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Generous to a Fault? Fair Shares and Charitable Giving

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Article

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Miranda Perry Fleischer†

"In charity there is no excess."
Sir Francis Bacon[1]

Charities play a vital role in our society. In addition to enhancing pluralism, private philanthropy meets many societal needs more efficiently, creatively, and 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 American culture.

Given the charitable sector's importance and value, it is not surprising that the Internal Revenue Code encourages cha-

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1. FRANCIS BACON, OF GOODNESS, AND GOODNESS OF NATURE, *in* ESSAYS CIVIL AND MORAL (1625), *reprinted in* 2 THE WORKS OF FRANCIS BACON 271 (1826).

ritable giving by allowing a deduction for charitable donations.[2] 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 Internal Revenue Code: the cap that prevents an individual from claiming a charitable deduction greater than fifty percent of her income, even if she gives more than half her income to charity.[3] As a result, someone who generously donates all her income to charity must still pay income tax.

Neither the fifty-percent limit nor the broad principle it represents are well-theorized. Only a few scholars have explored the question of whether an individual who gives all her income to charity should also pay income tax or whether the tax code's current limits are appropriate.[4] Those who have addressed this issue appear hard-pressed to find a satisfactory justification for limiting one's deduction.[5] Only one explanation—that the cap serves as a crude alternative minimum tax

2. *See* I.R.C. § 170 (West Supp. 2008).

3. *See id.* § 170(b)(1). As explained in Part I, this fifty-percent limit applies only to cash contributions to public charities. Limits of thirty percent or twenty percent apply in other instances, depending on the asset donated and the recipient charity. *See id.* Similar limits apply to corporations: generally, they can deduct no more than ten percent of their income. *Id.* § 170(b)(2). While the corporate provisions are interesting and merit further study elsewhere, this Article focuses only on the individual limit.

4. Some scholars have, however, criticized the current limits on a practical level for dampening giving by creating unnecessary complexity. C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL'Y 399, 411–12 (1995).

5. *See, e.g.*, Boris I. Bittker, Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility, The Seventh Mortimer H. Hess Memorial Lecture, *in* 31 THE RECORD OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, 1976, at 168–70 (discussing the implications of percentage limits on charitable bequests); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 23–25 (2002) (asserting that arguments defending percentage limits "have merit" but "are not overwhelming"). Only a handful of scholars have proffered explanations with which they appear at least somewhat satisfied. *See, e.g.*, Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947, 985–86 (2005) ("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. . . ."); Steuerle & Sullivan, *supra* note 4, at 413–15 (suggesting that the cap may serve to limit government outlays or as an alternative minimum tax).

ensuring that everyone above a certain economic income pays some tax—has gained any scholarly traction.[6]

That explanation is insufficient. The alternative minimum tax (AMT)[7] addresses the results of some tax preferences that allow individuals to retain substantial economic income *for their own use* that goes untaxed.[8] This justification for the AMT, 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 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 better to answer the question of whether limiting the ability of taxpayers who make substantial contributions to take a charitable deduction is justified.[9] 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 body of work posits that a subsidy for charitable donations is warranted because a democratic process dependent on majority preferences[10] will supply public goods only at the level de-

6. *See* Steuerle & Sullivan, *supra* note 4, at 414; *see also infra* note 173.

7. *See* I.R.C. § 55 (2000) (codifying the alternative minimum tax).

8. *See* H.R. REP. NO. 91-413, at 8–12 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1653–56 (noting reasons for enacting the alternative minimum tax).

9. As explained in Part I, 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 credit. Rather, the broader question I explore is whether subsidizing charitable donations while still requiring donors to pay some income tax is justified.

10. Although I recognize that majority preferences do not always prevail due to intrinsic characteristics of our legislative system, I take the majoritarian model in the public goods literature on the charitable deduction as my starting point. *See, e.g.*, JOHN D. COLOMBO & MARK A. HALL, THE CHARITABLE

manded by the median voter.[11] 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 undersupplied public goods then coalesce to form what I term a "new majority" that agrees to provide partial funding (via a tax subsidy) for each individual's preferred minority projects.[12] In that manner, charitable tax subsidies allow individuals whose preferences differ from the classic majority to redirect a portion of funds otherwise flowing to the federal treasury 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,[13] and the new majority, which has coalesced for the purpose of approving partial funding for minority-preferred projects.[14] By definition, some voters are members of both groups. How can

TAX EXEMPTION 101–02 (1995); Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS 21, 24–25 (Susan Rose-Ackerman ed., 1986). Existing literature recognizes that majority votes do not always determine political outcomes but uses the majoritarian model for simplicity. COLOMBO & HALL, *supra*; Weisbrod, *supra*, at 23–24. I explore the possible role of limits on the charitable subsidy in non-majoritarian situations in Part IV.E.

11. For an explanation of this phenomenon, see *infra* Part III.A.1.

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

13. Many government projects are not "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.

14. Not all projects undertaken by nonprofits constitute public goods in the economic sense. Mark P. Gergen, *The Case for a Charitable Contribution Deduction*, 74 VA. L. REV. 1393, 1397–98 (1988). Although the requirements of § 501(c)(3) and § 170 generally ensure that their partial subsidies flow to organizations providing public goods, their contours are imperfect. *Id.* at 1398; *see also* COLOMBO & HALL, *supra* note 10, at 108. Not all organizations providing public goods qualify for such subsidies, and not all qualifying groups provide public goods. COLOMBO & HALL, *supra* note 10, at 108. 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. *Id.* 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 purposes of this Article is that some individuals with a different 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," I will continue to use that term.

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 with each other, which I term the "dual-majority bargain," by splitting the governmental "pie" equally:[15] the classic majority will fund the new majority's 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 governmental subsidy for the individual's preferred projects will not exceed the amount of taxes she pays to fund the classic majority's projects.[16] This bargain-saving role is, I argue, a compelling explanation for precluding a taxpayer from erasing her tax liability by making charitable contributions.

Part I of this Article provides an overview of the income tax charitable deduction and the current percentage-of-income limitations. Part II explores whether the base-measurement theory for the deduction justifies limiting an individual's deduction to some portion of her income, and concludes that, at best, it does so only weakly. Part III 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. Part IV details the economic dual-majority bargain justification. The Article concludes that the percentage-of-income limits are integral to the functioning of a democratic society because they enable individuals to fund cherished charities while also shouldering their civic responsibilities to pay for government projects.

15. As explored in Part IV.C, the two majorities do not necessarily have to make the split fifty-fifty. 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 infra* note 215.

16. A tax credit limited to half of an individual's tentative tax liability would have the same effect.

I. 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.[17] It allows individuals who make voluntary transfers to organizations formed for religious, scientific, literary, educational, and other charitable purposes[18] to deduct such transfers from their adjusted gross income (AGI).[19] Despite the deduction's longstanding place in the tax system, no consensus exists as to its purpose.[20] As explained in Parts II and III, some theorists argue that the charitable deduction is necessary to measure income, while others believe that it is best characterized as a subsidy for charitable activity.[21]

Limits on the deduction have also been a permanent fixture in the tax system, although their form and magnitude

17. John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 VA. TAX REV. 229, 229 & n.1 (1984).

18. Organizations eligible to receive tax-deductible contributions under § 170 generally are also eligible for tax-exemption under § 501(c)(3). COLOMBO & HALL, *supra* note 10, at 20. To that end, analytical interpretations of which purposes qualify an entity for § 170 generally apply to § 501(c)(3), and vice versa. *Id.* Interpretations of "charitable purposes" are broad and support 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. *See generally* 26 C.F.R. § 1.501(c)(3)-1 (2008). As a general rule, such organizations must provide some type of "community benefit" by 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).

19. I.R.C. § 170 (West Supp. 2008). Very generally, AGI represents one's net income after deducting from gross income the expenses of producing that income. *See id.* § 62; *see also id.* § 61 (defining gross income).

20. *See* David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 547 (2006) (describing the theories of the charitable deduction as "underdetermined" and "undertheorized").

21. 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*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 10 at 272–76 (supporting a deduction), *with* Harold M. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 10 at 236 (supporting a credit). 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 & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION 219–20 (5th ed. 2005).

have fluctuated.[22] Until the mid-1950s, the Code limited most people to a deduction equal to fifteen percent of their income; the limit rose to thirty percent in 1954 and remained at that level until 1969.[23] Also prior to 1969, individuals whose charitable gifts and income taxes together surpassed ninety percent of their taxable income in eight of the ten preceding years were allowed an unlimited deduction.[24] 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 receive an unlimited deduction based on the property's high fair-market value relative to their income.[25] Even though such individuals still retained substantial income for their own use, some paid no tax due to the unlimited deduction.[26] Congress repealed this targeted unlimited deduction in 1969, but although it explicitly criticized wealthy individuals who paid little or no tax due to the charitable deduction, the legislative history does not link this phenomenon to the donation of appreciated property.[27] Interestingly, the legislative history suggests

22. Initially, the deduction was limited to fifteen percent of "net taxable income" with no carry-forwards for any unused deduction. Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061–63 & n.35 (2003). The limit loosened somewhat in 1944 when it changed to fifteen percent of AGI (because AGI is generally larger than net taxable income, this resulted in a higher limit). *Id.* at 1062. It rose to twenty percent of AGI in 1952 and then to thirty percent in 1954; in 1964, Congress allowed individual carry-forwards. *Id.* at 1062–63 & n.35. The current fifty-percent limit was codified in 1969. *Id.* at 1065.

23. *Id.* at 1064.

24. *See, e.g.*, I.R.C. § 170(b)(1)(C) (1964); *see also* R. Palmer Baker, Jr., *The Tax Treatment of Charitable Contribution Deductions Under the Tax Reform Act of 1969*, *in* 20 PROC. ANN. TUL. TAX INST. 327, 331 (1971). Despite a 1924 Senate proposal to allow an unlimited deduction to individuals who regularly contributed a substantial portion of their income, such a deduction was not implemented until 1964. Lindsey, *supra* note 22, at 1064. As a result, the unlimited deduction was in effect only five years. Interestingly, the legislative history of the 1924 proposal implies that taxing someone who was already benefiting society by donating large portions of his income to charitable organizations 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 equalling [sic] virtually his entire income." J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 34 (1938) (quoting S. REP. NO. 68-398, at 24 (1924)).

25. Halperin, *supra* note 5, at 24.

26. *Id.*

27. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550–53 (codified as amended at I.R.C. § 170(b) (2000); Halperin, *supra* note 5, at 24 & n.80.

that fewer than 100 individuals per year used the unlimited deduction, albeit at a cost to the Treasury of $25 million.[28]

Also in 1969, the general AGI limit rose to its current level of fifty percent.[29] This limitation means that even if someone donates all her income to charity, she can only deduct up to fifty percent of her income in the year of the contribution. The remaining amount carries forward for five years.[30] The general fifty-percent limit applies to cash contributions to public charities.[31] If some of the donor's contributions are of appreciated property or are made to a private foundation,[32] more stringent AGI limitations of thirty percent apply.[33] In addition, contributions of appreciated property to private foundations are capped at twenty percent of AGI.[34] Carry-forwards are allowed in the latter two scenarios as well.[35]

Although the legislative history of the limits suggests they were intended to target a small number of wealthy taxpayers,[36] the limits apply to all income levels and affect a larger number of taxpayers than one might suspect. In 2003, approximately 500,000 returns included charitable deductions carried forward from previous years.[37] The amount of these carried-forward de-

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28. Baker, *supra* note 24, at 330.

