

2014

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### Recommended Citation

DiRusso, Alyssa A. (2014) "Charity at Work: Proposing a Charitable Flexible Spending Account," *Utah Law Review*: Vol. 2014 : No. 2 , Article 2.

Available at: <https://dc.law.utah.edu/ulr/vol2014/iss2/2>

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# CHARITY AT WORK: PROPOSING A CHARITABLE FLEXIBLE SPENDING ACCOUNT

Alyssa A. DiRusso\*

## I. INTRODUCTION

In charitable giving, it is not just the thought that counts. American society depends upon a robust third sector to provide public services and benefits, and to lessen the burdens of government.<sup>1</sup> The third sector, in return, depends upon government to regulate charitable organizations and provide mechanisms for their financial support.<sup>2</sup>

The traditional primary mechanism for providing support to nonprofits is the charitable income tax deduction, available to taxpayers who itemize.<sup>3</sup> This system, although noble in its aspirations and moderately successful in its application, falls short of the ideal. As an itemized deduction, its incentives reach only taxpayers who itemize. The majority of taxpayers who do not itemize—who tend to be less wealthy—reap no benefit from the tax incentive.

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<sup>1</sup> The first sector is government, the second sector is business, and the third sector is philanthropy. See ROBERT L. PAYTON & MICHAEL P. MOODY, UNDERSTANDING PHILANTHROPY: ITS MEANING AND MISSION 46–52 (2008). The third sector is also defined as “the voluntary and community sector, the non-profit sector, the social enterprise sector and civil society.” Stephen P. Osborne, *Key Issues for the Third Sector in Europe*, in THE THIRD SECTOR IN EUROPE: PROSPECTS AND CHALLENGES 6 n.1 (Stephen P. Osborne ed., 2008).

<sup>2</sup> The U.S. third sector has a dualist approach to governance, with regulation at both the state and national levels, which “bifurcates responsibility for regulating” nonprofits between state government and federal government. See Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1125 (2007). On the regulation of charitable organizations broadly, see MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 151–52 (2004).

<sup>3</sup> See I.R.C. § 170(a) (2012).

Relegating the benefits of the charitable deduction to those who itemize their income taxes threatens the deduction's goals of equity and pluralism.<sup>4</sup> A tax incentive that by its design systematically excludes two-thirds of the population fails to reflect a truly diverse and representative expression of society's charitable priorities.<sup>5</sup> It is also inequitable, largely excluding lower-income taxpayers who have a greater need for the tax subsidy, and providing disproportionate benefits to some demographic groups at the expense of others.

Discrimination against nonitemizing taxpayers may seem benign enough at first. Categorizing on the basis of whether a person itemizes is hardly a suspect classification, like race or sex, which naturally triggers our concern. Itemizers and nonitemizers are, however, different demographic groups which may have very different priorities. Nestled within these demographic details are distinctions that matter.

Those itemizers for whom charitable deductions are available tend to be the wealthiest among us. Using IRS Statistics of Income from 2005, the Tax Foundation's research demonstrates the class divisions between those who itemize and those who do not.<sup>6</sup> There is an enormous gap between higher-income and lower-income households in itemization rates: over 89% of households earning \$100,000 or more itemize,<sup>7</sup> compared to less than 18% of those with incomes under \$50,000.<sup>8</sup>

These economic distinctions map onto other demographic distinctions that matter. Hidden in these statistics based on income is a startling divide based on race. The IRS does not collect data on race of itemizers and nonitemizers, but U.S. Bureau of the Census data provides a contrast between the under-\$50,000 and over-\$100,000 groups.<sup>9</sup> In 2009, nearly two-thirds of blacks and Latinos respectively reported incomes of less than \$50,000 (61% of blacks and 60.2% of Latinos).<sup>10</sup> By comparison, only about a third of whites and Asians, respectively,

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<sup>4</sup> For more on the goals of the charitable deduction, see *infra* Part III.

<sup>5</sup> In 2010, roughly 66% of taxpayers (93.68 million of 142.89 million returns) took the standard deduction, while nearly 33% of taxpayers itemized (46.64 million of 142.89 million returns). INTERNAL REVENUE SERV., STATISTICS OF INCOME—2010 INDIVIDUAL INCOME TAX RETURNS 38 tbl.1.2 (2012), available at <http://www.irs.gov/pub/irs-soi/10inal cr.pdf>.

<sup>6</sup> See GERALD PRANTE, TAX FOUND., MOST AMERICANS DON'T ITEMIZE ON THEIR TAX RETURNS (2007) (at p. 4 of .pdf manuscript) (noting that "itemization is highest among high-income taxpayers"), available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff95.pdf>.

<sup>7</sup> *Id.* tbl.1. This amount spikes to 93.34% for those with incomes over \$200,000, the highest income division marked by the table. *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> See U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 455 tbl.696 (2012), available at <http://www.census.gov/compendia/statab/2012/tables/12s0695.pdf>.

<sup>10</sup> See *id.*

report being in this lower-income group (38.9% of whites and 32.2% of Asians).<sup>11</sup> Whites and Asians are also disproportionately present in the over-\$100,000 group, with 27% of whites and 37.7% of Asians reporting incomes over \$100,000, compared to only 12.1% of blacks and 12.4% of Latinos.<sup>12</sup> Rules that divide based on income have disproportionate impacts on certain races.<sup>13</sup>

The division between itemizers and nonitemizers, however, is not based purely on income (and the attributes that may underlie income levels, such as race). Itemized deductions are also geographically discriminatory. People who live in states with high state and local tax burdens, like Maryland and New Jersey, are far more likely to claim itemized deductions.<sup>14</sup> In Maryland, 50.03% of taxpayers itemize, and in New Jersey, 45.23% do.<sup>15</sup> Those with lower state tax burdens, like West Virginia and Texas, have much lower rates of itemization (18.02% and 25.99%, respectively).<sup>16</sup> States with low home values, which in turn reduce the value of the mortgage-interest deduction, also produce fewer taxpayers who itemize their returns.<sup>17</sup> Whether an individual can take a federal tax deduction for charitable contributions is largely affected by the local tax policy of his or her home state.

Homeownership also affects whether an individual is likely to itemize. Of the 45,695,736 itemized returns filed for the 2009 tax year, 37,004,065 of them (roughly 81%) claimed a deduction for interest paid.<sup>18</sup> There are notable demographic differences in rates of homeownership. Younger individuals, for example, are less likely to own homes.<sup>19</sup> In 2000, the U.S. census showed that

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<sup>11</sup> *See id.*

<sup>12</sup> *Id.*

<sup>13</sup> *See* Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751, 757–58. In addition to supporting the notion that the tax code benefits whites more than blacks due to income disparities, the authors argue that factors other than income also account for the differential impact of tax provisions on black taxpayers. *Id.* For more information on how the tax code has broad impacts based on race and class, see Dorothy A. Brown, *Teaching Civil Rights Through the Basic Tax Course*, 54 ST. LOUIS U. L.J. 809, 813–20 (2010).

<sup>14</sup> *See* PRANTE, *supra* note 6 (at p. 3 of .pdf manuscript).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* tbl.1.

<sup>17</sup> *Id.* (at p. 3 of .pdf manuscript).

<sup>18</sup> *SOI Tax Stats—Individual Statistical Tables by Filing Status, Table 2.2, Returns With Itemized Deductions: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Marital Status, Tax Year 2009* (July 2011), <http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Filing-Status> (scroll down to “Individual Income Tax Returns with Exemptions and Itemized Deductions”; select the year “2009” under “Individual Complete Report (Publication 1304), Table 2.2”). Deductible interest includes that paid on home mortgages, home equity lines of credit, points, and other specific debts. *See* I.R.C. § 163(h) (2012).

<sup>19</sup> *See* Kelly Pottorff & Tammy Tidmore, *Home Buyer Demographics Show “Echo Boomers” Poised to Revive Ownership Stats*, DEL MAR TIMES (Nov. 1, 2012), <http://www.>

people over the age of sixty-five owned homes at double the rates of those under thirty-five.<sup>20</sup> Homeownership also varies by race, income level, and state.<sup>21</sup>

Demographic differences clearly underlie the division between itemizer and nonitemizer. Should only people who itemize derive an income tax benefit from charitable donations? Do we only intend to incentivize and reward charitable giving within certain privileged groups based on income, race, homeownership, or state of residence? Unless we believe these assertions, the itemized deduction for charitable donations is flawed. The incentive should be restructured to be more inclusive and fair, supporting the contributions and the voices of nonitemizing individuals.

Scholars and policy makers have largely assumed that the alternatives available for modifying the charitable income tax deduction are rather limited.<sup>22</sup> The deduction could be moved above the line and made available to nonitemizers. It could be eliminated or capped, shrinking the advantage it gives to higher-income itemizers. It could be exchanged for a credit, either dollar for dollar or at some lower proportion. It could be left the way it is. These seem to be the only options. They are not.

The charitable deduction does not represent the first occasion where the Internal Revenue Code (“the Code”) had a deduction whose benefits failed to reach nonitemizing taxpayers.<sup>23</sup> The conundrum facing the charitable deduction mirrors that which historically faced the income tax deduction for medical expenses. Although intended to support the tax policy of providing relief to taxpayers for

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delmartimes.net/2012/11/01/home-buyer-demographics-show-%e2%80%9cecho-boomers-%e2%80%9d-poised-to-revive-ownership-stats/ (“Data drawn from 2011 shows that the sharpest increase in homeownership indeed occurs within this jump from the 25 to 29-year-old cohort to the 30 to 45-year-old cohort.”).

<sup>20</sup> See *Historical Census of Housing Tables: Homeownership by Selected Demographic and Housing Characteristics*, U.S. CENSUS BUREAU, <http://www.census.gov/housing/census/data/ownerchar.html> (last visited Mar. 7, 2014) (noting that “[o]lder householders (65 years and over) have always had high homeownership rates” with those in the 65+ group having 78% homeownership rates, compared to 39% of the under-35 group).

<sup>21</sup> See *Historical Census of Housing Tables: Homeownership by Race and Hispanic Origin*, U.S. CENSUS BUREAU, <http://www.census.gov/hhes/www/housing/census/historic/ownershipbyrace.html> (last updated Oct. 31, 2011).

<sup>22</sup> See generally CONG. BUDGET OFFICE, A CBO STUDY: OPTIONS FOR CHANGING THE TAX TREATMENT OF CHARITABLE GIVING (2011) (reporting findings from a study by the Congressional Budget Office), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12167/charitablecontributions.pdf> (last visited Mar. 7, 2014); Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056 (2003) (outlining the historical background of the charitable deduction as well as possible alternatives and adjustments being considered by Congress).

<sup>23</sup> Although section 213 of the Internal Revenue Code provides for a deduction based on unreimbursed medical expenses, nonitemizing taxpayers cannot use this deduction according to section 62. See I.R.C. §§ 62, 213.

burdensome medical costs, the assistance of the deduction is out of reach for taxpayers who do not itemize. Fortunately, in the medical-expense arena, a solution evolved that entitled working Americans, regardless of income level or ability to itemize, to receive tax subsidies for medical costs: a flexible spending arrangement.

A flexible spending arrangement (sometimes also called a flexible spending account or an FSA) is an employee benefit offered under a cafeteria plan.<sup>24</sup> The benefit allows employees to set aside pretax dollars to fund an account from which they can be reimbursed for eligible expenses. A flexible spending arrangement incurs the same tax cost as a deduction, in that the revenue loss to the government for providing the benefit is the value of the deduction multiplied by the taxpayer's marginal rate. Unlike a deduction, however, an FSA has the inclusiveness of a tax credit, in that it is potentially available to all employees, rather than only to taxpayers who itemize. Several types of FSAs are recognized by tax law—most notably the medical flexible spending arrangement (MFSA). This Article will argue that a charitable FSA ought to be recognized as well.

Under a charitable flexible spending arrangement (CFSA), employers could offer an extension of their cafeteria plan benefits to all employees, in which employees could elect to set aside a pretax contribution to be used for charitable contributions. Management and administration of a CFSA would work in a manner similar to medical flexible spending arrangements.<sup>25</sup> Employees opting in to the plan would have pretax contributions deducted from their paycheck. Upon making a qualifying charitable donation, the employee would submit documentation of that donation to the plan administrator.<sup>26</sup> If the plan administrator found the contribution to be in compliance with the rules for eligible expenditures (the same rules that would apply to the charitable income tax deduction), the plan administrator would reimburse the employee from the employee's charitable flexible spending account.<sup>27</sup> Like the analogous rule for medical costs, a taxpayer

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<sup>24</sup> A cafeteria plan is a collection of employee benefits that qualifies for favorable income tax treatment. *See id.* § 125(i)–(j).

<sup>25</sup> For details on how employers establish and implement FSAs, see Brenda Porter-Rockwell, *How to Set Up a Flexible Spending Account Program*, INC.COM., <http://www.inc.com/guides/2010/04/setting-up-a-flexible-spending-plan.html> (last updated Apr. 21, 2010).

<sup>26</sup> Many benefits-administration companies provide FSA administration services, including substantiation of expenses. WageWorks, Inc., for example, provides services to employers who offer FSAs. *See WageWorks-FBMC Transaction and Partnership Expands Market Opportunities*, PR NEWSWIRE (December 6, 2010), <http://www.prnewswire.com/news-releases/wageworks-fbmc-transaction-and-partnership-expands-market-opportunities-11378969.html>.

<sup>27</sup> The substantiation procedures would be similar to what corporate private foundations operating matching grant programs conduct, and experience in matching grant administration could provide useful guidance. For guidance on how these programs are administered, see THE HEP/CASE MATCHING GIFT NETWORK, *MATCHING GIFT ADMINISTRATION: EXAMINING THE EVOLVING WORLD OF MATCHING GIFTS 1–16* (Tracy Baird et. al. eds., 4th ed. 2009), available at <http://www.case.org/Documents/MatchingGift>

who was reimbursed for a particular expense from an FSA could not reflect the same expense as an itemized deduction,<sup>28</sup> but the taxpayer could take an itemized deduction for other qualifying costs not reimbursed from the account.<sup>29</sup> If any balance remained at the end of the plan year, the remaining funds would pass to a default charitable organization the employee had selected.<sup>30</sup>

Charitable Flexible Spending Accounts, offered as an alternative to the traditional itemized charitable income tax deduction, offer many advantages.<sup>31</sup> Most notably, they can bring significant numbers of nonitemizing taxpayers into the reach of charitable tax incentives. This is critical for reasons of equity, diversity, and pluralism. It is also a potential bargain to the extent many nonitemizers have lower incomes. Because lower-income taxpayers have lower marginal tax rates, donations from this group subsidized by tax rules have lower tax cost than those that provoke revenue loss from taxpayers in higher brackets.

This Article will propose a Charitable Flexible Spending Account system to enhance the current regulatory regime of the itemized charitable deduction. Part II begins by explaining the current charitable income tax deduction, including its history and the policies underlying its enactment. Part III then explores academic critiques and criticisms of the charitable deduction, and it determines the extent to which the current system of charitable tax incentives is sufficient. Part IV discusses the parallel challenge and development of tax rules relating to medical expense deductions, and it explains both the itemized deduction for medical expenses and medical flexible spending arrangements. Building upon this foundation, Part V proposes a Charitable Flexible Spending Account system and explains the details of its implementation. Finally, the Article will conclude with thoughts on the future of the evolution of tax incentives for charitable giving.

