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## Why Limit Charity?

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## **Abstract**

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This Article fills that void by proposing two complementary explanations for the AGI limits, one grounded in economic theory and one in political philosophy. The economic explanation proceeds directly from the literature conceptualizing the charitable deduction as a way of overcoming market and government failure for various public goods by spurring non-profits to produce them. It suggests that the AGI limits reflect a bargain between individuals whose preferred public goods are fully funded by the government and those whose projects are only partially subsidized. The philosophical explanation is anchored by the idea of reciprocity inherent in liberal democratic theory. It argues that allowing some individuals to pay no taxes, even if supporting a “good” cause, is tantamount to allowing them to opt out of a previously agreed-to scheme of cooperation and undermines the stability of our democratic society.

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## Why Limit Charity?

By Miranda Perry Fleischer\*

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

### I. Introduction

In the wake of Hurricane Katrina, Congress temporarily lifted one of the most puzzling limits in the tax Code:<sup>1</sup> the cap that prevents an individual from claiming a charitable deduction greater than 50% of her income, even if she gives more than half her income to charity.<sup>2</sup> Although scholars often criticize the cap in passing for dampening giving and creating unnecessary complexity,<sup>3</sup> few have explored its theoretical underpinnings, and those who have appear hard-pressed to find a satisfactory justification.<sup>4</sup> Only one explanation – that the cap serves as a

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<sup>1</sup> Katrina Emergency Tax Relief Act, H.R. 3768 (September 23, 2005). Although prompted by Hurricane Katrina, the Act lifted the 50% AGI limitation for cash contributions by individuals to any public charity--whether engaged in hurricane relief or not—until the end of 2005.

<sup>2</sup> IRC § 170(b). As explained in Section II, this 50% limit applies only to cash contributions to public charities. Limits of 30% or 20% apply in other instances, depending on the asset donated and the recipient charity. Similar limits apply to corporations: Generally, they can deduct no more than 5% of their income. KETRA temporarily raised the corporate limit to 10%, but only for contributions to hurricane-related charities. While the corporate provisions are interesting and merit further study elsewhere, this Article focuses only on the individual limit.

<sup>3</sup> C. Eugene Steuerle and Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 *Am. J. Tax Pol’y* 399, 411-12 (1995) (suggesting that the limits and their complexity dampen wealthy donors’ incentives to make charitable contributions).

<sup>4</sup> See, e.g., Boris Bittker, *Charitable Bequests and the Federal Estate Tax: Proposed Restrictions on Deductibility*, The Seventh Mortimer H. Hess Memorial Lecture, 31 *N.Y.S.B.A. Record* 159, 168-69 (1976); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 *Tax L. Rev.* 1, 23 (2002). Only a handful of scholars have proffered explanations that at least they appear somewhat satisfied with. See, e.g., Steuerle and

crude alternative minimum tax ensuring that everyone above a certain income pays at least some tax – has gained any scholarly traction at all.

That explanation, however, is insufficient. It does not answer the further question of why, if an individual donates all her income to a cause deemed 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 proposes two complementary answers to that further question, one based on economic theory and one in political philosophy.

*Economic theory:* The existing public goods literature posits that a charitable deduction is warranted because a democratic process dependent on majority preferences<sup>5</sup> will only supply public goods at a level demanded by the median voter.<sup>6</sup> This majority, which I term the “classic majority,” will therefore supply some public goods (for example, a lighthouse or national defense) but not others (perhaps a community theater). Individuals who support the under-supplied public goods then coalesce to form what I term a “new majority” that agrees to provide partial funding (via a tax subsidy) for each other’s preferred minority projects. In that manner, a charitable deduction thus allows individuals whose preferences differ from the classic majority to redirect a portion of funds otherwise flowing to the federal fisc toward their preferred visions of the public good.

Two majorities now exist simultaneously: the classic majority, which has agreed to fund the lighthouse, national defense and other projects not suffering

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Sullivan, 12 Am. J. Tax Pol’y at 413-15 (suggesting that the best explanation for the cap is as a crude alternative minimum tax); Johnny Rex Buckles, The Community Income Theory of the Charitable Contributions Deduction, 80 Ind. L. J. 947, 985-86 (2005) (suggesting that the limitation serves a political role by precluding the wealthy from using all their “resources. . . to fund those charitable activities that they value, at the cost of denying the federal government any control over the use of such funds.”).

<sup>5</sup> Although I recognize that majority preferences do not always prevail due to intrinsic characteristics of our legislative system, I am taking the existing models in the public goods literature on the charitable deduction (which do use a majoritarian model) as my starting point. See, e.g., Burton A. Weisbrod, Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy 24-25, in Susan Rose-Ackerman, ed., *The Economics of Nonprofit Institutions* at 21 (1986); John D. Colombo and Mark A. Hall, *The Charitable Tax Exemption* xx (1995). That literature does recognize that majority voting does not always determine political outcomes, but uses such a model for simplicity. Weisbrod at 23; Colombo and Hall at xx. The possible role of the AGI limits in non-majoritarian situations is explored more fully in Section V.D.4.

<sup>6</sup> For an explanation of this phenomenon, see Section IV.A.1.

from government failure,<sup>7</sup> and the new majority, which has coalesced for the purpose of approving partial funding for minority-preferred projects.<sup>8</sup> By definition, some voters are members of both groups. How can these two majorities exist simultaneously? How do voters who are members of both majorities balance their competing interests? Current literature ignores these questions.

This Article argues that these two majorities strike a bargain (which I term the “dual-majority bargain”) with each other by splitting the governmental “pie” equally.<sup>9</sup> 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 50% of her AGI 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, I argue, a compelling economic explanation for the AGI limits’ continued presence in the tax code.

*Political theory:* Political theory also justifies the AGI limits. As an initial matter, the very existence of the charitable deduction reflects that citizens in a society that recognizes them as free and equal will hold differing conceptions of the “good.” The AGI limits, however, ensure that the charitable deduction does not undermine the scheme of fair cooperation that enables that very citizenry

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<sup>7</sup> I acknowledge that many government projects would not be considered “public goods” in the economic sense. The point, however, is that the government only funds projects (whether public goods or not) that do not suffer from government failure.

<sup>8</sup> Similarly, not all projects undertaken by non-profits constitute public goods in the economic sense. Mark A. Gergen, *The Case for a Charitable Contribution Deduction*, 74 Va. L. Rev. 1393, xxx (1988). Although the requirements of §§ 501(c)(3) and 170 generally ensure that these partial subsidies flow to organizations providing public goods, their contours are imperfect. *Id.*; Colombo and Hall. This means that not all organizations providing public goods qualify for such subsidies, and not all groups that do qualify provide public goods. *Id.* Generally speaking, however, groups qualifying for subsidies that do not provide pure public goods in the economic sense either provide impure public goods or provide some other “public benefit” to society. Colombo and Hall. In other words, there are limits on which projects may receive these subsidies; one cannot qualify for a partial subsidy for just “any” project not funded by the government.

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

<sup>9</sup> As explored in Section V.B, the two majorities do not necessarily have to make the split 50/50. Splitting down the middle, however, may reflect common heuristics often observed in bargaining, even in situations where parties have unequal bargaining power (such as the Ultimatum Game). See note 171.

with diverse views of the good to come together to form a stable and just system of self-governance in the first instance. Specifically, the limits reflect 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.<sup>10</sup> Reciprocity suggests that one person cannot reasonably agree to terms of cooperation for a joint project if she knows others can opt out later: Allowing others to opt out post hoc undermines the whole point of cooperating in the first place and creates instability. By precluding citizens from “opting out” of funding public goods identified by a just legislative process as deserving funding, the AGI limits protect democratic equality and are justified on political theory grounds.

This Article proceeds as follows. Section II provides an overview of the income tax charitable deduction and the AGI limitations. Section III explores whether the AGI limitations are normatively justified under the base-measurement theory for the charitable deduction and concludes that they are, at best, only weakly justified. Section IV first explains the subsidy theory for the deduction, assesses existing normative theories for the AGI limitations (including the alternative minimum tax explanation), and concludes that none are satisfactory. Section V details the economic dual-majority bargain justification sketched out above, and Section VI justifies the limits on political theory grounds. Section VII concludes.

## **II. An Overview of the Charitable Deduction and the AGI Limitations**

A charitable deduction has been part of the income tax since 1917. It allows individuals who make voluntary transfers to organizations formed for religious, scientific, literary, educational and other charitable purposes<sup>11</sup> to deduct

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<sup>10</sup> John Rawls, *Political Liberalism* 16 (1993).

<sup>11</sup> Organizations eligible to receive tax-deductible contributions under § 170 generally are also eligible for tax-exemption under § 501(c)(3). To that end, analytical interpretations of such purposes for § 170 generally apply to § 501(c)(3), and vice versa. John D. Colombo and Mark A. Hall, *The Charitable Tax Exemption* 20 (1995). “Charitable purposes” has been broadly interpreted to include a wide variety of purposes: preserving the environment, providing traditional legal aid as well as cause-oriented public interest litigation, furthering public health, supporting the arts, and so on. As a general rule, such organizations must provide some type of “community benefit” in the form of fulfilling needs unmet by the private market. John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 *Wash. U. L. Q.* 343 (2004) (discussing “charitable” organizations in the context of § 501(c)(3)).

such transfers from their adjusted gross income.<sup>12</sup> Despite the deduction's permanent place in the tax system, no consensus exists as to its purpose. As explained in more detail in Sections III and IV, some theorists argue that the charitable deduction is necessary accurately to measure income, while others believe that it is simply subsidizes charitable activity generally.

Limits on this deduction have also been a permanent fixture in the tax system, although their form and severity have fluctuated over time.<sup>13</sup> Until the mid-1950's, most people were limited to a deduction equal to 15% of their income; this limit was raised to 30% in 1954, where it stood until 1969.<sup>14</sup> Also prior to 1969, individuals whose charitable gifts and income taxes together surpassed 90% of their taxable income in eight of the ten preceding years were allowed an unlimited deduction.<sup>15</sup> Although intended to benefit nuns and other individuals taking a vow of poverty, the unlimited deduction had an unintended consequence: It also enabled wealthy individuals to donate low-basis, high-appreciation property to charity, receive an unlimited deduction based on the property's high fair-market value relative to their income, and still retain substantial income on which to live.<sup>16</sup> Congress repealed this targeted unlimited deduction in 1969, explicitly criticizing wealthy individuals who paid little or no tax due to the charitable deduction (which was often possible due to the unintended consequence from donating appreciated property described above,

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<sup>12</sup> IRC § 170. Very generally, adjusted gross income represents one's net income after deducting from gross income the expenses of producing that income. IRC §§ 61 and 62.

<sup>13</sup> Initially, the deduction was limited to 15% of "net taxable income," with no carry-forward for any unused deduction. This was loosened somewhat in 1944, when the limitation was changed to 15% of "adjusted gross income," and a bit more in 1952, when it was raised to 20% of adjusted gross income. The limit was further raised to 30% in 1954, and in 1964, carry-forwards were allowed. The current limit was codified in 1969. Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 Neb. L. Rev. 1056, 1061-68 (2002).

<sup>14</sup> *Id.*

<sup>15</sup> IRC 170(b)(1)(c) (before repeal in 1969). See also R. Palmer Baker, Jr., *The Tax Treatment of Charitable Contribution Deductions Under the Tax Reform Act of 1969*, \_\_ Tulane Tax Institute 327, 328-31. Despite a 1924 Senate proposal to allow individuals who regularly contributed a substantial portion of their income an unlimited deduction, such a deduction was not implemented until 1964. As a result, the unlimited deduction was in effect only five years before repeal. Lindsey, 81 Neb. L. Rev. at 1061-68. Interestingly, the legislative history of the 1924 proposal seems to suggest a feeling that taxing someone who was already benefiting society with large portions of his income seemed superfluous. The history provides that "This provision is designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equaling virtually his entire income". *Id.* at 1061 n. 23.

<sup>16</sup> See Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 Tax Law Review 1, 24 (2002).

although the provision's legislative history does not link the two).<sup>17</sup> Interestingly, the legislative history suggests that fewer than 100 individuals per year took advantage of the unlimited deduction, albeit at a cost to the Treasury of \$25 million.<sup>18</sup>

Also in 1969, the general AGI limit was raised to its current level of 50%.<sup>19</sup> This limitation means that even if an individual donates all her income to charity, she can only deduct up to 50% of her income in the year of the contribution. The remaining amount carries forward for five years. The general 50% limit applies to cash contributions to public charities.<sup>20</sup> If some of her contributions are of appreciated property or are to a private foundation,<sup>21</sup> more stringent AGI limitations of 30% apply. Contributions of appreciated property to private foundations are capped at 20% of AGI. Carry-forwards are allowed in those situations as well. The limits do not apply, however, if recipients of "achievement" awards such as the Nobel Prize transfer them to charity.<sup>22</sup>

Although the limits' legislative history suggests that they were intended to target a small number of wealthy taxpayers,<sup>23</sup> the limits actually apply across all income levels and on a larger scale than one might suspect. In 2003, approximately 500,000 returns included charitable deductions carried-forward from previous years.<sup>24</sup> The amount of carried-over deductions claimed that year

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<sup>17</sup> Id.; Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 550-52.

<sup>18</sup> Baker, Tulane Tax Institute at 330.

<sup>19</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b)(1)(A), 83 Stat. 487, 550-51.

<sup>20</sup> "Public charities" are the types of organizations that spring to mind when most people think of the words "charity" or "non-profit," for example, schools, homeless shelters, tutoring programs, churches, and the like. Such organizations conduct their own charitable activities directly, and obtain income from a range of sources, including donations from the public, dues from members, fees for services, and grants from private foundations. Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* 27 (28<sup>th</sup> ed. 2003).

<sup>21</sup> A private foundation is a charitable organization that is initially funded by a single source (such as an individual, a family, or a corporation), whose income comes from investments rather than fees for services or donations from the public, and that makes grants to other charities instead of conducting its own charitable activities. Id. at xx.

<sup>22</sup> IRC § 74(b). Specifically, § 74 excludes from gross income "prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement" that are transferred to charity. The act of excluding from gross income funds that would otherwise be taxable renders the limits inapplicable.

<sup>23</sup> See Section IV.B.5 and text accompanying notes 138-41.

<sup>24</sup> Michael Parisi and Scott Hollenbeck, *Individual Income Tax Returns 2003*, at p. 44, Table 3 (IRS SOI division publication available at [www.irs.gov](http://www.irs.gov)). Due to the manner in which the IRS reports data from income tax returns, the amount of carried-over deductions claimed in a given year is a more accessible way of measuring the impact of the limits than trying to ascertain the amount of deductions *not* claimed in a given year because of the limits. To be sure, however, this

totaled over \$25.5 billion,<sup>25</sup> comprising about 18% of all individual income tax charitable deductions claimed in 2003. That amount exceeds the amounts of charitable bequests (\$18.2 billion) and corporate giving (\$11.1 billion) for 2003 and approaches the level of foundation giving for that year (\$26.8 billion).<sup>26</sup>

What may be surprising is the extent to which the limits apply to taxpayers at all income levels. Of the roughly 500,000 returns claiming a carried-over deduction in 2003, over 191,000 returns (about 38%) showed an AGI under \$25,000. An additional 214,000 returns (roughly 43%) reflected an AGI between \$25,000 and \$100,000. Just over 89,000 of the 500,000 returns (almost 18%) showed an AGI between \$100,000 and \$1,000,000; and only about 6,500 returns (approximately 1.3%) had an AGI greater than \$1,000,000.<sup>27</sup> Because AGI reflects only current income and not a taxpayer's accumulated wealth, it is likely that some of the generous lower-income taxpayers who carry-forward charitable deductions have substantial wealth yet little current income.<sup>28</sup> It is also likely, however, that some of these lower-income taxpayers do not have substantial accumulated assets and are not what most people would consider "wealthy."<sup>29</sup>

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data does not illuminate how many contributions in a given year were not made at all due to the limits.

<sup>25</sup> *Id.*

<sup>26</sup> Giving USA 2006 at 204.

