

## TAX DEDUCTIBILITY AND THE PUBLIC GOOD

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Until very recently we have come to take the charitable deduction pretty much for granted as a natural part of the landscape of civil society in the United States. A recent scholarly article on the deduction notes that “Since 1917, the US Tax Code has encouraged charitable giving through the use of the Charitable Contribution Deduction. . . . Originally created to eliminate the fears that increased wartime taxes would destroy American charity. Today, the Deduction is not only widely used, but because of it, the Federal Government does not have to “step in” and subsidize charity.”<sup>1</sup> It is not so clear that the federal government does not have to “step in,” but there is no doubt that the deduction is a major incentive to private charitable donations. Over the course of the century in which we have lived with the deduction the Congress has experimented around the edges, but the charitable deduction itself has remained nearly sacrosanct. In this centenary year, however, given the political rhetoric of the 2016 presidential campaign, it seems quite possible that attempts will be made to significantly alter or even eliminate the deduction. It behooves those of us who value it to be clear about why the deduction was created, and what constitutes its continuing rationale – to create incentives for citizens voluntarily to contribute some portion of their wealth to support welfare goods in American society, and thereby to reduce the burden on the state to provide such goods.

The charitable deduction has its roots in the fundamental importance of charitable organizations in the United States. As Tocqueville noted nearly two hundred years ago, “Americans make really great sacrifices for the common good . . . [and] the American’s heart easily inclines to benevolence,” which leads to the major role of “associations in [American] civil life”: Americans of all ages, all stations in life, and all types of disposition are forever forming associations . . . .”

A single Englishman will often carry through some great undertaking, whereas Americans form Associations for no matter how small a matter.

This is the underlying intuition about American civil society that has led our state to create a legal regime in which private action for the public good was encouraged, and privileged.<sup>2</sup>

In the modern period of American history, the twentieth century, this sector was almost entirely supported by private wealth, which we in the United States have called “charity” or “philanthropy”. The charitable tradition in our country of course goes back to the very origins of the republic, but it began to take on new and greater responsibilities in the 20th century, when Americans first began to agree that public goods (welfare) needed to be provided for those Americans who could not help themselves. Financial support was also needed for necessary non-welfare functions, ranging from religion to education and culture that were not supported by the state or produced by the market. Individual private support, both monetary and through voluntary labor, sustained such civil society functions –

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<sup>1</sup> James Patrick Huston, “Pauper’s Parity: Taking Away the Fine Print of ‘Your Contribution is Tax-Deductible,’” (2016) [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2909908](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2909908).

<sup>2</sup> Alexis de Tocqueville, *Democracy in America*, ed. J.P.Mayer (New York, 1969), pp. 513-514.

many of which in contemporary European countries, were directly provided by the state and funded through taxation. For a variety of reasons, however, we in the United States had inherited a “weak state” tradition that relied upon the market and civil society to meet most social needs.

Our legal system provided the underlying structure for civil society organization and function. Although we had originally inherited the English system of law in which charity was narrowly defined, by the late nineteenth century Americans had expanded the legal definition of charity to provide mechanisms through which private wealth could more easily be devoted to the production of public goods. One area in which this mattered greatly was in the development of modern philanthropy, through which the very wealthy could organize, preserve and distribute their wealth for charitable purposes. Our law came to define “charity” so broadly that the benevolent could donate funds for almost any purpose that was neither criminal nor self-injuring. The most important institution that was created to facilitate this process was the philanthropic foundation. In effect, the law either passively or actively permitted the wealthy to institutionalize their philanthropy in perpetuity.

Until the early 20<sup>th</sup> century, American charitable organizations existed under state, not federal, law. State laws of incorporation governed charitable activities and states subsidized charitable work through property tax exemptions. Churches were the earliest instances of tax exemption. After the passage of the Sixteenth Amendment in 1913, federal income taxation became constitutionally authorized, and it became possible for those (few) charities authorized on a state basis to be exempt from federal taxes.

But more important to charities than federal tax exemption was the creation of the mechanism of tax deductibility for individual contributions to charities. Tax deductions would henceforth provide indirect subsidies to individuals who donate to federally-recognized civil society organizations, reflecting early twentieth century national lawmakers’ recognition of the need to stimulate the flow of private funds to charity. After all, a state which was ideologically disinclined to support welfare directly, but which recognized the social imperative of welfare, had to find alternative means to provide it.

The idea for a deduction for charitable contributions appears to have first emerged in the congressional debates over the first federal income tax law in 1913, although there was also such a provision in the 1909 corporate excise tax and in the 1913 corporate income tax legislation. The War Revenue Act of 1917, raising taxes for American participation in World War I, provided federal tax exemption for “contributions or gifts . . . to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes” so long as the gifts did not “inure to the benefit of any private stockholder or individual” up to 15% of the taxpayer’s annual income”. One of the senatorial proponents justified the measure by saying:

Usually people contribute to charities and educational objects out of their surplus. After they have done everything else they want to do, after they have educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific

purposes. Now, when war comes . . . that will be the first place where wealthy men will be tempted to economize, namely, in donations to charity.<sup>3</sup>

That is, the fear was that the imposition of high taxation would deter individuals from continuing the American practice of annual support of local and national charitable institutions: schools, churches and social welfare institutions.