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s/MatchingGiftAdministration\_4th\_Edition.pdf, and ROBERT S. COLLIER ET AL., COUNCIL OF MICH. FOUNDS., A GUIDE FOR A SUCCESSFUL MATCHING GIFT PROGRAM 1–8 (2002), available at <http://www.dfwonline.org/userdata/userfiles/file/Corporate%20Grantmakers%20Materials/11108.PDF>.

<sup>28</sup> Robert E. Lynn, *Optimize the Tax Savings for Specialized or Innovative Medical Care*, 79 PRAC. TAX STRATEGIES 151, 155 (2007).

<sup>29</sup> See I.R.C. § 213(a) (2012) (allowing taxpayers to deduct qualifying medical expenses paid in excess of a set percentage of their adjusted gross income); *infra* notes 160–161 and accompanying text.

<sup>30</sup> Alternatively, any balance remaining in the account could pass to the employer, as is the case with health-care FSAs. See Employee Benefits—Cafeteria Plans, 70 Fed. Reg. 43,938, 43,942–43 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1).

<sup>31</sup> My suggestion is to offer charitable flexible spending accounts as an option to all employees whose employers are willing to sponsor a plan, while leaving the current charitable income tax deduction intact. Although it would be possible to replace, rather than supplement, the charitable deduction with a CFSA, such a transition would remove the charitable tax incentives from donors who itemize but are not employed, including many high-net-worth donors whose income comes from investments. A CFSA therefore seems better suited to act as an alternative rather than a substitute.

## II. THE CHARITABLE INCOME TAX DEDUCTION

### A. *The Modern Charitable Income Tax Deduction*

American tax law provides several incentives for individuals to engage in charitable giving. In allowing a reduction in tax liability for charitable contributions, Congress encourages taxpayers to support a wide range of activities that the government does not directly assist.<sup>32</sup> The most common tax incentives are provided through a deduction in the taxpayer's liability for federal income taxes.

The general rule is that individuals are allowed itemized deductions on their federal income tax returns for any charitable contributions made during the taxable year.<sup>33</sup> There are limitations, however, not only on which charitable contributions will qualify for a deduction, but also on the value of allowable deductions in any given year.<sup>34</sup> Taxpayers who take the standard deduction, rather than itemizing, are not eligible to deduct the value of any charitable contributions.<sup>35</sup> The majority of taxpayers—roughly two-thirds—fall into this category and do not itemize.<sup>36</sup> Taxpayers who do itemize must meet several requirements to take advantage of these incentives.

As an initial matter, the charitable contribution must be made to, or for the use of, a qualifying recipient.<sup>37</sup> Section 170(c) of the Internal Revenue Code (the

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<sup>32</sup> See, e.g., *Brinley v. Comm'r*, 782 F.2d 1326, 1336 (5th Cir. 1986) (Hill, J., dissenting) (“[T]he practice of making charitable contributions is a most worthy attribute of our society and should be encouraged since it aids in the accomplishment of many social goals which our federal and local governments otherwise cannot or will not accomplish . . .”).

<sup>33</sup> See I.R.C. § 170(a)(1). In most cases, however, donations of less than the donor's full interest in the property will not qualify for a charitable contribution deduction. *Id.* § 170(f)(3)(A). Certain partial interests in trust will qualify for the charitable deduction if the requirements of section 170(f)(2) are followed. See *id.* § 170(f)(2). A charitable contribution of the remainder interest of a charitable remainder annuity trust, a charitable remainder unitrust, or pooled income fund, will qualify for a deduction. *Id.* § 170(f)(2)(A); see also John G. Steinkamp, *Decoding Estate Planning: A Review of Frequently Used Acronyms*, 2001 ARK. L. NOTES 73, 74–76 (providing a general overview of charitable remainder annuity trust and charitable remainder unitrust). Likewise, a charitable contribution of the lead income interest of a charitable lead annuity trust or charitable lead unitrust will qualify. I.R.C. § 170(f)(2)(B).

<sup>34</sup> The Internal Revenue Code also regulates valuation of charitable deductions and may impose tax penalties in the event a taxpayer inflates the value of a donation. See I.R.C. § 6662 (2006) (discussing imposition of tax penalties generally).

<sup>35</sup> The standard deduction arose out of the Individual Income Tax Act of 1944. Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 850 (2001).

<sup>36</sup> See INTERNAL REVENUE SERV., *supra* note 5, at 38 tbl.1.2.

<sup>37</sup> See I.R.C. § 170(c) (2012) (discussing entities that may appropriately make use of charitable contributions).



Code) defines a charitable contribution to include contributions given to a state, or any political subdivision of a state, “if the contribution or gift is made for exclusively public purposes.”<sup>38</sup> A contribution to a corporation, trust, community chest, fund, or foundation will also qualify for a deduction if the organization is created or organized in the United States and “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.”<sup>39</sup> Contributions given directly to individuals will not qualify for a deduction, and the donor cannot benefit directly from the contribution made to the qualifying recipient.<sup>40</sup>

In addition, Congress caps the amount of charitable contributions that may be taken as a deduction in any given tax year.<sup>41</sup> These caps prevent taxpayers from completely avoiding the payment of federal income tax by giving all of their income to a qualifying charity.<sup>42</sup> At most, the amount allowed as a deduction may reach 50% of the individual’s “contribution base.”<sup>43</sup> The amount of the cap depends on the nature of the property contributed and the nature of the charitable organization that receives the donation.<sup>44</sup>

The Internal Revenue Code, of course, includes provisions designed to encourage charitable giving beyond the individual income tax deduction.

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<sup>38</sup> *Id.* § 170(c)(1).

<sup>39</sup> *Id.* § 170(c)(2)(A)–(B). In addition, any net earnings of the organization cannot benefit any private shareholder or individual. *Id.* § 170(c)(2)(C). Moreover, the organization cannot be “disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” *Id.* § 170(c)(2)(D).

<sup>40</sup> *Ottawa Silica Co. v. United States*, 699 F.2d 1124, 1131 (Fed. Cir. 1983). Furthermore, contributions are limited to donations of property; services rendered for a charitable organization may not be deducted. Treas. Reg. § 1.170A-1(g) (2010); *see also* Lindsey, *supra* note 22, at 1057 n.2 (“The out-of-pocket expenses associated with the provision of services are, however, deductible.”).

<sup>41</sup> I.R.C. § 170(b)(1)(B).

<sup>42</sup> *See* J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 579 (8th ed. 2007).

<sup>43</sup> I.R.C. § 170(b)(1)(A). “Contribution base” is generally equated by the IRS as the taxpayer’s adjusted gross income. *Id.* § 170(b)(1)(G).

<sup>44</sup> For most charitable contributions, the amount allowed as a deduction cannot exceed 50% of the taxpayer’s contribution base. *Id.* § 170(b)(1)(A). Caps imposed on capital-gain property, as well as contributions to organization not listed in section 170(b)(1)(A), are limited to 20% or 30% of a taxpayer’s contribution base. *Id.* §§ 170(b)(1)(C), (D)(i). For further discussion of the deduction limits, see C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL’Y 399, 402–03 (1995).

Corporations, likewise, have tax incentives to encourage charitable giving.<sup>45</sup> The federal gift and estate tax system favors philanthropy by offering an unlimited deduction for qualifying transfers to charitable organizations.<sup>46</sup> Federal tax law also provides substantial oversight and regulation of the charitable organizations themselves through its system of regulating the tax-exempt status afforded to certain nonprofit organizations.<sup>47</sup> The Code lists the permissible purposes for charitable organizations,<sup>48</sup> limits the private benefits of transactions in which they engage,<sup>49</sup> and restricts the activities and investments of various types of charities.<sup>50</sup> These additional tax incentives are largely beyond the scope of this Article.

### *B. The History of the Charitable Income Tax Deduction*

The charitable income tax deduction has a rich history that helps inform current understanding of its justifications and structure. Notably, the tax incentive for charitable donations has varied with respect to whom the incentive was intended to reach: only very high-income taxpayers or a much broader swath of society. It has also varied whether the tax benefit was available only to those who itemize deductions or whether it was available to nonitemizers as well. It has been remarkably consistent over time as to its structure, as a deduction from income rather than a tax credit or other format. Other modifications to the deduction have reflected concerns with providing sufficient incentive to make gifts while minimizing opportunities for abuse.

The charitable contribution deduction is one of the oldest deductions permitted from the income tax, first established through the War Revenue Act of

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<sup>45</sup> See I.R.C. § 170(d)(2). Section 170(c)(2) provides that charitable contributions by a corporation can only be to those charitable organizations that operate “exclusively for religious, charitable, scientific, literary, or educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.” *Id.* § 170(c)(2). The amount of deductions allowed for corporations cannot exceed 10% of the total amount of the corporation’s taxable income, determined without regard to its charitable contributions. *Id.* § 170(b)(2)(C).

<sup>46</sup> See *id.* §§ 2055, 2522.

<sup>47</sup> See generally BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 3–25 (7th ed. 1998) (discussing the types of nonprofit organizations, their corresponding tax statuses, and policy goals accomplished through tax exemption). It should be noted that “[a] nonprofit organization is not necessarily a tax-exempt organization.” *Id.* at 4. The scope of this Article does not apply to all nonprofit organizations, but only to the subset of nonprofits that are eligible to receive contributions that would entitle the donor to an income tax deduction under section 170 of the Code. All references to “charities,” “charitable organizations,” or “nonprofits” used in this Article should be understood in that vein.

<sup>48</sup> I.R.C. § 501.

<sup>49</sup> See *id.* § 501(c)(3).

<sup>50</sup> *Id.* §§ 4941–4945.

1917.<sup>51</sup> Under this original iteration of the deduction, taxpayers were permitted to deduct up to 15% of net taxable income for contributions made during the year to charitable organizations.<sup>52</sup> Because only individuals with higher incomes were subject to the tax at all, only wealthier individuals were contemplated when the deduction was created.<sup>53</sup> The motivations for the deduction were to incentivize charitable giving in the face of lower disposable income triggered by the income tax, and to counteract the anticipated drop in donations from wealthy individuals to worthy organizations, specifically “institutions of higher learning.”<sup>54</sup>

The charitable deduction changed significantly when Congress passed the Individual Income Tax Act of 1944, which increased the number of individuals subject to paying income tax by a multiple of almost fifteen.<sup>55</sup> Now that the income tax reached far beyond the top twentieth of income earners, simplicity in administration became a higher priority, and the standard deduction was created to help simplify the process for new filers.<sup>56</sup> Under the standard deduction, taxpayers could deduct a set amount against income, representing typical cumulative deductions, rather than track actual transactions triggering itemized deductions. Because taxpayers who take the standard deduction are not also entitled to take itemized deductions, some members of Congress (and charitable organizations) raised concerns that the bill was unfair to lower-income taxpayers, who should also benefit from a charitable tax incentive.<sup>57</sup> This argument did not prevail, with proponents of the bill arguing that tax deductions for lower-income taxpayers were not the driving force behind donations<sup>58</sup> and that including a representation of charitable giving within the standard deduction was sufficient.<sup>59</sup> The same Act that established the standard deduction (eliminating the ability of nonitemizing taxpayers to deduct their charitable contributions) increased the value of the charitable deduction for higher-income taxpayers by tying the maximum contribution to the higher “adjusted gross income” instead of the lower “net

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<sup>51</sup> War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

<sup>52</sup> *Id.*

<sup>53</sup> Aprill, *supra* note 35, at 849.

<sup>54</sup> *Id.* “Senator Hollis . . . explained that the country had permitted institutions of higher learning ‘to grow up and become firmly established on the plan of depending upon private contributions’” and “feared that the war would affect colleges ‘more seriously than it does any other character of institution.’” *Id.* While no mention was made of religious groups, there are some records that indicate he was also concerned with the impact it could have on them as well. *Id.*

<sup>55</sup> *Id.* at 850. “Between 1939 and 1945, the coverage of the tax system grew from about 5% to 74% of the population.” *Id.*

<sup>56</sup> Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 68 CORNELL L. REV. 429, 439–40 (1983). For further discussion on the decision to enact the standard deduction, see H.R. REP. NO. 78-1365 (1944), and S. REP. NO. 78-885 (1944).

<sup>57</sup> Aprill, *supra* note 35, at 850–52.

<sup>58</sup> 90 CONG. REC. 4704 (1944); *see also* C. HARRY KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 46–47 (1960).

<sup>59</sup> 90 CONG. REC. 3973 (1944) (statement of Rep. Robertson).

taxable income.”<sup>60</sup> Congress again increased the value of the deduction to higher-income itemizing taxpayers in 1952, adjusting the maximum contribution amount from 15% to 20% adjusted gross income.<sup>61</sup>

The charitable contribution deduction became section 170 of the Internal Revenue Code in 1954.<sup>62</sup> At the same time, contribution caps were increased to 30% of adjusted gross income, but only for outright transfers (not those in trust), and only for transfers to prioritized charitable recipients, including churches or religious orders and educational institutions.<sup>63</sup> The change to the charitable deduction was intended to encourage specific forms of giving to specific classes of charities.<sup>64</sup> This was the first time that Congress had singled out some types of organizations as being more worthy than others.<sup>65</sup>

Major changes to the rules governing tax-exempt organizations and charitable deductions were instituted through the Tax Reform Act of 1969.<sup>66</sup> Reacting to perceived abusive transactions involving charities, Congress restructured the Code to differentiate between public charities and private foundations, and it provided more restrictive rules on operations of private foundations and donations to them.<sup>67</sup>

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<sup>60</sup> See Individual Income Tax Act of 1944, 1 Stand. Fed. Tax Rep. (CCH) ¶ 328 (1944), at 2055.

<sup>61</sup> 2 Stand. Fed. Tax Rep. (CCH) ¶ 328 (1952).

<sup>62</sup> Lindsey, *supra* note 22, at 1062.

<sup>63</sup> Lindsey, *supra* note 22, at 1062–63 (citing H.R. REP. NO. 83-1337 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4190).

<sup>64</sup> H.R. REP. NO. 83-1337, at 25–26 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4050–51.

<sup>65</sup> See Lindsey, *supra* note 22, at 1063. Congress made various additional changes to the charitable deduction throughout the 1950s and 1960s, attempting to tighten loopholes and adjust caps on amounts taxpayers could deduct. *Id.* at 1063–64. In 1958, Congress amended the tax code to disallow double deductions and ensure the value of deductions was reduced by liabilities passing with the property. Technical Amendments Act of 1958, Pub. L. No. 85-866, §§ 11–12, 72 Stat. 1606, 1609–10 (1958) (codified at scattered sections of 21, 26, and 42 U.S.C.). In 1962, Congress added organizations to the list for which a taxpayer would receive a 30% deduction and matched deductions more closely to the amount actually donated to the charity. Lindsey, *supra* note 22, at 1064. In 1964, Congress passed a bill that allowed for an unlimited charitable deduction to those taxpayers who contributed at least 90% of their income for the taxable year in question and in eight of the past ten years. H.R. REP. NO. 91-413, at 4, reprinted in 1969 U.S.C.C.A.N. 1645, 1698; William A. Drennan, *Charitable Donations of Intellectual Property: The Case for Retaining the Fair Market Value Tax Deduction*, 2004 UTAH L. REV. 1045, 1061 n.53; Lindsey, *supra* note 22, at 1064. The unlimited deduction was short lived, however, and was slowly reduced to 50% of the taxpayer’s income by 1974. See 1 A PRACTITIONER’S GUIDE TO THE TAX REFORM ACT OF 1969, at 74 (Miriam I. R. Eolis & Joseph S. Robinson eds., 1970).