29. Tax Reform Act § 201(b)(1)(A).

30. I.R.C. § 170(d)(1)(A) (West Supp. 2008).

31. "Public charities" are the organizations that spring to mind when most people think of the words "charity" or "nonprofit"; they include schools, homeless shelters, tutoring programs, churches, and the like. Most 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. "Supporting organizations," which are entities that are organized and operated solely for the benefit of groups that conduct charitable activities directly, are also considered public charities. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 11.3, at 287, 293–94 (8th ed. 2003). The term "public charity" is colloquial; these organizations are not defined as such in the Code. *Id.*

32. A "private foundation" 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 who makes grants to other charities instead of conducting its own charitable activities. HOPKINS, *supra* note 31, at 274; *see also* I.R.C. § 509 (West Supp. 2008).

33. I.R.C. § 170(b)(1)(B)–(C).

34. *Id.* § 170(b)(1)(D).

35. *Id.* § 170(b)(1)(B)–(D).

36. *See infra* Part III.B.4.

37. Michael Parisi & Scott Hollenbeck, *Individual Income Tax Returns, 2003*, *in* 25 STATISTICS OF INCOME DIVISION, IRS, SOI BULLETIN 9, 44 tbl.3 (Fall 2005). Due to the manner in which the IRS reports data, the amount of

ductions that were usable in 2003 totaled over $25.5 billion,[38] comprising about eighteen percent of all individual income tax charitable deductions claimed in 2003.[39] 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).[40]

The extent to which the limits apply to taxpayers at all income levels is surprising. 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.[41] Approximately an additional 214,000 returns (roughly 43%) reflected an AGI between $25,000 and $100,000.[42] Just over 89,000 returns (almost 18%) showed an AGI between $100,000 and $1 million and only about 6500 returns (approximately 1.3%) had an AGI greater than $1 million.[43] 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 but little current income.[44] It is also likely, however, that others among these lower-income

carried-over deductions claimed in a given year is a more accessible way of measuring the impact of the limits rather than trying to ascertain the amount of deductions *not* claimed in a given year because of the limits. To be sure, however, these data do not illuminate how many contributions in a given year were not made at all due to the limits.

38. *Id.*

39. *See id.* (stating that taxpayers claimed $145.7 billion in individual income tax charitable deductions in 2003).

40. *See* CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA 2006, at 204 (2006).

41. *See* Parisi & Hollenbeck, *supra* note 37.

42. *Id.*

43. *Id.*

44. An examination of estate tax data sheds light on the interplay between accumulated wealth and income. A recent ten-year panel study of individuals who died between 1996 and 1998 showed that a fair number of individuals with estates over $1 million (in 1997 dollars) had mean AGIs lower than $1 million for the ten years before death. *See* David Joulfaian, *Charitable Giving in Life and at Death*, *in* RETHINKING ESTATE AND GIFT TAXATION 350, 355 tbl.8-3 (William G. Gale et al. eds., 2001). Of such decedents, more than five percent had a negative mean AGI, approximately one percent had a mean AGI between zero and $50,000, just over two percent had a mean AGI between $50,000 and $100,000, and about eight percent had a mean AGI between $100,000 and $200,000. *See id.* at 358 tbl.8-5. Approximately eighteen percent had a mean AGI between $200,000 and $500,000, and nineteen percent had a mean AGI between $500,000 and $1 million. *See id.* The remaining forty-seven percent had a mean AGI over $1 million. *See id.*

taxpayers do not have substantial accumulated assets and are considered lower or middle class.[45]

In the wake of Hurricane Katrina, Congress temporarily lifted these limits for contributions made between August 28, 2005 and December 31, 2005 by passing the Katrina Emergency Tax Relief Act of 2005 (KETRA).[46] Although prompted by Katrina, the Act removed the fifty-percent AGI limitation for cash contributions to any public charity—whether engaged in hurricane relief or not.[47] Congress had two motivations in passing the Act. First, it wanted not only to spur giving to hurricane relief groups but also to assist other charities susceptible to donor fatigue in the aftermath of Hurricane Katrina and the December 2004 tsunami in Asia.[48] Second, Congress sought to forestall a potential drop in donations from rising gas prices and fears of an economic downturn.[49] One year later, in the Pension Protection Act of 2006, Congress again temporarily lifted the limits in narrow circumstances: the Act excluded from income IRA distributions of up to $100,000 made directly to charitable recipients in 2006 and 2007.[50] Excluding such distributions from a retiree's income rendered the AGI limits inapplicable.

Unfortunately, it is too early to estimate, even roughly, whether these provisions will have a long-term impact on giving.[51] Early and unofficial data suggest that KETRA spurred

45. The Treasury study also shows, however, that mean AGI tends to rise with estate size. *Id.* at 355 tbl.8-4. Thus, it is also quite likely that some extremely charitable individuals with low AGIs *do not* have much accumulated wealth. Unfortunately, more detailed information on these taxpayers—regarding the organizations they donate to and information on why someone with an AGI of only $50,000 might give more than $25,000 in a year—is unavailable.

46. Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016, 2022–23. The Act also temporarily repealed the then three-percent phase-out of itemized deductions in § 68 for charitable contributions and increased the corporate limit from five percent to ten percent (but only for contributions to hurricane-related charities). *See id.*

47. *Id.*

48. 151 CONG. REC. H8020–21 (daily ed. Sept. 15, 2005) (statements of Reps. Hayworth & Souder); Holly Hall, *A Special Katrina-Inspired Tax Break Produced Mixed Results for Charities*, CHRON. PHILANTHROPY, Jan. 26, 2006, at 18; Stephanie Strom, *Hurricane Tax Break Spurs Triple Projected Donations*, N.Y. TIMES, Apr. 21, 2007, at A9.

49. Strom, *supra* note 48, at A9.

50. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1201(a), 120 Stat. 780, 1063–64 (2006) (amending I.R.C. § 408(d) (2000)).

51. 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

$11 billion in charitable donations, costing the Treasury more than $3 billion—far greater than the estimated cost of $819 million.[52] 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.[53] 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.[54] Many experts thus do not anticipate a long-term increase in giving from KETRA.[55] At passage, however, the Joint Committee on Taxation estimated KETRA's revenue effect between 2006 and 2015 from lifting the limits and the three-percent phase-out to be over $871 million.[56] It is unclear how to interpret this estimate. On the one hand, it may indicate that the committee expected an increase in otherwise unmade gifts. On the other hand, it may reflect an expectation that donors previously unable to deduct the full amount of their gifts (even with the carry-forwards) could now take a full deduction, meaning that overall giving was not necessarily expected to increase. Regardless of these provisions' ultimate im-

dates and the IRS's release of statistics from a given set of returns. According to Melissa Brown, 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, Editor, Giving USA (Jan. 8, 2007). For the Pension Protection Act, this is because the provision does not expire until the end of 2007, Pension Protection Act, § 1201(a), meaning that many gifts eligible for the provision have not even been reported to the IRS yet.

52. Strom, *supra* note 48, at A9.

53. CTR. ON PHILANTHROPY AT IND. UNIV., *supra* note 40, at 67. It appears that large charities that reached out to their donors about KETRA's provisions (such as Cornell, Haverford, and the ACLU) were the main beneficiaries of KETRA's largesse. Hall, *supra* note 48, at 18.

54. CTR. ON PHILANTHROPY AT IND. UNIV., *supra* note 40, at 124.

55. For example, Patrick M. Rooney, the director of research at Indiana University's Center on Philanthropy, opined that "[p]eople are using these special incentives to pay off pledges early and make other gifts they were planning on making over the next several years. . . . I don't know that anyone thinks this means charity will increase dramatically over the next several years." Strom, *supra* note 48, at A9.

56. JOINT COMM. ON TAXATION, 109TH CONG., ESTIMATED REVENUE EFFECTS OF THE HOUSE RESOLUTION OF CONCURRENCE WITH AN AMENDMENT TO THE SENATE AMENDMENT TO H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2006" 1–3 (Comm. Print 2005).

pact, many in the charitable community believe that the AGI limits dampen giving.[57]

II. BASE MEASUREMENT AND LIMITING THE CHARITABLE DEDUCTION

This Article explores the possibility that features intrinsic to the Code or to the legislative subsidy process justify a limit on an individual's ability to reduce her tax liability to zero through charitable deductions.[58] 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 in the first instance. Two rationales, detailed below, predominate in justifying the deduction: the base-measurement theory and the subsidy theory. 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 by economic theory.

A. THE BASE-MEASUREMENT THEORY FOR THE DEDUCTION

The base-measurement theory, first articulated by Professor William Andrews, suggests that a deduction for charitable transfers is necessary to measure income accurately.[59] Starting from the Haig-Simons definition of the ideal income tax base as accumulation plus consumption,[60] Andrews argued that per-

57. *See, e.g.*, Strom, *supra* note 48, at A9. One fund-raising consultant predicted that KETRA might spur as much as ten billion dollars in charitable gifts. *See id.*

58. 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.

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

60. More specifically, Haig-Simons defines income as the sum of what an individual consumes during the taxable period plus the increase in his wealth. Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921); *see also* HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (defining income as consumption plus wealth at the end of a tax period less starting wealth). Because this definition focuses on purchasing power, most scholars believe it to be the purest definition of what should constitute "income" for purposes of levying an income tax in accordance with ability to pay. *E.g.*, DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 16 (1986). Although the Code departs from this

sonal consumption, and therefore income, should not include amounts expended by an individual for charitable purposes.[61] 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."[62] 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 contributions."[63] Under this reasoning, because any benefit the donor receives is necessarily shared by others, a charitable contribution should not constitute consumption.[64] In a similar vein, Boris Bittker has argued that charitable contributions have such a high moral value that they should not be considered consumption, and therefore should be ignored when determining the amount of income at the voluntary disposal of the taxpayer.[65] To these ends, some tax theorists believe that allowing a deduction for charitable contributions is necessary to define the income tax base.[66]

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ideal in many important respects, it is considered a benchmark against which to measure various aspects of our current system. *See*, *e.g.*, *id.*; GRAETZ & SCHENK, *supra* note 21, at 89–91.

61. Andrews, *supra* note 59, at 344–75.

62. *Id.* at 346.

63. *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] [a]ttendance at church on a particular Sunday . . . 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 14, at 1397. For that reason, some scholars have recharacterized Andrews's argument as simply another rationale for subsidizing public goods. *See id.* at 1416.

64. Andrews, *supra* note 59, at 344–75.

65. 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).

66. *See, e.g.*, Andrews, *supra* note 59, at 344–75; McNulty, *supra* note 17, at 233. As explained in note 21, *supra*, by definition, deductions (as opposed to credits) determine the appropriate tax base. In contrast, after one determines the tax base and tentative tax, credits then 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

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 income measurement 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 through charitable deductions reflects a notion that charitable transfers involve some element of personal consumption and therefore should not be completely exempted from taxation. This rationale is initially plausible: giving is voluntary, and donors choose to make donations instead of purchasing wine, vacation homes, or other goods for personal consumption. 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.[67] Other benefits are more tangible, like the ability to enjoy an opera or attendance at a benefit party.[68]

If charitable giving includes an element of consumption, then some limits on charitable deductions should apply.[69] This

base. GRAETZ & SCHENK, *supra* note 21, at 219–20. To that end, Part II looks only at a charitable deduction and a limit on that deduction based on one's AGI.

67. *See* 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); Gergen, *supra* note 14, at 1408, 1430; Eric A. Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 WIS. L. REV. 567, 574–77 (1997).

68. Colombo, *supra* note 67, at 670. *See also* COMM'N ON PRIVATE PHILANTHROPY & PUB. NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 107–11 (1975); McNulty, *supra* note 17, at 236.