<sup>27</sup> Author's calculations based on data at p. 44, Table 3 of Parisi and Hollenbeck.

<sup>28</sup> Looking at estate tax data can shed light on the interplay between accumulated wealth and income. David Joulfaian, an economist at Treasury, recently conducted a ten-year panel study of individuals dying between 1996 and 1998 that showed that a fair number of individuals with estates of over \$1,000,000 (in 1997 dollars) had mean AGIs lower than \$1,000,000 for the ten years before death. Of such decedents, for example, approximately 1% had a mean AGI below \$50,000; just over 2% had a mean AGI between \$50,000 and \$100,000; about 8% had a mean AGI between \$100,000 and \$200,000. Approximately 18% had AGIs between \$200,000 and \$500,000; and 19% had AGIs between \$500,000 and \$1,000,000. The remaining 47% had mean AGIs over \$1,000,000. See David Joulfaian, *Charitable Giving in Life and Death*, 22 *tbl.* 3 (2000) (available on SSRN). This suggests that it is likely that at least some extremely charitable individuals with low AGI's have some accumulated wealth.

<sup>29</sup> The Treasury study also shows, however, that mean AGI tends to rise with estate size. *Id.* This in turn suggests that it is also quite likely that some extremely charitable individuals with low AGIs do not have much accumulated wealth. This makes sense: Unless one invests one's wealth almost solely in assets paying no current taxable income at all, large stocks of wealth will likely spin off at least some realized taxable income. For example, even accumulated wealth of \$5,000,000 with a realized taxable return of only 1% a year would give someone an AGI of \$50,000. One might, of course, invest heavily in tax-exempt bonds or be the beneficiary of trust income taxed at the trust level [insert other possibilities], and this might explain the ability of at least some individuals to make large donations relative to their AGI. Unless that is the case, however, it is hard to be extremely wealthy and have a very low AGI at the same time. It is thus likely, therefore, that at least some of the returns showing a low AGI and carried-over deductions are from individuals without substantial accumulated wealth who are what we might think of as

In the wake of Hurricane Katrina, these limits were temporarily lifted for certain contributions made between August 28, 2005 and December 31, 2005.<sup>30</sup> Although prompted by Hurricane Katrina, the Act lifted the 50% AGI limitation for cash contributions to any public charity--whether engaged in hurricane relief or not. The Act's legislative history suggests that Congress's concern was two-fold: First, it wanted to spur giving to hurricane relief groups. In addition, Congress wanted to assist other charities susceptible to donor fatigue from both the hurricane and the December 2004 tsunami, as well as a potential drop in donations due to rising gas prices and fears of an economic downturn.<sup>31</sup> One year later, in the Pension Protection Act of 2006, Congress again temporarily lifted the limits in narrow circumstances: The Act excludes from income IRA distributions made in 2006 and 2007 directly to charitable recipients of up to \$100,000.<sup>32</sup> (The act of excluding such distributions from the retiree's income renders the AGI limits inapplicable.)

Unfortunately, it is too early to estimate, even roughly, whether these provisions will have a long-term impact on giving.<sup>33</sup> Early and unofficial data suggests that KETRA spurred \$11 billion in charitable donations, costing the Treasury more than \$3 billion—far greater than the estimated cost of \$819 million.<sup>34</sup> However, anecdotal evidence suggests that while KETRA may have

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lower- or middle-class. Data on the interplay of wealth levels, mean AGI, and carried-over deductions are not currently available to the public, although Treasury has indicated that it may publish such a study in the future. Author's conversation with David Joulfaian, January 9, 2007.

<sup>30</sup> Katrina Emergency Tax Relief Act, H.R. 3768 (September 23, 2005). The Act also temporarily repealed the then 3% phase-out of itemized deductions in § 68 for charitable contributions.

<sup>31</sup> Statements of Representatives Mark Souder, [add others] in Congressional Record for KETRA, Sept. 15, 2005 (available at [www.govtrack.us](http://www.govtrack.us)); Holly Hall, A Special Katrina-Inspired Tax Break Produced Mix Results for Charities, *Chronicle of Philanthropy* 18 (Volume 18, Issue 7, January 26, 2006).

<sup>32</sup> Pension Protection Act of 2006 § 1201, H.R. 4 (amending § 408(d)).

<sup>33</sup> For KETRA, this is so because gifts made in 2005 will appear on returns due as late as August of 2006, and a lag time exists between filing due dates and the IRS's release of statistics from a given set of returns. However, the 2005 version of Schedule A of Form 1040 (on which taxpayers report itemized deductions) does have a separate line in which taxpayers can report charitable contributions for which they are specifically claiming the benefit of KETRA. See [http://cdn.digitalcity.com/ch\\_pf/tax\\_forms\\_2006\\_scheduleab.pdf](http://cdn.digitalcity.com/ch_pf/tax_forms_2006_scheduleab.pdf). Such specificity will be helpful in the future. According to Melissa Brown, the editor of Giving USA, the IRS has indicated that it will not release final data on 2005 charitable giving until the fall of 2007. For Author's phone conversation with Ms. Brown, January 8, 2007. For the Pension Protection Act, this is because the provision does not expire until the end of 2007, meaning that many gifts eligible for the provision have not even been reported to the IRS yet.

<sup>34</sup> Stephanie Strom, Hurricane Tax Break Spurs Triple Projected Donations, *N.Y. Times* A9 (April 21, 2007).

encouraged some gifts that otherwise would have gone unmade, it also likely shifted some giving planned for 2006 or later into 2005, as donors fulfilled pledges early or otherwise sped up giving to take advantage of the temporary provision.<sup>35</sup> 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.<sup>36</sup> Many experts thus do not anticipate a long-term increase in giving from KETRA.<sup>37</sup> At passage, however, the Joint Committee estimated KETRA's revenue effect between 2006 and 2015 from lifting the limits and the 3% phase-out to be over \$861 million dollars.<sup>38</sup> This suggests that an increase in otherwise unmade gifts was expected. Regardless of these provisions' ultimate impact, however, their passage suggests that many in the charitable community believe that the AGI limits do dampen charitable giving.

### III. Base-measurement and the AGI limits

Given the limits' substantial and widespread impact, they have attracted surprisingly little theoretical attention. This Paper fills that void by exploring whether, as a normative matter, there is any reason to limit someone's charitable deduction based on the portion of income it represents. This cannot be done, however, without understanding *why* charitable deductions are allowed in the first instance. Two theoretical rationales predominate in justifying the income tax charitable deduction: the base-measurement theory and the subsidy theory. My goal in this Article is not to critique or justify these rationales for the charitable deduction in the first instance. Rather, my goal is to assess whether, under each theory for the deduction, a limit based on what portion of AGI one's donations comprise is normatively justified. I argue that if one subscribes to the base-measurement theory for the deduction, the AGI limits are only weakly justified. If, however, one believes that the subsidy theory justifies the deduction, then the

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<sup>35</sup> Giving USA 2006 at 67. It appears that large charities that reached out to their donors about KETRA's provisions (such as Princeton, Haverford, and the ACLU) were the main beneficiaries of KETRA's largesse. Hall, Chron. Of Phil. article.

<sup>36</sup> Giving USA 2006 at 124; other data on 1986 changes re AMT and appreciated property.

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

<sup>38</sup> Joint Committee Print JCX-68-05, Estimated Revenue Effects to H.R. 3768, the "Katrina Emergency Tax Relief Act of 2005," (Sept. 21, 2005).

AGI limits are strongly justified on both economic theory and political theory grounds.

### **A. The base-measurement theory for the charitable deduction**

The base-measurement theory, first articulated by Professor William Andrews,<sup>39</sup> suggests that a deduction for charitable transfers is necessary to measure income accurately. Starting from the Haig-Simons definition of the ideal income tax base<sup>40</sup> as accumulation plus consumption,<sup>41</sup> Andrews argued that personal consumption (and therefore income) should not include amounts expended by an individual for charitable purposes.<sup>42</sup> In other words, such expenditures should be excluded from the ideal income tax base.

As explained by Professor 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.”<sup>43</sup> Charitable contributions, he reasoned, deflect resources away from private use and toward common goods “whose enjoyment is not confined to contributors nor apportioned among contributors according to the amounts of their contribution.”<sup>44</sup> Under this reasoning, because any benefit the donor receives is necessarily shared by others, a charitable contribution should not

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<sup>39</sup> William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 309 (1972).

<sup>40</sup> That is, what most scholars of tax policy believe to be the purest definition of what should constitute “income” for purposes of levying an income tax in accordance with one’s ability to pay. Although the Internal Revenue Code departs from this ideal in many important respects, it is often used as a benchmark against which to measure various aspects of our current system. See, e.g., Michael J. Graetz and Deborah H. Schenk, *Federal Income Taxation: Principles and Policies* 89-91 (5<sup>th</sup> ed. 2005).

<sup>41</sup> Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, in *The Federal Income Tax* 1, 7 (Robert M. Haig, ed., 1921), reprinted in *Am. Econ. Ass’n, Readings in the Economics of Taxation* 54 (Richard A. Musgrave & Carl Shoup, eds., 1959); Henry C. Simons, *Personal Income Taxation* 50 (1938).

<sup>42</sup> Andrews at 344-75.

<sup>43</sup> *Id.* at 346.

<sup>44</sup> *Id.* For example, “a wealthy man cannot purchase and enjoy the sound of a new church organ without conferring a benefit on his fellow parishioners . . . [and] attendance at church on a particular Sunday, use of the town library, or listening to a symphony orchestra broadcast will not immediately prevent someone else from doing the same thing.” *Id.* at 357-58. Modern economic terminology refers to such goods as “public goods;” Mark A. Gergen, *The Case for a Charitable Contribution Deduction*, 74 *Va. L. Rev.* 1393, 1397 (1988), and for that reason, some scholars have re-characterized Andrew’s argument as simply another argument for subsidizing public goods. See *id.* at xx.

constitute consumption.<sup>45</sup> In a similar vein, Boris Bittker has argued that charitable contributions have such a high moral value that they should be ignored when determining the amount of income at the voluntary disposal of the taxpayer—in other words, that they should not constitute consumption due to that high moral value.<sup>46</sup> To these ends, many tax theorists believe that allowing a deduction for charitable contributions is necessary to define the ideal income tax base.

## **B. Base-measurement and the AGI limits**

If the deduction helps define the ideal income tax base, one potential justification for the AGI cap is that a limited charitable deduction, rather than an unlimited one, most accurately measures income. This section explores two alternative conceptions of measuring income under which AGI limits might be justified.

### **1. Measuring Personal Benefit as Consumption**

Perhaps the AGI cap reflects a notion that charitable transfers involve some element of consumption and therefore should not be completely excepted from tax. This rationale is initially plausible: Because giving is voluntary, and donors choose to make donations instead of purchasing wine or vacation homes or whatever else it is that they spend their money on, it is 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.<sup>47</sup>

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<sup>45</sup> Andrews at 344-75.

<sup>46</sup> 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 (1990). (arguing that charitable transfers should be exempted from tax due to their altruistic nature).

<sup>47</sup> See, e.g., Gergen at 1408, 1430; Colombo, 36 *Wake Forest L. Rev.* at 670-73; Eric Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 *Wis. L. Rev.* 567, 574-77. One study examined donations to schools that divide donors into various ranges—such as \$500 to \$999, or \$1,000 to \$2,500—for purposes of listing them in alumni magazines. A disproportional number of alumni made gifts that just barely qualified them for each level. For example, 93% of those listed as contributing between \$500 and \$999 to Harvard Law School in its 1993-94 report contributed exactly \$500. Donations to Carnegie Mellon show a similar pattern. These results, coupled with extremely low numbers of anonymous gifts, suggest that purchasing recognition is one identifiable and desired benefit from making a charitable gift. Amihia Glazer and Kai A. Konrad, *A Signaling Explanation for Charity*, 86 *Am. Econ. Rev.* 1019, 1021 (1996).

Other benefits are more tangible, such as the ability to enjoy an opera, attendance at a benefit party, nicer facilities at their children's school, and the like.<sup>48</sup>

If charitable giving includes an element of consumption, then it makes sense that donations should not be fully deductible.<sup>49</sup> This conclusion, however, does not justify limiting one's charitable deduction to some portion of her AGI as we currently do. For several reasons, the existing limit is an ineffective means of reflecting that charitable transfers may contain an element 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.<sup>50</sup> Tying deductibility to AGI in this manner creates the following paradox: Someone who contributes 49% of her income to charity can deduct the full amount; no portion of her gifts is thus treated as consumption. In contrast, once an individual donates more than half<sup>51</sup> her income to charity, an increasingly larger portion of her contributions is treated as consumption.<sup>52</sup> While donations may have different elements of consumption depending on the taxpayer's motives and the intangibles received in return, it is unlikely these are tied to the ratio of the size of the donation to AGI.

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<sup>48</sup> Colombo, 36 Wake Forest L. Rev. at 67; McNulty, Public Policy and Private Charity: A Tax Policy Perspective, 3 Va. Tax rev. 229, 236 (1984). (also check Schwartz book at 674, quoting Giving in America: Toward a Stronger Voluntary Sector, Report of the [Filer] Commission on Private Philanthropy and Public Needs 107-111 (1975). Insert cites to Andrews's critics.)

<sup>49</sup> See Bittker, Hess Lecture at 165. Mark Kelman, Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World, 31 Stan. L. Rev. 831, 849-51 (1979) (criticizing Andrew's contention that charitable giving is not consumption in part, because donors receive deference, respect, and attention); Stanley A. Koppelman, Personal Deductions Under an Ideal Income Tax, 43 Tax L. Rev. 679, 707 (1988) (conceptualizing an ideal income tax as taxing the power to consume and concluding that spending cash or property on charitable purposes "represents a clear personal benefit to the donor"); S. Surrey, Pathways to Tax Reform (1973) at 21 or S. Surrey and P. McDaniel, Tax Expenditures at 21 (1985); Thomas D. Griffith, Theories of Personal Deductions in the Income Tax, 40 Hastings L. J. 343, 375-77 and n.169 (1989)(See Strnad, in Susan Rose Ackerman 278-86.

<sup>50</sup> Steurle and Sullivan, 12 Am. J. Tax Pol'y at 409.

<sup>51</sup> Or more than whatever other percentage limit might apply. My criticism is of using any percentage of AGI as a baseline, not of using 50% per se. The same reasoning used here with respect to a 50% limit would apply with equal force to some other percentage limit.

<sup>52</sup> To illustrate: If a donor contributes 60% of her income to charity, she can deduct five-sixths of the transfer (an amount equal to 50% of her AGI). Only one-sixth of her transfer is treated as non-deductible consumption. If she instead contributes 75% of her income to charity, she can deduct only two-thirds of the transfer. In that situation, twice as much of her transfer – one-third – is treated as non-deductible consumption. Under this reasoning, the same \$100,000 transfer has differing elements of consumption based on what percentage of a donor's AGI it represents.

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

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

Moreover, the existence of carry-forwards for unused deductions suggests that ferreting out consumption cannot justify the current AGI limits. If the limits were meant to make consumption expenses non-deductible, there would be no carry forwards. If part of an individual’s contribution was consumption in the year made, why change its status and allow a deduction the next year?<sup>53</sup>

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 inherent in a charitable gift further suggests that the AGI limits cannot be justified on that ground.<sup>54</sup> Two types of such potential limits exist.

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<sup>53</sup> Even if carry-forwards were disallowed, however, I believe that the limits do a poor job of delineating the potential element of consumption in a charitable gift for the other reasons suggested in this Section.

<sup>54</sup> Obviously, much more can be said about how to structure limits on the charitable deduction that are designed to accurately differentiate the consumption and non-consumption elements of a charitable donation, and proposing such a structure is not within the scope of this Article. I make these observations by way of contrast to illustrate how the current limits fail.

First, limiting deductibility to some flat percentage of each contribution (much like allowing a deduction of 50% for business meals)<sup>55</sup> would reflect the idea that any charitable contribution contains both consumption and non-consumption elements simultaneously, regardless of how many other contributions a donor makes, her AGI, or the portion of her AGI represented by any given contribution.

