dollar deduction for every dollar donated), *Francie* would be entitled to a credit of $35 so long as she paid $35 in taxes.

[196] The following arguments, although they use a 50/50 split for illustration, would apply with equal force to any other division of the pie that the two majorities might agree to, such as ¼ and ¾ or 1/3 or 2/3, and so on. The only difference would be the numbers used for illustration.

[197] Likewise, if the subsidy was a credit, limiting the credit to some portion of one's tentative tax liability does so better than a per transfer limit on the credit or an absolute dollar cap per person on the credit.

[198] Although the following analysis focuses on a deduction (since that is our current structure), the same result would hold if the subsidy were a credit.

[199] This is so because aggregate taxable income of $3,000,000 and a tax rate of 35% would yield approximately $1,000,000 in tax revenues.

Per-person dollar ceilings reflect this division only in a static world. To illustrate: A per-person ceiling that in the aggregate allowed taxpayers to deduct up to $1,500,000 (that is, half of the total AGI of $3,000,000) would split the pie down the middle.[200] One could simply divide the aggregate allowable deduction of $1,500,000 by the number of taxpayers in this hypothetical world to arrive at the "correct" per-person ceiling. If there were ten taxpayers, each should be allowed to deduct up to $150,000; if this world contained 15 taxpayers, each should be allowed to deduct up to $100,000, and so on.[201]

Let's say that initially there are 10 taxpayers and each is allowed to deduct up to $150,000, resulting in an aggregated deductible limit of $1,500,000. If the society's total AGI increases but the per-person limit stays the same, then the new majority does not get its bargained-for half of the pie. It gets $1,500,000, but now the classic majority gets all of the increase in AGI. If AGI doubles to $6,000,000, then the classic majority gets 75% and the new majority 25%. Likewise, if the per-person limit stays the same but the number of taxpayers increases, the new majority gets too much: Assume that total AGI stays at $3,000,000 but now this world contains 15 taxpayers: Now the new majority can deduct up to $2,250,000, which means that it gets 75% and the classic majority only gets 25%.[202]

A per-person cap on the deduction (or credit) therefore splits the pie exactly in the manner bargained for by the parties only in extremely limited circumstances. In the real world, AGI fluctuates over time, as do the number of taxpayers.[203] It is highly unlikely that any single cap would reflect the exact bargained-for division of governmental funds.

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[200] Under this scenario, taxable income would be $1,500,000 and tax revenue would be roughly $500,000. The total amount of charitable deductions claimed would also be $1,500,000, yielding a subsidy of roughly $500,000 to the donors' favored projects.

[201] If the subsidy were a credit, the aggregate allowable credit in this example would be roughly $500,000. (Having an aggregate AGI of $3,000,000 yields approximately $1,000,000 in tentative tax liability to be split up). If there were ten taxpayers, the correct per person credit would be $50,000; if there were 15 taxpayers, the correct credit would be $35,000, and so on.

[202] The same distortions would result if the subsidy were structured as a credit limited with an absolute per person dollar cap.

[203] *See* MICHAEL PARISI AND MICHAEL STRUDLER, SELECTED INCOME AND TAX ITEMS FROM INFLATION-INDEXED INDIVIDUAL TAX RETURNS, 1990-2004, S.O.I. BULL. 75 (Spring 2007), *available at* http://www.irs.gov/pub/irs-soi/90-04indiv.pdf.

Starting from the aggregate pie and then crafting a per-person limit to divide the aggregate pie therefore does not work in a non-static world. In the face of changes such as total income or the number of taxpayers, the only way to maintain the bargained-for-split of the overall pie is to focus on each individual taxpayer's pie:[204] If the two majorities each bargain for half of *Alex's* pie, half of *Bonnie's* pie, half of *Christine's* pie, and so forth, then across taxpayers, they will have bargained for half of the total pie. Getting the bargain right on the individual level necessarily means that the bargain will be right in the aggregate—even in the face of changing circumstances—whereas the opposite is not true.