69. *See* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 186–87 (1985); Bittker, *supra* note 5, at 165; Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 375–77 & n.169 (1989); Strnad, *supra* note 21, at 278–86; *see also* Mark G. 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 Andrews'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.

conclusion, however, does not justify an AGI limit that prevents someone from zeroing out her tax liability via charitable contributions. For several reasons, an AGI limit is an ineffective means of reflecting the theory 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.[70] Let's use the existing fifty-percent limit as an example, although the reasoning would apply with equal force to any other percentage limit.[71] Tying deductibility to AGI in this manner creates the following paradox: Someone who contributes forty-nine percent 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.[72] While donations may have different elements of consumption depending on the taxpayer's motives and the intangibles received in return, it is unlikely that these are tied to the ratio of the size of the gift to AGI.

One might argue that the greater the percentage of 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, which suggest that as contributions increase, the utility derived from each additional contribution decreases, instead of vice versa.

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").

70. Steuerle & Sullivan, *supra* note 4, at 409.

71. 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 fifty percent per se.

72. To illustrate: If a donor contributes sixty percent of her income to charity, she can deduct five-sixths of the transfer, an amount equal to fifty percent of her AGI. Only one-sixth of her transfer is treated as non-deductible consumption. If she instead contributes seventy-five percent 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.

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 and work expenses like clothing and commuting. Generally, the Code does not differentiate consumption and non-consumption on any type of basis unique to the taxpayer in question. Instead, it generally determines the treatment of such transactions according to the type of transaction, rather than the taxpayer's characteristics.[73]

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 suggests the inadequacy of precluding someone from zeroing out her taxable income via the charitable deduction on that ground.[74] Two types of such potential limits exist. First, limiting deductibility to some flat percentage of each contribution (much like allowing a deduction of fifty percent for business meals)[75] 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

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73. Dual-nature expenses and receipts, for administrative ease, are generally treated one of three ways: (1) as all consumption (commuting), *cf.* I.R.C. § 162(a)(2) (2000) (allowing a deduction for travelling expenses but not commuting); (2) as no consumption at all (most fringe benefits), *see, e.g.*, *id.* § 132 (excluding various fringe benefits from income); or (3) the same portion of a given transaction is treated as consumption for all individuals (business meals), *e.g.*, *id.* § 274(n) (allowing a deduction up to fifty percent of expenses for business meals).

74. 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.

75. *Id.* § 274(n).

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, further suggesting that ferreting out consumption does not satisfactorily justify such a limit.[76]

2. Moral Theory

Alternatively, percentage-of-income limits might be tied to the notion that we have a moral duty to contribute to charity.[77] Many religions hold that we have a duty to help those less fortunate, as do many secular conceptions of distributive justice.[78] Bittker and others have 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.[79]

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 with the obligations we have to the broader community, might suggest the following: that a certain percentage of your income is "God's"[80] money—not the government's—on moral grounds and therefore should not be taxed, but anything beyond that is fair game for taxation. Under this reasoning, a limit based on the 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 fifty percent, perhaps ten percent 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 and glosses 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

76. As explained in Part I, 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). Part IV.E. addresses whether different limits are justified.

77. I thank Bill Klein for this suggestion.

78. For a readable account of these philosophies, *see* DANIEL M. HAUSMAN & MICHAEL S. MCPHERSON, ECONOMIC ANALYSIS AND MORAL PHILOSOPHY 101–33, 174–208 (1996).

79. *E.g.*, Bittker, *supra* note 65, at 58–59.

80. *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 588–89 (1998).

than donations say, to the opera. It is likely that some philosophies would consider certain charities to be morally superior to others.[81] For the reasons outlined in Part III.B.2, 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 ten percent of one's income).[82] 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.[83] Indeed, there is a long-standing debate about the best mechanisms for implementing these general philosophies.[84] It is therefore 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 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.

III. 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.[85]

81. 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 (unpublished article on file with author).

82. For a description of Jewish tithing requirements, see generally Adam S. Chodorow, Maaser Kesafim *and the Development of Tax Law*, 8 FLA. TAX REV. 153 (2007).

83. *Cf.* HAUSMAN & MCPHERSON, *supra* note 78, at 101–33, 174–208.

84. For example, many justify the estate tax on the grounds that moral philosophy requires ensuring that everyone has an "equal opportunity." Tax scholars debate, however, what that means in terms of actually structuring an estate tax. *See, e.g.*, ERIC RAKOWSKI, EQUAL JUSTICE 143–49 (1991); Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 476–85 (2007); David G. Duff, *Taxing Inherited Wealth: A Philosophical Argument*, 6 CAN. J.L. JURIS. 3, 45–57 (1993).

85. Because the current subsidy is structured as a deduction, my argument largely focuses on a deduction limited to some portion of one's AGI. My

It argues that such a limit is not justified by any of the reasons that other tax scholars have previously suggested, such as preventing the wealthy from engaging in tax shelters, protecting progressivity, or limiting the subsidy of "rich people's charities." Instead, I argue that under the economic theory for the deduction, the structure of our legislative process compels such a limit.

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.[86] A variety of arguments abound as to why charities should be subsidized. The more recent and probably more widely accepted explanation is grounded in economics: subsidizing charities is necessary to assist them in providing public goods that would otherwise be under-produced due to market and governmental failures.[87]

The more traditional explanation is that subsidizing charities is "good" because of the benefits they provide.[88] Some theorists focus on the fact that charities relieve the government of burdens it would otherwise have to bear (for example, poverty relief).[89] Others emphasize the role charities play in providing creative and diverse solutions to society's problems, or in

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argument would apply with equal force to a credit limited to some portion of one's tentative tax liability.

86. The deduction subsidizes charity in the following manner. Imagine a taxpayer in the thirty-five percent bracket who donates $100 to charity thereby receiving 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 a taxpayer's incentive to make them. *See* Gerald E. Auten et al., *Taxes and Philanthropy Among the Wealthy*, *in* DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 392, 393 (Joel B. Slemrod ed., 2000). Increased giving in turn enhances the scope and activity of the charitable sector. The subsidy can also be characterized as a matching grant from the government, which matches each taxpayer's donation with a grant equal to thirty-five percent of that gift. Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405 (1998). From that perspective, taxpayers can be thought of as individually directing the allocation of federal funds. *See* Bittker, *supra* note 65, 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 thirty-five 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 by $35.

87. *See* Colombo, *supra* note 18, at 366; *infra* Part III.A.

88. *See* COLOMBO & HALL, *supra* note 10, at 5.

89. *See id.* at 45–58.

offering alternative viewpoints in the arts and culture.[90] Lastly, some scholars highlight the role that nonprofits play in countering governmental power and enhancing pluralism.[91]

Although traditionalists rarely couch their explanations as such, their rationales are grounded in the ideas of public goods. To them, a 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.[92] Thus, the traditional and economic explanations for subsidizing charity do not differ as much as they initially seem to.[93] To that end, 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[94] 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.[95]

1. Nonprofit Institutions, Market Failure, and Government Failure

Both the traditional and the economic explanation of the subsidy theory rest on the idea that the charitable sector *generally* provides public goods. Classic economic theory suggests that the market will undersupply public goods[96] due to free rid-

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90. *Cf.* TERESA ODENDAHL, CHARITY BEGINS AT HOME 204–07 (1990) (discussing the promotion of social change through charitable arts organizations).

91. *See, e.g.*, *id.* at 234; Bittker, *supra* note 65, at 39.

92. *See* COLOMBO & HALL, *supra* note 10, at 5–6.

93. *See* Colombo, *supra* note 18, at 367 (arguing that a test that focuses on whether an organization increases a population's access to services unavailable through private markets bridges the traditional and economic subsidy arguments).

94. 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 why we subsidize charities through the tax system at all. It would therefore apply with equal force if the subsidy for donations was structured as a credit instead of a deduction.

95. See discussion *infra* Part III.A.

96. Gergen, *supra* note 14, at 1397 ("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).") (citation omitted).

ing and positive externalities.[97] Either the good remains undersupplied, or the government or nonprofit 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."[98] As explained below, however, in some instances the government cannot or purposefully will not remedy the market failure.[99] In that case, nonprofits 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.[100] This argument first assumes that "governmental decisions in a democracy are roughly shaped by the desires of the majority of the electorate"[101] and that the median voter determines the level at which government supplies a given public good.[102] It concludes that if demand for the good is relatively homogenous, then the median voter's demand for the good

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97. Gergen explains, "Some 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." *Id.* at 1398; *see also* COLOMBO & HALL, *supra* note 10, at 101 ("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 it [sic] signal, I can watch 'for free.'").

98. COLOMBO & HALL, *supra* note 10, at 101; *see also* BURTON A. WEISBROD, THE NONPROFIT ECONOMY 20 (1988) (explaining that "government can finance, subsidize, mandate, or otherwise encourage" remedies to market failures through its power of taxation). This coerced purchase precludes freeriding and ensures that individuals do not under purchase public goods with large positive externalities. Once the government has coerced the purchase of a public good, it can either provide the public good directly (e.g., Temporary Assistance for Needy Families (TANF)), or subsidize others to do so (e.g., by granting a charitable deduction for donations to a soup kitchen).

99. I argue below that the instances where government *cannot* remedy the market failure illustrate the application of the economic strand of the subsidy theory. The instances where the government *will not* remedy the market failure illustrate the traditional subsidy theory.

100. *See, e.g.*, COLOMBO & HALL, *supra* note 10, at 101–13; Weisbrod, *supra* note 10, at 23; *cf.* Gergen, *supra* note 14, at 1403 (arguing that the deduction "better matches expense with preference in cases of collective goods for which demand is universal but heterogeneous").

101. COLOMBO & HALL, *supra* note 10, at 102.

102. The majoritarian, median-voter framework described above is only one possible description of the democratic process. See discussion *infra* Part IV.E for an analysis of this issue using a nonmedian-voter framework.

closely mirrors that of voters on each extreme.[103] 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.[104]

In contrast, the government will be unable to overcome a market failure when demand for a given public good is heterogeneous, and the amount each voter demands varies. 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—that is, those who demand more of a given good then the median voter.[105] 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 its demands.[106] One solution lies in the nonprofit sector. Individuals who demand more of a given public good than the government produces often make voluntary donations to nonprofits to produce the good at a satisfactory level.[107]

Some readers might object that the median-voter model is flawed. I acknowledge this objection, and briefly explore other models in Part IV.E. At this point, however, it is important to take away from the model 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 nonprofits in the face of government failure does not depend on *why* a government failure occurred.[108]

In fact, the term "government failure" may sometimes be a misnomer. This so-called failure may not always be bad. In some cases, provision by a nonprofit may be preferable to governmental provision. Maybe the nonprofit sector provides the good more efficiently or more creatively than the government.[109] Perhaps voters wish to avoid sullying the good in ques-

103. *See* COLOMBO & HALL, *supra* note 10, at 102.

104. Weisbrod, *supra* note 10, at 22–26.

105. *See id.*

106. *See id.* at 26–32.

107. *See* COLOMBO & HALL, *supra* note 10, at 102; *see also* Weisbrod, *supra* note 10, at 31 (arguing that the size of the voluntary sector in an industry is a function of the heterogeneity of population demands).

108. COLOMBO & HALL, *supra* note 10, at 102–03.

109. *Cf.* Atkinson, *supra* note 65, at 579 (suggesting that private nonprofit suppliers may provide goods and services experimentally or informally). For example, even voters who support traditional governmental antipoverty programs such as TANF may also recognize the value in having charities provide supplemental mechanisms for reducing poverty. Charities may implement

tion with the taint of coerced government funding, preferring the moral purity of altruistic funding and production.[110] Or maybe voters recognize the importance of a strong nonprofit sector that can serve as a check on government power and enhance pluralism.[111] Lastly, sometimes the government *cannot* produce the good in question for constitutional or other reasons, as is the case with religious goods.[112]

In situations where provision of a good by a nonprofit is preferable, 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 the case of both accidental and purposeful government failure, governmental refusal to provide the desired public goods leads to production by the nonprofit 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

Recall that purposeful government failure occurs when an affirmative decision is made to have the nonprofit sector rather than government provide a given public good. Unfortunately,

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alternative ways to reduce poverty that the government did not think of, or charities may implement similar activities in a more efficient or appealing manner.