Second, such a limit would likely differ based on the charitable recipient. For example, it is likely that giving to an opera you regularly attend, to your child's college, or to the local museum in exchange for a wing with your name on it has a greater element of consumption than giving to a soup kitchen or tutoring center across town. Other than imposing lower deductibility limits for contributions to private foundations as opposed to public charities, the current AGI limits treat all charities equally, further suggesting that ferreting out consumption does not satisfactorily justify their existence.

## 2. Moral Theory

The AGI limits might, alternatively, reflect the boundaries of the notion that we have a moral duty to contribute to charity.<sup>56</sup> As Bittker, among others has argued, because of this moral duty, some or all charitable transfers should not be taxed.<sup>57</sup> Can the AGI limits be justified on this ground? Perhaps, but only if one believes that this duty is somehow limited to contributing a percentage of one's income. To explain: If this duty was unlimited, then the charitable deduction should be unlimited, rendering the AGI limits unjustifiable. Alternatively, if this duty was limited to supporting only organizations with a high moral value, then the AGI limits would also be unjustifiable. Instead, a limit allowing deductions only for contributions to those favored organizations would make sense.

It may be the case, however, that the AGI limits reflect a judgment about the extent to which charity is morally required or valuable. Traditionally, for example, many religious denominations have required members to tithe a set percentage of their income, often ten percent. Perhaps an AGI limit reflects the idea that donating up to a certain percentage of one's income signals a moral duty, but that donations beyond that percentage suggest that other motivations are at play. In other words, up to a certain percentage of your income is "God's"<sup>58</sup>

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<sup>55</sup> IRC § 274(n); [insert additional examples].

<sup>56</sup> I thank Bill Klein for this suggestion.

<sup>57</sup> Bittker at \_\_\_\_.

<sup>58</sup> Or some other charity's money. This is somewhat similar to Evelyn Brody's suggestion that charities deserve tax-exemption on sovereignty grounds. Evelyn Brody, *Of Sovereignty and Subsidy*, J. Corp. Law.

money—not the government’s—on moral grounds, but anything beyond that is fair game for taxation. Under this reasoning, some limit based on what percentage of AGI a donation represents might be justified as structuring the deduction to reflect one’s moral duty to give to charity. It is possible, however, that such a limit would be lower than 50%, perhaps 10% to reflect traditional tithing requirements.

#### IV. The Subsidy Theory

Turning away from the base-measurement theory, this Section analyzes whether the limits make sense under the subsidy theory for the charitable deduction.<sup>59</sup> In this Section, I argue that the AGI limits are not justified under any of the reasons that other tax scholars have previously suggested, forcing us to turn elsewhere for their justification. The limits cannot be justified as reflecting a desire to limit the private production of various public goods for reasons related to the goods in question or to prevent the wealthy from engaging in tax shelters. Instead, in Sections V and VI, I rely on economic and political philosophy to argue that the limits are compelled by certain aspects of our democratic structure.

Under the subsidy theory, even if charitable transfers should be taxed in a pure Haig-Simons world, the deduction is justifiable as a tax expenditure to subsidize charity generally.<sup>60</sup> A variety of arguments abound as to why subsidize charity. The more recent (and probably more accepted) explanation is grounded in economics: Quite generally, it theorizes that subsidizing charities is necessary to assist them to provide public goods that would otherwise be under-produced due to market and governmental failures.<sup>61</sup>

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<sup>59</sup> I reiterate that my goal here is neither to critique the subsidy theory generally nor to use the AGI limits as a tool for so doing. Rather, my goal is to determine whether, accepting that theory as a given, one can justify the AGI limits.

<sup>60</sup> The deduction is thought to subsidize charity in the following manner. Imagine a taxpayer in the 35% bracket who donates \$100 to charity and receives a \$100 deduction. This deduction reduces her tax bill by \$35, meaning that she has 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 taxpayer’s incentives to make them. Gerald E. Auten, Charles T. Clotfelter, and Richard L. Schmalbeck, *Taxes and Philanthropy Among the Wealthy* 417 in Joel B. Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* 392 (2000). This increased giving in turn enhances the scope and activity of the charitable sector. This subsidy can also be characterized as a “matching grant” from the government, which matches each taxpayer’s gift to charity with a grant equal to 35% of that gift. From that perspective, taxpayers can be thought of as individually directing the allocation of federal funds. Levmore at 405, Bittker, 28 *Tax L Rev* 37 [check]; McDaniel, 27 *Tax L Rev* 377 [check].

<sup>61</sup> See note 56 and Section IV.A. generally.

The more traditional explanation is that subsidizing charities is “good” because of the benefits charities provide. Some theorists focus on the fact that charities relieve the government of burdens the government would otherwise have to bear (for example, poverty relief). Others emphasize the role that charities play in providing creative and diverse solutions to society’s problems, or in offering alternative viewpoints in the arts and culture. Lastly, some scholars highlight the role that non-profits play in countering governmental power and enhancing pluralism.<sup>62</sup>

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

### **A. The subsidy theory**

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

#### **1. Non-profit institutions, market failure, and government failure**

As mentioned above, both the traditional and the economic explanation of the subsidy theory rest on the idea that the charitable sector *generally* provides public goods.<sup>63</sup> This is so because classic economic theory suggests that the

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<sup>62</sup> Cites.

<sup>63</sup> To be sure, not every organization eligible under § 170 to receive deductible gifts provides public goods (or even impure ones), and not all organizations providing public goods are eligible to receive deductible contributions. I emphasize here that the existing economic theory for the charitable deduction, which I am taking as my starting point, merely attempts to best justify the very *existence* of a charitable deduction as a means of subsidizing transfers to groups providing both pure and impure public goods (because the latter contain some—but not all—of the characteristics of the former, they are also susceptible to market failure). Colombo and Hall at 108-09. Proponents of this model do not assert that it justifies every detailed facet of the current

market will undersupply public goods<sup>64</sup> due to free-riding and positive externalities.<sup>65</sup> Either the good remains undersupplied, or the government or non-profit sector remedies the market failure in question by supplying the good. Often, the government overcomes the market failure in question by “coerce[ing] ‘purchase’ by everyone via the power of taxation.”<sup>66</sup> As explained further below, however, in some instances the government cannot or purposefully will not remedy the market failure.<sup>67</sup> In that case, non-profits step in to help.

Existing literature on the economic subsidy theory 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).<sup>68</sup> This argument first assumes that “governmental decisions in a democracy are roughly shaped by the desires of the majority of the electorate”<sup>69</sup> and that the median voter determines

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deduction’s *structure*. Indeed, many proponents of this model recognize that some of the details of § 170 do not “fit” with the model and thus argue that § 170 should be modified. See, e.g., *id*; Gergen at XX. This does not detract from the theory’s main contribution, which is that the subsidy rationale best justifies the deduction’s existence and general contours. In other words, even though the structure of § 170 itself might not perfectly reflect the economic subsidy argument, there is enough fit to render the argument worthy of study as a rationale for § 170’s existence. Moreover, groups receiving a partial subsidy under § 170 must provide some “public benefit” even if they do not provide public goods in the economic sense. Colombo and Hall; Gergen. Thus, this imperfection in the structure of § 170 does not detract from my broader point that § 170 allows individuals to direct government subsidies to groups that fulfill their own visions of what is beneficial to society (whether that vision includes public goods, impure public goods, or some other project benefiting society).

<sup>64</sup> [Define public goods. Nonrivalry (consumption by one person does not reduce availability to others) and nonexclusivity (once provided for one person, cannot exclude others). Gergen at 1397.]

<sup>65</sup> [Give examples and cites. Gergen at 1398; Weisbrod; Colombo and Hall.]

<sup>66</sup> Colombo and Hall, *The Charitable Tax Exemption* at 101; Weisbrod, *The Nonprofit Economy* at 20 (1988). This coerced purchase precludes free riding and ensures that individuals do not under-purchase public goods with large positive externalities. Once the government has thus coerced the purchase of a public good, it can either provide the public good directly (for example, TANF), or subsidize others to do so (for example, by granting a charitable deduction for donations to social service agencies like the Salvation Army and soup kitchens).

<sup>67</sup> As explained below, I believe the instances where the government *cannot* remedy the market failure illustrate the application of the economic view of the subsidy theory and the instances where the government *will not* remedy the market failure illustrate the more traditional subsidy theory.

<sup>68</sup> Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in Susan Rose-Ackerman, ed., *The Economics of Nonprofit Institutions* 21 (1986); Hall and Colombo, 101-113; Gergen; [others].

<sup>69</sup> Colombo and Hall at 102, citing Buchanan and Tullock, Weisbrod.

the level at which government supplies a given public good.<sup>70</sup> It thus concludes that if demand for the good is relatively homogenous,<sup>71</sup> then the median voter's demand for the good closely mirrors that of voters on each extreme. In such cases, if the government supplies "enough" of a good to satisfy the median voter, it will be very close to supplying "enough" to satisfy most other voters. Little unmet demand remains.<sup>72</sup>

In contrast, the government will be unable to overcome a market failure when demand for a given public good is heterogeneous (that is, the amount each voter demands varies). This is so because if the government supplies enough of the public good to satisfy only the median voter, it will fall short of satisfying the "high-demand" minority.<sup>73</sup> I shall term this "accidental" governmental failure. The high-demand minority, failed by both the market and the government, must seek another solution to meet their demands.<sup>74</sup> One solution is the non-profit sector: Individuals who demand more of a given public good than the government can or will produce are often thus moved to make donations of time and money to non-profits to produce the good at a satisfactory level.<sup>75</sup>

Some readers might object to the existing model at this point on the grounds that the median-voter model is flawed. I acknowledge this objection, and briefly explore other models in Section V.D.4. At this point, however, what is important to take away from the model is that the government, for some reason, cannot overcome a market failure. As Professors Colombo and Hall have noted, the conclusion that high-demanders turn to non-profits in the face of government failure does not depend on *why* a government failure occurred.<sup>76</sup>

In fact, the term "government failure" may sometimes be a misnomer. This "failure" may not always be bad: In some cases, provision by a non-profit may be preferable to governmental provision. For example, maybe the non-profit sector provides the good more efficiently than the government,<sup>77</sup> or perhaps it

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<sup>70</sup> I recognize that the majoritarian, median-voter framework described above is only one possible description of the democratic process. See n. 5. See Section V.D.4. for an analysis of the charitable deduction and AGI limits using a non-median-voter framework.

<sup>71</sup> That is, the amount of the good demanded is relatively similar among voters.

<sup>72</sup> Colombo and Hall at 102; Weisbrod at 22-26.

<sup>73</sup> That is, those who demand more of given good than the median voter. Colombo and Hall at 102; Weisbrod at 22-26.

<sup>74</sup> Colombo and Hall at 102; Weisbrod at 26-32.

<sup>75</sup> Colombo and Hall at 102; Weisbrod at 30.

<sup>76</sup> Colombo and Hall at 102-103.

<sup>77</sup> *Id.*

provides the good in a more creative manner.<sup>78</sup> Voters may wish to avoid sullyng the good in question with the taint of coerced government funding, preferring the more morally pure halo of altruistic funding and production.<sup>79</sup> Or maybe, voters recognize the importance of a strong non-profit sector that can serve as a check on government power and enhance pluralism.<sup>80</sup> Lastly, sometimes the government *cannot* produce the good in question for constitutional or other reasons, as is the case with churches and other charities producing religious goods.

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

## 2. The role of tax subsidies

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

### a. Subsidies and “purposeful” government failure

Let’s start with the latter dilemma. As explained above, purposeful government failure occurs when an affirmative decision is made that it is better for the non-profit sector to provide a given public good than the government. Unfortunately, however, the same free-rider and externality problems that inhibit provision of these goods by the market also plague charities, making it difficult

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<sup>78</sup> For example, even voters who support traditional governmental anti-poverty programs such as TANF may also recognize the value in having charities provide supplemental mechanisms for reducing poverty, such as Dress for Success. Sometimes charities may implement alternative ways to reduce poverty that the government did not think of, or sometimes charities may implement similar activities in a more efficient or appealing manner.

<sup>79</sup> Colombo and Hall at 102-03; Atkinson; [insert cites for efficiency and transaction cost arguments].

<sup>80</sup> Theresa Odendahl; *Charity Begins at Home* xx; [insert additional cites].

for the charitable sector to fulfill the role envisioned for it by traditionalists. Thus, it is necessary to help charities overcome these problems without polluting the attributes that make them preferable to government in the first instance.

Enter the charitable deduction: By lowering the cost of supporting such institutions via a tax subsidy, free rider problems can be lessened.<sup>81</sup> By the same token, since the tax subsidy depends upon independent acts by non-governmental actors, all the benefits of non-governmental provision are saved.<sup>82</sup> In this manner, the charitable deduction is a product of purposeful government failure.<sup>83</sup>

### **b. Subsidies and “accidental” government failure**

What about the case of accidental government failure?<sup>84</sup> 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 justification. As the price of a good decreases, the amount demanded by a given consumer increases. By replacing full funding of a public good with only partial funding (via the charitable deduction), cost is reduced and the amount demanded by the consumer/voter will increase. The median voter will thus be willing to partially subsidize the good at greater levels than she would be willing to fully subsidize it. In other words, she receives some benefit from increased production of the good in question – enough to pay a little more for it via a tax subsidy, but not enough to pay for all of it.<sup>85</sup>

A similar rationale for the subsidy is that it represents a bargain among various taxpayers with minority interests.<sup>86</sup> The median voter may agree to

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<sup>81</sup> Hochman and Rodgers, in Susan Rose-Ackerman at 225. In addition, non-profits use a variety of other tools to reduce the free-rider problem, such as social pressure, donor recognition, appeals to altruism and the like.

<sup>82</sup> Colombo and Hall; Weisbrod, *The Nonprofit Economy*; Hochman and Rodgers at 226; Halperin, 56 *Tax Law Rev.* 7.

<sup>83</sup> I note that many of the benefits I describe in more detail in section IV.B.2.c. could also apply here.

<sup>84</sup> I do not necessarily view accidental vs purposeful government failure as all-or-nothing proposals, and believe that some legislative results may simultaneously contain aspects of both. Explain.

<sup>85</sup> Colombo and Hall at 108; Weisbrod, *Voluntary Nonprofit Sector* at 36.

<sup>86</sup> Colombo and Hall 108; see also Saul Levmore, *Taxes As Ballots*, 65 *U. Chi. L. Rev.* 387, 404- (1998); Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 *Tax L. Rev.* 377, 390-91 (1971) (recognizing that tax-subsidized charitable transfers enhance pluralism but arguing that matching grants are preferable to deductions since the latter favor higher-income individuals' preferences).

provide partial subsidies for public goods from which she receives no direct marginal benefit from increased production *so long as* she receives another benefit—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 studying, especially if the bargain results in each group getting some help for its own preferred interest. Because everyone who has a particular interest subject to government failure benefits from exemption, and because virtually all segments of society either have such an interest or directly benefit from such an interest . . . exemption becomes a method for government to assist *all* of society in providing goods and services that the market cannot provide . . . and which the government cannot fully provide directly because of structural deficiencies in the democratic system.<sup>87</sup>

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

### **c. Subsidies and taxes**

A question remains: Why provide the bargained-for subsidy via the tax system instead of governmental grants? As an initial matter, using a deduction means that individual taxpayers (instead of the legislature) decide which charities receive the subsidies and how large the subsidies should be.<sup>88</sup> Tying the subsidy

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<sup>87</sup> Id. at 108 (emphasis in original).