Per- person dollar ceilings, however, will not get the bargain right on an individual level. Any given per-person dollar limit will be more than half of many taxpayers' incomes, and will be less than half of many other taxpayers' incomes. It will only be happenstance that it is exactly half of any given taxpayer's income.

On the other hand per-person dollar ceilings may get the overall division roughly correct. Maybe rough justice, coupled with the fact that per-person dollar ceilings are easy to understand and are similar to other limits in the Code[205] renders them a "good-enough" method of implementing the dual-majority bargain. While such caps might ensure that each majority has roughly enough for its preferred set of projects, they do not address the optics problem described above. This is so because whatever cap that is picked will allow some taxpayers, but not others, to deduct all their income and thus fund none of the priorities set by the legislative process.[206] The perception that some individuals might be able to undermine the decisions of their fellow citizens still remains.

[204] Recall that in the above analysis, we first looked at total income in the aggregate in order to determine which per person-limit would implement a bargained-for split of the pie. Once a given per-person cap is set, however, it is almost certain that either total income or the number of taxpayers will fluctuate. Unless the per-person cap also fluctuates in tandem with those factors (which would be administratively difficult, if not impossible), it will no longer reflect the appropriate division of funds.

[205] *See*, *e.g*., I.R.C. § 163(h) (West 2007) (imposing a ceiling on mortgage interest deduction).

[206] And would hold true if the subsidy were structured as a credit with a per-person dollar ceiling.

Perhaps this perception only matters in the case of "wealthy" people. If so, a low per-person cap isn't problematic on optics grounds. The problem is that any realistic per-person cap would likely be fairly high,[207] thus enabling a large percentage of people to pay no tax. If we only cared about requiring the super-ultra-wealthy to support government projects, then a high per-person cap would still satisfy the optics problem. This, however, raises its own set of troubling implications: Why should one set of individuals have a different set of obligations vis-à-vis their fellow citizens than another set?[208]

For this reason, therefore, it seems that a per-person dollar cap on the charitable deduction (or credit) is not the best way to implement the dual-majority bargain. Although so doing might roughly implement the bargained-for division of funds, it would not address the optics problem by ensuring that each taxpayer contributes not simply to "good projects" generally speaking but to the good projects chosen by their fellow citizens.

2. Per-Transfer Limits and the Dual-Majority Bargain

Nor are per-transfer limits an appealing way of implementing the dual-majority bargain. As an initial matter, such limits would not split the pie in the manner bargained for in the dual-majority bargain.[209] As explained above, the only way to ensure that the aggregate pie is split down the middle is to ensure each taxpayer's pie is split down the middle. To illustrate the effect of a per-transfer limit, let's imagine *Gail.* Assume that she has income (before charitable deductions) of $100,000 and faces a tax rate of 35%. *Gail*'s income produces an individual pie of government funds worth $35,000. Under the reasoning described above, a bargain has been struck whereby she is allowed to use half ($17,500)

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[207] This is based solely on intuition. Right now, many large and influential charities rely heavily on a small number of large gifts (in addition to a large number of small gifts). One can only imagine the outcry if individuals could no longer deduct more than $500,000 or $1,000,000 or even $2,000,000 or $5,000,000 each year. As a matter of political reality, therefore, it seems likely that any per person ceiling would be so high as to be meaningless for most people.

[208] The next article in this series will address that question on political philosophy grounds.

[209] Although this analysis continues to use a 50/50 split as an example, the reasoning would apply to any other split the parties made.

for her pet projects, but no more.[210] The other half must go to the government to fund its projects. Of course, *Gail* might choose not to use any or all of her half of the pie, but the key is that the new majority has bargained for her to have that option.