110. *See* COLOMBO & HALL, *supra* note 10, at 102–03.

111. *See* ODENDAHL, *supra* note 90, at 234.

112. For an analysis of the constitutional limitations on government funding of religious entities and activities, see Ira C. Lupu & Robert W. Tuttle, *The Faith-Based Initiative and the Constitution*, 55 DEPAUL L. REV. 1, 21–30 (2005).

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.[113] Thus, it is necessary to help charities overcome these issues 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.[114] By the same token, since the tax subsidy depends upon independent acts by nongovernmental actors, all the benefits of nongovernmental provision are saved.[115] In this manner, the charitable deduction is a product of purposeful government failure.

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.[116] 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.[117] The median voter will thus be willing to partially subsidize the good at greater levels than she would be willing to subsidize it fully.[118] 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.[119]

113. *Cf.* Hochman & Rodgers, *supra* note 21, at 225 (arguing that the charitable sector is subject to free riders who benefit from goods and services without making contributions).

114. *See id.* at 225–26 (arguing that relying exclusively on unsubsidized voluntary donations increases free-rider problems and that preferential tax treatment is one effective remedy). Nonprofits use a variety of additional tools to reduce the free-rider problem, such as social pressure, donor recognition, appeals to altruism and the like.

115. *Cf. id.* at 226 (arguing that nonprofit charities mitigate government monopoly and promote creative projects). Many of the benefits described in more detail in Part III.A.2.c. would also apply here.

116. *See* COLOMBO & HALL, *supra* note 10, at 107–08.

117. *Id.*

118. *See id.*

119. *See id.* at 108; Weisbrod, *supra* note 10, at 36.

A similar rationale is that the subsidy represents a bargain among various taxpayers with minority interests.[120] 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.

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 study, 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 private market cannot provide . . . and which the government cannot fully provide directly because of structural deficiencies in the democratic system.[121]

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 Congress's motivation in implementing the deduction or the events that 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 ratify post hoc the bargain it represents.[122]

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 decide which charities receive the subsidies and how large the subsidies should be.[123] Tying the subsidy to the prefe-

120. *See* COLOMBO & HALL, *supra* note 10, at 108.

121. COLOMBO & HALL, *supra* note 10, at 108 (citation omitted).

122. *See, e.g.*, *id.*

123. *See* Halperin, *supra* note 5, at 7. A deduction acts like a matching grant: When a taxpayer in the thirty-five percent bracket contributes $100 to a

rences of individual taxpayers has several benefits. On a political level, this removes the decision about which projects partially to subsidize from the legislature, thus shielding those decisions from the vagaries of the legislative process and diminishing the prospect of further government failure.[124] The matching grant aspect, moreover, means that the charities that receive the most donations receive the largest subsidies. This allows the subsidies to reflect the electorate's enthusiasm for given charities, which might not happen if the legislature—or some agency to which Congress might delegate that decision-making authority—determined how much of a subsidy each charity could receive.[125] Moreover, the matching grant is triggered only by an affirmative sacrifice on the part of the taxpayer. Indeed, 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.[126] This out-of-pocket expenditure may spur taxpayers to think more carefully about which projects they fund and to develop other commitments to those projects, such as volunteering.[127]

This structure also has economic benefits: it helps allocate the costs of funding a given charitable good among taxpayers in accordance with how much each taxpayer values that good.[128] High-demanders pay "more" by making charitable contribu-

given charity and receives a $100 deduction, it lowers her taxes by $35. She and the government are now partners in the contribution. It has triggered a $35 "match" from the government, thus allowing her to allocate $35 of federal funds to the charity of her choice. Giving a taxpayer a $35 credit has the same effect.

124. Some readers may wonder why the legislature would delegate decision making in this way. Professor Saul Levmore offers two explanations. The pessimistic view is that Congress supported the charitable deduction because nonprofits would be "frugal supplicants" and Congress had much to lose by favoring some charities over others. The optimistic view is that the deduction is a "precommitment" to discourage rent seeking that otherwise might occur. Levmore, *supra* note 86, at 408.

125. *See id.* at 404–05.

126. The same holds true if she instead were to receive a $35 credit.

127. *See* Halperin, *supra* note 5, at 8; Levmore, *supra* note 86, at 411, 427–28.

128. *See* Gergen, *supra* note 14, at 1400–06 (citing Hochman & Rodgers, *supra* note 21, at 228–35, 238; Strnad, *supra* note 21, at 271–75) (summarizing what economists call the Lindahl solution, in which a collective good is funded at a level where the marginal benefit received by both contributors and noncontributors alike equals their respective marginal costs). Economists disagree, however, as to whether a tax deduction or a tax credit is preferable. *Compare* Strnad, *supra* note 21, at 272–76 (supporting a deduction) *with* Hochman & Rodgers, *supra* note 21, at 236 (supporting a credit).

tions. Low-demanders pay "less" by not contributing directly, but they still pay something. The subsidies funded by their tax bills constitute smaller, indirect payments to charitable goods chosen by high-demanders, reflecting the fact that low-demanders do receive a small benefit from these goods.[129] 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.[130]

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.[131] 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.[132] 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.[133] Perhaps setting limits on the ability of a taxpayer to take a charitable deduction addresses these concerns.[134]

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129. For a discussion of whether it is morally fair to force low-demanders to subsidize such goods partially, see Gergen, *supra* note 14, at 1401 n.27. Here, the bargain is considered 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.

130. *See id.* at 1402 (arguing that voters would be unlikely to support a direct subsidy to nonprofits).

131. Levmore, *supra* note 86, at 406.

132. *See infra* Parts III.B. It may be, however, that non-itemizers implicitly benefit from the bargain as recipients and patrons of nonprofit organizations. *See, e.g.*, Bittker, *supra* note 65, at 55–56; Strnad, *supra* note 21, at 269.

133. *See* Levmore, *supra* note 86, at 405–06. For example, approximately seventy million people voted in the 2002 midterm election for the House of Representatives. FED. ELECTION COMM'N, FEDERAL ELECTIONS 2002: ELECTION RESULTS FOR THE U.S. SENATE AND THE U.S. HOUSE OF REPRESENTATIVES 5 (2003). In contrast, approximately forty million tax returns reflected an itemized charitable deduction. Brian Balkovic, *Individual Income Tax Returns, Preliminary Data, 2002*, *in* 23 STATISTICS OF INCOME DIVISION, IRS, SOI BULLETIN 6, 15 tbl.1 (Winter 2003–2004). However, these returns could represent more than forty million people as some are joint returns from married couples.

134. Structuring the subsidy as a refundable credit would equalize the

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).[135] 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 potential justification.

1. Protecting Progressivity

One common justification for the current limits—based on their intended target of high income donors[136]—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.[137] This raises the question whether precluding a donor from zeroing out her tax liability by making charitable deductions might protect progressivity. Perhaps doing so reflects the view that under the traditional subsidy theory, any such subsidy must not adverse-

match given to all charitably inclined citizens, regardless of their tax bracket. It would not, however, address the other criticisms levied at the deduction.

135. *See* COLOMBO & HALL, *supra* note 10, at 99–113 (addressing whether to have a subsidy in the first instance); Hochman & Rogers, *supra* note 21, at 238–40 (questioning whether the subsidy should be a deduction or a credit); Levmore, *supra* note 86, at 404–18 (asking whether the subsidy should flow through the tax system); Weisbrod, *supra* note 10, at 34–37 (addressing whether to have a subsidy in the first instance). I do not mean this as a criticism of the subsidy theory itself or of those scholars, who were simply asking fundamental questions requiring analysis before any further scrutiny of the deduction's details could occur.

136. Although the limitations technically apply to taxpayers in all brackets, the legislative history suggests that Congress intended to curb the extent to which the wealthy benefit from the charitable deduction. *See* H.R. REP. NO. 91-413, at 52–53 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1698–99; S. REP. NO. 91-552, at 78–79 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2106–07; STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 76 (Comm. Print 1970).

137. *See* MARILYN E. PHELAN & 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 aggregating deductions in one year as opposed to spreading such deductions over many years."). I thank participants at the 2006 Junior Tax Scholars' Workshop, University of Colorado, June 16–17, 2006, for this suggestion.

ly affect progressivity in order for it and the nonprofit sector to play the positive role envisioned by its proponents.[138] Alternatively, 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.[139]

As an initial matter, there is no reason to preclude a taxpayer from zeroing out her liability to preserve progressivity if the subsidy is structured as a credit instead of a deduction. This is so because credits have equal value to all taxpayers: a tax credit of one dollar reduces the taxes of both a low-bracket and a high-bracket taxpayer by one dollar, regardless of their marginal rates.[140] Non-refundable credits, of course, do not benefit taxpayers without any tentative tax liability.[141] However, any given credit could be made refundable, thus benefiting such individuals.[142]

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.[143] 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	$5000 plus 25% of the amount over $50,000
$150,000	No limit	$30,000 plus 50% of the amount over $150,000

138. *See* Weisbrod, *supra* note 10, at 34–37 (discussing the traditional subsidy theory).

139. *See* COLOMBO & HALL, *supra* note 10, at 107–08 (discussing the economic subsidy theory).

140. *See* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 24 (2006).

141. *Id.* at 53–55.

142. *Id.* at 56.

143. *Id.* at 24; Gergen, *supra* note 14, at 1405.

Now imagine three taxpayers, Alex, Bonnie, and Christine, who each make a $100 donation. Alex is in the fifty-percent tax bracket; his donation reduces his tax bill by $50. Compare Bonnie, who is in the twenty-five percent bracket: her deduction is worth only $25. Christine, who is in the ten-percent bracket, is even worse off. Her taxes are reduced 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.[144] Perhaps by limiting the deduction available to high-bracket taxpayers in any given year, AGI limits protect progressivity.[145]

Protecting progressivity is a poor justification for AGI limitations for several reasons. Let's use the existing fifty-percent 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 fifty percent of her AGI. To continue the previous example, if Alex, Bonnie, and Christine each contribute less than fifty percent of their income, exactly the same amount of progressivity results both with and without the limits: Alex's benefit is twice that of Bonnie's and five times that of Christine's.[146]

Second, even when this type of limit does apply, it will not always limit the magnitude of the upside-down effect because a limit based on what portion of AGI a contribution represents applies to taxpayers in all brackets.[147] If Alex, Bonnie, and Christine each give all their income to charity, Alex still rece-

144. *See* COMM'N ON PRIVATE PHILANTHROPY & PUB. NEEDS, *supra* note 68, at 108–09; STANLEY S. SURREY, PATHWAYS TO TAX REFORM 36 (1973); Gergen, *supra* note 14, at 1405; Kelman, *supra* note 69, at 833 n.7, 856–58; McDaniel, *supra* note 86, at 383. *But see* Griffith, *supra* note 69, at 363; Strnad, *supra* note 21, at 271–72.

145. Two criticisms of the anti-progressive upside-down effect predominate. The first is that charities favored by the rich are over-funded. *See infra* Part III.B.2. The second criticism is that the wealthy are not paying "enough" tax relative to their true ability to pay. *See infra* Part III.B.4 (discussing the primary concern of 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.