<sup>88</sup> Halperin, 56 Tax Law Rev. 7. This is because a deduction (or a credit) acts like a matching grant: When a taxpayer contributes \$100 to a given charity and receives a \$35 deduction, she and

to the preferences of individual taxpayers has several benefits. On a political level, by removing the decision about which particular groups to partially subsidize from the legislature, those decisions are shielded from the vagaries of the legislative process, thus diminishing the prospect of further government failure.<sup>89</sup> The matching grant aspect, moreover, means that the charities that receive the most donations (that is, the most support from individual taxpayers) receive the largest subsidies. This allows the subsidies to reflect the electorate's enthusiasm for given charities, which might not happen if the legislature<sup>90</sup> determined how much of a subsidy each charity could receive.<sup>91</sup> Moreover, the matching grant is triggered only by an affirmative sacrifice on the part of the taxpayer (someone who makes a \$100 donation and receives a deduction is, even after the \$35 drop in her tax bill, still out of pocket \$65). Perhaps this spurs taxpayers to think more carefully about which projects they fund and to develop other commitments to those projects, such as volunteering.<sup>92</sup>

This structure is also beneficial from an economic viewpoint. Namely, it helps allocate the costs of funding a given charitable public good among taxpayers in accordance with how much each values that good.<sup>93</sup> High-demanders pay "more" by making charitable contributions. Low-demanders pay

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the government are now partners in the contribution. Her donation has triggered a \$35 "match" from the government, and she is now single-handedly responsible for allocating \$35 of federal funds to the charity of her choice.

<sup>89</sup> Some readers may wonder why the legislature would purposely choose to delegate decision-making in this way. Professor Saul Levmore offers two explanations. The pessimistic view is that perhaps Congress conducted a rough cost-benefit analysis and decided that the benefits of having non-profits lobby for favors were outweighed by the costs of favoring some charities over others. The optimistic view is that the deduction is a "pre-commitment" to discourage rent-seeking that otherwise might occur. Levmore at 408.

<sup>90</sup> Or some agency (such as the IRS) to whom Congress delegated that decision-making authority. One could imagine a situation, for example, where charities applied for federal grants from some central administrative agency. Such decisions also might not reflect the populace's enthusiasm. Of course, that agency could look at the level of donations received as a way of gauging support. That, however, leads us back to the merits of using the tax system – so doing would have the same effect and be more administratively convenient.

<sup>91</sup> Levmore at 398-99, 404-405.

<sup>92</sup> *Id.* at xx, 411; Halperin, 56 *Tax Law Rev.* at 8.

<sup>93</sup> See Gergen at 1400-1406 (summarizing the works of Jeff Strnad and Hochman and Rodgers on this point). This approximates what economists call a Lindahl solution, in which a collective good is funded at the level where the marginal benefits received by both contributors and non-contributors alike equals their respective marginal costs (in the form of voluntary contributions and cost-shifting from taxes that support the subsidy). *Id.*; Hochman and Rodgers at 228. Economists disagree, however, as to whether a tax deduction or a tax credit is preferable on efficiency grounds. Cf. Strnad (supporting a deduction) with Hochman and Rodgers (supporting a credit).

“less” in that they won’t contribute directly to a given charity, but are forced to pay for the smaller benefit they receive indirectly, through the tax system.<sup>94</sup> 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.<sup>95</sup>

On the other hand, structuring the subsidy as a tax deduction 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.<sup>96</sup> Others question the fact that higher-bracket taxpayers receive more of a “match” per dollar than other taxpayers, and that non-itemizers receive no match at all.<sup>97</sup> 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.<sup>98</sup> Maybe setting limits on the ability of a taxpayer to take a charitable deduction addresses some of these potential concerns.

## **B. Subsidy theory and existing explanations for the AGI limits**

Although the works discussed above are helpful in justifying the existence of the charitable deduction as well as its potential flaws, none attempt to justify the AGI limits.<sup>99</sup> This Section analyzes existing theories for the limits under the

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<sup>94</sup> For a discussion of whether it is morally “fair” to force low-demanders to partially subsidize such goods, see Gergen at 1401 n. 27. For my purposes, I am assuming that the bargain described above that results in the deduction is a “fair” bargain 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.

<sup>95</sup> Gergen at 1402.

<sup>96</sup> Levmore at 406.

<sup>97</sup> See Section IV.B.1 and 2. It may be the case, however, that non-itemizers are implicitly benefiting from the bargain described above as recipients and patrons of non-profit organizations. Strnad, others.

<sup>98</sup> Levmore at xx. Approximately 80 million people, for example, voted in the 2002 mid-term elections. Cite. In contrast, approximately 40 million tax returns reflected an itemized charitable deduction. (This could represent more than 40 million people, however, as some of those returns represent joint returns from married couples.) 2002 SOI data, published in 2004.

<sup>99</sup> 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 coherent scrutiny of the details of the deduction could occur. For example, Weisbrod, Colombo and Hall were addressing the question of whether to have a subsidy in the first instance. Levmore asked whether that subsidy should flow through the tax system, and Strnad, Hochman and Rodgers questioned whether that tax subsidy should be a deduction or a credit.

subsidy rationale offered by other scholars, and finds that they do not hold up under scrutiny, thus requiring us to look elsewhere for their justification.

### 1. Limiting the governmental subsidy of “rich people’s” charities

Looking at the provision’s intended reach—high-income donors—suggests one plausible justification for the AGI limits under the subsidy theory:<sup>100</sup> Perhaps the limitation minimizes the governmental subsidy of charities favored by the wealthy,<sup>101</sup> either as part of an affirmative decision about what a proper charitable sector should be or as part of the bargain about which charities to subsidize. This idea stems from the well-documented fact that higher-bracket taxpayers generally—but not always—donate to different types of charities than lower-bracket taxpayers. The former tend to favor colleges and universities, health institutions, and cultural institutions such as museums. In contrast, lower-income givers tend to favor churches and other religious organizations, federated campaigns, and social service organizations.<sup>102</sup>

Why might limiting the subsidy of “rich people’s charities” be desirable? Perhaps this desire stems from a belief that such organizations are less worthy of a subsidy because they lack a strong redistributive component.<sup>103</sup> Alternatively,

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<sup>100</sup> Although the limitations technically apply to taxpayers in all brackets, the legislative history suggests that they were intended to curb the extent to which the wealthy benefit from the charitable deduction. See, e.g., H.R. Rep. No. 91-413, reprinted in 1969-3 C.B. 200, 234; S. Rep. No. 91-552, reprinted in 1969-3 C.B. 423, 423 and 474; Joint Committee on Taxation, Explanation of H.R. 13270, Tax Reform Act of 1969, 91st Cong., 1st Sess. 76 (1970).

<sup>101</sup> I thank my colleagues at the 2006 Junior Tax Scholars’ Workshop for suggesting this possible justification.

<sup>102</sup> Gerald E. Auten, Charles T. Clotfelter, and Richard L. Schmalbeck, Taxes and Philanthropy Among the Wealthy 403-06, in Joel B. Slemrod, ed., *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* at 392 (2000); Odendahl, [Insert additional cites].

<sup>103</sup> The deduction is often justified on the grounds that it helps redistribute income among social classes. [Cites.] Not all charitable transfers do so equally, however. On some level, gifts to Ivy League schools primarily benefit the wealthy students who comprise much of the student bodies, and gifts to art museums primarily benefit the upper and upper-middle class individuals who patronize such institutions. Because health organizations are not required to offer charitable care other than open emergency rooms, such gifts may also lack a redistributive element. Colombo paper on access. This is not to suggest that such contributions do not benefit the non-wealthy at all: Elite schools provide scholarships, a passion for art is not limited to the wealthy, and all of society benefits from medical and scientific advances. While fully assessing the redistributive element of such charitable contributions is outside the scope of this Article, it is not a stretch to suggest that many charitable donations by the wealthy do little to benefit the non-wealthy. See Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, forthcoming, 60 *Tax L. Rev.*, for a more detailed exploration of which types of charitable transfers contain redistributive elements. Moreover, much evidence exists that charitable dollars tend to stay “close to home”

maybe it stems from a belief that the institutions and projects favored by the wealthy—even if as socially worthy as those favored by the non-wealthy—are already sufficiently funded or perhaps even over-funded, rendering a subsidy unnecessary or even inefficient.<sup>104</sup>

These desires do not, however, provide a coherent normative justification for the AGI limitations. 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—the AGI limitations are an ineffective means of implementing such treatment for several reasons.

First, although there is often a link between a donor’s income and the charities she favors, there are numerous exceptions. [Insert recent examples.] 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 less wealthy to support the ballet or some other less-favored “rich person’s charity” in addition to the Salvation Army.<sup>105</sup>

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with respect to the socio-economic status of those benefiting from a given charitable donation. See, e.g., Reich; Odendahl, Clotfelter.

<sup>104</sup> There is some evidence, for example, that capital projects in educational and arts organizations are over-funded, and that many university endowments are much larger than necessary to achieve their goals. Gergen at 74 Va. L. Rev. at 1409; Colombo; Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. Legal Studies 3 (1990); University of Raising Big Money, NYT (October 21, 2006); John Hechinger, *When \$26 Billion Isn’t Enough*, Wall Street Journal 1 (Dec. 17, 2005). It might also be desirable to target subsidies to charities providing public goods that would not be provided absent a subsidy due to market and governmental failure. Gergen; Colombo and Hall. 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 at remedying an inefficient or unnecessary subsidization of them.

<sup>105</sup> Thinking about other ways to adjust the size of the subsidy given to various types of charitable transfers is useful to show how the AGI limits fail to do so: If the concern is that certain charities should be treated less favorably than others, a more exact solution would be simply to vary the size of the allowable charitable deduction based on the nature of the recipient charity, not the donor’s AGI. This is the case in several other countries, insert cites, and has been proposed by several scholars in this country. See Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, forthcoming, 60 Tax L. Rev. at n. xx. If the concern is that certain projects or organizations are over-funded, the donor’s AGI is also a poor proxy. A better proxy would be the absolute size of the gift, the size of a gift relative to the recipient organization’s budget, or less-favorable treatment of gifts to endowments and capital projects. I offer these suggestions merely by way of comparison; my goal in this Article is not to propose a new structure for the charitable

Second, even if one assumes that a donor's AGI is a workable proxy for the charities benefited, limiting a deduction based on its percentage of a donor's AGI (instead of limiting a donor's ability to take a deduction based on her absolute AGI) is ineffective. The limits apply to taxpayers in all brackets.<sup>106</sup> Thus, they affect the incentives of a low-bracket taxpayer to donate a large portion of his income to the Salvation Army or his neighborhood church as much as those of a high-bracket taxpayer to donate a similar percentage of his income to Harvard or the opera.<sup>107</sup>

Moreover, even as applied to wealthy donors, limits based on what fraction of a donor's income a gift represents do a poor job of minimizing the subsidy given to charities favored by the wealthy. They only apply to the extent a donor makes gift exceeding half her income,<sup>108</sup> leaving most gifts by such donors unchecked by the limits.<sup>109</sup> When they do apply, they treat the same \$1,000,000 gift to the ballet differently depending on what portion of the donor's AGI the gift represents. If a donor with an AGI under \$2,000,000 makes such a gift, some of the deduction is disallowed. But if a donor with an AGI larger than \$2,000,000 makes the same gift, all of it is deductible. This means that sometimes, the wealthiest of the wealthy receive a *greater* subsidy for their gifts—which is not what one would expect if the limits were meant to limit the subsidy granted to such individuals. Moreover, the carry-forwards enable the donor to receive a deduction in future years, thus undermining the goal of minimizing the subsidy.<sup>110</sup>

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deduction that could differentiate among various types of charitable transfers. While I hope to attempt such an exploration in the future, doing so is a complicated project outside the scope of this Article.

<sup>106</sup> See Section II.

<sup>107</sup> Again, comparing the current limits to other possibilities is useful to show how the AGI limits fail. A much more direct way of limiting the subsidy given to high-income donors would be to impose deductibility 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). For example, once a donor's AGI places her in the class of donors whose gifts society wishes to subsidize less, perhaps only some fraction of her gifts should be deductible, or only some pecuniary amount of gifts should be deductible.

<sup>108</sup> Or exceeding whatever other percentage of income was agreed upon. My criticism is of the use of any percentage, not of using 50%. Even if the general AGI limit was something other than 50%, the same reasoning described above would apply to render the limits ineffective.

<sup>109</sup> Given that donors plan around the limits, perhaps some given to such charities simply doesn't take place. If so, then the limits would have some impact on the amount of subsidy given to such charities.

<sup>110</sup> Even without the carry-forwards, however, the AGI limits do a poor job of minimizing this subsidy for the other reasons described in this section.

## 2. Protecting Progressivity

A somewhat similar potential rationale for the AGI limitation (also based on the provision's intended targeting of the wealthy) is that it answers a recurring criticism of the charitable deduction: the notion that the deduction adversely affects progressivity.<sup>111</sup> Perhaps, then, the caps reflect a view that under the traditional justification for the deduction, the deduction must not adversely affect progressivity in order for it and the non-profit sector to play the positive role envisioned by its proponents. Or perhaps they reflect a view under the economic model that certain voters are willing to fund others' pet projects only so long as the overall progressivity of the tax system is not impaired.

This progressivity-related criticism of the deduction stems from the "upside down effect" of its structure as a deduction instead of a credit. Because deductions reduce taxable income, they are worth more to higher-bracket taxpayers than to lower-bracket taxpayers. To illustrate, imagine the following hypothetical marginal rate structure:

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

Now imagine three taxpayers, *Alex*, *Bonnie* and *Christine*, each of whom make a \$100 donation. *Alex* is in the 50% tax bracket; his donation reduces his tax bill by \$50. Compare *Bonnie*, who is only in the 25% bracket. She receives a deduction worth only \$25. *Christine*, who is in the 10% bracket, is even worse off: her taxes drop by only \$10 for every \$100 that she contributes to charity.<sup>112</sup> Taxpayers in higher brackets thus receive more of a subsidy for their charitable gifts than taxpayers in lower brackets. For this reason, many scholars feel that

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<sup>111</sup> I thank my fellow participants at the 2006 Junior Tax Scholars' Workshop for suggesting this potential justification for the limitations. See also Marilyn E. Phelan and Robert J. Desiderio, *Nonprofit Organizations Law and Policy* 376 (2003). "The reason for annual limitations on the amount of a charitable contribution deduction relates to our progressive tax system and the worth of aggregating deductions in one year as opposed to spreading such deductions over many years."

<sup>112</sup> The effect is even worse if *Christine* does not itemize, as is the case with most lower-bracket taxpayers: in that event, she receives NO tax benefits at all for her contribution!

this upside down effect undermines progressivity.<sup>113</sup> Perhaps by limiting the extent to which high-bracket taxpayers can take a charitable deduction in any given year, the AGI limits protect progressivity.<sup>114</sup>

Protecting progressivity is a poor justification for the AGI limitations for several reasons. First, the limitations only apply to the extent a taxpayer's charitable contributions exceed 50% of her AGI (or whatever other fraction of AGI at which one might wish to set the limits). To continue the previous example, if *Alex*, *Bonnie* and *Christine* each contribute less than 50%<sup>115</sup> of their income, exactly the same amount of progressivity results both with and without the limits: *Alex's* benefit is twice that of *Bonnie* and five times that of *Christine*. As the AGI limits affect only about one-fifth of donors claiming a charitable deduction, this means that they have no effect on progressivity 80% of the time.<sup>116</sup>

Second, even when the limits do apply, they do not always limit the magnitude of the upside down effect. This is because the AGI limits apply to taxpayers in all brackets.<sup>117</sup> If *Alex*, *Bonnie*, and *Christine* each give all their income to charity, *Alex* still receives the greatest tax benefit and *Christine* still receives the least. In that case, all that the AGI limits do is cut in half the amount of the subsidy each taxpayer receives.<sup>118</sup> This decreases the nominal amount of *Alex's* benefit compared to *Christine's* (instead of benefiting 40 cents per dollar

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<sup>113</sup> See, e.g., Giving in America: Toward a Stronger Voluntary Sector, Filer Commission 109 (1975); McDaniel, Federal Matching Grants for Charitable Contributions, 27 Tax L. Rev. 377; Kelman, Personal Deductions Revisited, 31 Stan L. Rev. at 833 n.7 (and 856-58/0); Surrey, Pathways to Tax Reform at 36 and 21; Gergen, 74 Va. L. Rev. at 1405. But see Thomas D. Griffith, Theories of Personal Deductions in the Income Tax, 40 Hastings L. J. 343, xx (criticizing the notion of an upside down subsidy); Strnad, The Charitable Contribution Deduction: A Politico-Economic Analysis, in the Economics of Nonprofit Institutions, ed by Susan Rose-Ackerman at 271-72.