Will allowing taxpayers to deduct a set percentage of each transfer implement the dual-majority bargain in an appealing way? The likely answer is no. If *Gail*'s ability to use the charitable deduction is limited on a per-transfer basis, she is cheated out of part of her half of the pie unless she transfers all her income to charity. To illustrate, if her only charitable contribution for the year is a single \$10,000 donation, she should receive a full \$10,000 deduction, which would be equivalent to allowing her to take out a \$3,500 piece of the pie for her preferred project.[211] If, however, she can deduct only a portion of that \$10,000 transfer, she does not receive the full subsidy due to her (since she should be able to access up to \$17,500). A per-transfer limit thus precludes individuals in the new majority from receiving their bargained-for share unless they contribute their whole income.[212]

Moreover, if *Gail*'s donations exceed her income for the year, then the government is cheated out of part of its half of the pie. To illustrate, imagine that taxpayers can deduct 50% of each donation. Next, suppose that despite having an income of only \$100,000, *Gail* donates \$200,000 to charity. Even if she could only deduct 50% of each gift, she could still take deductions totaling \$100,000 and wipe out her tax liability. Regardless of what the per-transfer limit was, *Gail* could hypothetically donate an amount larger than her income, take deductions totaling more than half her income, and thereby deprive the government of part of its half of the pie.

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[210] Of course, *Gail* is quite free to contribute more to her vision of the public good. My emphasis here is on her ability to direct funds otherwise flowing to the government to that vision.

[211] The \$10,000 deduction lowers her tax bill by \$3,500, generating a \$3,500 "matching transfer" to her chosen charity.

[212] This reasoning applies regardless of what portion of the pie each majority ends up being able to bargain for. It would apply, for example, even if the new majority was only able to bargain for a share of the pie equal to 25, 30 or some other percent of the pie. It also holds if the subsidy is structured as a credit limited to some portion of each transfer (that is, a credit equal to less than 35 cents for each dollar donated to charity). To adapt the example in the text, giving *Gail* a credit of less than \$3,500 for a \$10,000 donation deprives her of the full subsidy bargained for on her behalf.

Moreover, per-transfer limits do not fully addresses the optics problem. As demonstrated above, they still allow some individuals potentially to zero out their tax liability via charitable contributions. The unfairness resulting from the ability of some individuals to potentially undermine the decisions made by the legislative process still remains.[213]

3. Percentage-of-Income Limits and the Dual-Majority Bargain

A limit based on percentage-of-AGI (or tentative tax liability, in the case of a credit), however, solves the problems inherent in the other two limits. First, unlike per-person dollar caps, percentage-of-income limits keep the bargained-for division of the pie constant in the face of changes such as aggregate AGI and numbers of taxpayers. Moreover, such limits solve the optics problem while ensuring that each majority receives their bargained-for division of the pie when they contribute less than their entire income.

To illustrate, imagine a rule limiting each donor to a deduction equal to 50% of her income (much like the current rule):[214] Until the limit is triggered, *Gail* may fully deduct her transfers and receive as much of her half of the pie as she desires.[215] For example, if *Gail* donates $50,000 or less to charity (still assuming an income of $100,000), she receives a deduction for the entire transfer. She is now able to take as much of her share of the pie as she desires, ensuring that the new majority has received its bargained-for share of the pie.

However, once Gail's donations exceed 50% of her income, the limits kick in to protect the classic majority. Imagine, for example, that *Gail* donates $60,000 to charity. If she could deduct all of it, the governmental subsidy of her pet project would be $21,000 (the amount by which her tax bill decreases when rates are 35%) and her taxable income would drop to $40,000, resulting in a tax bill of $14,000. She

[213] The same holds true if the subsidy were structured as a credit but only 50% of each donation were creditable.
[214] Although the following example uses a 50% of AGI limit for illustration, the same principles would apply to any percentage of AGI limit.
[215] Again, the same analysis follows if there is a charitable credit instead of a charitable deduction. In that situation, *Gail* should receive the entire 35 cent credit for each dollar transferred to charity until the point at which her credit equals her tax liability (that is, her half of the pie equals the classic majority's).

would then get more than the bargained-for share of the pie, thus hurting the classic majority.