146. As currently structured, the general limit on the subsidy affects only about one-fifth of donors claiming a charitable deduction, meaning that it has no effect on progressivity eighty percent of the time. *See supra* Part II. Any other percentage limit would also be under inclusive, although the percentage of taxpayers affected would differ.

147. *See supra* Part I.

ives the greatest tax benefit and 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.[148] This decreases the nominal amount of Alex's benefit compared to Christine's (instead of benefiting forty cents more per dollar than Christine, now he only benefits twenty cents more per dollar) but not its proportional magnitude. He still benefits five times as much as she does.

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. Using the example rates previously set forth, after applying the charitable deduction and the AGI limitation with the previous corresponding rate structure, 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 drops from $17,500 to $5000. Christine's income decreases from $50,000 to $25,000 and her tax bill drops from $5000 to $2500. By reducing Alex's tax bill by $75,000, his $300,000 contribution garnered a 25% subsidy from the government. Bonnie's $100,000 contribution cut her tax bill by $12,500 and resulted in a 12.5% subsidy from the government. Christine's $50,000 contribution reduced her tax bill by only $2500—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.

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). Even then, however, this kind of limit does not erase the upside-down effect.[149]

To illustrate, first assume that Christine (still with an income of $50,000) contributes half her income to charity. Be-

148. The same reasoning applies if the limit was something other than fifty percent, as it would reduce each taxpayer's benefit by some other fraction.

149. In fact, the existing limits as currently structured only exacerbate this problem. 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 top of the donor's highest marginal rate in the year used. *See* Steuerle & Sullivan, *supra* note 4, at 412.

cause the limits don't apply in that event, she can deduct her entire $25,000 contribution, resulting in a decrease in her tax bill from $5000 to $2500. Consequently, she receives a tax benefit of ten cents for every dollar contributed. Next, assume that Alex contributes all his $300,000 income to charity, thereby triggering the 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 twenty-five cents for every dollar contributed.

Limits based on the 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.[150]

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.[151] Perhaps the AGI limit minimizes the governmental subsidy of charities favored by the wealthy, either as part of an affirmative decision about what constitutes a proper charitable sector or as part of the bargain about which charities to subsidize. This idea stems from the well-documented fact that wealthier taxpayers generally donate to different types of charities than other taxpayers.[152] The former tend to favor colleges and universities, health institutions, and cultural institutions such as museums.[153] In contrast, lower-income givers generally favor churches and other

150. *See supra* notes 145–48 and accompanying text.
151. *See supra* note 136 and accompanying text.
152. Auten et al., *supra* note 86, at 403–06.
153. *Id.*

religious organizations, federated campaigns, and social service organizations.[154]

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.[155] Alternatively, maybe 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.[156]

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154. *Id.*

155. Subsidizing charity is often justified on the grounds that it helps redistribute income downward. *See id.* (citing ROBERT A. DAHL, DILEMMAS OF PLURALIST DEMOCRACY 83 (1982)). However, not all charitable transfers redistribute equally. *Id.* ("The philanthropy of the wealthy serves many purposes, but primarily it assists in the social reproduction of the upper class."). Gifts to Ivy League schools primarily benefit the wealthy students who comprise much of the student bodies, while gifts to art museums primarily benefit the upper and upper-middle class individuals who patronize such institutions. *See id.* In addition, because health organizations are not required to offer charitable care other than open emergency rooms, gifts to such institutions may also lack a redistributive element. Colombo, *supra* note 18, at 347–48. Nevertheless, some of the benefits from these types of contributions do extend beyond the wealthy: elite schools provide scholarships, a passion for art is not limited to the wealthy, and all of society benefits from medical and scientific advances. ODENDAHL, *supra* note 90, at 232. While fully assessing the redistributional element of such charitable contributions is outside the scope of this Article, it is plausible to suggest that many charitable donations by the wealthy do little to benefit the nonwealthy. *See* Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. 263, 318 (2007) (exploring which types of charitable transfers contain redistributive elements). Moreover, considerable evidence shows 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*, *in* TAKING PHILANTHROPY SERIOUSLY 27, 36–39 (William Damon & Susan Verducci eds., 2006); ODENDAHL, *supra* note 90, at 232; Auten et al., *supra* note 86, at 397–400, 406.

156. For example, evidence exists that capital projects in educational and arts organizations are overfunded and that many university endowments are much larger than necessary to achieve their goals. *See* Gergen, *supra* note 14, at 1409 (commenting on overbuilding on college campuses due to "edifice complex"); Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 22 (1990) ("[The] average [university] had an endowment twice as large as its current operating budget."); John Hechinger, *When $26 Billion Isn't Enough*, WALL ST. J., Dec. 17, 2005, at 1 (noting that the wealthiest colleges and universities are "so flush with cash that . . . philanthropy experts are starting to wonder whether these schools really need more money"); Joe Nocera, *The University of Raising Big Money*, N.Y. TIMES, Oct. 21, 2006, at C1 (noting that over twenty-five universities are in the process of raising more than $1 billion). It might also be desirable to target subsidies to charities pro-

These desires do not, however, provide a coherent normative justification for 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.[157] 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."[158]

Second, even assuming that the size of a donor's income is a workable proxy for the charities benefited, limiting the subsidy based on percentage of AGI, instead of absolute AGI, is ineffective. A percentage-of-income limit, in and of itself, applies to taxpayers in all brackets.[159] Thus, it affects 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 it affects the incentives of a high-bracket taxpayer to donate a similar share of his income to Harvard or the opera.[160]

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viding public goods that would not be provided absent a subsidy due to market and governmental failure. COLOMBO & HALL, *supra* note 10, at 109; Gergen, *supra* note 14, at 1398. 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 inefficient or unnecessary subsidization.

157. *See* Auten et al., *supra* note 86, at 403–06.

158. As demonstrated, limiting the deduction based on the donor's income fails to tailor the size of the subsidy given to various charities when the donor's income is not a proxy for the charity favored. Consequently, if certain charities are to 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. I offer these suggestions merely for comparison. My goal is not to propose a new structure for the deduction that does distinguish among charities, but simply to show the AGI limits fail to do so.

159. *See supra* Part I.

160. Comparing the current limits to other possible structures is useful to demonstrate that a percentage-of-income limit fails to constrain the subsidy to

Lastly, 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. Take the current fifty-percent limit as an illustration. It applies only to the extent a donor makes a gift exceeding half her income, leaving most gifts untouched.[161] When it does apply, it treats the same $1 million 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 million makes such a gift, some of the deduction is disallowed. But if a donor with an AGI larger than $2 million 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.[162]

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.[163] With some exceptions,[164] donors can contribute property containing substantial unrealized gain, receive a deduction based on the property's fair-market value (FMV), and use that deduction to reduce taxable income from other sources (such as salary in-

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"rich people's charities." A more direct way of limiting the subsidy given to these charities 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 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.

161. Given that donors plan around the limits, perhaps some giving to such charities simply doesn't take place. *See* Steuerle & Sullivan, *supra* note 4, at 412. If so, then the limits would have some impact on the amount of subsidy given to such charities.

162. The same argument would apply if the subsidy were structured as a credit limited to some portion of a taxpayer's bill.

163. *See* Andrews, *supra* note 59, at 373 (suggesting that the limits minimize this preference but acknowledging that they are a "crude way" of doing so); Halperin, *supra* note 5, at 23–25 (suggesting that this preference influenced the repeal of the unlimited deduction but concluding that limits would be unnecessary if "transfers of property did not allow gain to escape tax").

164. For example, donors of tangible personal property unrelated to a recipient charity's exempt purpose are limited to a deduction equal to basis. Halperin, *supra* note 5, at 1.

come).[165] Because of the realization requirement, this puts donors of appreciated property in a better position than donors of cash.[166] 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 $1500, 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 an FMV of $1000). Economically, both are in the same position; each is better off to the tune of $1500. Due to the realization requirement, however, Diane's taxable income is $1500, 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.[167]

Now imagine that Diane contributes $1000 cash to charity and can deduct that full amount. Using a flat thirty-five percent rate for illustration, her taxable income drops to $500, resulting in a tax bill of $175. Compare Ed, who donates his stock with an FMV of $1000 and a basis of $100. If he can deduct the full FMV, 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, he is not taxed on his salary income. And if he had other income as well, some of that would be offset by the portion of the donation exceeding his salary income.[168]

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 fifty-percent limit applies to both Ed and Diane, the following happens. Based on her $1500 AGI, Diane can only deduct $750 of her $1000 cash contribution. This gives her taxable income of $750 and a tax bill of $262.50. Based on his

165. *See id.* at 10–11.

166. *Id.* at 13–14.

167. Of course, Ed has enjoyed the time value of money in the meantime and will likely enjoy preferential rates when he sells.

168. The same distortions would result if the subsidy was a credit based on the full fair market value of donated property. Although the mechanics would be different, the credit would still enable Ed to offset tax on salary and other income.

AGI of $600, Ed can only deduct $300 of his $1000 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 thirty percent 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.[169]

The only way to erase the preference fully is either to (1) limit Ed's deduction to his basis[170] or (2) allow him a FMV deduction but force Ed to realize and recognize gain upon donating appreciated property.[171] In both situations, Ed would have taxable income of $500, thus putting him on equal terms with Diane.[172]

That each of these two alternatives erase the preference given to donors of appreciated property more thoroughly and more directly than 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 not sole—support for precluding a taxpayer from zeroing out her tax liability via charitable gifts.

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169. Andrews, *supra* note 59, at 373. Structuring the subsidy as a credit limited to some portion of tax liability yields the same result. The preference given to Ed would lessen but not disappear, regardless of whether Ed and Diane faced identical or different limits.

170. In this 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.

171. Here, Ed's gross income would be $1500 ($600 salary plus $900 gain from the property), and he could take a $1000 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.

172. *See, e.g.*, Halperin, *supra* note 5, at 24–25 ("[T]rading 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 doing so serves as an alternative minimum tax has the most scholarly support.[173] This support stems both from dissatisfaction with other potential justifications and from the legislative history of the existing caps.[174]

First, as Steuerle 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.[175] 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 above, before 1969, an unlimited income tax charitable deduction was allowed under certain conditions. When Congress repealed this allowance,[176] it emphasized the unfairness of "allow[ing] a small number of high-income persons to pay little or no tax on their income."[177] The House Report explained that "[o]urs 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

173. *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."); JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 936 (3d ed. 2006) ("The limitations reflect a judgment that no taxpayer should completely avoid federal income tax by making charitable contributions."); Steuerle & Sullivan, *supra* note 4, 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.").

174. Steuerle & Sullivan, *supra* note 4, at 408.

175. *Id.* at 414.

176. Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550–53 (codified as amended at I.R.C. § 170(b) (2000).

177. H.R. REP. NO. 91-413, at 152 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1698.

which is tolerable for all taxpayers."[178] The Senate Report echoed these concerns,[179] as did the Joint Committee's Explanation, which noted that "[i]t 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."[180]

While this justification is more sound 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.[181] 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.[182] While the preference for tax-exempt bonds[183] is thought to benefit society by subsidizing state and local government activity, it also directly benefits the individual holders of such bonds, who receive the income tax-free.[184] As such, a preference for some municipal bonds is disallowed in the AMT.[185]

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[186] expensing and accelerated depreci-

178. *Id.* at 1, *reprinted in* 1969 U.S.C.C.A.N. 1645.

179. S. REP. NO. 91-552 at 79 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2108.

180. STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 76 (Comm. Print 1970).

181. *See* Michael J. Graetz & Emil Sunley, *Minimum Taxes and Comprehensive Tax Reform*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 385, 387–88 (Henry J. Aaron et al. eds., 1988).