<sup>114</sup> At this point, some readers may begin to wonder, "So what? What is the harm to society if the charitable deduction is administered in a non-progressive manner?" Two criticisms of the upside-down effect predominate. The first is that charities favored by the rich are over-funded, a concern whose relationship to the AGI limits has already been addressed in Section IV.B.1 The second criticism is that the wealthy are not paying "enough" tax relative to their true ability to pay. As explored in Section IV.B.5, this concern is really about minimum tax issues. I address the concept of the upside down subsidy separately, however, because so many other commentators levy it, without more, as a criticism of the deduction.

<sup>115</sup> Or less than whatever other fraction of income might be agreed upon.

<sup>116</sup> See Section II.

<sup>117</sup> See Section II.

<sup>118</sup> Of course, if the limit was something other than 50%, it would reduce each taxpayer's benefit by some other fraction. The same reasoning would apply, however.

more than *Christine*, now he only benefits 20 cents more per dollar) but not its proportional magnitude. He still benefits five times as much as she does.<sup>119</sup>

The limits diminish the proportional magnitude of *Alex's* benefit only if he is the only taxpayer affected by them. 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).<sup>120</sup> Even then, however, the limits do not erase the upside down effect.<sup>121</sup>

Lastly, when incomes fluctuate over time, the limitations may actually exacerbate the upside down effect. This is because the current structure, which precludes a full deduction in *Year 1* but allows a carry-forward for the next five years, essentially allows income averaging. By prohibiting full use of the

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<sup>119</sup> To illustrate, imagine that before applying the charitable deduction, *Alex's* taxable income was \$300,000, *Bonnie's* was \$100,000, and *Christine's* was \$50,000. After applying the charitable deduction and the AGI limitation, *Alex* reduces his taxable income from \$300,000 to \$150,000 and his tax bill from \$105,000 to \$30,000. *Bonnie's* taxable income decreases from \$100,000 to \$50,000 and her tax bill from \$17,500 to \$5,000; *Christine's* taxable income drops from \$50,000 to \$25,000 and her tax bill decreases from \$5,000 to \$2,500. This means that *Alex's* \$300,000 contribution cut his tax bill by \$75,000. Put another way, his contribution received a 25% subsidy from the government. *Bonnie's* \$100,000 contribution cut her tax bill by \$12,500, resulting in a 12.5% subsidy by the government of her donation. *Christine's* \$50,000 contribution reduced her tax bill by only \$2,500 – a subsidy of only 5%. With or without the AGI limitation, *Alex* receives a benefit from the contribution that is five times as large as the benefit that *Christine* receives

<sup>120</sup> Let's first assume that *Christine* (still with an income of \$50,000) contributes half her income to charity. Because the limits do not apply in that event, she can deduct her entire \$25,000 contribution. Her tax bill drops from \$5,000 to \$2,500, meaning that she receives a tax benefit of 10 cents for every dollar contributed. Next, let's assume that *Alex* contributes all his \$300,000 income to charity, thereby triggering the AGI limitations. In the year of contribution, he can deduct only half this amount, thus reducing his taxable income from \$300,000 to \$150,000 and his tax bill from \$105,000 to \$30,000. He now receives a \$75,000 tax cut for making a \$300,000 contribution, or a tax benefit of 25 cents for every dollar contributed.

<sup>121</sup> Moreover, the foregoing has ignored the fact that *Alex* may carry-forward his unused deduction. In that situation, the limits do not even dampen the upside-down effect. To illustrate, continue the assumption that in *Year 1*, *Alex* donates all his income to charity and *Christine* only donates half. Further assume that in *Year 2*, everyone's income stays constant and nobody makes additional charitable contributions. In that event, *Alex* may deduct the remaining \$150,000 in *Year 2*, thus reducing his *Year 2* taxes by \$75,000. Now the \$300,000 contribution has saved him \$150,000 in taxes over two years. It is true that *Alex* is slightly worse off due to the cost of deferring half of his deduction by one year. This small toll charge, however, would have only a minimal effect on the relative benefits granted to *Alex* and *Christine*. The foregoing basically returns us to a world without the AGI limits: *Alex* benefits from the charitable deduction five times as much as *Christine*.

To illustrate, continue the previous assumption that *Alex* earned \$300,000 in *Year 1* (all of which he donated to charity) and that *Christine* earned \$50,000 (half of which she donated).

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.<sup>122</sup> See Appendix A for an illustration of this point.

The AGI limits thus protect progressivity only in very narrow circumstances and only in a limited manner. Because they affect only about twenty percent of charitable deductions, they do not impact progressivity in the majority of cases. Moreover, even when triggered, the limitations merely dampen, and do not erase, the upside down effect. Lastly, the carry-forwards erase some of the limits' impact on the magnitude of the upside down effect and may sometimes even exacerbate it. Protecting progressivity is thus a poor rationale for the AGI limitations. The best remedy for the upside down effect, as several scholars have already thoughtfully suggested, would be to replace the deduction with a credit.<sup>123</sup>

### 3. Limiting the Government's Outlay of Charity Generally

A third possible justification for the AGI limits under the subsidy theory is that they reflect a desire to limit the government's subsidy of charitable activity more generally.<sup>124</sup> In other words, for reasons unrelated to the nature of the charitable recipient or the income of the donor, perhaps the government simply wishes to cap its charitable outlays.

Unfortunately, the reasons for this desire have not been well-articulated in prior literature and remain vague.<sup>125</sup> Without a more clearly defined reason for wishing to limit charitable subsidies, the AGI limits seem to be an imprecise method of doing so for many of the same criticisms levied previously in this Article at other potential rationales. In particular, tying deductibility to the percentage of a donor's AGI that a gift represents seems a very roundabout way of implementing a decision that the government wants to subsidize only a certain dollar amount of charitable activity. If the government has some cap in mind, a

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<sup>122</sup> Steurle and Sullivan, 12 Am. J. Tax Pol'y at 412.

<sup>123</sup> See, e.g., Hochman and Rodgers; [other cites]. This is so because credits have equal value to all taxpayers: A tax credit of \$1 reduces the taxes of both a low-bracket and a high-bracket taxpayer by \$1, regardless of their respective marginal rates. Non-refundable credits, of course, do not benefit taxpayers with no tax liability. Any given tax credit could also be made refundable, thus also benefiting taxpayers with no tax liability. Batchelder, Goldberg and Orszag, Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 Stan. L. Rev. xx

<sup>124</sup> Bittker, Steurle and Sullivan; [other cites].

<sup>125</sup> See Bittker, Steurle and Sullivan (making the same criticism).

more direct way of implementing that cap would be to impose some absolute dollar cap on the amount any given individual can deduct.<sup>126</sup>

Moreover, the carry-forwards suggest that the government is more concerned with limiting its outlay in any given year, rather than its overall outlay.<sup>127</sup> As explained in Section V, *infra*, this suggests that the limits stem from a desire to ensure that at any given time, the government has not spent so much money subsidizing charity that it does not have enough to fund its own priorities, rather than from a desire to cap charitable activity for unarticulated reasons.

#### **4. Backstopping the Preference for Donations of Appreciated Property**

It is also plausible that the AGI limits are justified to offset the preference given to donors of appreciated property.<sup>128</sup> With some exceptions,<sup>129</sup> donors can contribute property containing substantial unrealized gain, receive a deduction based on the property's high fair-market value, and use that deduction to reduce taxable income from other sources, such as salary income. Because of the realization requirement, this puts donors of appreciated property in a better position than donors of cash. Maybe the AGI limits erase this preference.

To illustrate the preference given to donors of appreciated property, compare *Diane*, who receives a salary of \$1,500, with *Ed*, who receives a salary of \$600 but also owns stock (with a basis of \$100) that appreciates by \$900 during the year (to a fair market value of \$1,000). Economically, both are in the same position; each is better off to the tune of \$1,500. Due to the realization requirement, however, *Diane's* taxable income is \$1,500, while *Ed's* is only \$600. He will, however, pay tax on the unrealized appreciation when he sells the

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<sup>126</sup> See, e.g., C. Eugene Steurle and Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 *Am. J. Tax Pol'y* 399, 413-15 (1995).

<sup>127</sup> Determine what percentage, if any, of gifts can't ever be fully deducted even over 5 years.

<sup>128</sup> See text surrounding notes 14-16; Andrews, 86 *Harv. L. Rev.* at 373 (suggesting that the limits minimize this preference but acknowledging that they are a "crude way" of so doing); Halperin, 56 *Tax L. Rev.* at 23-25 (suggesting that this preference influenced the repeal of the unlimited deduction but concluding that limits would be unnecessary if unrealized gains were not deductible).

<sup>129</sup> For examples, donors of tangible personal property unrelated to a recipient charity's exempt purpose are limited to a deduction equal to basis.

property, thus putting him roughly in the same position as Diane (and making the Treasury whole) when viewed over time.<sup>130</sup>

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

Limiting donors to some portion of their AGI does not, however, put *Ed* on equal footing with *Diane*. First, the AGI limits apply to donors of cash as well as property. If a 50% limit applies to both *Ed* and *Diane*, the following happens: Based on her \$1,500 AGI, *Diane* can only deduct \$750 of her \$1,000 cash contribution. This gives her taxable income of \$750 and a tax bill of \$262.50. Based on his AGI of \$600, *Ed* can only deduct \$300 of his \$1,000 contribution. This gives him taxable income of \$300 and a tax bill of \$105. The relative preference given to *Ed* has lessened somewhat, 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 30% of his AGI (as the current rules do) does not solve this problem. 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.<sup>131</sup>

The only way to definitely erase the preference is either to (1) limit *Ed*'s deduction to his basis<sup>132</sup> or (2) allow him a FMV deduction but force *Ed* to realize

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<sup>130</sup> Of course, *Ed* has enjoyed the time value of money in the meantime and will likely enjoy preferential rates when he sells.

<sup>131</sup> Andrews, 86 Harv. L. Rev. at 373;

<sup>132</sup> In that situation, he would have gross income of \$600 from his salary, less a \$100 charitable deduction (the amount of his basis), yielding taxable income of \$500.

and recognize gain upon donating appreciated property.<sup>133</sup> In both situations, *Ed* would have taxable income of \$500, thus putting him on equal terms with *Diane*.<sup>134</sup> Backstopping the preference given to donors of appreciated property therefore cannot justify the AGI limits.

## 5. A Crude Alternative Minimum Tax

Of all the existing normative rationales for the limits, the notion that the AGI limits serve as some type of alternative minimum tax has found the most scholarly support.<sup>135</sup> This support stems both from dissatisfaction with other potential justifications for the limits and from their legislative history.<sup>136</sup>

First, as Steurle and Sullivan have noted, almost every other existing justification for the limits ends up in the same place: reflecting, on some level, a desire to make sure that people do not spend too much money on charitable projects instead of paying taxes. For example, criticism of the upside down effect of the charitable deduction often reflects a concern that the wealthy are not paying “enough” tax relative to their ability to pay. A desire to limit the overall subsidy given to the charitable sector in a given year can also be thought of as ensuring that society as a whole pays some minimum tax.

The limits’ legislative history also supports this alternative minimum tax idea. As mentioned in Section II, before 1969, an unlimited income tax charitable deduction was allowed under certain conditions. When Congress repealed this allowance,<sup>137</sup> it emphasized the unfairness of “allow[ing] a small number of high-income persons to pay little or no tax on their income.”<sup>138</sup> The House Report explained that “Ours is primarily a self-assessment system. If taxpayers are

<sup>133</sup> Here, *Ed*’s gross income would be \$1,500 (\$600 salary plus \$900 gain from the property) and he could take a \$1,000 deduction (the FMV of the property), giving him taxable income of \$500.

<sup>134</sup> See, e.g., Halperin, 56 Tax L. Rev. at 24-25 (arguing that “trading an unlimited deduction for constructive realization would substantially improve the equity of the tax system”).

<sup>135</sup> See, e.g., Steurle and Sullivan 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.”); Marvin A. Chirelstein, *Federal Income Taxation*, 190 (10<sup>th</sup> Edition 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 and Stephen Schwarz, *Taxation of Nonprofit Organizations* 714 (2<sup>nd</sup> ed. 2006) (“The limitations reflect a judgment that no taxpayer should completely avoid federal income tax by making charitable contributions”).

<sup>136</sup> Steurle and Sullivan at 408.

<sup>137</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487-550-52.

<sup>138</sup> H.R. Rep. No. 91-413, reprinted in 1969-3 C.B. 200, 234.

generally to pay their taxes on a voluntary basis they must feel that these taxes are fair. Moreover, only by sharing the tax burden on a fair basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers.”<sup>139</sup> The Senate Report echoed these concerns,<sup>140</sup> as did the Joint Committee’s Explanation, which noted that “it appeared that the charitable contributions deduction was one of the two most important itemized deductions used by high-income persons, who paid little or no income tax, to reduce their tax liability.”<sup>141</sup>

While this justification is sounder than other existing rationales, it does not go far enough. It does not address what, exactly, is unfair about allowing an individual to donate all of his or her income *to charity* in lieu of paying tax. The rationale behind the AMT is the concern that in its absence, some individuals would be able to retain substantial economic income for their *own use* that would go untaxed due to tax preferences that incentivize certain activities beneficial to society.<sup>142</sup> 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.<sup>143</sup> While the preference for tax-exempt bonds<sup>144</sup> is thought to subsidize state and local government activity (thereby benefiting society), it also directly benefits the individual holders of such bonds, who receive the income tax-free.<sup>145</sup> As such, this preference is disallowed in the AMT.

Many other preferences available under the regular tax system but not available under the AMT also directly benefit taxpayers (while benefiting society at large). For example, § 179 expensing and accelerated depreciation both spur investment activity (benefiting society) but also allow taxpayers to benefit directly by offsetting otherwise taxable income that they retain for their own use. To preclude a taxpayer from using those preferences to fully offset otherwise taxable income retained by the taxpayer, the AMT disallows § 179 expensing and requires the use of a less-accelerated depreciation schedule. In other words, the AMT addresses tax preferences that, while benefiting society, still enable individuals to shelter income that they actually retain and use for their own

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<sup>139</sup> Id. at 200.

<sup>140</sup> S. Rep. No. 91-552, reprinted in 1969-3 C.B. 423, 423 and 474.

<sup>141</sup> Joint Committee on Taxation, Explanation of H.R. 13270, Tax Reform Act of 1969, 91st Cong., 1st Sess. 76 (1970).

<sup>142</sup> Graetz articles on the AMT.

<sup>143</sup> Graetz and Schenk book at 768.

<sup>144</sup> IRC § 103.

<sup>145</sup> To be sure, the benefit is less than it first appears due to tax capitalization, see Bittker, but the fact remains that such holders still receive income from the bonds free of federal income tax.

benefit.<sup>146</sup> At root, it is the fact that individuals retain the income for their own benefit that seems most abusive, not the use of a deduction in and of itself.

In contrast, true charitable contributions do not benefit the donor in the same way that the tax preferences described above do. By definition, if you give money to charity, you do not retain it for your own use.<sup>147</sup> A complex web of rules that apply to both public charities and private foundations are designed to prevent taxpayers from (1) creating “sham” charities that benefit donors and other private individuals instead of the community at large and (2) reaping personal gain even from charities that do benefit the public.<sup>148</sup> 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.<sup>149</sup> 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 the current 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. Because the AGI limits apply to all charitable donors (the vast majority of whom truly are deriving no financial gain from their contribution), they are an extremely overbroad means of remedying such abuses.

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<sup>146</sup> See Michael J. Graetz and Emil Sunley, *Minimum Taxes and Comprehensive Tax Reform*, in *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (1988) (“[T]he enactment of a minimum tax . . . is an admission that the U.S. income tax involves trade-offs among competing objectives. Congress wants to use income tax provisions to encourage particular investments or activities and to promote certain societal goals. At the same time, it wants to ensure that the income tax burden is distributed generally in accordance with taxpayers’ abilities to pay.”).