If, however, *Gail* can deduct only $50,000 of her transfer, that problem is rectified. In that situation, her taxable income drops by only $50,000 (instead of $60,000). This reduces *Gail*'s tax bill by only $17,500 (instead of $21,000), accordingly lowering the governmental subsidy of her pet project from $21,000 to $17,500. At the same time, her resulting tax bill now rises from $14,000 to $17,500. The government is now funding her pet project equally to the lighthouse: $17,500 of *Gail*'s pie goes to each.[216]

Percentage-of-AGI limits (or percentage-of-tax liability limits, in the case of a charitable credit) thus split each individual taxpayer's pie down the middle. Aggregating across taxpayers then necessarily splits the total amount of federal funds available down the middle as well. In this manner, this type of limit allows members of the new majority to take as much as they want from the pie up to the point at which they have taken their whole share but prevents them from taking more than their share.

This in turn ensures that each individual contributes something not just to the "good" generally, but to the vision of the "good" approved by their fellow citizens. This solves the optics problem by erasing the ability of any individual to undermine the decisions of the legislative process. When coupled with the structural issues addressed above, these concerns demonstrate why percentage-of-income limits are the best method of precluding a taxpayer from zeroing out her tax bill via

[216] I acknowledge that as a technical matter, due to the increasing marginal rate structure, *Gail* actually directs something slightly more than 50% of her pie to her projects and something slightly less than 50% of her pie to the government's projects. This is so because her deduction comes off the top of her income, and results in the subsidy being calculated at her highest marginal rate or rates. In contrast, the tax rate applied to her remaining taxable income will be the lower rates applicable to her. That said, this distinction between "exactly" 50% and "really close" to 50% is very fine and likely lost on most of the individuals involved in this bargain. Allowing a deduction of up to 50% of AGI "looks like" they are splitting the pie down the middle to most people, and in fact comes quite close—closer than per-person dollar ceilings or per-transfer limits. Further this type of limit also ensures that each individual contributes something to the "good" chosen by her fellow citizens. (Or course, if the subsidy were a credit limited to some portion of tentative tax liability, the split would be exact. This is because it does not matter whether a $1 credit comes "off the top" or "off the bottom. A $1 credit erases a $1 worth of tax liability, however that liability was calculated.)

charitable contributions. Such limits do the best job of splitting the pie of available funds into whatever portions the two majorities have agreed upon while ensuring that some citizens cannot undermine the decisions made by others in the democratic process. Limiting the charitable subsidy in this way thus reconciles the delivery of public goods through the private charitable sector with broader principles of democratic government, allowing both to co-exist within the same system.[217]

D. Fine Points of the Dual-Majority Bargain Theory

Having laid out the basic argument for percentage-of-income caps, certain questions remain: Are different limits based on the type of asset donated or the recipient charity justified? What about carry-forwards? And finally, how would this framework differ if one departs from a majoritarian median-voter model of legislative behavior?

1. Should There Be One Limit or Many?

[217] For essentially the same reasons, the framework proposed here also applies to the more traditional subsidy theory, although the argument is not as precise. What my argument boils down to is the fact that no matter how noble or worthy charitable projects are, they are by definition not the projects funded by the government. Those who support the traditional subsidy theory believe that this is a good thing, and that this justifies the subsidy. Even so, however, it is plausible to believe that such traditionalists may not want to take their own arguments too far.