<sup>66</sup> Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 492–98 (codified as amended at I.R.C. § 509 (1976)).

<sup>67</sup> See I.R.C. §§ 4941–4945 (2006) (imposing excise taxes on improper activities of private foundations).

Whereas contributions to public charities were generally capped at 50% of a taxpayer's income, contributions to private foundations were now capped at 20% or 30%.<sup>68</sup> The same Act established additional rules restricting the value of contributions of capital gain property, such as appreciated securities.<sup>69</sup>

The Economic Recovery Tax Act of 1981 instituted a remarkable change to the charitable deduction: between 1982 and 1986, the charitable deduction was available to taxpayers who did not itemize deductions as well as to those who did.<sup>70</sup> As a result of this amendment, for the first time “many low- and middle-

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<sup>68</sup> See I.R.C. § 170(b)(1)(B) (2012) (imposing caps that prevent taxpayers from completely avoiding the payment of federal income tax by giving all of their income to a qualifying charity). These limitations place a cap on the amount allowed as a deduction; the amount allowed as a deduction cannot exceed 50% of the individual's “contribution base,” which is generally the taxpayer's adjusted gross income. See *id.* § 170(b)(1)(G). The amount of the cap depends on the nature of the property contributed and the nature of the charitable organization that receives the donation. *Id.* For most charitable contributions, the amount allowed as a deduction cannot exceed 50% of the taxpayer's contribution base. *Id.* § 170(b)(1)(A)(viii). Caps imposed on capital gain property, as well as contributions to organizations not listed in section 170(b)(1)(A), like private foundations, are limited to 20% or 30% of a taxpayer's contribution base. *Id.* §§ 170(b)(1)(C), (D)(i). Interesting to note, the figure of 50% was arbitrarily picked following a conversation with President Nixon, as that amount was the limit he always thought the law should allow for, and as such, his cabinet members proposed that figure when presenting the proposal to the Ways and Means Committee. C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules For Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL'Y 399, 410 (1995).

<sup>69</sup> I.R.C. § 170(b)(1)(C), (D)(i); see also Lindsey, *supra* note 22, at 1065–68. These provisions were altered the most as Congress felt that the most abuse occurred from the donation of appreciated property and stocks. Lindsey, *supra* note 22, at 1065–68; see also *Bialo v. Comm'r*, 88 T.C. 1132, 1139 (1987) (disallowing the deduction of stock when it was clear the intent of the taxpayer was to reduce his overall taxable liability through the use of the charitable deduction). Arguably, the caps on deductions still allow for most taxpayers to contribute a large portion of their income without feeling stifled in their choice to donate and to meet their individual tax burden. See Steuerle & Sullivan, *supra* note 68, at 410–11. That said, a study conducted by Teresa Odendahl found that most wealthy donors “contribute up to the maximum for which they receive a deduction.” *Id.* at 411 (quoting Teresa Odendahl, *Independent Foundations and Wealthy Donors: An Overview*, in AMERICA'S WEALTHY AND THE FUTURE OF FOUNDATIONS 1, 11 (Teresa Odendahl ed., 1987)).

<sup>70</sup> Economic Recovery Act of 1981, Pub. L. No. 97-34, § 121, 95 Stat. 196 (1981); H.R. REP. NO. 97-215, at 201–02 (1981) (Conf. Rep.), reprinted in 1981 U.S.C.C.A.N. 285, 291–92 (reporting on the Economic Recovery Tax Act of 1981). In addition to the standard provisions found in section 170, Congress also placed dollar caps on the amount each taxpayer could deduct for the respective years. JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 50; see also H.R. REP. NO. 97-215, at 201–02.

income taxpayers were able to claim the deduction.”<sup>71</sup> The amendment expired in 1986, and Congress has never since allowed taxpayers using the standard deduction the option of also deducting donations made to charitable organizations.<sup>72</sup> Instead, as part of the Tax Reform Act of 1986, Congress enacted changes that further expanded the use of the standard deduction as a means of simplifying the tax system, and proponents for the greater use of the charitable deduction by taxpayers could not stop that movement.<sup>73</sup> While the use of the deduction by all taxpayers has never been revived, members of Congress and the executive branch periodically reconsider its potential.<sup>74</sup> The idea spreads across a wide political spectrum, with both President Clinton and President Bush proposing legislation during their terms in office that would allow nonitemizing taxpayers to benefit from the charitable deduction.<sup>75</sup> The changes actually made to the charitable deduction during the 1990s were modest and primarily centered on ensuring the accuracy of taxpayer reporting.<sup>76</sup>

More recent political movements suggest a contraction in the availability of the charitable deduction to high-income taxpayers.<sup>77</sup> The 2013 Revenue Proposal propagated by the Obama administration recommended reinstating the 36% and 39.6% tax brackets for high-income taxpayers but limiting the benefit of itemized deductions—including the charitable deduction—to 28% of income.<sup>78</sup> The Revenue Proposal also contemplated the revival of a tax provision capping the overall value of most itemized deductions, including charitable donations, tying

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<sup>71</sup> Lindsey, *supra* note 22, at 1068. The amendment was temporary and was included in the Act to allow the government to study the effect it had on influencing charitable giving. JOINT COMM. ON TAXATION, *supra* note 70, at 49.

<sup>72</sup> See Aprill, *supra* note 35, at 853; Lindsey, *supra* note 22, at 1069.

<sup>73</sup> Ronald A. Pearlman, *Repeal of Charitable Contributions for Nonitemizers Explained*, 28 TAX NOTES 1140, 1140 (1985).

<sup>74</sup> See Aprill, *supra* note 35, at 854–55.

<sup>75</sup> *Id.*

<sup>76</sup> The changes included requiring taxpayers who wished to claim the deduction for any contribution over \$250 to have written confirmation of the donation, as well as requiring organizations to provide donors written confirmation of contributions over \$75 as to what portion of the contribution was in money or property, as services rendered are not deductible. See I.R.C. § 6115 (2006); Comm. Reports on Pub. L. No. 103-66 (Omnibus Budget Reconciliation Act of 1993), 4 Stand. Fed. Tax Rep. (CCH) ¶ 11,600, at 25,850–56 (2002).

<sup>77</sup> See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS 74 (2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. The proposal limits all itemized deductions (not just charitable donations) to 28% and also limits other tax advantages for those with incomes over \$200,000 (married taxpayers over \$250,000). *Id.* at 67, 74.

<sup>78</sup> The proposal would apply to taxpayers with over \$250,000 if married and filing jointly, and \$200,000 otherwise. *Id.* at 70, 74.

deductibility to a statutory floor.<sup>79</sup> The Revenue Proposal has been robustly criticized on the grounds that limiting incentives to high-income taxpayers to give is particularly troubling in an economic downturn and could threaten the vitality of the third sector.<sup>80</sup>

The evolution of the charitable deduction is in all likelihood still incomplete. The history of the deduction reflects shifting standards as to whether the deduction was to extend beyond high-income taxpayers and how strong or limited the incentives for those taxpayers were to be. As the structure and value of the charitable deduction is challenged, the strength of the tax policy underlying its existence gains new importance. The power of the justifications for the charitable contribution deduction informs the extent to which its structure should be modified.

### III. SCHOLARLY CRITIQUES OF THE CHARITABLE INCOME TAX DEDUCTION

The tax benefits afforded to charities have inspired a rich and varied literature. Both critics and supporters have struggled to expose the theoretical underpinnings of the charitable deduction. Scholars have developed several theories as to what justifies a charitable income tax deduction and what goals the existence of the deduction ought to further.<sup>81</sup> The following discussion outlines the main themes in the academic literature.

#### A. *What Should Charitable Tax Benefits Do, and How Are They Justified?*

There is large consensus that the charitable income tax deduction represents an indirect subsidy to charity and operates as a substitute for direct government

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<sup>79</sup> Under this rule, most itemized deductions are reduced by 3% of the amount by which adjusted gross income is greater than a statutory floor (with an inflation index); the overall reduction cannot exceed 80% of the value of the deductions. *Id.* at 67. The Economic Growth and Tax Relief Reconciliation Act of 2001 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided temporary relief from this rule from 2001–2012. But when the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act sunset at the end of 2012, the proposal did not contemplate reinstating this relief. *Id.*

<sup>80</sup> See Patrick E. Tolan, Jr., *Compromising the Safety Net: How Limiting Tax Deductions for High-Income Donors Could Undermine Charitable Organizations* 55–63 (unpublished manuscript), available at [http://works.bepress.com/cgi/viewcontent.cgi?article=1007&context=patrick\\_tolan](http://works.bepress.com/cgi/viewcontent.cgi?article=1007&context=patrick_tolan).

<sup>81</sup> Many scholars address charitable tax subsidies collectively, considering not only the charitable income tax deduction but also tax-exempt status, eligibility to issue tax-exempt bonds, and other tax benefits. For purposes of this Article, the focus shall be the contribution of scholarship to justifying the charitable income tax deduction.

funding of public projects.<sup>82</sup> A deduction acts like a subsidy because the government will forgo revenue in the amount of the deduction triggered by the taxpayer's contribution. For example, if a taxpayer in the 30% marginal rate bracket makes a \$1,000 contribution to her alma mater, the cost to the taxpayer is only \$700, as reduced by the \$300 forgone revenue (and effective subsidy) represented by the cost of the deduction. The tax structure "operate[s] like matching grants."<sup>83</sup> The charitable contribution deduction is therefore largely understood as a tax expenditure.<sup>84</sup>

Notwithstanding this consensus, some scholars instead argue that the charitable deduction is central to the definition of income.<sup>85</sup> In a classic *Harvard Law Review* article, Professor William Andrews pioneered the theory that income ought only to include funds available for consumption.<sup>86</sup> Amounts given to charity, not being available for consumption by the taxpayer, are therefore properly excluded from income.<sup>87</sup> The charitable deduction, consequently, results in a more accurate construction of ability to pay.<sup>88</sup> Although some scholars have challenged and criticized this theory,<sup>89</sup> others persist in the belief that removing charitable gifts from the tax base is necessary to reflect true income.<sup>90</sup>

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<sup>82</sup> See Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 608–09 (2011) (noting that the view that tax provisions serve as subsidies to the charitable sector is widely accepted).

<sup>83</sup> Ray D. Madoff, *What Leona Helmsley Can Teach Us About the Charitable Deduction*, 85 CHI.-KENT L. REV. 957, 965 (2010).

<sup>84</sup> See Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047, 1055–59 (2009). *But see* Ariz. Christian Sch. Tuition Org. v. Winn, 131 S. Ct. 1436, 1444 (2011) (distinguishing between tax credits and governmental expenditures).

<sup>85</sup> See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314–15, 346 (1972) (arguing that because the taxpayer does not consume funds transferred to charity, they are not properly includable in income); Johnny Rex Buckles, *The Community Income Theory of the Charitable Contributions Deduction*, 80 IND. L.J. 947, 972 (2005) (arguing that consumption by the community ought not be construed as income).

<sup>86</sup> Andrews, *supra* note 85, at 314–15, 346.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> See, e.g., Mark P. Gergen, *The Case for a Charitable Contribution Deduction*, 74 VA. L. REV. 1393, 1421–26 (1998); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 345, 375–77 (1989).

<sup>90</sup> See, e.g., Buckles, *supra* note 85, at 983–84. As Buckles puts it,

[E]ven if we characterize a person's charitable contribution to the community as a "withdrawal" from the private partnership that gives rise to positive consumption, this amount should be offset by the negative consumption that inheres in the contribution to the community partnership. The net result is no income to the taxpayer. By reducing a taxpayer's income subject to tax, the charitable contributions deduction effectuates the same result.

*Id.*



Regardless of which theory prevails, prudent tax policy dictates that society ought to be getting some benefit out of the charitable deduction.<sup>91</sup> Scholars have pinpointed several desirable consequences of the charitable deduction, and the extent to which the deduction attains these goals has been debated. Specifically, as a normative matter, the charitable deduction should be economically efficient, incentivize charitable giving, produce horizontal and vertical equity, reflect and promote pluralism, and provide incentive for donors to monitor charities. The following discussion highlights the primary justifications and expected returns relating to the charitable deduction.<sup>92</sup>

### 1. *Economic Efficiency*

A primary justification given for the charitable income tax deduction is that it is an economically efficient way to allow collective action for the benefit of the public. Professor Mark Gergen, for example, has argued that under the Kaldor-Hicks conception of efficiency (that a social policy is efficient if the societal gains from its adoption more than offset the losses), charitable deductions are efficient to the extent that “the dollar gain to beneficiaries from moving towards an optimal level of funding for the charity is greater than the dollar loss to the disinterested.”<sup>93</sup> Moreover, the charitable tax deduction may be necessary to allow efficient pooling of resources to pursue goals hampered by a collective-action problem.<sup>94</sup>

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<sup>91</sup> The tax benefit is arguably more critical if the subsidy theory is correct and less so if the income theory prevails.

<sup>92</sup> This Article does not exhaustively discuss the theoretical underpinnings of the charitable deduction, since the primary goal of this Article is to augment the charitable deduction with an FSA. Regardless of how the charitable deduction is justified, so long as there is some valid justification, the only difference is structural: whether the value of the deduction is realized through an FSA (and reached by itemizers and nonitemizers) or realized through the present itemized deduction process. That said, modern movements are expanding the justifications for the charitable deduction beyond the traditional notions of efficiency, pluralism, incentives, and monitoring to include important themes like distributive justice and critical race theory. For a discussion on distributive justice, see Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505 (2010), and Fleischer, *supra* note 82, at 620. For a discussion on critical race theory, see David A. Brennen, *A Diversity Theory of Charitable Tax Exemption—Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 PITT. TAX REV. 1, 11 (2006).

<sup>93</sup> Gergen, *supra* note 89, at 1412–13.