<sup>147</sup> As explained in Section IV.B.4., *infra*, allowing donors of appreciated property to deduct the full fair-market value of such property also allows donors to use a deduction to offset income that they actually retain for their own benefit. Although the AMT briefly disallowed a charitable deduction for untaxed appreciation in the mid-1980s, it contains no such remedy today. And, as explained in Section IV.B.4., while precluding a donor’s ability to deduct the full fair market value of appreciated property may well be a valid goal, the current AGI limits are an ineffective means of reaching that goal.

<sup>148</sup> See, e.g., §§ 170(c)(2)(C) (precluding a deduction for contributions to public charities in which the net earnings inure to the benefit of private individuals; 501(c)(3) (requiring “no private inurement” to maintain tax-exempt status); 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); § 4941 (imposing very strict limitations on transactions between private foundations and their founders and donors).

<sup>149</sup> Cites.

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

#### **a. Benefit theory**

One oft-mentioned possibility is that everyone should pay some tax because everyone benefits from certain goods provided by the government: roads, sidewalks, national defense, fire protection, and so on.<sup>150</sup> The problem with this argument, however, is that there is generally no link between taxes paid and benefits received. On a broad theoretical, it is hard to determine how much someone benefits from the government. Take police protection. Do all citizens benefit equally? Do the poor benefit less, because the property protected is worth less? Or do they benefit more, because they are unable to afford private security?<sup>151</sup> On a more administrative level, there is no attempt to match taxes paid with benefits received. My taxes fund the fire department regardless of whether I ever ring them; if I did ring them, they would respond without regard to whether or how much tax I had paid. Without more context, then, the argument that everyone should pay some tax because everyone benefits from government does not justify the AGI limits.<sup>152</sup> Our tax system is based on ability to pay, not benefits received.

#### **b. Optics**

A second oft-mentioned possibility is that even though charitable donations do not allow individuals to shelter income the way that other tax preferences do, something just “seems unfair” about allowing some individuals to

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<sup>150</sup> I thank Amanda Frost, Clare Huntington, and David Zaring, among others, for this suggestion.

<sup>151</sup> [Cites.]

<sup>152</sup> At this point, some readers may argue that all citizens benefit from the provision of public sidewalks (to take one example), and if enough citizens did not pay any tax, then public sidewalks might be under-funded. This argument basically restates the proposition that public sidewalks are subject to free-rider problems in the market, thus requiring government taxation to overcome this problem. The possibility that the government may lack enough funds to pay for the sidewalks leads to the dual-majority bargain proposed in Section V.

escape taxation completely—even if they retain no income for their own use.<sup>153</sup> Perhaps then, the AGI limits can be justified on the grounds of optics: Allowing some individuals to pay no tax (regardless of the reason) “undermines public confidence in the tax system by inducing widespread perceptions of tax inequity.”<sup>154</sup> This perception of unfairness might then encourage more taxpayers to find more ways of avoiding taxes by engaging in tax shelters or simply not reporting income.<sup>155</sup> (This argument is, of course, a second justification for alternative minimum taxes, but with different implications than the justifications discussed above in Section IV.B.5.)

As with the traditional alternative minimum tax argument, however, this reasoning does not go far enough. It does not address what, exactly, *seems* unfair about not taxing individuals who have voluntarily donated all their income to a cause that by definition benefits the general public (just as tax monies do). Such individuals are benefiting society just as much (if not more) than individuals who do not contribute to charity but pay taxes.<sup>156</sup> What, precisely, is unfair about allowing such individuals to pay no income tax? Again, traditional tax policy arguments for a minimum tax do not answer this question. The next Sections seek to do so.

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

More compelling rationales for the AGI limits can be found by locating them squarely within the economic strand of the subsidy theory and then layering in democratic political theory. The next two Sections do just that. As previously described, the subsidy theory conceptualizes charitable tax subsidies as a bargain among various voters to overcome simultaneous market and government failures.<sup>157</sup> As detailed below, I suggest that limiting the charitable deduction is a necessary second bargain (what I call the “dual-majority bargain”) that enables the initial bargain to hold: Limiting the deduction is the classic majority’s way of

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<sup>153</sup> See notes 147-49 and associated text. I thank Lee Fennell for urging me to give this argument weight.

<sup>154</sup> Graetz and Sunley (relating an additional argument for the AMT).

<sup>155</sup> [Cite to background of 1986 Tax Act; Gucci Gulch, etc.]

<sup>156</sup> Take, for example, two taxpayers with incomes of \$100,000. The first makes no donations, and pays \$35,000 in tax monies, which, broadly speaking, benefit the public. If the second donates all her income to charity, then she has paid \$100,000 (far more than the first taxpayer!) toward projects that also, broadly speaking, benefit the public.

<sup>157</sup> See, e.g., John D. Colombo and Mark A. Hall, *The Charitable Tax Exemption 101-04* (1995); Hansmann; Weisbrod book; Weisbrod in Susan-Rose Ackerman; Strnad; Gergen.

making sure that its priorities in the democratic process are funded even if they agree to partially subsidize minority projects via the deduction.<sup>158</sup>

Focusing on this reason for limiting the charitable deduction provides a better tax policy justification for AGI limits than those rejected above. As a matter of the deduction's structural logic, limiting one's deduction based on what portion of one's income 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: (1) maximizing the subsidy given to charity and (2) addressing the optics problem described in Section IV.B.5 (which can now be better understood as perceived 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). Moreover, as explored in Section VI., this reasoning is consistent with the notions of reciprocity inherent in liberal democratic theory.

#### **A. Limiting charity to uphold the bargain that makes the charitable deduction possible: the “dual-majority” bargain**

My proposal that some limits on the deduction are necessary 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.<sup>159</sup> Recall that Colombo and Hall posited that opera lovers would be willing to work with ruffled-grouse lovers so long as they were repaid in kind. Once opera lovers and ruffled-grouse lovers strike this bargain and form a new majority willing to approve partial subsidies via the charitable deduction,<sup>160</sup> two majority groups simultaneously exist: The “classic majority” represents the majority in which the median voter approves the lighthouse or national defense or other projects not subject to government failure, and the “new majority”

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<sup>158</sup> As explored later, the idea of wanting to make sure the government has enough money left to fund its own priorities may also be relevant under some strands of the traditional subsidy theory, although I do not believe the case is as strong. See note 116.

<sup>159</sup> Colombo and Hall, other cites.

<sup>160</sup> I reiterate that this theory does not attempt to explain what actually happened in Congress when it implemented the charitable deduction. Rather, this theory attempts to justify the deduction's continued existence: people allow it to continue on because they implicitly recognize they will lose something if it is repealed.

represents the new group that has coalesced to help fund others' pet projects.<sup>161</sup> By definition some voters are members of both majorities simultaneously.

Another bargain must now be struck between these two majorities (or voters who belong to both majorities must weigh their competing desires), and this bargain is represented by the AGI limits. 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.<sup>162</sup> It is this second bargain which existing literature ignores; I shall term this the "dual-majority bargain."

Without that second bargain, high-demanders could substitute completely their view of the public good for that initially set by the classic majority in the traditional democratic process. A cap on the deduction ensures that such individuals may have government subsidize their view of the public good, but only if, in return, they also subsidize the goods demanded by the classic majority. Without the cap, the bargain among the two majorities might falter, and the newly-formed majority that has agreed to subsidize each other's minority projects might unravel.<sup>163</sup>

To take an extreme example, imagine a society in which a "new majority" has approved a charitable deduction 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 fund research by a non-profit on *Disease A*.<sup>164</sup>

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<sup>161</sup> 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 am using that as my starting point. I explore other possible models in Section V.D.4.

<sup>162</sup> [Similar reasoning likely applies if competing interest groups have controlled the democratic process, instead of a traditional majority. See Section V.D.4.]

<sup>163</sup> My theoretical model of the dual-majority bargain – like the existing theoretical model of the first bargain justifying the deduction's existence – does not attempt to explain what actually happened in Congress when limits were passed. I offer this theory as a justification for the limits' continued existence: Both majorities implicitly recognize that repealing the limits may have consequences that they fear.

<sup>164</sup> 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

Giving *Francie* an unlimited deduction allows *Francie* to undercut the preferences of the classic majority. With an unlimited deduction, she could pay no taxes at all and thus fund none of the research on *Disease B*.<sup>165</sup> If *Francie*'s tax revenues would otherwise comprise a substantial portion of the community's revenue, then giving her an unlimited deduction would drastically reduce revenue available to fund research on *Disease B*.<sup>166</sup> *Francie* has thus single-handedly over-ruled 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 the new majority seeking partial subsidies for minority projects via the charitable deduction.

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 the individual whose preferences are subsidized (that is, members of the new majority) also agrees to support the majority's preferences (*Disease B*) by paying some tax.<sup>167</sup> This bargain-preserving role justifies the need to limit the charitable deduction in some manner.

Moreover, viewing the charitable deduction and possible limits in this light illuminates what seems unfair in the optics problem described in Section IV.B.6: The problem is not that some taxpayers are doing nothing to benefit society. Rather, the problem is that some taxpayers are able to fund only their preferred vision of the public good, and none of what their fellow citizens deem important. Some people get to pick and choose what projects to fund, while others are stuck funding what the government decides to fund.<sup>168</sup> That, I think, is

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contributes to the public good broadly speaking (whether such projects, as explained in note 63, are true public goods, impure public goods, or other projects providing a public benefit).

<sup>165</sup> That is, fund none of the government projects desired by the classic majority.

<sup>166</sup> Due to the distribution of the tax burden, this is not an impossible scenario. In 2001, for example, the top 5% of taxpayers paid over 55% of federal income taxes. [cite]. It may be unlikely, however, given the government's ability and propensity to borrow to finance deficit spending.

<sup>167</sup> Although the model I have set forth to this point envisions the classic majority as being comprised of individuals voting to fund government projects directly, some members may also be individuals who derive other indirect subsidies from the tax system (for example, real estate developers who benefit from the many tax breaks for housing, cite to tax capitalization literature) and for that reason have a stake in ensuring that funds flow to the classic majority (without such funds, they would receive no subsidy).

<sup>168</sup> It is true that technically, anyone has the option of donating all their income to charity and thus funding only their pet projects and none of the government's projects. As a practical matter, however, not everyone has this option. Many people, across income levels, need to retain some of their current income on which to live.

what strikes some people as unfair. And, as explained in Section VI, this not only *seems* unfair, but *is* unfair in the context of liberal democratic theory.

### **B. 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 one’s charitable deduction based on the portion of a donor’s AGI that a contribution represents. Three types of limits could, as a structural matter, ensure that the classic majority maintained enough funds for its own projects: (1) AGI limits, (2) percentage caps on the portion of a given contribution that is deductible, or (3) absolute dollar ceilings on the amount a given individual could deduct in a given year. Thus, AGI limits are justified as a means of implementing the dual-majority bargain only if they are the most appealing of these three options to those involved in the bargain.

A simple analogy helps illustrate the pros and cons of each of these three limits. What the two majorities are really bargaining about is how to split the governmental “pie” that is available to fund public goods. The pie is comprised of two ingredients: (1) taxes received by the government for projects it conducts directly and (2) the subsidy given to charitable projects via foregone revenue from the charitable deduction. 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 terms of a fraction: Maybe one side gets 1/3 and the other 2/3, maybe one side gets 1/4 and the other 3/4, or maybe they agree to split the pie equally.

Let’s assume, for the sake of illustration, that the two majorities have agreed to an equal, 50/50 split. This division provides a simple model, and although it is not inevitable, it is quite plausible.<sup>169</sup> 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.<sup>170</sup> Arguably, that bargain among the minority taxpayers who coalesce to form the new majority is maintained over time only if the back-scratching is roughly equal.<sup>171</sup>

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<sup>169</sup> See note 160.

<sup>170</sup> Colombo and Hall at xx.

<sup>171</sup> I acknowledge that an equal, 50/50 split is not necessarily the only result that will enable the bargain to hold. Although a 50/50 split is somewhat arbitrary, it does accord with many people’s

Similar reasoning plausibly applies to the bargain between the two majorities described above that leads to a limited charitable deduction. In that interaction, a feasible, attractive, end point is that each majority bargains for the possibility of an equal amount of government funding for its preferred public goods.<sup>172</sup> 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 transfers, this means that individuals with strong minority interests can have their project subsidized up to the point where that subsidy equals the amount they pay in taxes which fund the classic majority's projects (such as the lighthouse), but no more.<sup>173</sup>

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 the new majority has bargained for that option. 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?<sup>174</sup>

As explored below, AGI limits better protect that bargain than per-transfer limits or per-taxpayer ceilings on the deduction.

### **1. Per taxpayer dollar ceilings and the dual-majority bargain**

Applying a dollar ceiling on the amount any given individual may deduct 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 given year, without regard to any individual taxpayer's contributions to the pie. Imagine that the total AGI of all

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intuitions about what is fair, which in turn affects their bargaining approaches. To that end, a 50/50 split is a convenient number that people often resort to when reaching a compromise. [Describe ultimatum game and other experimental economics] [also cite paper on bargaining in agricultural contracts].

<sup>172</sup> 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.

<sup>173</sup> For the reasoning just described, a 50/50 split is not the necessary endpoint for this bargain, either, although it is a plausible one.

<sup>174</sup> The following arguments, although they use a 50/50 split for illustration, would apply with equal force to any other division of the pie that the two majority's agreed to, such as  $\frac{1}{4}$  and  $\frac{3}{4}$  or  $\frac{1}{3}$  or  $\frac{2}{3}$ , and so on. The only difference would be the numbers used for illustration.

the taxpayers in this simplified world would be \$3,000,000, yielding a pie of approximately \$1,000,000 (using a flat 35% rate for simplicity and rounding). This means that the new majority should get up to \$500,000 in subsidies for its projects, if it so desires.

Per person ceilings reflect this division only in a static world. To illustrate: A per person ceiling that in the aggregate allowed taxpayers together to deduct up to \$1,500,000 (that is, half of their total AGI of \$3,000,000) would split the pie down the middle.<sup>175</sup> One could simply divide the aggregate allowable deduction of \$1,500,000 by the number of taxpayers in this hypothetical world to arrive at the “correct” per person ceiling. If there were ten taxpayers, each should be allowed to deduct up to \$150,000; if this world contained 15 taxpayers, each should be allowed to deduct up to \$100,000, and so on.

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

A per person cap on the deduction therefore splits the pie in the manner bargained for by the parties only in extremely limited circumstances. In the real world, AGI fluctuates over time, as do charitable contributions and the number of taxpayers.<sup>176</sup> It is highly unlikely that any single cap would reflect the bargained-for division of governmental funds.

Moreover, such a cap is under-inclusive with respect to the optics problem first described in Section IV.B.5.b., now viewed in light of the need for a dual-majority bargain. Whatever cap that is picked will allow some taxpayers, but not others, to deduct all their income. Let’s return to the example above, where each person can deduct up to \$150,000 but no more. Charitably-inclined taxpayers with AGIs under \$150,000 can thus deduct their entire income and pay no taxes to

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<sup>175</sup> Under this scenario, taxable income would be \$1,500,000 and tax revenue would be roughly \$500,000. The total amount of charitable deductions claimed would also be \$1,500,000, yielding a subsidy of roughly \$500,000 to the donors’ favored projects.

<sup>176</sup> SOI bulletins.

support their fellow citizen's projects. In contrast, charitably-minded taxpayers with AGIs over \$150,000 cannot do the same. The same holds true no matter what dollar ceiling one picks.

It may be the case, of course, that some individuals care about the optics problem only with respect to "wealthy" individuals, and if so, a low per ceiling cap isn't problematic on optics grounds. The problem is, however, that any realistic per person cap would be fairly high,<sup>177</sup> thus enabling a large percentage of people to pay no tax. Maybe, then, we only care about requiring the ultra-wealthy to support government projects. This is a plausible response to the optics problem, but has troubling implications: Why should one set of individuals have a different set of obligations vis-à-vis their fellow citizens than other groups of individuals?