182. GRAETZ & SCHENK, *supra* note 21, at 768.

183. I.R.C. § 103 (2000).

184. *See generally* Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?*, *in* THE ECONOMICS OF TAXATION 19 (Henry J. Aaron & Michael J. Boskin eds., 1980) (acknowledging that holders of tax-exempt bonds receive income free of federal income tax, even if that benefit is less than it first appears due to tax capitalization).

185. *See* I.R.C. § 55(b)(2)(B) (2000).

186. I.R.C. § 179 (West Supp. 2008).

ation under § 168[187] both benefit society by spurring investment activity, but also benefit the taxpayer in question by offsetting otherwise taxable income retained for personal use.[188] To preclude a taxpayer from fully offsetting such income in that manner, the AMT requires the use of a less-accelerated depreciation schedule.[189] The AMT thus targets tax preferences that, although 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 minimum tax concerns, not the use of a deduction in and of itself.[190]

In contrast, true charitable contributions do not benefit the donor the same way the tax preferences described above do. By definition, if one gives money to charity, one does not retain it for her own use.[191] A complex web of rules that applies to both public charities and private foundations is designed to prevent taxpayers from (1) creating "sham" charities that benefit donors and other private individuals instead of the community at

187. *Id.* § 168.

188. *Cf.* Gerard M. Brannon, *Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument*, *in* THE ECONOMICS OF TAXATION, *supra* note 184, at 87, 97 (stating that accelerated depreciation and exclusions encourage high-income individuals to invest by providing a higher rate of untaxed return).

189. *See* I.R.C. § 56 (2000).

190. 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.

191. As explained *supra* Part III.B.3, 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, 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. *See supra* Part III.B.3.

large and (2) reaping personal gain from charities that do benefit the public.[192] As with any anti-abuse rule, however, organizations and taxpayers sometimes purposefully evade these rules, allowing donors to reap direct benefits from charities to which they have contributed.[193] 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 to take a deduction based on the percentage of income the gift represents is an over-broad means of remedying such abuses.

Keeping these anti-abuse rules in mind and viewing the purposes of a minimum tax in the light described above, the question still remains: what is unfair about allowing an individual, who does not retain income for her own use but instead donates it all to charity, to pay no income tax?

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. The problem with this argument, however, is that there is generally no link between taxes paid and benefits received.[194] On a theoretical level, it is hard to determine how much someone benefits from the government. Take police pro-

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192. *See, e.g.*, I.R.C. § 170(c)(2)(C) (West Supp. 2008) (precluding a deduction for contributions to public charities in which the net earnings inure to the benefit of private individuals); I.R.C. § 501(c)(3) (2000) (requiring "no private inurement" to maintain tax-exempt status); I.R.C. § 4941 (West Supp. 2008) (imposing very strict limitations on transactions between private foundations and their founders and donors); *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).

193. *See, e.g.*, Walter V. Robinson & Michael Rezendes, *Foundation Chief Agrees to Repay Over $4M*, BOSTON GLOBE, Dec. 16, 2004, at A1 (reporting the result of a 2003 *Boston Globe* investigative series on financial abuses at charitable foundations that resulted in sanctions against Paul C. Cabot, Jr. for draining foundation funds for personal use).

194. *See* Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 451–55 (1952).

tection. 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?[195] On a more administrative level, there is no attempt to match taxes paid with benefits received. An individual's taxes fund the fire department regardless of whether he or she ever calls them; if called, the fire department would respond without regard to whether or how much tax an individual 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). The tax system is based on ability to pay, not benefits received.

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 Part IV. 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.

b. Optics

A second oft-mentioned possibility is that it just seems unfair to allow some individuals to escape taxation completely—

195. *Compare id.* (arguing that a progressive tax is unjustified because no greater benefit is conferred upon higher-income individuals as opposed to lower-income individuals such that the rate at which those benefits increase could be calculated and made proportional to the rate at which income would be taxed) *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) (arguing that even though the taxes paid and benefits conferred cannot be directly correlated, higher-income individuals benefit from taxes more significantly than lower-income individuals).

even if they retain no income for their own use. 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 "undermines public confidence in the tax system by inducing widespread perceptions of tax inequity."[196] This perception of unfairness might encourage more taxpayers to find ever-increasing ways of avoiding taxes by engaging in tax shelters or simply not reporting income.[197]

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. Such individuals are benefiting society just as much, if not more, than individuals who do not contribute to charity but pay taxes.[198] Again, traditional tax policy arguments for a minimum tax do not address this point.[199] The next section seeks to do so.

VI. 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. As previously described, the subsidy theory conceptualizes charitable tax subsidies as a bargain among various voters to overcome simultaneous market and government failures.[200] 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 or credit is the classic

196. Graetz & Sunley, *supra* note 181, at 388.

197. GRAETZ & SCHENK, *supra* note 21, at 28; *see also* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH 47 (1987) (detailing the passage of the Tax Reform Act in 1986, done in large part to fight such happenings).

198. 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.

199. *See, e.g.*, Bittker, *supra* note 65, at 62 ("If a taxpayer contributes 100 percent of his income to charities, it is preposterous to suggest his character will suffer if he does not pay 'some' amount in taxes.").

200. *See supra* Part III.A.

majority's way of making sure that its priorities in the democratic process are funded even if it agrees to partially subsidize minority projects via the deduction.

The dual-majority bargain provides a better tax policy justification for limiting the charitable subsidy available to a given donor. As a matter of the subsidy's structural logic, limiting one's deduction based on what portion of one's income it represents (or limiting a credit based on what portion of one's tax bill it represents) 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: maximizing the subsidy given to charity and 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 justification for precluding taxpayers from zeroing out their taxable income via charitable gifts 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.[201] 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.[202] Once opera lovers and ruffled grouse lovers strike this bargain and form a new majority willing to approve partial subsidies via the charitable deduction,[203] two majority groups simultaneously exist. The "classic majority" represents the majority in which the median voter approves the lighthouse, national defense, or other projects not subject to government failure. The "new majority" represents the new group that has

201. *See supra* Part III.A.

202. COLOMBO & HALL, *supra* note 10, at 108.

203. 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. Similarly, the dual-majority bargain theory is not an attempt to explain what actually occurred when Congress passed the limits. Rather, it attempts to justify their continued existence.

coalesced to help fund its members' pet projects.[204] By definition, some voters are members of both majorities simultaneously.

Another bargain must now be struck between these two majorities (with members who belong to both majorities weighing their 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. 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 the view 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 its members' minority projects might unravel.

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.[205]

204. 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 Part IV.E.

205. 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 contribute to the public good broadly speaking (whether such projects, as explained *supra* note 14, 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.[206] 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.[207] Francie could thus override 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.

A cap on the deduction 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.[208] This bargain-preserving role justifies the need to prevent taxpayers from zeroing out their tax liability by making charitable gifts.

B. RECOGNIZING THE DUAL-MAJORITY BARGAIN RENDERS PREVIOUSLY INADEQUATE JUSTIFICATIONS FOR AGI LIMITS SATISFACTORY

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

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206. That is, fund none of the government projects desired by the classic majority.

207. Due to the distribution of the tax burden, this is not an impossible scenario. In 2002, for example, the top ten percent of taxpayers paid over sixty-two percent of federal income taxes. It may be unlikely, however, given the government's ability and propensity to borrow to finance deficit spending. *See* GRAETZ & SCHENK, *supra* note 21, at 22.

208. 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 and therefore have a reason to ensure that funds continue to flow into that system. *See* Roger Lowenstein, *Who Needs the Mortgage Interest Deduction?*, N.Y. TIMES MAG., March 5, 2006, at 78 (noting the resistance of real-estate developers to eliminating the mortgage-interest deduction).

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 Part III.B.4 attempted to answer those questions by arguing that it "seemed unfair" to exempt from tax someone who donates all her income to charity. This justification, standing alone, still does not go far enough: why does not taxing people who donate all their income to charity seem unfair?

Conceptualizing the dual-majority bargain helps answer these questions. 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. Limiting the charitable subsidy achieves two goals: (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. Taxpayers must fund the government's specific priorities (and not just the public good, broadly speaking) so that individuals with the ability to make large donations cannot undercut the legislative process and leave the government's projects underfunded.

The congressional hearings on 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 to insert their own decisions about what should be provided. For example, one legislator arguing for the AGI limits 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."[209] Another argued, "We are 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

209. *Tax Treatment of Charitable Contributions: Hearings on Tax Reform Before the H. Comm. on Ways and Means*, 91st Cong. 1571 (1969) (statement of Rep. Byrnes).

individuals who decide which goods and services should be provided."[210]

The legislative debates illuminate the core of the optics argument. 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 singlehandedly override the preferences of one's fellow citizens that seems unfair.[211] Precluding an individual from zeroing out her tax liability via charitable contributions ensures that everyone contributes something to what his or her fellow citizens deem good and prevents individuals from undermining the decisions made in the legislative process. The next article in this series will argue that liberal democratic theory also justifies this kind of limit and that the alternative would, as a matter of political theory, be unfair and inconsistent with our democratic structure.

C. Implementing the Dual-Majority Bargain

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. 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.[212] Thus, percentage-of-income limits are justified as a means of implementing the dual-majority bargain only if they

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210. *Id.* at 1577 (statement of Rep. Utt, Member, H. Comm. on Ways and Means).

211. *See* George F. Break, *Charitable Contributions Under the Federal Income Tax: Alternative Policy Options*, *in* COMM'N ON PRIVATE PHILANTHROPY AND PUB. NEEDS, DEP'T OF THE TREASURY, RESEARCH PAPERS 1521, 1524 (1977), *available at* http://eric.ed.gov/ERICDocs/data/ericdocs2sql/content_storage_01/0000019b/80/31/88/5f.pdf (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"); Buckles, *supra* note 5, at 985–86.

212. 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.

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. The two majorities are really bargaining about how to split the governmental "pie" that is available to fund public goods. The pie is comprised of two ingredients: taxes received by the government for projects it conducts directly and the subsidy given to charitable projects via foregone revenue from the charitable deduction. 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 one-third and the other two-thirds, maybe one side gets one-fourth and the other three-fourths, or maybe they agree to split the pie equally.

Assume, for illustration, that the two majorities agree to an equal, fifty-fifty split. This division provides a simple model, and, although it is not inevitable, it is quite plausible.[213] 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.[214] Arguably, that initial bargain among the minority taxpayers who coalesce to form the new majority is maintained over time only if the back-scratching is roughly equal.[215]

Similar reasoning plausibly applies to the second bargain between the classic and new majorities that leads to a limited deduction. In that interaction, a feasible, attractive end point is

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213. *See infra* note 215.

214. COLOMBO & HALL, *supra* note 10, at 108.

215. The arbitrary determination of a fifty-fifty split is not the only result that will enable the bargain to hold. However, several experiments on rational choice, as well as empirical evidence from actual bargaining situations, show that a fifty-fifty split is often used. Plausible explanations are that such a split accords with common intuitions of fairness and is an "easy" fraction to understand, rendering it a convenient number to use when reaching a compromise. *See* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1135 (2000) (describing the "ultimatum game," in which one person is asked to split money between himself and a stranger who can either accept the offer or reject it and receive nothing, and finding that the first player will often use a fifty-fifty split to divide the money even though it is not in his best interest to do so); H. Peyton Young & Mary A. Burke, *Competition and Custom in Economic Contracts: A Case Study of Illinois Agriculture*, 91 AM. ECON. REV. 559, 560–63 (2001) (citing empirical studies of crop-sharing farming contracts ranging from Illinois to India where a fifty-fifty split between landlords and tenants is most common, regardless of the parties' relative bargaining powers).

that each majority bargains for the possibility of an equal amount of government funding for its preferred projects.[216] In this scenario, 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 projects subsidized up to the point where that subsidy equals the amount they pay in taxes that fund the classic majority's projects, but no more.[217] Returning to our previous example, Francie is allowed to take a charitable deduction of $100 (funneling $35 to Disease A) so long as she pays taxes on $100 (funneling $35 to Disease B).[218]

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?[219] As explained below, AGI limits best protect that bargain.