<sup>94</sup> Professor Gergen explains,

The virtue of private giving is that it enables smaller groups to act collectively without having to secure direct government expenditures for the good through the political process. If there is a high preference minority and a relatively indifferent majority, a tax subsidy for private funding of the good may be the only way to fund the good at the level the minority desires. Left to its own

Under this theory, the charitable tax deduction creates economic efficiencies by funding public goods or services that the market and government fail to provide in adequate quantities.<sup>95</sup> Government, constrained by its political reliance upon the financial priorities of the median voter, is unable to fund public projects favored only by a minority.<sup>96</sup> Private action likewise fails if the endeavor lacks sufficient financial reward or if collective-action barriers prove too difficult to overcome.<sup>97</sup> The charitable income tax deduction, therefore, allows partial funding (to the extent of the forgone revenue at marginal tax rates) when full governmental financing would provide too much of the good or service and private financing would produce too little. Whereas direct grants from the government would result in the cost being shared without reference to whether a taxpayer values the project, a charitable tax deduction results in the bulk of the financial burden resting with those who value it enough to contribute, with a smaller fraction allocated to the general public.<sup>98</sup> This leveraging of private dollars with federal funding results in an efficient way to bear the cost of public goods and services.<sup>99</sup>

## 2. *Incentivizing Charitable Gifts*

To achieve this efficiency, the deduction is expected to induce taxpayers to increase donations.<sup>100</sup> A primary goal of the charitable deduction is to reward

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devices without a tax subsidy, the minority may not be able to overcome its freerider problems to provide the appropriate amount of the good.

*Id.* at 1399. To simplify (although as Professor Gergen liked to remind his students, he has already “done the heavy lifting here”), groups of people often fail to allocate resources appropriately due to human tendencies like greed, laziness, or selfishness. Sometimes collaboration needs a little push.

<sup>95</sup> See Fleischer, *supra* note 82, at 611 (citing JOHN D. COLOMBO & MARK A. HALL, THE CHARITABLE TAX EXEMPTION 100–08 (1995)); Gergen, *supra* note 89, at 1396–406; Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS 21, 21–40 (Susan Rose-Ackerman ed., 1986).

<sup>96</sup> Miranda Perry Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 MINN. L. REV. 165, 167–68 (2008).

<sup>97</sup> Gergen, *supra* note 89, at 1399.

<sup>98</sup> *Id.* at 1399–406.

<sup>99</sup> There are, however, limits to the efficiency analysis with respect to charitable giving. For example, we cannot precisely determine what the optimal burden should be that is borne by the donor as opposed to the public, and the amount established by marginal income tax rates may be underinclusive or overinclusive. At a minimum, the efficiency theory provides some justification for permitting individuals to deduct contributions to charities.

<sup>100</sup> Todd Izzo, Comment, *A Full Spectrum of Light: Rethinking the Charitable Contribution Deduction*, 141 U. PA. L. REV. 2371, 2372–73 (1993) (“Empirical research

generosity and encourage charitable giving.<sup>101</sup> As Professor David Schizer explains in his recent article, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, a charitable deduction is needed to “persuade donors to be more generous.”<sup>102</sup> In the absence of a tax benefit, “potential funders sometimes free ride, withholding support even from programs they favor, hoping others will pick up the slack,” and may conceal their ability to pay and their “true level of generosity.”<sup>103</sup> The charitable deduction, then, provides an incentive to indulge in philanthropy rather than suppress generosity in the hopes others will bear the costs.

The extent to which the charitable deduction increases charitable gifts is hard to quantify, although several attempts have been made to determine the impact of the deduction on behavior.<sup>104</sup> Studies have had mixed results, but most indicate that the elasticity of charitable giving—how donations change in relationship to the tax rate—is positive.<sup>105</sup> These metrics generally suggest that the charitable deduction does in fact incentivize charitable giving and quantitatively increase taxpayer giving behavior among those who qualify for the deduction.<sup>106</sup> The impact of the charitable tax deduction on the giving behavior of nonitemizing taxpayers is harder to assess,<sup>107</sup> although there is some indication that taxpayers of all income levels are or would be motivated by charitable tax subsidies.<sup>108</sup>

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bears out the assumption that the existence of a deduction will induce taxpayers, on average, to increase their contributions rather than simply pocketing the tax savings.”).

<sup>101</sup> See generally David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221 (2009) (citing three rationales for charitable giving subsidies: encouraging generosity, reflecting the true funding preferences of the public, and monitoring quality of charitable organizations).

<sup>102</sup> *Id.* at 229.

<sup>103</sup> *Id.*

<sup>104</sup> See Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1319 (2012) (collecting sources).

<sup>105</sup> See Faulhaber, *supra* note 104, at 1319. Professor Faulhaber notes that studies “generally find an elasticity above zero,” meaning that individuals do change behavior in response to the rate change—and even sometimes report an elasticity above one, which would indicate an increase in giving that exceeded the tax savings attributable to the tax rate. *Id.*

<sup>106</sup> *Id.* at 1318.

<sup>107</sup> See Aprill, *supra* note 35, at 857; Faulhaber, *supra* note 104, at 1332. In addition to noting that studies have struggled with assessing elasticity for nonitemizing taxpayers if the benefit were extended to them, Faulhaber argues that the charitable deduction may impact the elasticity of nonitemizers when the benefits are not extended to them, because the hypersalience of the charitable deduction leads these taxpayers to mistakenly believe they do benefit from the deduction. Faulhaber, *supra* note 104, at 1332.

<sup>108</sup> See Alice Gresham Bullock, *Taxes, Social Policy and Philanthropy: The Untapped Potential of Middle- and Low-Income Generosity*, 6 CORNELL J.L. & PUB. POL’Y 325, 339–40 (1997) (noting that “[i]t is generally accepted that the incentive tax effect of the charitable contributions deduction is relatively high for high-income taxpayers,” that

Some scholars have argued that a charitable contribution deduction is not necessary to encourage charitable donations or, at least, that it is not as central as much scholarship assumes.<sup>109</sup> In *What Leona Helmsley Can Teach Us About the Charitable Deduction*, Professor Ray Madoff discusses the current status and shortcomings of the charitable deduction.<sup>110</sup> Although the charitable contribution deduction seems well ensconced, Professor Madoff points out that “[f]or most of history, charitable giving has occurred independent of any government support.”<sup>111</sup> Another counterargument to the idea that strong tax incentives are central to the survival of the nonprofit sector is the fact that many other countries do not rely on tax subsidies at all.<sup>112</sup> Despite these counterarguments, the expectation that the charitable deduction will incentivize and reward charitable giving is a common justification for its role in the tax code.

### 3. Equity

Another argument in favor of the charitable deduction rests on equitable concerns. There is “general agreement” that a critical principle used to evaluate any tax system is equity, both horizontal and vertical.<sup>113</sup> Horizontal equity dictates that taxpayers in similar situations should be taxed similarly, while vertical equity maintains that one should be taxed based upon his or her ability to pay.<sup>114</sup>

Donating property to charity reduces one’s ability to pay tax because the assets are no longer available for the taxpayer’s private consumption or enjoyment. It is therefore argued that charitable donors “are thereby made less well-off and so should pay less tax than people who spend their resources on personal consumption.”<sup>115</sup> The argument is amplified by the consideration that some taxpayers may feel morally compelled to make charitable contributions—such as a religiously mandated tithe—so the extent to which the reduction in ability to pay is voluntary is questionable.<sup>116</sup> The horizontal equity concerns, raised due to the

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“empirical studies support the view that the charitable behavior of low- and middle-income taxpayers is affected by the price of giving,” and that “the charitable behavior of low- and middle-income taxpayers is indeed sensitive to the tax incentive”).

<sup>109</sup> See, e.g., Madoff, *supra* note 83, at 957.

<sup>110</sup> *Id.* at 964–67. Professor Madoff’s analysis and critique addresses not just the income tax charitable deduction, but also the estate tax charitable deduction. *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> See Alyssa A. DiRusso, *American Nonprofit Law in Comparative Perspective*, 10 WASH. U. GLOBAL STUD. L. REV. 39, 83 (2011) (“Few other countries share America’s commitment to tax as the center of nonprofit law. In some countries, tax plays no role at all.”).

<sup>113</sup> STEPHANIE J. WILLBANKS, *FEDERAL TAXATION OF WEALTH TRANSFERS* 10 (3d ed. 2012).

<sup>114</sup> *Id.*

<sup>115</sup> Gergen, *supra* note 89, at 1426.

<sup>116</sup> Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?* 28 TAX L. REV. 37, 58–59 (1972).

decrease in ability to pay following charitable contributions, have been used to support arguments for the charitable deduction itself and for the exclusion of amounts donated to charity from income.<sup>117</sup>

The charitable deduction has also been criticized for its failure to incorporate notions of vertical equity appropriately.<sup>118</sup> Although tax burden ought to be tied to ability to pay,<sup>119</sup> the charitable deduction decreases the overall tax liability of those most able to pay, without providing any tax benefit to those least able to pay. The flaw is due to its characteristics as an itemized deduction; its benefits are not available to lower-income taxpayers who do not itemize. Perhaps this flaw is somehow offset by the fact that some charitable contributions will inure to the benefit of those who are less well off, even though those who are better off receive the benefit of the deduction.

#### 4. *Pluralism*

Pluralism is another common justification for the existence and structure of the charitable income tax deduction. Some commentators take the position that the charitable tax subsidy is justified by the pluralistic nature of American society, in that it allows a variety of taxpayers with a variety of views and priorities to participate in funding decisions. In *Taxes as Ballots*, Professor Saul Levmore argues that the charitable deduction allows individuals to “vote” with their dollars as to which projects merit funding, allowing the government to follow those favored projects with a matching subsidy.<sup>120</sup> Although the progressive effect of the deduction, and its inaccessibility by nonitemizers, prevents the system from being a “one-person one-vote ideal,” a wide variety of taxpayer perspectives still exists and helps direct government funds.<sup>121</sup> The deduction helps ensure that a variety of priorities will be funded by providing a platform for support unhampered by the majoritarian demands of the democratic political process.<sup>122</sup>

Diversity considerations support robust charitable tax subsidies that contemplate a broad range of public and private interests.<sup>123</sup> The existence of a variety of charities, funded by a variety of donors, “promote[s] pluralism and

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<sup>117</sup> See Tolan, Jr., *supra* note 80, at 15–18.

<sup>118</sup> See, e.g., Bullock, *supra* note 108, at 343–45; Izzo, *supra* note 100, at 2373, 2390.

<sup>119</sup> WILLBANKS, *supra* note 113, at 10; see also Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1, 46–47, 47 nn.148–49 (2002) (providing a summary of taxation policy influences).

<sup>120</sup> Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405 (1998).

<sup>121</sup> *Id.* at 388–89, 405.

<sup>122</sup> See Gregg D. Polsky, *Rationally Cutting Tax Expenditures*, 50 LOUISVILLE L. REV. 643, 648–49 (2012).

<sup>123</sup> Brennan, *supra* note 92, at 4.

diversity.”<sup>124</sup> The charitable deduction not only supports pluralism, but it also disperses power among a variety of donors.<sup>125</sup>

##### 5. *Incentivizing Donors to Monitor Charities*

The charitable deduction is also critical to the method by which charities are overseen. By incentivizing people to put their money in the hands of charitable organizations, the deduction creates motivation for those stakeholders to monitor the charity’s use of those funds. The existence of the deduction effectively “recruits” individuals who now have a stake in the organization to oversee its activities.<sup>126</sup> Donors play an important oversight role in culling information to ferret out impropriety at nonprofits.<sup>127</sup> Donors care how their money is used, and “[m]embers of the public are more likely to seek out records of the publicly supported charities to which they have donated . . . and thereby monitor the charities themselves.”<sup>128</sup> Larger and more influential donors may not only monitor but effectively shape charities, such as through venture philanthropy.<sup>129</sup>

Other aspects of tax law also indicate that incentivizing public surveillance is critical to the effective monitoring of tax-exempt organizations. Charities are subject to the public-disclosure requirements of section 6104(d) of the Internal Revenue Code.<sup>130</sup> These regulations require charities to reveal their informational returns (which include detailed financial information about the organization) to members of the public. The ability of donors and the public to monitor charities effectively depends upon access to this information.<sup>131</sup> The disclosure requirements

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<sup>124</sup> Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 605 (1990).

<sup>125</sup> Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 390 (1972).

<sup>126</sup> Schizer, *supra* note 101, at 256.

<sup>127</sup> See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 647 (1999). In favor of increased public disclosure to aid in protecting charities against fiduciary abuse, she noted that “[e]asier public access to information, more effective disclosure, and for certain transactions, increased disclosure, will help.” *Id.* at 639.

<sup>128</sup> See Alyssa A. DiRusso, *Supporting the Supporting Organization: The Potential and Exploitation of 509(a)(3) Charities*, 39 IND. L. REV. 207, 246 (2006).

<sup>129</sup> Schizer, *supra* note 101, at 256–62.

<sup>130</sup> I.R.C. § 6104(d) (2006). Certain types of charities, such as hospitals and other health-care organizations, are also regulated outside of the tax system. For a discussion of how transparency and disclosure are used to regulate the health-care industry, see William M. Sage, *Regulating Through Information: Disclosure Laws and American Healthcare*, 99 COLUM. L. REV. 1701 (1999).

<sup>131</sup> See Nina J. Crimm, *A Case Study of a Private Foundation’s Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1188 (2001) (“To enhance the standards of accountability, states and the federal government should

increase the probability that improper financial dealings will be revealed, since not only the IRS but now also the public and the media may access these records.<sup>132</sup> The charitable deduction, therefore, engages donors in monitoring behavior of nonprofits that seek deductible donations.<sup>133</sup>

### B. *How Should Charitable Tax Benefits Be Structured?*

Even among scholars who believe that providing tax incentives relating to charities is justified one way or the other, there is wide disagreement as to how such a tax benefit is best structured. Whereas some would maintain the charitable deduction in its current form, others would make modest or radical changes.<sup>134</sup> The charitable deduction has recently been criticized on hypersalience grounds. Professor Lilian Faulhaber has argued that the charitable deduction is hypersalient—taxpayers are unusually well aware of it and overestimate its application.<sup>135</sup> Because of the hypersalience of the deduction, lower-income taxpayers, who receive no benefit from charitable tax subsidies because they do not itemize, may alter their behavior in response to a tax incentive that does not apply to them.<sup>136</sup> As Professor Faulhaber explains, exploiting tax illiteracy fosters mistrust and may be economically inefficient in the long run, even if it results in U.S. Department of the Treasury savings by incentivizing taxpayer behavior without paying for it.<sup>137</sup> Because some taxpayers believe they are benefiting from a deduction from which they are not,<sup>138</sup> and some taxpayers believe that the tax benefit is a dollar-for-dollar credit,<sup>139</sup> the current structure and implementation of the charitable deduction does not seem ideal.

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consider reforming the types of information and format of data required to be disclosed at [a] foundations' formation, application for tax exempt status, and annually thereafter.”).

<sup>132</sup> For an argument that the public disclosure requirements are insufficient to motivate public monitoring in the supporting organization context, see DiRusso, *supra* note 128, at 207, 246–50.

<sup>133</sup> Part of the reason private foundations are subject to additional restrictions on their activities backed by excise taxes is that they lack the rigorous oversight by donors that public charities are expected to have. *Cockerline Mem'l Fund v. Comm'r*, 86 T.C. 53, 64–65 (1986) (“Public charities are exempt from private foundation treatment and, consequently, the excise taxes, on the theory that public scrutiny arising from a foundation’s dependence upon public funds will prevent abusive acts by the foundation.”).

<sup>134</sup> Among the more radical proposals in the literature is the proposal to afford for-profit businesses tax benefits similar to those offered to charities, to the extent they pursue charitable goals. See Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 264–67 (2007). This proposal has been heartily critiqued. See generally Brian Galle, *Keep Charities Charitable*, 88 TEX. L. REV. 1213 (2010).