There is one appeal to per-person ceilings: they are easy to understand, and are similar to other types of limits in the Code.<sup>178</sup> That said, however, it is unlikely that any given individual could in any way determine (given total societal AGI and number of taxpayers) whether any proposed ceiling accurately reflected the division of resources bargained for by the two majorities. It is hard to imagine, for example, that a charitably-inclined individual could look at a cap of say, \$1,000,000, and even roughly determine whether that implemented a given split of the pie. On the whole, therefore, per-person limits are an inexact means of implementing the dual-majority bargain.

## **2. Per transfer limits and the dual-majority bargain**

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

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<sup>177</sup> This is based solely on intuition. Right now, many large and influential charities rely heavily on a small number of large gifts (in addition to a large number of small gifts). One can only imagine the outcry if individuals could no longer deduct more than \$500,000 or \$1,000,000 or even \$2,000,000 or \$5,000,000 each year. As a matter of political reality, therefore, it seems likely that any per person ceiling would be so high as to be meaningless for most people.

<sup>178</sup> See, e.g., IRC § 163(h) (imposing a ceiling on mortgage interest deduction).

The only way to make sure that the bargained-for split of the aggregate pie remains constant in the face of such changes is to focus on each individual taxpayer's pie. 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.

We know from the above analysis that a per-person dollar ceiling on the deduction will not get the bargain right on an individual level, because it is not tied at all to the taxpayer's individual AGI. Any given per-person dollar limit will be more than half of many taxpayers' incomes, and will be less than half of many other taxpayers' incomes. It will only be happenstance that it is exactly half of any given taxpayer's income.

To explore other ways to split an individual taxpayer's pie, let's imagine *Gail*. Assume that she has income (before charitable deductions) of \$100,000 and faces a tax rate of 35%. *Gail's* income produces an individual pie of government funds worth \$35,000. Under the reasoning described above, a bargain has been struck whereby she is allowed to use half (\$17,500) for her pet projects, but no more.<sup>179</sup> The other half must go to the government to fund its projects. Of course, *Gail* might choose not to use any or all of her half of the pie, but the key is that the new majority has bargained for her to have that option.

Will allowing taxpayers to deduct a set percentage of any given transfer implement the dual-majority bargain in an appealing way? The likely answer is no. If *Gail's* ability to use the charitable deduction is limited on a per transfer basis, she is cheated out of part of her half of the pie unless she transfers all her income to charity. To illustrate, if her only charitable contribution for the year is a single \$10,000 donation, she should receive a full \$10,000 deduction, which would be equivalent to allowing her to take out a \$3,500 piece of the pie for her preferred project.<sup>180</sup> If, however, she can deduct only a portion of that \$10,000 transfer, she does not receive the full subsidy due to her (since she should be able to access up to \$17,500). A per-transfer limit thus precludes individuals in the

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<sup>179</sup> Of course, *Gail* is quite free to contribute more to her vision of the public good. My emphasis here is on her ability to direct funds otherwise flowing to the government to that vision.

<sup>180</sup> The \$10,000 deduction lowers her tax bill by \$3,500, generating a \$3,500 "matching transfer" to her chosen charity.

new majority from receiving their bargained-for share unless they contribute their whole income.<sup>181</sup>

### 3. AGI limits and the dual-majority bargain

A limit based on AGI, however, has the following effect: Until the AGI 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 (still assuming an income of \$100,000), she receives a deduction for the entire transfer. She is now able to take as much of her share of the pie as she desires. The limits should apply only when necessary to limit her to her share. Imagine, for example, that *Gail* donates \$60,000 to charity. If she could deduct all of it, the governmental subsidy of her pet project would be \$21,000 (the amount by which her tax bill decreases when rates are 35%) and her taxable income would drop to \$40,000, resulting in a tax bill of \$14,000. She is now getting more than the bargained-for share of the pie.

If, however, *Gail* can deduct only \$50,000 of her transfer, that problem is rectified. In that situation, her taxable income drops by only \$50,000 (instead of \$60,000). This reduces *Gail's* tax bill by only \$17,500 (instead of \$21,000), accordingly lowering the governmental subsidy of her pet project from \$21,000 to \$17,500. At the same time, her resulting tax bill now rises from \$14,000 to \$17,500. The government is now funding her pet project equally to the lighthouse: \$17,500 of *Gail's* pie goes to each.<sup>182</sup>

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<sup>181</sup> This reasoning applies regardless of what portion of the pie each majority ends up being able to bargain for. It would apply, for example, even if the new majority was only able to bargain for a share of the pie equal to 25, 30 or some other percent of the pie.

<sup>182</sup> I acknowledge that as a technical matter, due to the increasing marginal rate structure, *Gail* actually directs something slightly more than 50% of her pie to her projects and something slightly less than 50% of her pie to the government's projects. This is so because her deduction comes off the top of her income, and results in the subsidy being calculated at her highest marginal rate or rates. In contrast, the tax rate applied to her remaining taxable income will be the lower rates applicable to her. An obvious better fit, therefore, would be to give taxpayers a tax credit for charitable contributions that was capped at half the taxpayer's tentative tax liability. I don't think, however, that the existence of the tax credit option undermines my theory. The distinction between "exactly" 50% (tax credit) and "really close" to 50% (tax deduction) is very fine and likely lost on most of the individuals involved in this bargain. Allowing a deduction of up to 50% of AGI "looks like" they are splitting the pie down the middle to most people, and in fact comes quite close. Moreover, I propose this theory simply as the best way of explaining why the AGI limits continue to exist. The fact that they are far superior method of implementing the dual majority bargain than per-person ceilings or a per-transfer limit is relevant to justifying their existence as opposed to the existence of the latter two options: The latter two are not "appealing enough" given the far superior alternative of the AGI limits. The tax credit option is only marginally better than the deduction structure, and is not so much better that its existence would

The AGI limits thus split each individual taxpayer's pie down the middle. Aggregating across taxpayers would yield a split down the middle of the total amount of federal funds available. Viewing the AGI limits from this perspective provides the strongest justification for their existence: They do the best job of splitting the pie of available funds into whatever portions the two majorities have agreed upon. Such a limit thus 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. In so doing, the AGI limits reconcile the delivery of public goods through the private charitable sector with broader principles of democratic government, allowing both to co-exist within the same system.<sup>183</sup>

### **C. Focusing on the dual-majority bargain extends previously insufficient justifications for the AGI limits to a satisfactory level**

Recall that Section IV.B. argued that many previous justifications for the AGI limits – such as the arguments that the limits might enhance progressivity,

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undermine the appeal of the limited deduction. In other words, even with the credit option, many people might likely continue to find the deduction structure appealing enough to implement the bargain. Lastly, the AGI limits were instituted long before tax credits became common, and my theory attempts to explain their continued existence: they remain an appealing enough means of implementing the bargain, even if starting anew we might choose a credit.

<sup>183</sup> For essentially the same reasons, the framework proposed here also applies to the more traditional subsidy theory, although the argument is not as precise. What my argument boils down to is the fact that no matter how noble or worthy charitable projects are, they are by definition not the projects funded by the government. Those who support the traditional subsidy theory believe that this is a good thing, and that this justifies the subsidy. Even so, however, it is plausible to believe that such traditionalists may not want to take their own arguments too far.

Some traditionalists may well be comfortable with a world in which individuals can fund only their desired projects and not contribute to what the government has deemed important. It is also likely, however, that not all traditionalists are comfortable with that scenario, and that many supporters of the charitable sector are at least on some level, also supporters of the government. If one supports the charitable sector because it provides alternative solutions to social problems, one may well want to see what kind of solutions the government also offers. If one supports the charitable sector on the grounds that it spreads out power in our society and enhances pluralism, one would likely want to create some sort of checks and balances system whereby the charitable sector did not have all the power and the government no power. Lastly, most (but not all) individuals who bump up against the AGI limits are wealthier individuals. Perhaps, as articulated by the conference reports quoted above, the limits represent a desire to make sure that wealthy individuals contribute to the same pot of chosen works as less-wealthy individuals so that wealthy individuals do not “opt out” of the common government and operate solely in the charitable sector. [See also excerpt from Odendahl on page 685 of Schwarz casebook (find real page in real book). “in this way the upper class, rather than the majority of the population, through a political process, defines the public good.” Page 687 of Schwarz book – she seems to suggest limiting gifts any one person can make to a given charity – like political contributions.]

serve as an alternative minimum tax, or serve as some cap on overall government subsidies to charity—were not satisfying because those explanations did not answer the further question of *why* those goals matter. Why make sure the rich pay “enough” even if they make large charitable gifts, why make sure everyone pays some tax in addition to making donations that fund public goods, why cap government transfers to charities providing public goods? The optics argument explored in IV.B.5.b. took a first step toward answering those questions: Because it seems unfair. As that Section argued, however, the optics justification, standing in isolation, does not go far enough: It still does not answer what, exactly seems unfair about not taxing people who donate all their income to charity?

Refocusing on the problem that the dual-majority bargain solves does, however, better answer these questions. The problem addressed by that bargain was the fact that an unlimited charitable deduction would allow some individuals to fund only their preferred vision of the public good and fund none of the government’s vision of the public good. Viewed through this framework, those previously-unsatisfactory justifications for the limits can be recast as variations on two themes: (1) ensuring the government has enough revenue to fund its own priorities and (2) avoiding handing over too much discretion to individuals with minority preferences. It is not enough that everyone contributes to the public good broadly speaking; rather, everyone must pitch in to fund what the government prioritizes. Otherwise, individuals with the ability to make large charitable donations could opt out of the legislative process, while individuals without the ability to make large donations would be unable to opt out. Moreover, if enough of the former opted out, they could undercut the legislative process and leave the government’s projects under-funded.

The hearings for the 1969 reforms that repealed the unlimited deduction reflect this concern. Reviewing those hearings, it appears that some legislators were concerned about the ability of wealthy people, through charitable contributions that completely erased tax liability, to supplant governmental decisions about which goods and services should be provided to the public at large and instead insert their own decisions about what should be provided. For example, one legislator arguing for the caps bemoaned the fact that the wealthy could control what services are to be provided while “the great mass of the American people ... have to pay for what the great, large, big Government decides are the services they are going to render.”<sup>184</sup> Another argued that he was “really concerned over the ability of a few individuals to actually appropriate

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<sup>184</sup> Hearings Before the Committee on Ways and Means, House of Representatives, 91<sup>st</sup> Cong., 1<sup>st</sup> Session, On the Subject of Tax Reform, Part 4 of 15, page 1571 (February 26 and 27, 1969) (Statement of Representative Byrnes).

what I would call Federal funds, because these funds have been short-circuited from the Treasury and are under the control of these few wealthy individuals who decide which goods and services should be provided.”<sup>185</sup>

This illuminates what the optics argument is really about: Even if those wealthy individuals were doing good with their money via charitable contributions, something still seemed unfair about their not contributing anything to what the majority, as represented by the government, deemed good.<sup>186</sup> Viewed in this light, the optics argument can be extended to a satisfactory level: The AGI limits ensure that everyone pays something to what their fellow citizens deem good and prevent the unfairness that could result if some, but not all, citizens, could opt out of the legislative process. Of course, whether or not one views that ability as actually unfair turns on one’s political philosophy. Section VI argues that liberal democratic theory also justifies the AGI limits and that allowing some individuals to opt out completely would, as a matter of political theory, be unfair and is inconsistent with our democratic structure.

#### **D. Fine points and permutations of the dual-majority bargain theory**

Having laid out the basic argument for the AGI limitations, certain questions still remain: Does it justify having different limits based on the type of asset donated or the recipient charity? Does it justify carry-forwards? Does recent legislation that temporarily lifts the limits undercut this model? And finally, how would this framework differ if one departs from a majoritarian median-voter model of legislative behavior?

##### **1. Should there be one limit or many?**

Those familiar with the AGI limitations may have noticed that my analysis thus far has focused on the general limitation that applies to cash transfers to

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<sup>185</sup> Id. at 1577 (Statement of Representative Utt),

<sup>186</sup> See also Johnny Rex Buckles, 80 Ind. L. J. 985-86. “But for [the AGI] limitations, a wealthy taxpayer could avoid paying taxes by donating all of her income the charity and living off of her savings. ... To allow all of the resources of the wealthy to fund those charitable activities that they value, at the cost of denying the federal government any control over the use of such funds, may simply be politically unacceptable to governmental policymakers;” George F. Break, *Charitable Contributions Under the Federal Income Tax: Alternative Policy Options* 1524, in *Volume III of the Filer Commission Reports* at 1521 (suggesting that limits on the charitable deduction may be justified because “permitting [some privileged individuals] to contribute only to their own privately chosen public goods while everyone else has to contribute to collectively chosen public goods is an option of dubious merit” but declining to analyze whether the AGI limits are an adequate constraint).

public charities.<sup>187</sup> Does the above analysis also justify more stringent limitations applicable to transfers of appreciated property and to private foundations, as is currently the case? As explained in Section II, the AGI limit currently drops to 30% for donations of appreciated assets, and 30% for cash contributions to private foundations. For donations of appreciated assets to private foundations, the AGI limit is 20%.

As an initial matter, I do not believe my framework justifies having separate limits that turn on the type of property an individual chooses to donate. The theory posited above rests on the idea that the government should subsidize the projects of charitably-inclined taxpayers only to the extent such taxpayers fund the government's projects.<sup>188</sup> Whether a taxpayer makes a donation with cash or with appreciated property in order to trigger the subsidy should, in and of itself, not matter so long as the taxpayer is still contributing something to the government's projects.

The additional subsidy the charity receives when someone donates to it appreciated property<sup>189</sup> may well, however, affect the way the two majorities end up splitting the pie in such situations. To that end, it may be plausible that a different bargain is struck in which taxpayers making donations of appreciated property are limited to a smaller percentage of AGI. And, of course, as explained in Section IV.B.4., the government may well have reasons to limit the deduction allowable for such property to its basis. That, however, is a separate issue.

What about lower limitations for donations to private foundations? Such organizations are usually founded by a single donor or a single family, and generally do not carry on their own charitable activities. Instead, private foundations make grants to other organizations that do conduct charitable activities directly. One twist in the private foundation rules is that they are *required* to spend at minimum only 5% of their assets each year on charitable activities;<sup>190</sup> this minimum includes not only grants to other charities but also administrative expenses like salaries.

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<sup>187</sup> While that limit is currently 50%, I re-emphasize here that I believe the above analysis would apply even if some other general limit applied. In other words, I believe my argument sheds light on whether there is merit to limiting a donor to a deduction equal to some percentage of her AGI (whether or not that percentage is 50%).

<sup>188</sup> Or only to some other extent bargained for in relation to the amount of tax paid. See note 118.

<sup>189</sup> Give example. Essentially, the untaxed appreciation never enters the pie that the two majorities split up, but goes directly to the charity.

<sup>190</sup> While some charities exceed this minimum, many do not, and those who do often do not exceed it by very much. Cites.

Although I do not believe private foundations should be treated differently as a normative matter, it seems plausible that supporters of private foundations might not be able (or should not be able) to strike the same bargain as individuals supporting public charities.<sup>191</sup> First, due to the lenient minimum pay-out rules, the immediate benefit of funding public goods is delayed. Although assets must eventually fund such goods, in the interim, they remain under the private control of trustees chosen by the founders. Thus, it may appear to the classic majority that private foundation supporters have less to bargain with in terms of the funding for public goods than supporters of public charities.

Moreover, any given private foundation attracts financial support from far fewer people than any given public charity (which by definition must attract at least xx% of its support from the general public).<sup>192</sup> Perhaps the knowledge that many people (even if not enough for a classic majority) support a minority project makes the bargain described above palatable with respect to public charities. In contrast, maybe the classic majority is less willing to subsidize projects that by definition are initially supported only by one or a few individuals.<sup>193</sup> In any case, it is plausible to believe that the two majorities might split the pie differently in the case of private foundations.