Some traditionalists may well be comfortable with a world in which individuals can fund only their desired projects and not contribute to what the government has deemed important. It is also likely, however, that not all traditionalists are comfortable with that scenario, and that many supporters of the charitable sector are at least on some level, also supporters of the government. If one supports the charitable sector because it provides alternative solutions to social problems, one may well want to see what kind of solutions the government also offers. If one supports the charitable sector on the grounds that it spreads out power in our society and enhances pluralism, one would likely want to create some sort of checks and balances system whereby the charitable sector did not have all the power and the government no power. Lastly, most (but not all) individuals who bump up against the AGI limits are wealthier individuals. Perhaps, as articulated by the conference reports quoted above, the limits represent a desire to make sure that wealthy individuals contribute to the same pot of chosen works as less-wealthy individuals so that wealthy individuals do not "opt out" of the common government and operate solely in the charitable sector. *See also* ODENDAHL, *supra* note 74, at 233 ("in this way the upper class, rather than the majority of the population, through a political process, defines the public good."); *id.* at 239 (suggesting limiting gifts any one person can make to a given charity, much like we currently limit political contributions).

Those familiar with the existing limits may have noticed that my analysis thus far has discussed limiting the subsidy to some portion of one's income in general terms, and has assumed one limit that would apply, regardless of the asset donated or the recipient charities. [218] In contrast, the existing rules have one limit (50%) for cash transfers to public charities, and other limits for donations of appreciated property and donations to private foundations. As explained in Section II, the existing AGI limit drops to 30% for donations of appreciated assets to public charities, and 30% for cash contributions to private foundations. For donations of appreciated assets to private foundations, the AGI limit is 20%. Does the analysis proposed above justify more stringent limitations applicable to transfers of appreciated property and to private foundations, as is currently the case?

Perhaps so, at least for appreciated property. Under current law, charities receive an additional subsidy when someone donates appreciated property.[219] This additional subsidy may well affect the way the two majorities split the pie in such situations. To that end, it may be plausible that a different bargain is struck in which taxpayers making donations of appreciated property are limited to a smaller percentage of AGI. (And, of course, as explained in Section IV.B.3., the government

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[218] More specifically, my analysis has used the current 50% of AGI limit that applies to cash contributions to public charities as an example. I re-emphasize here that I believe the analysis proposed above would apply even if some other general limit applied. In other words, I believe my argument sheds light on whether there is merit to limiting a donor to a deduction equal to some percentage of her AGI (whether or not that percentage is 50%) (or to limiting a credit equal to some percentage of tax liability, whether or not that percentage is 50%).

[219] This extra subsidy results from the following: Imagine a taxpayer with an AGI of $200 who donates $100 cash to a charity. Under the bargain described above, her pie of governmental funds is $70. Allowing her to deduct $100 lets her direct $35 of that pie to her preferred project so long as she funds the classic majority's projects to the tune of $35. Now imagine that she also owns some stock with a fair market value of $100 and a basis of $20. If she sells the stock and then donates $100 cash to charity, she pays tax on the $80 appreciation. Her pie thereby increases from $70 to $82 (assuming she receives the preference for long-term capital gain property and is taxed at only 15%), and each majority receives $41 for its projects. Under current law, however, she pays no tax on the appreciation if she donates the stock itself to charity—keeping her official "pie" at $70 and each majority's share at $35. Allowing her a deduction for the untaxed appreciation, however, essentially means that the charity's subsidy increases by the $12 foregone tax. Now her preferred project receives $47 and the classic majority receives only $35—a split no longer in line with the initial bargain. In this manner, charities receive an increased subsidy from donations of appreciated property.

may well have reasons to limit the deduction for such property to its basis. That, however, is a separate issue.)

What about lower limitations for donations to private foundations? Such organizations are usually founded by a single donor or family, and generally do not operate their own charitable activities. Instead, private foundations make grants to other organizations that do conduct charitable activities directly. One twist in the private foundation rules is that they are *required* to spend at minimum only 5% of their assets each year on charitable activities;[220] this minimum includes not only grants to other charities but also administrative expenses like salaries.