<sup>135</sup> See Faulhaber, *supra* note 104, at 1319–20.

<sup>136</sup> *Id.* at 1340–41.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 1321 n.66.

Some scholars have argued that the charitable deduction ought to be replaced by a credit for which all taxpayers would be eligible.<sup>140</sup> In *Taxes, Social Policy and Philanthropy: The Untapped Potential of Middle- and Low-Income Generosity*, Professor Alice Bullock criticizes the charitable income tax deduction for disproportionately benefiting higher-income taxpayers and disproportionately representing their views.<sup>141</sup> Noting that the charitable deduction provides a more valuable subsidy for a taxpayer in a higher bracket than one in a lower bracket and a nonexistent subsidy for a nonitemizer, Professor Bullock calls the charitable deduction an “upside-down subsidy.”<sup>142</sup> She argues that lower- and middle-income taxpayers would be spurred to increase giving by charitable tax incentives,<sup>143</sup> and she proposes a direct credit as a substitute for the charitable deduction.<sup>144</sup> Others

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<sup>140</sup> The credit versus deduction debate is far from settled. See Fleischer, *supra* note 92, at 522 n.87 (citing Jeff Strnad, *The Charitable Contribution Deduction: A Politico-Economic Analysis*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 95, at 265, 272–76 (supporting a deduction), and Harold M. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 95, at 224, 236 (supporting a credit)).

<sup>141</sup> Bullock, *supra* note 108, at 343–44. Bullock argues,

Under the tax code, the high-income group wields a disproportionate amount of power and influence in shaping institutions and their priorities. On the other hand, the Internal Revenue Code neither encourages nor subsidizes middle- and low-income taxpayers through the tax law, and it thus fails to confer a benefit for the public good.

*Id.* at 344–45 (citations omitted).

<sup>142</sup> *Id.* at 330; see also Faulhaber, *supra* note 104, at 1318 (noting that “many commentators, starting with Surrey,” consider the charitable deduction to be an upside-down subsidy (citing STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* 134–36 (1973))).

<sup>143</sup> Bullock, *supra* note 108, at 339–40. Bullock further adds,

[E]mpirical studies support the view that the charitable behavior of low- and middle-income taxpayers is affected by the price of giving. The contradictory conclusions about the effect of tax incentives on middle- and low-income taxpayers are a function of bias inherent in the models used for estimating the effect of the tax deduction. It appears that when adjustments are made to eliminate this identified bias, the findings support the conclusions that the charitable behavior of low- and middle-income taxpayers is indeed sensitive to the tax incentive.

*Id.* at 340 (citations omitted).

<sup>144</sup> *Id.* at 356–59.



have likewise argued that a credit is a more equitable tax incentive across income lines than is a charitable deduction.<sup>145</sup>

Credits may also enhance pluralism, as compared to a charitable deduction. A tax incentive that extends to a broader segment of society and a greater variety of donors should lead to a greater variety of nonprofits that benefit from contributions. As Professor Levmore has noted, scholarship on the role of pluralism in the charitable deduction often argues that a credit (or matching-grant) structure is superior to an itemized deduction

because nonitemizers would be given a voice, because low-bracket taxpayers would be as empowered as high-bracket taxpayers, because donors whose contributions were modest in absolute terms but quite impressive in relative, or wealth-corrected, terms could gain influence as well, and because private giving in the aggregate would be encouraged by empowering modest donors.<sup>146</sup>

Professor Miranda Fleischer has recently argued that a credit may be superior to a deduction (except to the extent budget constraints mandate a cap) from the perspective of distributive justice.<sup>147</sup> In terms of equality of opportunity and granting equal voice to citizens of diverse incomes, a credit is superior to a deduction.<sup>148</sup> Even though a credit may not be the most economically efficient approach—as it may provide a tax incentive to lower-income taxpayers who would have given in the absence of a tax incentive—it is superior to a deduction in its ability to “ensure that one’s ability to vote via charitable giving doesn’t depend on income.”<sup>149</sup>

Others have argued that lower-income nonitemizers should not be entitled to an additional tax benefit for contributions to charity because the standard deduction already assumes a baseline charitable contribution. Professor Ellen Aprill, for example, has argued that

to permit nonitemizers to deduct all charitable contributions, without a floor or some adjustment to the standard deduction, would give these taxpayers, in effect, a double deduction and put them in a position better

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<sup>145</sup> See, e.g., Izzo, *supra* note 100, at 2373, 2390, 2398 (arguing that the current charitable deduction is inequitable because it gives higher-income taxpayers greater power in selecting how public money is spent).

<sup>146</sup> Levmore, *supra* note 120, at 404 n.54.

<sup>147</sup> Fleischer, *supra* note 82, at 662. “The best solution, therefore, would be to determine a refundable credit large enough to provide the desired amount of incentives to the better-off.” *Id.*

<sup>148</sup> *Id.* at 661–62.

<sup>149</sup> *Id.* at 662.

than rather than equal to itemizers. Equity, like efficiency, requires some kind of floor beneath nonitemizer deductions.<sup>150</sup>

Professor Aprill, however, recognizes the equitable consequences of denying a direct charitable incentive to lower-income nonitemizers.<sup>151</sup> Citing several studies, Professor Aprill points out that the character of charitable recipients is different for higher-income individuals than lower-income ones.<sup>152</sup> Specifically, lower-income taxpayers most often select religious organizations as recipients of their charitable contributions.<sup>153</sup> Higher-income individuals, on the other hand, more often choose to benefit private foundations and educational institutions.<sup>154</sup> Disparate tax incentives, therefore, affect not only what classes of individuals are rewarded for donating but also what types of nonprofits benefit from such donations.

The current charitable deduction has sufficient weaknesses that warrant exploration of alternatives to its current structure and implementation. An ideal charitable incentive would better embrace the policies underlying the deduction, most notably pluralism and equity. Flexible spending accounts offer a better way.

#### IV. FLEXIBLE SPENDING ACCOUNTS: THE MEDICAL FSA MODEL

The literature relating to tax subsidies for charitable giving generally assumes that we are tied to one of three alternatives: a credit, a deduction, or neither. There is, however, a fourth alternative: a flexible spending account. FSAs combine the inclusiveness of a credit with the lower cost of a deduction. They are inclusive (and demonstrate horizontal equity) because they are available to lower-income nonitemizers and higher-income itemizers alike.<sup>155</sup> They support a pluralistic approach to funding because participants from a wide variety of backgrounds are included. Importantly, they are structured in a way that makes enhanced pluralism

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<sup>150</sup> Aprill, *supra* note 35, at 868.

<sup>151</sup> *Id.* at 846.

<sup>152</sup> *Id.* at 846, 868.

<sup>153</sup> *Id.* One study indicated that gifts to churches and similar religious organizations constituted over three-fourths of all charitable contributions made by taxpayers with income under \$40,000. *Id.*

<sup>154</sup> Madoff, *supra* note 83, at 966 (“While most Americans direct their charitable dollars to religious organizations, approximately three quarters of all bequests reported on estate tax returns go either to private foundations or educational institutions.”); *see also* Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. 263, 303 (2007) (noting the extent to which educational institutions benefit from donations from wealthy individuals).

<sup>155</sup> FSAs are more inclusive than itemized deductions, but as they are available only to families with at least one employee, they are not *all*-inclusive. Unemployed individuals cannot access this benefit because it is administered through an employer, and not all employers offer FSAs.

and equity affordable. Because flexible spending accounts are funded with pretax income, they have the economic impact of a deduction (the qualifying amount multiplied by the taxpayer's marginal rate) as opposed to the dollar-for-dollar setoff (the entire qualifying amount) of a credit. This makes the FSA model an attractive and affordable way to extend the benefits of charitable tax subsidies to nonitemizers.

The framework for the charitable flexible spending account is identical to that used for medical flexible spending arrangements. For that reason, it is important to analyze and understand the model and the reasons it evolved. Many parallels exist between the tax policies supporting expenditures for health care and those supporting expenditures for charity, so it is useful to track the path—and relative success—of the health-care expense model.

*A. Before (and Alongside) Medical Flexible Spending Arrangements: The Itemized Deduction for Medical Expenses*

Like tax incentives for donations to charity, support for medical expenses incurred by taxpayers is funded by a deduction for qualifying expenses. This deduction provides basic support for taxpayers who have faced costs relating to health care and serves to shift the burden of incurring these expenses away from the taxpayer individually and toward the public and government.

Section 213 of the Internal Revenue Code allows taxpayers to deduct certain unreimbursed expenses for medical care of the taxpayer or the taxpayer's spouse or dependents.<sup>156</sup> Expenses for "medical care" include payments for "the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body";<sup>157</sup> transportation needed for such medical care;<sup>158</sup> certain long-term-care expenses;<sup>159</sup> and qualifying health-care insurance and long-term-care insurance costs.<sup>160</sup> Expenses are deductible only to the extent

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<sup>156</sup> The Code provides that "[t]here shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . to the extent that such expenses exceed 7.5 percent of adjusted gross income." I.R.C. § 213(a) (2012). Treasury regulations emphasize that only costs actually paid during a taxable year are deductible. Treas. Reg. § 1.213-1(a) (as amended in 1979). They also provide additional guidance on what costs are qualifying medical expenses or related transportation expenses. Treas. Reg. § 1.213-1(e)(1) (as amended in 1979). There is no limitation on the amount of medical expenses that may qualify. Treas. Reg. § 1.213-1(c) (as amended in 1979). Note also that neither the alternative minimum tax nor the 2% limit on miscellaneous itemized deductions applies. See I.R.C. §§ 67–68.

<sup>157</sup> I.R.C. § 213(d)(1)(A).

<sup>158</sup> *Id.* § 213(d)(1)(B).

<sup>159</sup> *Id.* § 213(d)(1)(C).

<sup>160</sup> *Id.* § 213(d)(1)(D). The deduction is also allowed for costs of prescribed drugs or insulin. *Id.* § 213(b).

they exceed 7.5% of a taxpayer's adjusted gross income.<sup>161</sup> Courtesy of the Patient Protection and Affordable Care Act of 2010, this floor rose to 10% in 2013.<sup>162</sup>

The deduction for medical expenses is a below-the-line deduction, meaning that it is only available to taxpayers who itemize deductions. Because only one-third of taxpayers do itemize, the deduction is a nullity for the majority of the population.<sup>163</sup> Coupled with the percentage limitations that render all but the most catastrophic costs ineligible, this deduction lacks the teeth it needs to provide substantial support for health-care costs. The deduction, therefore, is supplemented by several additional tax subsidies in the Code.<sup>164</sup>

### *B. The Evolution of Medical Flexible Spending Arrangements*

Although a variety of tax subsidies for medical care existed for many decades, their efficacy fell short. Because of the holes in the various provisions—the hefty caps on itemizing medical expenses and the costs of medical care not covered by insurance—taxpayers still found themselves with substantial financial burdens relating to health care.<sup>165</sup> An important recent development provides some relief: the medical flexible spending arrangement (MFSA). An MFSA is a tax-advantaged

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<sup>161</sup> I.R.C. § 213(a) (2006).

<sup>162</sup> Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9013(a), 124 Stat. 119, 868 (2010) (codified as amended at I.R.C. § 213(a) (2012)).

<sup>163</sup> See INTERNAL REVENUE SERV., *supra* note 5, at 38 tbl.1.2 (noting that only 33% of taxpayers itemized their deductions in 2010).

<sup>164</sup> The Code also, notably, provides subsidies for employer-provided health insurance. See I.R.C. §§ 105–106. These provisions exclude payments employees receive from health insurance plans from gross income. *Id.* A substantial majority of employees are offered health-care benefits through their employer, although lower-income individuals are less likely to receive coverage than those with higher incomes. U.S. DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY, MARCH 2010, MEDICAL CARE BENEFIT COMBINATIONS: ACCESS, PRIVATE INDUSTRY WORKERS tbl.42 (2010), available at <http://www.bls.gov/ncs/ebs/benefits/2010/ownership/private/table40a.pdf>. Health savings accounts also offer useful benefits to some taxpayers. Health savings accounts were introduced as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and are specifically exempt from compensation deferral limits found in section 125(d)(2)(D) of the Code. See Medicare Prescription Drug Improvement and Modernization Act of 2003, Pub. L. No. 108-173, § 1201, 117 Stat. 2066 (2003) (amending 42 U.S.C. § 13995 and creating section 223 of the Code). Employee contributions to a health savings account are treated as an above-the-line deduction. I.R.C. §§ 62(a)(19), 223(a).

<sup>165</sup> See Kelly Phillips Erb, *Deduct This: The History of Medical Expenses Deduction*, FORBES (June 20, 2011), <http://www.forbes.com/sites/kellyphillipserb/2011/06/20/deduct-this-the-history-of-the-medical-expenses-deduction/> (discussing the development of the medical expense deductions); U.S. DEP'T OF HEALTH & HUMAN SERVS., LIFETIME & ANNUAL LIMITS, <http://www.hhs.gov/healthcare/rights/limits/index.html> (last visited Mar. 7, 2014) (describing generally the insurance company practice of setting limits on a policyholder's medical care and the effects of the Affordable Care Act).

account that functions as an additional level of health insurance.<sup>166</sup> An MFSA is essentially a “tax-planning mechanism” that, if used effectively, can help a participant lower her overall financial burden for the calendar year.<sup>167</sup> The legislative history surrounding the establishment of MFSAs shows that (1) the purpose of flexible spending account legislation was to provide a financial incentive to plan for unforeseen medical expenses that arose during the year, and (2) earned income was not a primary motivator behind the introduction of the legislation.<sup>168</sup>

Medical flexible spending arrangements are authorized by section 125 of the Code but are detailed in proposed Treasury regulations.<sup>169</sup> Section 125 allows “cafeteria plans”—employment benefits that are structured for favorable tax treatment. If a benefit constitutes an allowable selection under an employer’s cafeteria plan, the value of that benefit is not included in the employee’s gross income.<sup>170</sup> A cafeteria plan is “a written plan under which—(A) all participants are employees, and (B) the participants may choose among 2 or more benefits consisting of cash and qualified benefits.”<sup>171</sup> Benefits under a cafeteria plan may not include deferred compensation,<sup>172</sup> and benefits must not discriminate in favor of highly compensated employees.<sup>173</sup> Qualified benefits under a cafeteria plan include only benefits that are “not includible in the gross income of the employee

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<sup>166</sup> Health FSAs “must qualify as accident and health plans.” Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938, 43,958 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1).

<sup>167</sup> Vickie L. Hampton et al., *The Effect of Education on Participation in Flexible Spending Accounts*, 4 FIN. COUNSELING & PLANNING 95, 98 (1993).

<sup>168</sup> Adam Chodorow, *Charitable FSAs: A Proposal to Combine Healthcare and Charitable Giving Tax Provisions*, 2011 BYU L. REV. 1041, 1046.

<sup>169</sup> Prior to the recent health-care legislation, FSAs were exclusively within the purview of the regulations and were not even mentioned in the Code itself. The Patient Protection and Affordable Care Act amended section 125 of the Code to establish a new paragraph (i), establishing the following “Limitation on health flexible spending arrangements”:

For purposes of this section, if a benefit is provided under a cafeteria plan through employer contributions to a health flexible spending arrangement, such benefit shall not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to such arrangement.