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. 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 con-

216. 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).

217. For the reasoning just described, a fifty-fifty split is not the necessary endpoint for this bargain either, although it is a plausible one.

218. If the subsidy were structured as a thirty-five 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.

219. While this paper employs a fifty-fifty split for purposes of illustration, the arguments would apply with equal force to any other division of the pie to which the two majorities might agree.

tributions. Imagine that the total AGI of all the taxpayers in this simplified world would be $3 million, yielding a pie of approximately $1 million (using a flat thirty-five percent rate for simplicity and rounding).[220] 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.

Per-person dollar ceilings reflect this division only in a static world. For example, consider a per-person ceiling that, in the aggregate, allowed taxpayers to deduct up to $1.5 million (that is, half of the total AGI of $3 million), thus splitting the pie down the middle.[221] One could simply divide the aggregate allowable deduction of $1.5 million 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 fifteen taxpayers, each should be allowed to deduct up to $100,000, and so on.[222]

If, initially, there are ten taxpayers and each is allowed to deduct up to $150,000, an aggregated deductible limit of $1.5 million results. 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 $1.5 million, but now the classic majority gets all of the increase in AGI. If AGI doubles to $6 million, then the classic majority gets seventy-five percent and the new majority twenty-five percent. Likewise, if the per-person limit stays the same but the number of taxpayers increases, the new majority benefits more than the classic majority. Assume that total AGI stays at $3 million, but now this world contains fifteen taxpayers: the new majority can deduct up to $2.25 million, or seventy-five percent, and the classic majority only gets twenty-five percent.[223]

220. This is so because aggregate taxable income of $3 million and a tax rate of thirty-five percent would yield approximately $1 million in tax revenues.

221. Under this scenario, taxable income would be $1.5 million, and tax revenue would be roughly $500,000. The total amount of charitable deductions claimed would also be $1.5 million, yielding a subsidy of roughly $500,000 to the donors' favored projects.

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

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

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 does the number of taxpayers.[224] It is highly unlikely that any single cap would reflect the exact bargained-for division of governmental funds.

Starting from the aggregate pie and then crafting a per-person limit to divide the aggregate pie 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.[225] 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 the ceiling constitutes 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,[226] 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

224. *See* Michael Parisi & Michael Strudler, *Selected Income and Tax Items from Inflation-Indexed Individual Tax Returns, 1990-2004*, *in* 26 STATISTICS OF INCOME DIVISION, IRS, SOI BULLETIN 75 (Spring 2007), *available at* http://www.irs.gov/pub/irs-soi/90-04indiv.pdf.

225. The above analysis first examined total income in the aggregate 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. *See id.* Unless the per-person cap fluctuates in tandem with those factors (which would be administratively difficult, if not impossible), it will no longer reflect the appropriate division of funds.

226. *See*, *e.g.*, I.R.C. § 163(h) (2000) (imposing a ceiling on mortgage interest deduction).

do not address the optics problem described above. This is so because the chosen cap will allow some taxpayers, but not others, to deduct all their income and thus fund none of the priorities set by the legislative process. The perception that some individuals might be able to undermine the decisions of their fellow citizens still remains.

Perhaps this perception only matters in the case of wealthy people. If so, a low per-person cap isn't problematic on optics grounds. But any realistic per-person cap would likely be fairly high,[227] 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?[228]

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 such a cap might roughly implement the bargained-for division of funds, it would not ensure that each taxpayer contributes not only to their pet project but also to the good projects chosen by their fellow citizens. Because per-person dollar caps thus do not address the optics problem, they are not the most appealing implementation of the dual-majority bargain.

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

Per-transfer limits also are not an appealing way of implementing the dual-majority bargain. Such limits would not split the pie in the manner bargained for in the dual-majority bargain.[229] 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, a hypothetical taxpayer

227. 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, $1 million, $2 million, or even $5 million 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.

228. The next article in this series will address that question on political philosophy grounds.

229. Although this analysis continues to use a fifty-fifty split as an example, the reasoning would apply to any other split the parties made.

with income, before charitable deductions, of $100,000 and a tax rate of thirty-five percent. 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) for her pet projects, but no more. 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 new majority 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 Gail's only charitable contribution for the year is a single $10,000 donation, then she should receive a full $10,000 deduction, which would be equivalent to allowing her to take out a $3500 piece of the pie for her preferred project. This is because the $10,000 deduction lowers her tax bill by $3500, generating a $3500 "matching transfer" to her chosen charity. If, however, she can deduct only a portion of that $10,000 transfer, then she does not receive the full subsidy due to her (since she should be able to access a subsidy of 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.[230]

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 fifty percent 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 fifty percent of each gift, she could still take deductions totaling $100,000 and wipe out her tax liability. Regardless of the amount of the per-transfer limit, Gail could hypothetically donate an amount larger than her

230. This reasoning applies regardless of what portion of the pie each majority bargained for. It applies, for example, even if the new majority bargained for a share of the pie other than a fifty-fifty split. It also holds if the subsidy is structured as a credit limited to some portion of each transfer, such that it amounts to less than thirty-five cents for each dollar donated to charity. In Gail's example, if she received a credit of less than $3500 for a $10,000 donation, then she would be deprived of the full subsidy bargained for on her behalf.

income, take deductions totaling more than half her income, and thereby deprive the government of part of its half of the pie.

Lastly, per-transfer limits do not fully address 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 potentially to undermine the decisions made by the legislative process would thus still remain.

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. Second, such limits solve the optics problem while ensuring that each majority receives its bargained-for division of the pie when its members contribute less than their entire income.

To illustrate, imagine a rule limiting each donor to a deduction equal to fifty percent of her income (much like the current rule). Until the limit is triggered, Gail may fully deduct her transfers and receive as much of her half of the pie as she desires. For example, if Gail donates $50,000 or less to charity, 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. The same analysis follows if there is a charitable credit instead of a charitable deduction. In that situation, Gail should receive the entire thirty-five 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 and the classic majority's half of the pie are equal).

However, once Gail's donations exceed fifty percent 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 thirty-five percent) and her taxable income would drop to $40,000, resulting in a tax bill of $14,000.

She 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 tax bill now rises from $14,000 to $17,500. The government is now funding her pet project equally with the lighthouse: $17,500 of Gail's pie goes to each.[231]

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 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 it prevents them from taking more than their share. The AGI limits also solve 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, percentage-of-income limits are therefore the best method of precluding a taxpayer from zeroing out her tax bill via charitable contributions. Limiting the charitable subsidy in this way reconciles the delivery of public goods through the private charitable sector with broader principles of demo-

231. As a technical matter, due to the increasing marginal-rate structure, Gail actually directs something slightly more than fifty percent of her pie to her projects and something slightly less than fifty percent 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. This distinction between "exactly" fifty percent and "really close" to fifty percent is very fine and likely lost on most of the individuals involved in this bargain. Allowing a deduction of up to fifty percent 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. If the subsidy were a credit limited to some portion of tentative tax liability, then the split would be exact. This is because it does not matter whether a one dollar credit comes "off the top" or "off the bottom." A one dollar credit erases one dollar worth of tax liability, however that liability was calculated.

cratic government, allowing both to co-exist within the same system.[232]

D. The Dual-Majority Bargain, Appreciated Property, and Private Foundations

The analysis thus far has employed the current fifty-percent limit applicable to cash contributions to public charities as an example. As explained in Part I, however, the existing limit drops to thirty percent for donations of appreciated assets to public charities and thirty percent for cash contributions to private foundations.[233] For donations of appreciated assets to private foundations, the AGI limit is twenty percent.[234] Would the analysis proposed above also justify more stringent limitations in these situations? Perhaps.

Charities currently receive an additional subsidy when someone donates appreciated property. To illustrate, imagine a taxpayer with an AGI of $200 who makes a $100 cash donation and is in the thirty-five percent bracket. Under the bargain de-

232. This Article's framework also applies to the more traditional subsidy theory, although the argument is not as precise. No matter how noble or worthy charitable projects are, they are, by definition, not government-funded projects. To supporters of the traditional subsidy theory, this is precisely what justifies the charitable tax subsidies. Even so, however, it is plausible that such traditionalists may not want to take their own arguments too far.

While some traditionalists may be comfortable with a world in which individuals can fund only their desired projects and not contribute to governmental projects, it also likely 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 want to see solutions offered by the government as well. If one supports the charitable sector on the grounds that it redistributes power in our society and enhances pluralism, one might likely want to create some sort of checks-and-balances system whereby both the charitable sector and the government shared power.

Lastly, most (but not all) individuals who bump up against the AGI limits are wealthier individuals. Perhaps 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* ODENDAHL, *supra* note 90, 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 that any one person should be limited in her charitable contributions, in a similar manner to the limits placed on political contributions).

233. I.R.C. § 170(b)(1) (West Supp. 2008).

234. *Id.*

scribed 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 fifteen percent). To split her new pie equally, each majority should receive $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 of 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 currently receive an increased subsidy from donations of appreciated property. 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.

What about private foundations, which are usually founded by a single donor or family and generally do not operate their own charitable activities but instead make grants to other organizations that conduct charitable activities directly? One twist in the private foundation rules is that the foundations are required to spend at minimum only five percent of their assets each year on charitable activities.[235] This minimum includes not only grants to other charities but also administrative expenses, like salaries.[236]

While, as a normative matter, I believe that private foundations should not be treated differently, supporters of private foundations might not be able to strike the same bargain as individuals supporting public charities. First, due to the lenient minimum pay-out rules, the immediate benefit of funding pub-

235. *See* I.R.C. § 4942 (2000).
236. *Id.*

lic 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.

Second, any given private foundation attracts financial support from far fewer people than any given public charity, which by definition must attract at least thirty-three percent of its support from the general public.[237] Perhaps the knowledge that many people support a minority project makes the bargain described above palatable with respect to public charities. In contrast, the classic majority may be less willing to subsidize projects that, by definition, are initially supported only by one or a few individuals. In any case, it is plausible that the two majorities might split the pie differently in the case of private foundations.

E. THE DUAL-MAJORITY BARGAIN AND NON-MAJORITARIAN MODELS OF THE LEGISLATIVE PROCESS

As seen above, current literature on the charitable tax subsidies uses a majoritarian median-voter model for simplicity.[238] It conceptualizes the deduction as a bargain among minority high-demand voters who come together to create a new majority to obtain partial funding for their favored projects. Building on that model, this Article has argued that percentage-of-income caps represent a second bargain between the new majority and the classic majority that ensures each group will receive funding for its projects.[239]

By definition, the median-voter model assumes that the preferences of the median voter (as opposed to the preferences of individual legislators) shape the decisions of the legislature—that is, that the legislature accurately reflects the views of the voters.[240] The prior charitable goods literature using that model acknowledges that other models of the legislative process exist. It also accurately argues that *any* political process will

237. *See id.* § 509(a) (defining a private foundation).

238. *See* COLOMBO & HALL, *supra* note 10, at 101–13; Gergen, *supra* note 14, at 1403; Weisbrod, *supra* note 10, at 23–25 & n.4.

239. *See supra* Part IV.A.

240. *See* JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT 132–34 (1962) (describing simple majority voting); COLOMBO & HALL, *supra* note 10, at 102.

leave some voters dissatisfied with the level of public goods produced, in turn leading to the creation and subsidization of the nonprofit sector.[241] Although a full analysis of either that argument or the percentage-of-AGI limits under alternative models is beyond this Article's scope, a brief preliminary exploration of those issues is warranted.