The *New York Times* worried particularly about the negative impact of high war taxes on higher education: “The Presidents of the colleges, whose incomes from tuition and dormitory fees will be notably lessened by the war service of so many collegians . . . are in grave perplexity,” since the taxation of high income citizens “diminishes or dries up the springs of philanthropic eleemosynary and educational life.”<sup>4</sup> *The Washington Post* agreed: “This country cannot abandon or impoverish the great structure of private charity and education that has been one of the most notable achievements of American Civilization.<sup>5</sup> Elsewhere, the *Post* exemplified the Red Cross as a case in point. The Red Cross had recently received huge sums in contributions to support its war work, but “If the money thus contributed were subject to taxes it would be a penalty upon generosity and an inducement for the retention by individuals of all moneys which they formerly contributed to” charities, with the result that support of institutions such as the Red Cross “would fall entirely upon the Federal Government”.<sup>6</sup> The newspapers argued that the new income taxation, although necessary to support the war effort, should not constitute a “penalty on generosity,” charity, lest that vital aspect of American life be endangered and, politically more important, the federal government be forced to take on the burden of social welfare.

The same point had been made in a *New York Times* cartoon a few years earlier showing “a wealthy and prosperous-looking man with a top hat and banker’s coat being held up at gunpoint by a masked robber labeled “Income Tax.” Behind the banker stood an impoverished and pathetic-looking hooded figure labeled “Charity” with his empty hand stretched out.”<sup>7</sup> The concern in the Progressive Era in which the federal income tax originated was precisely that taxation might drive down charitable giving. So, although no one at the time could have known it, the creation of the deduction for individual contributions in 1917 set the model for federal charitable policy which has persisted until today. The twin pillars of charitable deduction and tax exemption for charitable institutions remain the core of our policy of affirmative governmental support for the private provision of welfare and other public goods.

Over the past century there have been a long series of changes to charitable tax policy. The percentage of taxable income subject to the deduction and the class of individual eligible for the deduction have changed, but federal policy has remained to offer the highest level of tax deductions to

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<sup>3</sup> Joseph J. Thorndike, “How the Charitable Deduction Made the World Safe for Philanthropy,” *Tax History*, 13 December 2012. See also Ellen P. Aprill, “Churches, Politics and the Charitable Contribution Deduction, 42 B.C.L.Rev. 843 (2001).

<sup>4</sup> “The Conscription of Wealth,” *New York Times*, 24 August 1917

<sup>5</sup> “Exempting Charity,” *The Washington Post*, 24 August 1917

<sup>6</sup> Thorndike

<sup>7</sup> Steven R. Weisman, *The Great Tax Wars* (New York, 2002), p.258

the wealthiest taxpayers, since they have been thought to be the most important source of charitable contributions.

For the purpose of this brief history, the next important point in the history of federal charitable policy emerges in the years that produced the Tax Reform Act of 1969. That landmark legislation resulted in large part from the growing complaint that philanthropic foundations were too often serving the interests of their donors rather than the public interest, and thereby acting against the public policy to provide tax benefits for the production of public goods. Congress responded by making an important distinction between public charities (those supported financially by public contributions and directly engaged in charitable work) and private philanthropic foundations (those that did not engage in inherently public activities nor derive financial support from a wide variety of public sources). The newly-defined private foundations were subject to a variety of limitations, including an annual excise tax on investment income and a 6% minimum annual distribution requirement – which was as far as Congress was then prepared to go in requiring annual philanthropic expenditures of foundations.

But the 1969 legislation increased charitable deduction limits for individuals (up to 30 percent of adjusted gross income) to public charities, and increased the maximum deduction limitation to 50 percent for cash contributions to public charities and operating foundations. The intent of these provisions, although they were not clearly spelled out, was to distinguish between organizations that engaged directly in charitable work or received broad public support for such work (“public charities”) and organizations that were financed by small numbers of wealthy people and constituted for the purpose of funding other charitable organizations (“private organizations”). In 1969 Congress thus expressed a preference for “doing” rather than “funding” charity by providing greater tax benefits for contributions to public charities and establishing rules designed to ensure that there would be a regular flow of dollars from private foundations to operating charities.

There were clear indications during the deliberations over the Tax Reform Act of 1969 that there was an awareness of the need to keep private charitable funds flowing to the nonprofit community. As early as the 1965 Treasury Department report on foundations commented: “Three broad criticisms have been directed at private foundations. It has been contended that the interposition of the foundation between the donor and active charitable pursuits entails undue delay in the transmission of the benefits which society should derive from charitable contributions.”<sup>8</sup> This sentiment continued into the debates over the legislation. Senator Long, for instance, noted that the proposed 40 year limit on the lifetime of private philanthropic foundations did not imply a more general objection to charity. The purpose of such a limitation would be to get charitable funds to nonprofits more quickly. Long cited Peter Peterson’s testimony that social needs were growing faster than the economy, and that most nonprofits were facing budgetary crises, so that a limitation on foundation lifetimes would be an effective way to generate greater funding for them.<sup>9</sup> Congress wanted tax policy to stimulate charitable investment in social needs.

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<sup>8</sup> *Treasury Department Report on Private Foundations* (Washington, DC: Government Printing Office, 1965), 5.

<sup>9</sup> U.S. Congress, *Congressional Record* 115 (December 5, 1969): S 37197.

What Congress couldn't anticipate in 1969 was the explosive growth of donor-advised funds—a mechanism through which community foundations and other public charities could use their public charity status to provide donors with the ability to gain the tax benefits of charitable giving while still retaining a form of on-going control over the donated assets.

This, in very brief compass, is the twentieth century history of the federal tax deduction. The deduction has been a crucial element in the support our national government has given to the private role in social welfare. In a state that has too often stepped away from the direct production of public goods, the private role has been crucial – but we must not forget that the private sector has for a century been subsidized through state tax policy. Particularly in an era of state retraction, the maintenance of the charitable tax deduction is now more important than it has ever been.