I.R.C. § 125(i)(1). The Code will adjust this contribution cap for inflation in \$50 increments. *Id.* § 125(i)(2).

<sup>170</sup> *Id.* § 125(a).

<sup>171</sup> *Id.* § 125(d)(1).

<sup>172</sup> *Id.* § 125(d)(2) (providing exceptions in only limited circumstances).

<sup>173</sup> *Id.* § 125(c).

by reason of an express provision of this chapter”<sup>174</sup> but also include “any other benefit permitted under regulations.”<sup>175</sup>

Proposed Treasury regulations provide significant guidance as to how an MFSA may be operated within the requirements for cafeteria plans. The regulations define a flexible spending arrangement to be “a benefit program that provides employees with coverage which reimburses specified, incurred expenses.”<sup>176</sup> These programs allow employees to forgo additional cash or taxable benefits (such as additional salary) in exchange for benefits under the cafeteria plan—in this case, participation in an MFSA.<sup>177</sup> Employers may also choose to make certain contributions to these accounts.<sup>178</sup>

Traditionally, there were no federally determined limits on the amount of pretax dollars employees could contribute from their paychecks to cover qualified expenses, although employers often set a cap.<sup>179</sup> The regulations do require a cafeteria plan to specify the maximum salary reduction the employer chooses to permit, but the employer could set that maximum.<sup>180</sup> Beginning in 2013, however, federal law has capped contributions to an MFSA at \$2,500, as indexed for inflation.<sup>181</sup>

MFSAAs allow reimbursement of certain expenses only during the plan period,<sup>182</sup> which is often the calendar year. Employees must be entitled to payment of claims irrespective of how fully the account has been funded with their contributions.<sup>183</sup> An employee could, for example, receive a distribution of five-

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<sup>174</sup> *Id.* § 125(f). Provisions under sections 106(b), 117, 127, or 132 are excluded, however. *Id.* Life insurance is includable in gross income for the amount that the cost exceeds the dollar limitation of section 79. *Id.*

<sup>175</sup> *Id.*

<sup>176</sup> Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938, 43,957 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> EMP. BENEFIT RESEARCH INST., FLEXIBLE SPENDING ACCOUNTS, (2007), <http://www.ebri.org/pdf/publications/facts/0507fact-flexspend.pdf>. “There are no legal limits on contributions to a health-care FSA, but a plan sponsor may set a limit.” *Id.*; see also Ron Lieber, *The Fight over Flexible Spending Accounts*, N.Y. TIMES (Sept. 26, 2009), [http://www.nytimes.com/2009/09/26/your-money/health-insurance/26money.html?\\_r=1](http://www.nytimes.com/2009/09/26/your-money/health-insurance/26money.html?_r=1) (discussing a congressional debate over whether a limit should be placed on how many pretax dollars should be allowed to be set aside for health-care FSAs).

<sup>180</sup> See Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938, 43,947–48 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1).

<sup>181</sup> See I.R.C. § 125(i) (2012); *I.R.S. Notice 2012-40*, IRS.GOV, <http://www.irs.gov/pub/irs-drop/n-12-40.pdf> (last visited Mar. 8, 2014) (providing guidance on the effective date of the \$2,500 limit under section 125(i) of the Code); *I.R.S. Pub. 969 (2012)*, IRS.GOV, <http://www.irs.gov/publications/p969/ar02.html> (last visited Mar. 8, 2014) (specifying a \$2,500 limit for FSA plans).

<sup>182</sup> 70 Fed. Reg. 43,938, 43,942–43.

<sup>183</sup> *Id.* at 43,957.

sixths of her account in January, even if she had only contributed one-twelfth of her annual funding amount.<sup>184</sup> Expenses incurred outside of the plan period are not reimbursable, even if a balance remains in the account.<sup>185</sup> Contributions to an MFSA are, therefore, subject to a “[u]se-or-lose rule.”<sup>186</sup> This rule ensures that benefits under a cafeteria plan will not be considered deferred compensation.<sup>187</sup> Reimbursement requests for expenses from an MFSA must be substantiated.<sup>188</sup>

Like most benefits offered to employees through a cafeteria plan, funds contributed to an MFSA are exempt from employer and employee payroll taxes, including FICA and FUTA.<sup>189</sup> FICA—taxes collected from both employers and employees under the Federal Insurance Contributions Act—funds benefits for retirement, medical care, and disability.<sup>190</sup> FUTA—taxes collected from employers under the Federal Unemployment Tax Act—funds unemployment benefits.<sup>191</sup> Exempting amounts contributed to MFSAs, therefore, results in lower government revenues for these programs. Congress can, however, choose not to exempt certain benefits offered under a cafeteria plan from these taxes, as is the case with retirement plan benefits under a 401(k) plan.<sup>192</sup>

Although medical flexible benefit plans were first introduced in 1974, they garnered little interest for the first few years they were in existence, due to a combination of employer and legal uncertainty as to how employees could use such plans.<sup>193</sup> Those fears began to be alleviated with the introduction of section 125 of the Code and, during the 1980s, the use of flexible benefit plans began to rise.<sup>194</sup> Allowing employees to select their own benefits has been identified as one reason these plans garner support from both employers and employees.<sup>195</sup> Some consultants tout the FSA as a recognized employee benefit that “is a key piece in a comprehensive employee benefits offering” that can help to recruit and retain employees.<sup>196</sup>

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<sup>184</sup> *Id.* at 43,957–58.

<sup>185</sup> *Id.* at 43,957.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> *Id.* at 43,960–61.

<sup>189</sup> See I.R.C. §§ 3121(a), (a)(2), (a)(5)(G) (2012).

<sup>190</sup> *Id.* §§ 3101–3128. The tax encompasses both old-age, survivor, and disability insurance and hospital insurance. For more information on payroll taxes generally, see PETER J. ALLMAN, WITHHOLDING, SOCIAL SECURITY AND UNEMPLOYMENT TAXES ON COMPENSATION (2012) (discussing the compensation subject to tax, employees and employers subject to tax, the rate and computation of tax, and the reporting and deposit requirements associated with employment taxes).

<sup>191</sup> I.R.C. §§ 3301–3311 (2006).

<sup>192</sup> I.R.C. §§ 3121 (v)(1)(A), 3306(r)(1)(A) (2012).

<sup>193</sup> See Joseph R. Meisenheimer II & William J. Wiatrowski, *Flexible Benefits Plans: Employees Who Have a Choice*, 112 MONTHLY LAB. REV. 17, 18 (1989).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* at 17.

<sup>196</sup> See Porter-Rockwell, *supra* note 25.

Although 40% of U.S. employees are eligible to participate in an MFSA, only about a quarter of those eligible choose to do so.<sup>197</sup> A study conducted in 2005 revealed that 26% of employers who had at least ten employees offered MFSA's.<sup>198</sup> Of those employees who were eligible to enroll, 35% enrolled with an average contribution of \$1,235.<sup>199</sup> The net tax benefit for an average (\$1,235) contribution by an employee who earned less than \$35,000 a year would be \$282 under 2005 tax rates.<sup>200</sup> Employers also stand to gain tax benefits from participation; for an employer with one hundred employees with a \$30,000 average annual salary and \$1,237 contribution, 21% participation could trigger \$1,987 in tax savings due to decreased payroll taxes.<sup>201</sup>

A separate study linked participation in FSAs to income and education levels, with a higher income or educational level resulting in a higher participation rate.<sup>202</sup> Participation at higher income levels stems in part from the increased tax break the participant receives due to the marginal effective tax bracket; the higher the bracket, the more incentive for the employee to participate in the FSA.<sup>203</sup> Tax benefits of FSAs, however, are also valuable to lower-income nonitemizers, because taxpayers electing the standard deduction can achieve them.<sup>204</sup>

FSAs are not without their critics. The fact that FSAs offer a more valuable benefit to taxpayers in higher income brackets has led to complaints from those who would like to eliminate or limit the amount of tax reduction an employee

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<sup>197</sup> See Chodorow, *supra* note 168, at 1043 (citing U.S. DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, MARCH 2009, at tbl.36 (2009) (describing the percentage of U.S. employees eligible to participate in health-care FSAs)).

<sup>198</sup> EMP. BENEFIT RESEARCH INST., FACTS FROM EBRI: FLEXIBLE SPENDING ACCOUNTS (2007), available at <http://www.ebri.org/pdf/publications/facts/0507fact-flexspend.pdf>. The study was conducted by Mercer Human Resource Consulting. *Id.*

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

<sup>200</sup> *Id.* The statistics assume a taxpayer under age sixty-five filing a single (not joint) return. *Id.* Calculations are based on an employee in the 15% federal tax bracket plus FICA tax contributions at a 7.65% rate. *Id.* Actual tax savings in other years would be based upon the marginal rate in effect during the year the account was used.

<sup>201</sup> *Id.* The \$1,237 average contribution was based on employers with 10–499 employees; the \$1,235 value applied to all employers with ten or more employees. *Id.*

<sup>202</sup> See Hampton et al., *supra* note 167, at 102–08 (discussing factors behind employee benefit choices). Hampton notes that the “mean and median family incomes for participants [in the researcher’s study] were nearly \$18,000 and \$20,000 higher, respectively, than that of nonparticipants.” *Id.* at 104.

<sup>203</sup> *Id.* at 100.

<sup>204</sup> *Id.* at 98. “[A] married taxpayer who [did] not have enough itemized deductions to exceed the standard deduction (\$6,200 in 1993 for a joint return) receive[d] no [additional] tax reduction for medical expenses . . . .” *Id.*



receives by electing to participate in an FSA.<sup>205</sup> Others argue that the structure of FSAs promotes wasteful spending and that reimbursement procedures are vexing and cumbersome.<sup>206</sup> The majority of complaints surrounding FSAs lie with the provision that requires a participant to use it or lose it within the time frame established under the Code.<sup>207</sup>

The medical flexible spending arrangement is not the only flexible spending arrangement authorized for cafeteria plans; employers may also offer dependent-care assistance or adoption assistance.<sup>208</sup> Dependent-care assistance is authorized under section 129 of the Code, which provides that “[g]ross income of an employee does not include amounts paid or incurred by the employer for dependent care assistance provided to such employee if the assistance is furnished pursuant to a program . . . .”<sup>209</sup> While this could be implemented with a tax credit, an employer has the ability to offer one such “program” through the use of an FSA.<sup>210</sup> The employer simply includes the option as part of its overall cafeteria plan, which is sanctioned under section 125.<sup>211</sup> In fact, FSAs are the most common way an employer offers a dependent-care assistance program.<sup>212</sup> Dependent-care benefits may extend to a variety of family members for whom the employee provides care.<sup>213</sup> Employers benefit from offering these plans as well, because the money an employee elects to use to fund the plan is not subject to payroll taxes to which they otherwise would be if paid directly to the employee in a paycheck.<sup>214</sup> Like other plans offered under section 125, dependent-care programs have

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<sup>205</sup> Ron Lieber, *The Fight Over Your Flex Account*, N.Y. TIMES, Sept. 26, 2009, at B1 (discussing a congressional debate over whether a limit should be placed on how many pretax dollars should be allowed to be set aside for health-care FSAs).

<sup>206</sup> See Uwe E. Reinhardt, *The Trouble with (In)flexible Spending Accounts*, N.Y. TIMES ECONOMIX BLOG (May 29, 2009, 7:14 AM), <http://economix.blogs.nytimes.com/2009/05/29/the-trouble-with-flexible-spending-accounts/?emc=eta1>.

<sup>207</sup> See *id.*

<sup>208</sup> Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938, 43,958 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1) (“Dependent care assistance (section 129), adoption assistance (section 137) and a medical reimbursement arrangement (section 105(b)) are permitted to be offered through an FSA in a cafeteria plan.”).

<sup>209</sup> I.R.C. § 129(a)(1) (2012).

<sup>210</sup> Kathleen A. Murray, *Child Care and the Law*, 25 SANTA CLARA L. REV. 261, 293 (1985); see also Cheryl Geerhold, *Establishing Dependent-Care Programs Through Cafeteria Plans: Fulfilling the Need for a Well-Balanced Benefit Menu*, 25 SANTA CLARA L. REV. 455, 464, 471 (1985).

<sup>211</sup> I.R.C. § 125; Geerhold, *supra* note 210, at 464; Murray, *supra* note 210, at 293.

<sup>212</sup> Giselle Sered, *Day Care and Tax Policy*, 12 AM. J. TAX POL’Y 159, 193 (1995).

<sup>213</sup> Geerhold, *supra* note 210, at 470–71 (citing I.R.C. § 152(a) (1982)); see also Lawrence A. Perlman, *Use Spending Accounts to Save on Dependent Expenses*, 73 TAXES 573, 573–74 (1995).

<sup>214</sup> JOINT COMM. ON TAXATION, *supra* note 70, at 54; Murray, *supra* note 210, at 294; Sered, *supra* note 212, at 195.

limitations on contribution limits.<sup>215</sup> The policy behind offering dependent-care assistance, including through a flexible spending account, is primarily to create incentives for work.<sup>216</sup>

Adoption assistance may also be offered by an employer as part of a flexible spending account plan.<sup>217</sup> The Small Business Job Protection Act of 1996 authorized the creation and funding by employers of adoption assistance programs.<sup>218</sup> The Act established the current section 137 of the Code, which provides that “[g]ross income of an employee does not include amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee.”<sup>219</sup> These expenses must be offered “pursuant to an adoption assistance program”<sup>220</sup> and may be expended directly by the employee or paid for by the employer.<sup>221</sup>

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<sup>215</sup> I.R.C. § 129(a)(2) (2012). The Code allows for a maximum contribution of \$5,000, however, this is further limited to an amount not to exceed the total income earned by the lowest-income earning parent. *Id.* § 129(b)(1)(B). In the case of a married couple, should one spouse not earn any income in the tax year, no money may be set aside pretax for dependent care. *See id.*

<sup>216</sup> *Id.* § 129(e)(1); JOINT COMM. ON TAXATION, *supra* note 70, at 53. “The term ‘dependent care assistance’ means the payment of, or provision of, those services which if paid for by the employee would be considered employment-related expenses under section 21(b)(2) (relating to expenses for household and dependent care services necessary for gainful employment).” I.R.C. § 129(e)(1); *see also* Geerhold, *supra* note 210, at 471. The Joint Committee on Taxation report stated that the provision was enacted because “Congress believed that the child care credit provides a substantial work incentive for families with children, [and] the Act increases the amount of expenses for which the credit may be claimed,” and that “[t]he increases in the credit percentage are directed toward low and middle-income taxpayers because the Congress believed that these taxpayers are in greatest need of relief.” JOINT COMM. ON TAXATION, *supra* note 70, at 53. Congress also felt that employers should take a more active role in providing assistance to their employees when it came to dependent-care costs. *Id.* at 54.

<sup>217</sup> Employee Benefits—Cafeteria Plans, 72 Fed. Reg. 43,938, 43,958 (proposed Aug. 6, 2007) (to be codified at 26 C.F.R. pt. 1).