There are several models in which legislative decisions may not represent the preferences of the median voter.[242] The most common include: republican theory, classic interest group theory, logrolling, and the pivotal politics models.[243] Under the republican model of the legislative process, it may be the case that legislative decisions do not reflect the preferences of the electorate of the whole as a result of a reasoned, republican, public-minded deliberative process.[244] In this model, the preferences of the electorate are filtered and refined during the careful deliberation that occurs during the legislative process.[245] Legislators' votes on which public goods to fund will thus reflect this reasoned debate, instead of blindly reflecting the preferences of the electorate.[246]

Even after thoughtful deliberation, however, it is quite plausible that individual legislators will still have differing views about what quantities of various public goods are appropriate for the government to fund. Some legislators, therefore, will be dissatisfied with the funding allocated to a project that

241. *See* COLOMBO & HALL, *supra* note 10, at 103; Gergen, *supra* note 14, at 1399; Weisbrod, *supra* note 10, at 24 ("For our present purposes we require only that the political process leaves significant numbers of voters dissatisfied with government output and taxation levels.").

242. *See* Weisbrod, *supra* note 10, at 23 n.4 (citing Kenneth J. Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation*, *in* PUBLIC EXPENDITURE AND POLICY ANALYSIS 59, 70 (Robert H. Haveman & Julius Margolis eds., 1971)).

243. Much more could be said, of course, about how the charitable tax subsidies fare under each framework. I do not claim fully to analyze either the subsidies or their limits under these models; such an analysis would be a complete work in and of itself. Nor do I claim to address the full assortment of ways in which the legislative process can depart from the median-voter model. I do not address, for example, Arrow's cycling problem. *See generally* KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963). Rather, I simply aim to offer a few preliminary thoughts about whether the dual-majority bargain described in this Article is consistent with the basic tenets of some of the more common alternative models.

244. *See* DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE 42–47 (1991).

245. *See id.*

246. *See id.*

they feel is beneficial to the public good, such as the ballet or tutoring programs in rural areas.

These dissatisfied legislators may come together in a spirit of public-mindedness to provide at least some funding, via the charitable tax subsidies, for each others' views of the public good. Just as in the median-voter model of the dual-majority bargain outlined above,[247] however, two majorities of legislators still exist simultaneously: one majority voting to fund some public goods fully, and another majority voting to fund other public goods partially. These two majorities must still reconcile their conflicting interests, and capping the tax subsidy for the partially funded public goods does just that by ensuring that the projects garnering full financial support during the deliberative process will not be undermined.

Charitable tax subsidies and percentage-of-income limits are also consistent with various interest group models of legislation. Take, for example, the classic public choice story in which lawmakers provide legislation to the highest bidder. In this model, the legislature will fully fund only those public goods whose supporters can afford the payments demanded by the legislature, with payment in the form of votes, endorsements, contributions, and future favors.[248] For example, supporters of a strong national defense may be able to promise enough votes (perhaps from military servicemen and women) to garner full funding by the government. In contrast, supporters of other public goods (for example, community theater) who cannot match that price will lose out in the bidding war for legislation and thus fail to garner full funding for their projects.[249] It is quite plausible, however, that by working together, losing bidders of disparate charitable projects can afford to "buy" a partial subsidy for their projects from the legislature.[250]

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247. *See supra* Part III.A.2.b.

248. FARBER & FRICKEY, *supra* note 244, at 15 (quoting William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 877 (1975)).

249. This is consistent with Mancur Olson's general observation that supporters of public goods often struggle to influence political activity due to free-rider problems. Olson also recognizes, however, that some such groups provide direct, non-political services to group members, thus making them better equipped to overcome free-rider problems. MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION 132–34 (1965).

250. Saul Levmore's "pessimistic" take on public choice theory and the charitable deduction is similar. Levmore, *supra* note 86, at 387–408. Under that view, Congress outsources to voters the decision of which public goods to subsidize via the tax subsidies because "legislators . . . have more to lose from

Once again, two majorities exist simultaneously: the classic majority who has sold full funding of some projects and the new majority that has sold partial funding of other projects via charitable tax subsidies. Once again, these two majorities must reconcile their interests. Capping the charitable subsidy ensures that the classic majority can still provide full funding of some projects to those bidders who can afford it.[251]

A logrolling model of legislation (in which various legislators trade votes with each other to secure funding for their preferred projects)[252] yields a similar analysis, although there are two plausible ways for both the subsidy and the cap to arise. In the first scenario, similar to the model mentioned above, the logrolling process itself produces winners and losers. To illustrate, imagine a scenario in which most legislators are relatively indifferent about the level of funding for a given public good (Project A), but that supporters of Project A are extremely enthusiastic about their support. It might be the case that Project A's supporters trade votes on other issues (perhaps voting to fund Project B, about which they are indifferent) with enough other legislators to gain a majority vote for full funding for Project A. In this example, logrolling has allowed some legislators to get exactly what they want.

Not all legislators, however, have that ability. Assume that a third project (Project C) exists, that most legislators are relatively indifferent about the level of funding for Project C, and that its supporters are very enthusiastic about their support. So far, Project C seems like Project A. It might be the case, however, that supporters of Project C are hostile to Project B, or otherwise unable to trade votes to obtain funding for Project C. Assume the same about supporters of Projects D and E—for whatever reason, they cannot successfully logroll to get their

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favoring some organizations or causes over others than they would gain from such favoritism." *Id.* at 408. Although Levmore analyzed whether voters (via the charitable deduction) or Congress (via direct grants) should decide which projects receive subsidies, the point that legislators may not stand to gain very much from supporters of charitable causes remains. *Id.*

251. Levmore also offers an "optimistic" view of public choice theory and the deduction, which frames the deduction as a "precommitment by Congress to refrain from . . . encouraging rent-seeking[] where it might have." Levmore, *supra* note 86, at 408. A limit on the deduction is also plausible under this view; while Congress may precommit not to rent seek in the charitable arena, an unlimited deduction could potentially undermine its ability to fund other projects and, therefore, rent seek in those areas.

252. For an excellent description of logrolling, see BUCHANAN & TULLOCK, *supra* note 240, at 132–42 (1962).

projects fully funded. Logrolling, like other models of the legislative process, still produces winners and losers in the legislative process.

The traditional economic model for the charitable deduction, in which dissatisfied voters bargain with each other to obtain part funding for each others' projects, also applies here. In fact, that model is itself a logrolling model, since it suggests that supporters of one underfunded project agree to vote for partial funding for another project in exchange for partial support of their project.[253] Legislators (or groups thereof) who did not have enough "logrolling clout" to obtain full funding are nonetheless able, working with other such legislators, to wield just enough clout to obtain partial funding for their projects.

Once again, two majorities of legislators exist simultaneously: one majority whose members are able to trade enough votes to obtain full funding for their projects and another majority that is able to trade only enough votes to procure partial funding. Once again, these two majorities must reconcile their competing interests, and percentage-of-income limits do this. They allow the majority with enough clout to trade for full funding to ensure that it does, in fact, receive full funding for those projects.

In the second logrolling scenario, the charitable subsidy itself may be part of the very vote-trading 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 that supposedly "foregoes" full funding of its preferred goods and supports full funding of other

253. *See id.* at 135 (providing an example of individual farmers agreeing to fund repair of roads for the benefit of other farmers in the township in exchange for repair of roads leading to their own farms).

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.

A final theory in which legislative outcomes do not reflect the preferences of the median voter is the pivotal politics model.[254] This understanding of the legislative process posits that the complex structure of the legislative process, which includes committees, floor debates and potential filibusters, floor votes, presidential vetoes, and super-majority veto overrides, sometimes prevents policies supported by the median voter or legislator from enactment.[255] This occurs when a piece of legislation fails to clear a pivotal veto-gate, such as a filibuster or presidential veto, even if a majority of the legislature supports it.[256]

Under this model, to obtain full funding for a given public good, it must garner the support of a majority of committee members, then a majority of legislators without facing a filibuster by a determined minority, and then either the president (if he does not veto such funding) or a super-majority of legislators who override a presidential veto.[257] Supporters of these goods are winners in the legislative process, while legislators whose preferred goods do not emerge from all these veto-gates comprise an initial set of losers.

It is entirely plausible, however, that by working together, the latter can successfully navigate the political process to obtain partial funding for their projects via the charitable tax subsidies. It is also plausible, however, that the actors controlling the various veto-gates might insist on capping that subsidy so that their preferred projects (which already obtained full funding) are not jeopardized. Although this model conceptualizes percentage-of-income limits as a bargain between suppor-

254. *Cf.* KEITH KREIEHBIEL, PIVOTAL POLITICS 20–48 (1998) (explaining pivotal-politics theory).

255. *Id.*

256. *Id.* at 22–24.

257. This model in and of itself does not, of course, explain why the key players in this process support the projects they do. The key players might be reflecting the preferences of their constituents, or perhaps their support stems from deliberate, republican-style deliberation. Alternatively, the support might be the product of logrolling or classic interest-group theory. This model, which focuses on how structure affects outcomes, can coexist without contradiction with the other models of how preferences are shaped within that legislative structure.

ters of charitable projects and controllers of the veto-gates, instead of between two majorities, the essential elements remain. It is still a bargain between winners and losers in the legislative process.

These preliminary thoughts suggest that the framework of the dual-majority bargain applies regardless of what model of the legislative process is used. In each model, there will be winners and losers after the initial decisions about which projects to fund fully. As these former losers come together to get partial funding for their projects, they become a second set of winners. At this point, two sets of "winners" exist simultaneously. Limiting the charitable subsidy can be thought of as a bargain among these two sets of winners, allowing the two sets to reconcile their competing interests. And in each case, for the reasons outlined in Part IV.C.3, percentage-of-income limits strike this bargain better than other potential limits.

CONCLUSION

This Article articulates the first of two justifications for precluding charitable donors from zeroing out their tax liability. The first stems from the economic subsidy theory for the charitable deduction, which posits that a democratic process dependent upon majority preferences will supply public goods only at the level demanded by the median voter. This majority, the "classic majority," therefore supplies some public goods but not others. Individuals supporting the under-supplied public goods then coalesce to form a "new majority" that agrees to provide partial funding (via a tax subsidy) for each other's preferred minority projects. In that manner, charitable tax subsidies allow 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.

Limiting the deduction to some portion of an individual's income represents a second bargain, this time between the classic majority and the new majority. 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 governmental subsidy to her preferred minority projects will not exceed the amount of taxes she pays to fund the classic majority's projects. This bargain-saving role is a compelling economic explanation for precluding a taxpayer from erasing her tax liability by making charitable contributions.

The second article in 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. Briefly, as an initial matter, the very existence of a tax subsidy for charitable donations reflects the notion that citizens in a free and equal society will hold differing conceptions of the "good." Limiting the subsidy, however, reinforces 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.[258] 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. Precluding citizens from opting out of funding public goods identified by a just legislative process and requiring individuals who make substantial charitable donations still to pay some income tax protects democratic equality and is justified on political theory grounds.

Layering political philosophy onto the economic theory of the dual-majority bargain will answer the questions left unanswered in prior justifications for limiting the subsidy granted to any given charitable donor. It is "unfair" to let some individuals pay no tax because doing so jeopardizes the ability of the classic majority to ensure that the projects it prioritizes retain adequate funding. It also denigrates the character of our democratic system. This explains the appeal of the "crude minimum tax" 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 the conclusion that even if some people give all their income to charity, they are somehow not living up to their civic obligations if they pay no tax.

258. JOHN RAWLS, POLITICAL LIBERALISM 16 (1993).