## 2. Should there be carry-forwards?

What does the dual-majority bargain suggest in terms of either allowing or requiring individuals to carry-forward contributions disallowed due to the AGI limits? To continue the pie example, I think the answer depends on whether the bargain is over a taxpayer's annual pie only, or also her lifetime pie.<sup>194</sup> If the bargain struck between the two majorities is *only* over a taxpayer's annual pie, then carry-forwards are inconsistent. Applying the AGI limits to her in the year of the charitable contribution is enough to split up her pie for that year, and what her pie looks like in future years isn't yet under discussion. In contrast, if the bargain is *also* over one's lifetime pie, then carry-forwards (and perhaps even carry-backs) should be allowed. In that case, allowing carry-forwards and maybe

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<sup>191</sup> I note here that I am assuming the private foundation rules are working as intended and preventing the abuses that led to their enactment in 1969. If such rules are not working and foundations are vehicles for abuse, as many currently allege (cites), the case for not allowing foundations to be part of the same bargain as public charities is even stronger.

<sup>192</sup> Cite to statutes defining private foundation and public charity.

<sup>193</sup> See Colombo and Hall, 66 Wash. L. Rev. 395.

<sup>194</sup> Some readers may wonder what the bargain would look like if it were only over a taxpayer's lifetime pie. I do not address that here, since I believe that because of the annual accounting period and then annual budget process, any bargain would be over a taxpayer's annual pie at minimum.

carry-backs would do two things. First, it would implement the bargain for any given year by ensuring a taxpayer equally funds majority and minority projects that year. Second, it would allow taxpayers to make large charitable gifts all at once instead of spreading them out over time, while still upholding the dual-majority bargain. Allowing taxpayers to do so reflects an understanding that sometimes large gifts may better help charities to provide the types of goods and services for that we are subsidizing them to provide in the first place.

### **3. What of the exceptions to the limits?**

What does the temporary repeal of the limits in KETRA and the Pension Protection Act suggest about the proposed dual-majority bargain? And the inapplicability of the limits to achievement awards like the Nobel Prize that are donated to charity? I don't think these exceptions undermine the model I have proposed, but rather illustrate the fact that sometimes parties deviate from previously-struck bargains when special circumstances arise. After Hurricane Katrina, for example, many thought that the charitable community needed more help than usual. This might explain why the "new majority" of charitable donors was let out of the bargain temporarily.

IRAs and prizes suggest a somewhat different analysis. Because achievement awards are infrequent and likely not one's main source of income, exempting them from the limits may be nothing more than limiting the bargain to taxpayers' "everyday" pies and recognizing that extraordinary windfalls given to charity don't upset the previously struck bargain. A similar argument might follow about exempting charitable IRA distributions of up to \$100,000 from income: Such distributions likely occur near the end of a taxpayer's life, and perhaps the classic majority feels that the retiree, by paying taxes throughout her life, has already filled her end of the initial bargain.

### **4. Non-majoritarian models of the legislative process**

As seen above, the majoritarian median-voter model anchors the current charitable deduction literature.<sup>195</sup> It is likely, however, that in some or many instances, other models of the legislative process are more accurate. Although a full exploration of either the deduction's existence or the AGI limits under alternative models is beyond the scope of this Article, I believe that the essential framework underlying the dual-majority bargain applies to other models of the legislative process, such as logrolling and interest groups.

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<sup>195</sup> Cites.

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

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

In other cases, the deduction itself may be part of the very vote-trading or other politicking that results in the funding of some goods by the government but not others. For example, supporters of a lighthouse might "buy" votes from supporters of a community theater by assuring the latter of partial funding via a charitable deduction. 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: The AGI limits serve as a second bargain between these two groups that enables the initial bargain to hold. Without the AGI limits, the group who supposedly "foregoes" full funding of its preferred goods and supports full funding of other goods in exchange for partial funding (and perhaps some other benefit) could do an "end-run" around this first bargain. If such groups donate all their income to charity and do not pay any taxes, then they are not truly supporting full funding of the goods they promised to support.

[Address Republicanism?]

## VI. The AGI Limits and Political Theory

An additional and complementary normative explanation for the AGI limits is grounded in political theory.<sup>196</sup> As detailed below, this explanation is anchored by the idea of reciprocity inherent in liberal democratic theory. It argues that allowing some individuals to pay no taxes, even if supporting a “good” cause, is tantamount to allowing them to opt out of a previously agreed-to scheme of cooperation and undermines the stability of our democratic society. This not only *seems* unfair, but *is* unfair to other members of society –which finally allows us to extend the previously-offered tax policy explanations for the AGI limits to a satisfactory level.

### A. A brief overview of liberal political theory

Very broadly speaking, such theory generally conceptualizes citizens as free and equal members of our society with basic rights that cannot be abridged. A result of this conception is that free and equal citizens will form a variety of reasonable yet different views of “the good” that should be respected precisely because the citizens holding those views are free and equal.<sup>197</sup> The task of liberal political theory, then, is to answer the question “How can citizens with differing views form a stable and just society?”<sup>198</sup>

In *Political Liberalism*, John Rawls theorizes that a stable and just society would use as its organizing principle a “fair system of cooperation” containing three elements: (1) it is governed by “publicly recognized rules and procedures” that participants agree to and regard as proper, (2) it requires reciprocity, that is, the idea that the terms of cooperation will be acceptable to each participant if the other participants also agree to follow them, and (3) each participant has a rational conception of what he or she is trying to achieve from the cooperative scheme.<sup>199</sup>

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<sup>196</sup> I thank Larry Solum for elucidating my thinking on these points.

<sup>197</sup> John Rawls, *Political Liberalism* 4, 16 (1993).

<sup>198</sup> *Id.* at \_\_.

<sup>199</sup> *Id.* at 16.

It follows from these three elements that once free and equal citizens have agreed to a given scheme of fair cooperation, they are necessarily bound by it. Letting citizens opt out after the fact violates the element of reciprocity. How can one free and equal person agree to terms of cooperation for a joint project if she knows others can opt out later? Allowing others to post hoc opt out undermines the whole point of cooperating in the first place and creates instability.

## **B. Liberal political theory and charitable giving**

How is this conception of justice related to charitable giving? Under Rawls's conception of justice, both the structure of a society's institutions and the specific laws produced by those institutions should reflect the elements of fair cooperation.<sup>200</sup> Roughly speaking, the types of laws produced by our legislative structure fall into three groups: (1) those that protect the rights of free and equal citizens (such as those guaranteed by the Constitution and in statutory civil rights legislation), (2) laws that impose obligations upon citizens (such as jury duty, military service or paying taxes), and (3) laws that impose duties upon the government (such as providing a given good or service, like national defense). Legislative choices about whether, how much, and which public goods to fund thus are (or should be) just as much an expression of democratic equality as laws that protect citizens' rights. Likewise, paying taxes to fund such public goods is just as much a burden of citizenship as jury duty or military service,<sup>201</sup> which are necessary for the government to provide a system of criminal justice or national defense. There is therefore something just as "special" about the system of paying taxes to fund government-provided public goods as there is something "special" about laws that are more viscerally democratic, like the Bill of Rights.

This is not to say that government-funded public goods are the *only* worthwhile public goods. My point is simply that such public goods exemplify democratic ideals in a way that other public goods, even if meritorious on other grounds, do not. This is so because the decision by the legislature to fund an identified public good at a set level means that the citizenry together has decided to conduct specific, identifiable projects *jointly*. This is inherently different than giving citizens money for their own separate projects of their own choosing, for in the latter case, the project itself has not gone through the democratic process "wringing" and is not part of the joint undertaking that the citizenry comes together for. To that end, the public goods singled out for funding in the legislative

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<sup>200</sup> Id. at xlv.

<sup>201</sup> See Deborah Schenk, Saving the Income Tax With a Wealth Tax, 53 Tax L. Rev. 423, 468-69 (2000) (arguing that paying taxes is part of what it means to be a "good citizen.").

process are unique. And assuming they represent the outcome of a just process, all citizens must contribute to their funding to comply with the element of reciprocity.

Of course, arguing that all citizens must pay taxes to fund legislatively-approved public goods does not answer the question of whether partially subsidizing *other* public goods is either required or allowable in a just society. It is unclear whether a just society would *require* a charitable deduction that enabled citizens whose conceptions of the “good” differ from that funded through the legislative process to receive partial funding. Although an interesting inquiry, answering that question is not necessary for our purposes.

Instead, the immediately relevant question is whether a charitable deduction is *consistent* with a just society, and if so, what justice suggests about its structure. As an initial matter, providing partial funding to citizens with differing conceptions of the good appears consistent with a just society, for it respects the reasonable pluralism that results from treating citizens as free and equal. To remain consistent with a just society, the method of providing such partial funding must itself embody the elements of fair cooperation that characterize a just society. In other words, partially subsidizing other public goods through the charitable deduction is just *only if* it reflects the ideals of fair cooperation.

Enter the AGI limits. By limiting the deduction to some portion of each individual’s AGI, the limits guarantee that every citizen contributes something to the bundle of goods set by the legislative process. This implements the element of reciprocity by not letting anyone completely opt out of the terms to which they previously agreed. The limits thus ensure that the charitable deduction is consistent with our notions of democratic equality by protecting the integrity of that process and honoring as equals those who entered into it.<sup>202</sup>

A simple example may help illustrate the reciprocity-guaranteeing and stability-enhancing role of the limits. Imagine that a group of co-workers meets

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<sup>202</sup> Some readers may wonder “Well, isn’t it enough that the legislature approved a charitable deduction? If the legislature does so as part of a just legislative structure, and if the charitable deduction is available to all, doesn’t that meet the criteria for a scheme of fair cooperation?” While appealing in its simplicity, I think that reasoning is too narrow. It looks at the charitable deduction in a vacuum, and not as part of the larger process of allocating joint funds and deciding what projects to fund. In other words, the terms of the charitable deduction cannot be assessed in a vacuum but must be assessed alongside the terms of all the other mechanisms for allocating joint funds for public goods.

to decide how to honor their administrative assistant on his birthday.<sup>203</sup> The group decides (1) to throw a surprise party at a local restaurant and (2) that each co-worker will pitch in \$50 to fund the party. Some co-workers may decide to go above and beyond the party in honoring their assistant, perhaps by buying him some kind of present. And the group might even decide that buying extra presents for the assistant is a good thing to do, but just not part of their joint project.

From there, the group has two options. It can insist on \$50 from each co-worker regardless of whether the co-worker also buys the assistant a present. Or, the group may decide to let some co-workers pay a little less for the party if they give the assistant a present. The latter approach recognizes that views about what the co-worker might like (a party or a present or both? What kind of present?) might reasonably diverge. Even if the group decides to let present-buyers contribute less to the party, it's hard to imagine that they'd allow present buyers to contribute nothing. If they did, then what's the point of the group entering into a joint project to fete their assistant in the first instance?

Viewed from this perspective, the AGI limits can be seen as integrating the reasonable pluralism resulting from a society of free and equal citizens with the need to protect the fairness and stability of the mechanisms by which they enter into joint projects.

## VII Conclusion

Coming full circle, layering political philosophy onto the economic theory of the dual-majority bargain finally allows us to answer the questions left unanswered in prior justifications for the limits. Together, these two strands of thought help us finally satisfactorily explain *why* it is “unfair” to let some individuals pay no taxes. So doing not only undercuts the ability of the classic majority to ensure that the projects it prioritizes retain adequate funding, but also denigrates the character of our democratic system. This explains the appeal of the “crude AMT” justification that everyone must pay some taxes; the appeal of the optics argument that it “seems” unfair for some citizens to not pay some taxes; and why our instinct is that even if someone gives all their income to charity, they are somehow not living up to their obligations if they pay no taxes at all.

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<sup>203</sup> I thank Larry Solum for the following example.

### Appendix A: Income Averaging Illustration

Section IV.B.2. argued that in some instances, the current AGI limits exacerbate the upside-down effect because the carry-forward allows income averaging. To illustrate, continue using the hypothetical rate table from Section IV.B.2. Imagine now that *Hank* has taxable income (before taking into account any charitable deductions) in *Year 1* of \$1 million and in *Years 2-5* of \$300,000. If *Hank* contributes all his income to charity in *Year 1*, makes no contributions in *Years 2* through *5*, and can deduct the full contribution in *Year 1*, his aggregate tax burden will be \$420,000, calculated as follows:

Year	Taxable income (before charitable deductions)	Charitable contributions	Allowable charitable deduction	Taxable income after charitable deductions	Tax due
1	\$1,000,000	\$1,000,000	\$1,000,000	\$0	\$0
2	\$300,000	\$0	\$0	\$300,000	\$105,000
3	\$300,000	\$0	\$0	\$300,000	\$105,000
4	\$300,000	\$0	\$0	\$300,000	\$105,000
5	\$300,000	\$0	\$0	\$300,000	\$105,000
Total	\$2,200,000	\$1,000,000	\$1,000,000	\$1,200,000	\$420,000

Now compare *Hank's* tax burden if he is allowed to deduct only half his contribution in *Year 1* but is allowed to carry-forward the remaining contribution in *Years 2 – 5*. In that case, his aggregate tax burden actually decreases by \$45,000,<sup>204</sup> to \$375,000:

<sup>204</sup> The true economic benefit to *Hank* of carrying-forward the deduction will be slightly less than \$45,000 due to the time value cost of having to defer a portion of the deduction. However, that cost will likely be slight compared to the benefit of being able to use the deduction to offset income taxed at higher rates.

Year	Taxable income (before charitable deductions)	Charitable contributions	Allowable charitable deduction	Taxable income after charitable deductions	Tax due
1	\$1,000,000	\$1,000,000	\$500,000	\$500,000	\$205,000
2	\$300,000	\$0	\$150,000	\$150,000	\$30,000
3	\$300,000	\$0	\$150,000	\$150,000	\$30,000
4	\$300,000	\$0	\$150,000	\$150,000	\$30,000
5	\$300,000	\$0	\$50,000	\$250,000	\$80,000
Total	\$2,200,000	\$1,000,000	\$1,000,000	\$1,200,000	\$375,000

When *Hank* deducts his entire contribution in *Year 1*, the deduction mops up income that would otherwise be taxed at rates of 50, 25, and 10%. When *Hank* deducts only half his contribution in *Year 1* and carries forward the rest during *Years 2* through *5*, the deduction only soaks up income taxed at 50%. The latter is far more valuable to *Hank*.<sup>205</sup> Further, *Hank* reaps essentially the same benefits if he structures his \$1 million gift to avoid the limits in the first place.<sup>206</sup> Thus, by altering his behavior to avoid the limits, *Hank* actually reaps more tax benefits<sup>207</sup> than in a world without the AGI limitations.

<sup>205</sup>It is possible, of course, that if a donor's income drops dramatically enough, the deduction that is carried-forward may end up offsetting income that would have been taxed at lower rates. Steurle and Sullivan, 12 Am. J. Tax Pol'y at 412.

<sup>206</sup>To that end, imagine that *Hank* simply makes donations equal to 50% of his income until he has contributed a total of \$1 million: A \$500,000 contribution in *Year 1*; \$150,000 contributions in *Years 2* through *4*; and a \$50,000 contribution in *Year 5*. Several studies of wealthy taxpayers indicate that donors do, in fact, structure their charitable gifts to stay clear of invoking the limits. Steurle and Sullivan, 12 Am. J. Tax Pol'y at 411-12. In some cases, this means that donors smooth out their gifts over time. In other instances, however, this may result in donors giving less over time than they would otherwise. *Id.* How might this affect progressivity? If gifts to charities that assist low-income individuals are minimized, progressivity is adversely affected. If gifts to charities that primarily benefit a wealthy clientele decrease, progressivity may be enhanced. The notion that perhaps the AGI limitations are designed to minimize the subsidy to the types of charities favored by the wealthy is discussed in Section IV.B.1. See also Miranda Perry Fleischer, Charitable Contributions in an Ideal Estate Tax, 60 Tax L. Rev. \_\_\_\_ (discussing the effect that charitable bequests have on progressivity).

<sup>207</sup>Steurle and Sullivan further note that by smoothing his charitable deductions, *Hank* may also obtain a larger benefit from other deductions and exemptions, further reducing his tax bill. *Id.* at 412. In contrast, the recipient charity is worse off due the time-value-of-money cost of having to wait for the contribution.