<sup>218</sup> Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, 1901 (1996). A somewhat less generous provision for adoption assistance, allowing deduction for costs incurred in the adoption of a child with special needs, was established under the Economic Recovery Tax Act of 1981. JOINT COMM. ON TAXATION, *supra* note 70, at 57. Congress passed this law based on the concern that the costs associated with adoption were prohibitive in nature and felt that a small deduction should be allowed to help ease this burden. *Id.*

<sup>219</sup> I.R.C. § 137.

<sup>220</sup> *Id.* The Code states that “[g]ross income of an employee does not include amounts paid or expenses incurred by the employer for qualified adoption expenses in connection with the adoption of a child by an employee.” *Id.*

<sup>221</sup> *Id.* § 137.

Types of flexible spending arrangements may not be combined.<sup>222</sup> For example, one may not seek reimbursement for both dependent care and health care from the same account.<sup>223</sup> This separation of accounts affords employers additional flexibility in determining the plan year for each account.<sup>224</sup> Flexible spending accounts remain popular elements of benefit plans offered to employees.<sup>225</sup>

Medical flexible spending accounts have accomplished a remarkable task: extending the benefits of tax relief traditionally available only to itemizing taxpayers to a wide variety of workers of varying income levels. The availability of this tax benefit enhances the equity of the tax system, taking into account the decreased ability to pay triggered by medical costs not reachable by the medical expense deduction.

#### V. PROPOSING A CHARITABLE FLEXIBLE SPENDING ACCOUNT

Medical flexible spending accounts provide the model for a new tax incentive for charitable giving. Just as medical flexible spending accounts have supplemented the existing below-the-line deduction for medical expenses, extending the benefits of tax-free medical costs to nonitemizers, charitable flexible spending accounts can enhance the charitable deduction in a way that extends the scope of the people benefitted by the tax subsidy and encourages increased overall giving. The Treasury should recognize and employers should adopt a new charitable flexible spending account regime.

A charitable flexible spending account, like the charitable deduction, can be justified on the grounds of equity, efficiency, incentive for charitable giving, monitoring, and pluralism. In each of these grounds, a charitable flexible spending account achieves at least as much as the traditional charitable deduction. The remainder of this Part discusses each advantage in turn.

A primary benefit of a charitable flexible spending account, when contrasted with the traditional charitable deduction, is its superiority in terms of vertical equity. Because the charitable income tax deduction is available only to the one-third of taxpayers who itemize, it produces an inverted tax result: it shifts tax burden away from those most able to pay, and it provides no tax benefit for those least able to pay. A charitable flexible spending account, by comparison, applies to itemizing and nonitemizing workers alike, allowing nonitemizing individuals to enjoy a tax benefit previously withheld from them.<sup>226</sup>

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<sup>222</sup> 72 Fed. Reg. 43,938, 43,942–43.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

<sup>225</sup> See Meisenheimer II & Wiatrowski, *supra* note 193, at 20.

<sup>226</sup> Even a CFSA, however, is not perfect by vertical equity standards. Because it is offered through employers, the unemployed could not participate. Furthermore, the nature of the progressive rate system means higher-income taxpayers receive a higher subsidy of their donations than lower-income taxpayers do. Despite its imperfections, a CFSA remains a step in the right direction.

A charitable flexible spending account also has advantages when it comes to economic efficiency. The traditional argument for the economic efficiency of the charitable deduction remains true: a charitable tax incentive results in the bulk of the financial burden of a contribution resting with those who value it enough to contribute, with a smaller fraction allocated to the general public.<sup>227</sup> This leveraging of private dollars with federal funding is economically efficient. A CFSA, however, is even more economically efficient because it leverages behavior at a lower tax cost, as it reaches taxpayers in lower marginal rates. A contribution incentivized by a CFSA can prompt a contribution with only a 15% “match” when lower-income workers contribute; a charitable deduction fails to reach taxpayers in lower brackets who do not itemize, and it is “buying” contributions largely from taxpayers in higher brackets.<sup>228</sup>

CFSAs also provide superior options when it comes to incentivizing charitable giving. Like the charitable deduction, a CFSA prompts generosity by providing a financial tax incentive, that in the reduction of income tax liability by the value of the contribution multiplied by the marginal tax rate of the contributor. This incentive, however, can potentially be offered to a broader range of participants (all workers), as opposed to only those who itemize. Furthermore, contributions to a CFSA may be further incentivized by a reduction in payroll taxes. Whether the loss of revenue inherent to providing this reduction is justified by the additional incentive is up to congressional judgment. Whereas most benefits offered under a cafeteria plan are exempt from payroll taxes,<sup>229</sup> not all are,<sup>230</sup> so Congress would have the option of providing the additional incentive or not, as deemed suitable.

A charitable flexible spending account provides similar incentives to donors to monitor the behavior of recipient charities as a charitable deduction does. The primary benefit of a CFSA over a deduction is the force of numbers. Greater numbers of individuals with financial skin in the game means more pairs of eyes on recipient charitable organizations.

Finally, a charitable flexible spending account also clearly bests a deduction in terms of pluralism. A charitable tax subsidy, whether a deduction or flexible spending account, allows a variety of taxpayers with a variety of views and priorities to participate in funding decisions. Taxpayers who “vote” with their dollars as to which projects merit funding, allowing the government to follow those favored projects with a matching subsidy,<sup>231</sup> helps to ensure a variety of priorities will be funded.<sup>232</sup> Expanding the pool of “voters” to include taxpayers

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<sup>227</sup> Gergen, *supra* note 89, at 1399–406.

<sup>228</sup> For the sake of simplicity, these calculations exclude any impact of payroll taxes.

<sup>229</sup> Most benefits under a qualified cafeteria plan, including MFSAs, are exempt from payroll taxes. *See* I.R.C. §§ 3121 (a)(2), (a)(5)(G) (2012).

<sup>230</sup> Congress can, and does, exclude certain cafeteria plan benefits from payroll tax exemption, as it has with 401(k) plans. *See id.* §§ 3121 (v)(1)(A), 3306(r)(1)(A).

<sup>231</sup> Levmore, *supra* note 120, at 405.

<sup>232</sup> Polsky, *supra* note 122, at 648–49.

who do not itemize will enhance diversity and offer a more representative view of the priorities of our pluralistic society.

In addition to mapping nicely onto the justifications for the charitable deduction, however, a CFSA offers additional benefits that the deduction does not. First, it takes advantage of lessons from behavioral economics to increase saving and budgeting for the purpose of making transfers to charities. Second, it provides an opportunity for employers to enhance corporate culture through promoting the value of philanthropy. Finally, it provides an oversight function, to ensure proper reporting, superior to the system of taxpayer self-reporting and occasional IRS auditing. Each of these issues will be addressed in turn.

Flexible spending accounts offer a substantial benefit that derives from the lessons of behavioral economics to increase saving and budgeting for the purpose of making transfers to charities. Studies suggest that people, when left to their own devices, do not always make consistent consumer choices.<sup>233</sup> Survey evidence demonstrates that although people know they should save and why, many simply don't—particularly individuals and families with low incomes.<sup>234</sup> Scholars studying this behavior have concluded that saving requires some level of effort and self-control on the part of the individual.<sup>235</sup> As such, some level of incentive to save, or some constraint against spending, helps individuals achieve their respective spending goals.<sup>236</sup> A “precommitment constraint” is a mechanism that, once adopted, allows a consumer to ensure future spending occurs at the level and time that consumer originally hoped it would.<sup>237</sup> One such precommitment constraint that can help a person achieve personal spending goals is an automatic payroll deduction.<sup>238</sup> According to survey research, automatic payments or withdrawals is a popular method by which a person can successfully achieve financial goals.<sup>239</sup> Having amounts automatically deducted from an employee's paycheck “is beneficial in that it is viewed as going to the more untouchable

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<sup>233</sup> Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1277 (1991) (citations omitted).

<sup>234</sup> See THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., SAVING INCENTIVES: WHAT MAY WORK, WHAT MAY NOT 7 (2006), available at <http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1021&context=crs>.

<sup>235</sup> See, e.g., Sondra G. Beverly et al., *A Framework of Asset-Accumulation Stages and Strategies*, 24 J. FAM. & ECON. ISSUES 143, 143–56 (2003) (discussing strategies to resist spending temptations through an analysis of Hersh M. Shefrin & Richard H. Thaler, *The Behavioral Life-Cycle Hypothesis*, 26 ECONOMIC INQUIRY 609, 609–43 (1988)).

<sup>236</sup> *Id.* at 143–56.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*; see also Shlomo Maital & Sharone L. Maital, *Is the Future What It Used to Be? A Behavioral Theory of the Decline of Saving in the West*, 23 J. SOCIO-ECONOMICS, 1–32 (1994).

<sup>239</sup> Automatic payments or withdrawals were the sixth-most-common response. Barbara O'Neill et al., *Successful Financial Goal Attainment: Perceived Resources and Obstacles*, 11 J. ASS'N FIN. COUNS. & PLAN. EDUC. 1, 3 (2000).

future-income account, thus encouraging self-control.”<sup>240</sup> Enrolling in the automatic funding of a charitable flexible spending account can leverage this psychological boost to budget and result in greater contributions to charitable organizations.<sup>241</sup>

A charitable flexible spending account system would have positive implications for employers as well. Charitable giving and philanthropic involvement is a value of many corporations.<sup>242</sup> Some promote this value through matching grants funded by a corporate private foundation.<sup>243</sup> Smaller businesses, however, lack the funds necessary to fund and maintain a corporate foundation. Allowing a charitable flexible spending account program would allow smaller businesses to promote the value of philanthropy and charitable giving.<sup>244</sup> Employers are also likely to appreciate the payroll tax benefit that often accompanies cafeteria plan benefits.<sup>245</sup>

An additional and critical benefit a charitable flexible spending account offers, when compared to a self-reported charitable deduction, is the auditing function of the plan administrator in ensuring accurate reporting of charitable contributions. Individuals preparing their own returns may, deliberately or inadvertently, report their contributions inaccurately.<sup>246</sup> Although taxpayers are required to substantiate charitable deductions,<sup>247</sup> not all taxpayers maintain

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<sup>240</sup> Narat Charupat & Richard Deaves, *How Behavioral Finance Can Assist Financial Professionals*, 3 J. PERS. FIN. 41, 44–45 (2004) (discussing strategies financial consultants can use to help their clients achieve their goals).

<sup>241</sup> It could be argued that lower-income individuals should not be provided mechanisms to budget more for charity, to the extent they ought to be budgeting their money for other purposes. To not offer a CFSA merely to discourage the proverbial widow from donating her two coins, however, seems paternalistic and inappropriate. *Cf. Luke* 21:1–4.

<sup>242</sup> See, e.g., *Matching Gifts*, GEN. ELEC. FOUND., <http://www.gefoundation.com/employee-programs/matching-gifts/> (last visited Mar. 8, 2014).

<sup>243</sup> For example, my former employer, Bank of America, matches charitable donations made by employees by gifts from its corporate foundation. See *Matching Gifts Program*, BANK OF AM., [http://about.bankofamerica.com/en-us/global-impact/matching-gifts-features-and-eligibility.html#fbid=e7m\\_1YvYxC5](http://about.bankofamerica.com/en-us/global-impact/matching-gifts-features-and-eligibility.html#fbid=e7m_1YvYxC5) (last visited Mar. 20, 2014). There is no need to include a matching grant program in a cafeteria plan, because matching grants from corporate private foundations are not considered taxable income to the employee. See Rev. Rul. 67-137, 1967-1 C.B. 63, available at [http://www.irs.gov/pub/irs-tege/rr67\\_137.pdf](http://www.irs.gov/pub/irs-tege/rr67_137.pdf).

<sup>244</sup> When rating the “100 Best Companies To Work For,” Fortune considers “pride [and] camaraderie, focusing on philanthropy and celebrations.” Marcia Heroux Pounds, *JM Family’s Family Auto Distributor Perennially Wins Recognition as a Great Place to Work*, SUN-SENTINEL OF FORT LAUDERDALE, Jan. 26, 2006, at 1D.

<sup>245</sup> See §§ 3121 (a)(2), (a)(5)(G) (2012).

<sup>246</sup> The IRS has identified “abuse of charitable organizations and deductions,” including overvaluation of contributions, as common tax scams. See *Beware of IRS’ 2010 “Dirty Dozen” Tax Scams*, IRS.GOV (Mar. 16, 2010), <http://www.irs.gov/uac/7>.

<sup>247</sup> See I.R.C. § 170 (f)(8)(a) (2012).

evidence of the contributions they deduct.<sup>248</sup> Indeed, the IRS routinely inspects tax returns and audits for overreporting where the charitable contributions seem disproportionate to the taxpayers' income.<sup>249</sup> The IRS, however, lacks the resources to audit significant numbers of returns; only about 1% of income tax returns are audited (and only a portion of these in connection with charitable contributions).<sup>250</sup> Charitable flexible spending accounts would use private-sector resources to monitor the substantiation of charitable gifts reimbursed through the account.

Though largely analogous to the charitable deduction, and offering many advantages to it, a charitable flexible spending account would have some significant hurdles. One such hurdle is the task of arriving at a critical mass: the CFSA program would not be effective if it were not adopted by a broad enough group of employers and employees. Put differently, if itemizers were the only ones that used CSFAs, the new program would serve no beneficial purpose. Higher-earning itemizers would receive tax benefits; lower-earning nonitemizers would not. CSFAs have potential to reach a broad base of donors, but whether they in fact will is hard to predict. Not just the creation of CFSA programs, but also the use of them, would change the face of philanthropy.

Another sticking point with offering a CFSA is concern over the extent to which employers could control contributions or use CSFAs to gather information on their employees. If employers could encourage or discourage donations to certain organizations, or base employment decisions on charitable giving patterns, freedom in selecting recipients would be curtailed. Having a CFSA overseen by a third-party plan administrator might alleviate these privacy concerns.<sup>251</sup> If issues arose, additional rules might be required to safeguard employee privacy and security.

Another potential hurdle is the argument that CSFAs should not be open to taxpayers who take the standard deduction, which theoretically includes a charitable deduction component.<sup>252</sup> Taxpayers who take an itemized deduction

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<sup>248</sup> Maintaining good records is critical. *See, e.g.,* Carole Feldman, *In an IRS Audit, the First Line of Defense is Having Complete, Accurate Records*, BOS. GLOBE, Jan. 24, 2012, at B9.

<sup>249</sup> *See* Karen Hube, *Red Flags: IRS Taking a Closer Look at Tax Deductions*, FISCAL TIMES (July 22, 2011), <http://www.thefiscaltimes.com/Articles/2011/07/22/Red-Flags-IRS-Taking-a-Tougher-Look-at-Tax-Deductions.aspx#page2>.

<sup>250</sup> Feldman, *supra* note 248, at B9 (“In 2011, the IRS audited nearly 1.6 million individual returns, slightly more than 1 percent of the total. . . . Only 1 percent of people with incomes under \$200,000 had their returns audited; the audit rate for those with incomes of \$1 million and higher was about 12.5 percent.”).

<sup>251</sup> Employees do, after all, disclose confidential health-care information in connection with MFSAs.