Although I do not believe private foundations should be treated differently as a normative matter, it seems plausible that supporters of private foundations might not be able to strike the same bargain as individuals supporting public charities.[221] First, due to the lenient minimum pay-out rules, the immediate benefit of funding public goods is delayed. Although donated assets must eventually fund such projects, in the interim, they remain under the private control of trustees chosen by the founders. Thus, it may appear to the classic majority that private foundation supporters have less to bargain with in terms of the funding for public goods than supporters of public charities.

Moreover, any given private foundation attracts financial support from far fewer people than any given public charity (which by definition must attract at least 33% of its support from the general public).[222] Perhaps the knowledge that many people (even if not enough for a classic majority) support a minority project makes the bargain described above palatable with respect to public charities. In contrast, maybe the

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[220] While some charities exceed this minimum, many do not, and those who do often do not exceed it by very much. *See* Leslie Lenkowski, *Foundations and Corporate Philanthropy* 375-77, *in* THE STATE OF NONPROFIT AMERICA at 355 (Lester M. Salamon, ed., 2002).

[221] I note here that I am assuming the private foundation rules are working as intended and preventing the abuses that led to their enactment in 1969. If such rules are not working and foundations are vehicles for abuse, as many currently allege, see, e.g., Walter V. Robinson and Michael Rezendes, *Foundation Chief Agrees to Repay Over $4M*, THE BOSTON GLOBE, Dec. 16, 2004 at A1, the case for not allowing foundations to be part of the same bargain as public charities is even stronger.

[222] I.R.C. § 509(a) (West 2007) (defining private foundation negatively by describing what they are not).

classic majority is less willing to subsidize projects that by definition are initially supported only by one or a few individuals.[223] In any case, it is plausible to believe that the two majorities might split the pie differently in the case of private foundations.

2. Should There Be Carry-Forwards?

What does the dual-majority bargain suggest in terms of either allowing or requiring individuals to carry-forward deductions (or credits) disallowed due to this kind of limit? To continue the pie example, I think the answer depends on whether the bargain is over a taxpayer's annual pie only, or also her lifetime pie.[224] If the bargain struck between the two majorities is *only* over a taxpayer's annual pie, then carry-forwards are inconsistent. Applying such limits to her in the year of the charitable contribution is enough to split up her pie for that year, and what her pie looks like in future years isn't yet under discussion. In contrast, if the bargain is *also* over one's lifetime pie, then carry-forwards (and perhaps even carry-backs) should be allowed. In that case, allowing carry-forwards and maybe carry-backs would do two things. First, it would implement the bargain for any given year by ensuring a taxpayer equally funds majority and minority projects that year. Second, it would allow taxpayers to make large charitable gifts all at once instead of spreading them out over time, while still upholding the dual-majority bargain. Allowing taxpayers to do so reflects an understanding that sometimes large gifts may better help charities to provide the types of goods and services that we are subsidizing them to provide in the first place.

3. Non-Majoritarian Models of the Legislative Process

As seen above, the majoritarian median-voter model anchors the current charitable deduction literature.[225] It is likely, however, than in some or many instances, other models of the legislative process are more

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[223] *See* Mark A. Hall and John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 395 (1991).

[224] Some readers may wonder what the bargain would look like if it were only over a taxpayer's lifetime pie. I do not address that here, since I believe that because of the annual accounting period and then annual budget process, any bargain would be over a taxpayer's annual pie at minimum.

[225] Weisbrod, *supra* note 6, at 21; COLOMBO AND HALL, *supra* note 6, at 101-113; Gergen, *supra* note 10, at 1403.

accurate. Although a full exploration of either the deduction's existence or percentage-of-AGI limits under alternative models is beyond the scope of this Article, I believe that the essential framework underlying the dual-majority bargain applies to other models of the legislative process, such as log-rolling and interest groups.

As an initial matter, the existence of alternative models does not undermine the basic economic justification for subsidizing charitable donations. Regardless of which model one chooses (median voter, log-rolling, interest group, or other), some public goods will be funded at levels lower than desired by high-demand voters, and these high-demanders will turn to the non-profit sector to meet that unmet extra demand. The median-voter model conceptualizes the deduction as a bargain among these minority high-demanders who come together to create a new majority to obtain partial funding.

This conception can translate to the other models in two ways. First, in some cases, the deduction can be thought of as a bargain among losing interest groups (or among voters who have traded their votes away) that is made after the fact (that is, after the legislative process results in less-than-satisfactory funding of their preferred public goods). In such instances, the bargain implementing the deduction is still a bargain among the "losers" in the legislative process, however those losers are determined. As these former losers come together to get partial funding for their projects, they become a second set of winners. At this point, the essentials of this Article's dual-majoritarian bargain still apply. Two sets of "winners" exist simultaneously, and limiting the charitable subsidy can be thought of as a bargain among these two sets of winners. Moreover, my proposals concerning the structure of that bargain (that is, why the bargain is structured as some percentage of a given individual's income (or tax liability)) likely apply to any similar bargain among two other sets of "winners."

In other cases, the charitable subsidy itself may be part of the very vote-trading or other politicking that results in the funding of some goods by the government but not others. For example, supporters of a lighthouse might "buy" votes from supporters of a community theater by assuring the latter of partial funding via a charitable deduction or credit. In this instance, the bargain is not made after the fact, and is not solely among losing groups. Rather, the bargain is made at the same time as the initial set of decisions about what to fund, and is between voters who willingly forego full government funding of their preferred goods for some reason and those who insist upon full funding. Again, the essentials of this Article's proposal still apply: Percentage-of-income limits serve as a second bargain between these two groups that enables the initial bargain to hold. Without such limits, the group who supposedly "foregoes" full funding of its preferred goods and supports full funding of other goods in exchange for partial funding (and perhaps some other benefit) could do an "end-run" around this first bargain. If such groups donate all their income to charity and do not pay any taxes, then they are not truly supporting full funding of the goods they promised to support.

VI. Conclusion

This Article has articulated the first of two justifications for precluding charitable donors from zeroing out their tax liability. By focusing on the dual-majority bargain, it has answered the questions left unanswered in prior justifications for limiting that subsidy: It is "unfair" to let some individuals pay no tax because so doing jeopardizes the ability of the classic majority to ensure that the projects it prioritizes retain adequate funding, thus undermining our democratic process. This explains the appeal of the "crude AMT" justification that everyone must pay some tax; the appeal of the optics argument that it "seems" unfair for some citizens to not pay tax; and why our instinct is that even if someone gives all their income to charity, they are somehow not living up to their obligations if they pay no tax.

The second part of this series will build on this economic explanation by arguing that political theory also justifies requiring individuals who donate all their income to charity still to pay some income tax. Very briefly, the argument is as follows: As an initial matter, the very existence of a tax subsidy for charitable donations reflects that citizens in a society that recognizes them as free and equal will hold differing conceptions of the "good." Limiting the subsidy, however, ensures that it does not undermine the scheme of fair cooperation that enables that very citizenry with diverse views of the good to come together to form a stable and just system of self-governance in the first instance.

Specifically, a limit that precludes someone from erasing his tax liability through charitable donations reflects the notion of reciprocity, which is the idea that free and equal citizens will reasonably propose terms for cooperation that they believe other free and equal citizens will reasonably accept.[226] Reciprocity suggests that one person cannot reasonably agree to terms of cooperation for a joint project if she knows others can opt out later: Allowing others to opt out post hoc undermines the whole point of cooperating in the first place and creates instability. By precluding citizens from "opting out" of funding public goods identified by a just legislative process as deserving funding, requiring individuals who make substantial charitable donations to still pay some income tax protects democratic equality and is justified on political theory grounds. This complements the economic theory laid out in this Article by illustrating why letting some citizens opt out not only *seems* unfair, but actually *is* unfair to other members of society.

[226] JOHN RAWLS, POLITICAL LIBERALISM 16 (1993).