<sup>252</sup> There is often a tension between the simplicity established by the charitable deduction and the equitable goals of the tax system. *See* John R. Brooks II, *Doing Too*

would be required to forgo credit for charitable deductions made from their pretax CFSAs, whereas taxpayers who do not itemize would not.<sup>253</sup>

Despite the initial quandary raised by this potential duplication of reward for charitable giving, the concern itself is easily discounted. It is unrealistic to believe that the standard deduction presently includes a specific proportion to reflect average charitable contributions, at least not with any semblance of accuracy. Certainly there has been no attempt to adjust the standard deduction based on recent empirical evidence of what would be qualifying charitable contribution deductions of nonitemizing taxpayers.<sup>254</sup> Notably, from 1982 through 1986, when taxpayers who took a standardized deduction were permitted to take a charitable contribution deduction, the standard deduction was not decreased in 1982, yet it was increased in 1985 to reflect this charitable giving component.<sup>255</sup> To the extent the standard deduction no longer accurately reflects a substitute for the charitable deduction (assuming it ever truly did), there should be no concern with nonitemizing taxpayers receiving an income tax benefit for donations to charity.<sup>256</sup>

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*Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 205 (2011).

<sup>253</sup> Theoretically, this could also have been an issue for medical or adoption FSAs, but it does not appear there was much conflict over this potential inequity.

<sup>254</sup> It is also arguable that the purpose of the standard deduction has evolved such that it no longer truly reflects a conglomeration of typical deductions. The standard deduction, when coupled with personal exemptions, creates a class of individuals who pay no income tax. The personal exemption alone used to accomplish this task, but it did not keep pace with inflation. The standard deduction therefore evolved to fill this role. I must credit Professor Bryan Camp with explaining this theory to me.

<sup>255</sup> See H.R. REP. NO. 97-215, at 201-02 (1981) (Conf. Rep.), *reprinted in* 1981 U.S.C.C.A.N. 285, 291-92.

<sup>256</sup> Even if one assumes that the effect of combining a CFSA with the standard deduction is to allow double credit for a charitable gift (to the extent the value of the gift is included in the standard deduction itself), this “inequity” is milder than it may at first appear. Remember that the charitable deduction is *already* an upside-down subsidy. Imagine two taxpayers, one in the 15% bracket who does not itemize and one in the 35% bracket who does itemize, each of whom gives \$1,000 to the United Way. Under the charitable deduction, the itemizer receives a \$350 tax benefit. While the nonitemizer receives no direct benefit, the value of the standard deduction takes into account a typical level of charitable giving; assuming the \$1,000 gift is the typical level of giving, it is as if the nonitemizer received a \$150 benefit. Under an FSA, if the itemizer funds his \$1,000 gift with pretax dollars from his FSA, he forgoes the \$350 itemized deduction (since it is already effectively implemented by the pretax funding). On the other hand, if the nonitemizer funds her \$1,000 gift with pretax dollars from her FSA, she keeps the \$150 benefit built into the standard deduction and receives an additional \$150 benefit by virtue of using an FSA. The nonitemizer has double-dipped. However, because the charitable deduction initially provides a bigger benefit to those (itemizers) in higher marginal rate brackets, the itemizer still enjoys a larger tax benefit (\$350) than the nonitemizer (\$300). The structure therefore enhances the equity of the charitable tax subsidy rather than threatens it.



Although the idea of a fully charitable flexible spending account has not been proposed in legal scholarship before now, a connection between the existing medical flexible spending account and the charitable deduction has been made. In *Charitable FSAs: A Proposal to Combine Healthcare and Charitable Giving Tax Provisions*, Professor Adam Chodorow proposes amending the “use it or lose it” provision of medical flexible spending accounts to allow a gift over of the balance to a qualifying charitable organization of the taxpayer’s choosing.<sup>257</sup> The proposal would allow an employee to designate a single qualifying nonprofit to receive the balance, if any, remaining in an employee’s account at the end of a plan year.<sup>258</sup> Professor Chodorow argues convincingly that allowing a distribution of the funds remaining in an MFSA to a charitable organization would be consistent with existing tax law and policy with respect to both the charitable deduction and MFSAs.<sup>259</sup> Allowing a gift of the balance would be a good start—but if we can get our foot in that door, why not swing it all the way open?

Rather than allowing merely a distribution of the balance of an MFSA to a charitable organization, taxpayers should have the alternative of a fully charitable FSA. Having separate accounts for medical and charitable purposes would be more consistent with the current structure of tax law, produce better incentives, and create more flexibility. The current tax regulations require separate maintenance of accounts for dependent care and for health care, so a separate account for charitable contributions would be consistent with that regime. A primary purpose of having an FSA is to encourage budgeting, and one is likely more able to establish separate budgets for medical costs and charitable gifts than to make a sensible estimate of the combination of the two. Having separate charitable and medical FSAs also gives employers flexibility as to which to offer and employees flexibility as to which to fund. The income tax incentives for charitable giving could be significantly enhanced by the establishment of a flexible spending account dedicated exclusively to reimbursement of qualifying charitable contributions.

To implement a charitable flexible spending arrangement, the Treasury should amend the proposed regulations governing cafeteria plans. It is possible to argue that a CFSA is already authorized by the Internal Revenue Code and other tax regulations. To the extent that section 125 permitted medical flexible spending arrangements to flourish before the proposed regulations articulated them in detail, charitable flexible spending arrangements may also be endorsed.<sup>260</sup> To assure

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<sup>257</sup> See Chodorow, *supra* note 168, at 1041–42.

<sup>258</sup> See *id.* at 1074 (explaining that “taxpayers would be allowed to select only one charity as recipient”).

<sup>259</sup> See *id.* at 1076 (citing I.R.C. § 125(d) (2012)).

<sup>260</sup> MFSAs provide tax benefits that would otherwise be deductible under section 213, subject to the limitations described in Part III of this Article, *supra*. However, MFSAs also function somewhat like insurance, so perhaps their justification for tax-free treatment rests upon sections 105 and 106 of the Internal Revenue Code, which exclude payments employees receive from health insurance plans from gross income. It is unclear whether it

employers, however, that these accounts are permissible, an express amendment to the regulations would be helpful and may be necessary.

An amendment to the Code itself should not be necessary to authorize a charitable flexible spending arrangement. Section 125 currently defines qualified benefits under a cafeteria plan to include benefits that are “not includible in the gross income of the employee by reason of an express provision of this chapter (other than section 106(b), 117, 127, or 132),” as well as “any other benefit permitted under regulations.”<sup>261</sup> Because of the integration of benefits permitted by the regulations into the Code itself, an amendment to the Code should not be required.

The proper place to include an amendment authorizing charitable flexible spending accounts is the proposed Treasury Regulations to section 125 (“Proposed Regulations”), which already authorize medical, adoption, and dependent-care FSAs. The Treasury should amend a few provisions to include charitable FSAs in this group<sup>262</sup> and add provisions detailing their administration. First, the Treasury should add “Charitable Flexible Spending Accounts” as a new subsection, (a)(3)(K), to section 1.125-1 of the Proposed Regulations, which lists benefits to be offered under a cafeteria plan, and it should adjust the table of contents in section 1.125-0 to reflect this and any other changes to the regulation that affect the table of contents. Second, the Treasury should amend section 1.125-5(h) to read, “Dependent care assistance (section 129), adoption assistance (section 137), a medical reimbursement arrangement (section 105(b)), and a charitable reimbursement arrangement (for expenses otherwise deductible under section 170) are permitted to be offered through an FSA in a cafeteria plan.”

The Treasury should also add provisions to the regulation that mirror those used to explain and endorse the other types of FSAs. The following language is based on the regulation used to permit a dependent-care assistance program and could be adopted by the Treasury.<sup>263</sup>

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matters which Code section is relevant for purposes of whether MFSAs are analogous to CFSAs. In any case, an express revision to the Proposed Regulations is likely necessary for the assurance of employers.

<sup>261</sup> I.R.C. § 125(f)(1). “[A]ny group term life insurance which is includible in gross income only because it exceeds the dollar limitation of section 79” is also included. *Id.*

<sup>262</sup> I have focused here on Proposed Treasury Regulations § 1.125-5, located at 72 Fed. Reg. 43938, 43942 (2007), but there are several other sections in the Proposed Regulations that essentially just list the types of benefits that qualify under a cafeteria plan; all of these references should be updated.

<sup>263</sup> The language could either be adopted as a new proposed section 1.125-5(q), or in place of proposed section 1.125-5(k) and relettering sections (k)–(p). For simplicity, I use section (q) for the sample language.

(q) *Section 170 rules for charitable reimbursement arrangement offered through a cafeteria plan*—(1) *General rule.* In order for charitable contribution reimbursement to be a qualified benefit that is excludible from gross income if elected through a cafeteria plan, the cafeteria plan must satisfy section 125 and the charitable contribution must satisfy section 170.

(2) *Charitable flexible spending accounts in general.* Section 170 provides an employee with a deduction from gross income for qualifying donations to charitable organizations. See paragraph (a)(5) in § 1.125-6 on when charitable donations are completed.

(3) *Reimbursement exclusively for charitable donations.* A charitable flexible spending accounts program may not provide reimbursements other than for charitable donations; in particular, if an employee makes charitable contributions less than the amount specified by salary reduction, the plan may not provide other taxable or nontaxable benefits for any portion of the specified amount not used for the reimbursement of charitable donations. Thus, if an employee has elected coverage under the charitable flexible spending account program and the period of coverage has commenced, the employee must not have the right to receive amounts from the program other than as reimbursements for charitable donations. An employee may, however, designate one or more charitable organizations that are to receive any funds remaining in the account at the end of the plan year.

(4) *Alternative to itemized deduction.* An employee who participates in a charitable flexible spending account shall not take a deduction under section 170 for a contribution that is reimbursed from the flexible spending account. A participating employee may claim deductions under section 170 for contributions that are not reimbursed, to the extent the employee otherwise qualifies for a deduction under that section.

Small adjustments should also be made to section 1.125-6 of the Proposed Regulations, which relates to substantiation of expenses for cafeteria plans. Paragraph (a)(4) of this regulation explains the details of reimbursements of dependent-care expenses, and a new paragraph (a)(5) should be added to address charitable flexible spending accounts. The following proposed language is based upon section 1.125-6(a)(4) of the Proposed Regulations:

(5) *Reimbursements of charitable flexible spending account expenses*—(i) *Charitable donations must be expended.* In order to satisfy section 170, charitable expenses may not be reimbursed before the donations are expended. For purposes of this rule, charitable donations are expended when the employee irrevocably transfers funds to a charity and not when the employee pledges or otherwise agrees to make a transfer in the future.

(ii) *Charitable donations made during the period of coverage.* In order for charitable donations to be provided through a charitable flexible spending account program eligible for the section 170 deduction, the donations must be made on behalf of the employee during the period for which the employee is covered by the program. For example, if for a plan year, an employee elects a charitable flexible spending account program providing for reimbursement of charitable donations, only reimbursements for charitable donations actually made during that plan year are provided from a charitable flexible spending account program within the scope of section 170. Also, for purposes of this rule, expenses incurred before the later of the program's effective date and the date the employee is enrolled in the program are not incurred during the period when the employee is covered by the program. See also section 1.125-5 for FSA rules.

(iii) *Example.* The following example illustrates the rules in paragraphs (a)(5)(i)–(ii) of this section: A is an employee of Company X, which sponsors a charitable flexible spending account. On April 1 of the plan year, A contributes \$500 to U, a university that is a qualifying charitable organization. On April 10, A pledges to contribute \$1,000 to L, a library that is a qualifying charitable organization, to be payable within five years. The contribution to U is properly reimbursable from the charitable flexible spending account. No amount of the pledge to L is reimbursable unless and until the donation is paid to L while A is participating in the program.

These modest additions to the existing Treasury regulations will provide additional guidance for employers and employees who wish to participate in charitable flexible spending accounts as part of a cafeteria plan. Employers who already offer medical and dependent-care flexible spending accounts can enhance their benefits offerings—and promote a corporate culture that values philanthropy and community involvement—by sponsoring a charitable flexible spending account.

The timing of the amendment to the Proposed Regulations is ideal. The Treasury already must amend the Proposed Regulations to section 125 to reflect the \$2,500 cap on annual contributions to a medical flexible spending account

required by the new health-care law.<sup>264</sup> The Treasury has, in fact, issued a notice of proposed rulemaking; it did so in the summer of 2012.<sup>265</sup> The notice reflects a willingness to amend the Proposed Regulations more broadly, specifically with reference to the use-it-or-lose-it provision relating to the balance remaining in FSAs at the end of the year, and it requests comments.<sup>266</sup> While the Treasury's attention is already directed to the regulations of section 125, it is a remarkable opportunity to amend the regulations in a manner that would embrace CFSAs.

## VI. CONCLUSION

The current federal system of tax law, in attempting to encourage the shift of assets from private individuals to charitable organizations, fails to reach significant portions of Americans. Not all donors are equal in the eyes of the law; donors with particular demographic characteristics—ranging from income, to race, to state of residence—are more likely to itemize than others. Despite its aim to reflect a pluralistic society, the charitable deduction sanctions the privileging of one-third of American voices over the rest. If taxes are ballots, the election is rigged.<sup>267</sup>

Despite its shortcomings, the charitable deduction has many laudable goals and accomplishments; it should be enhanced rather than abolished. What the itemized deduction for charitable contributions needs is a supplement to extend its benefit to taxpayers who do not itemize. This supplement is a charitable flexible spending account offered to all workers. A charitable flexible spending account, working alongside the charitable deduction, will complement the existing tax structure to provide incentives to make charitable gifts in a way that achieves vertical equity unattainable by a structure consigned to itemizing taxpayers. Expanding the benefits of the deduction to lower-income taxpayers (and the many others who do not itemize) enhances the pluralistic benefit of the nonprofit sector and contributes to greater diversity and democracy in philanthropy.

A charitable flexible spending account, like the charitable deduction, can be justified on the grounds of efficiency, incentive for charitable giving, pluralism, equity, and monitoring. A charitable flexible spending account, however, consistently outperforms the traditional charitable deduction on these grounds and offers additional benefits. It leverages concepts from behavioral economics to

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<sup>264</sup> See I.R.C. § 125(i).

<sup>265</sup> *Section 125-Cafeteria Plans: Notice 2012-40*, IRS.GOV, <http://www.irs.gov/pub/irs-drop/n-12-40.pdf> (last visited Mar. 8, 2014).

<sup>266</sup> *Id.* The notice indicates that comments may be submitted by email to [Notice.comments@irscounsel.treas.gov](mailto:Notice.comments@irscounsel.treas.gov) or mailed to CC:PA:LPD:PR (Notice 2012-40), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. *Id.* The notice lists Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), reachable at (202) 622-6080, as the author of the notice. *Id.* This would seem to be the best way to make the Treasury aware of this new proposal for a CFSAs.

<sup>267</sup> On “taxes as ballots,” see Levmore, *supra* note 120, at 405.

increase saving and budgeting for the purpose of making transfers to charities. It provides an opportunity for employers to enhance corporate culture through promoting the value of philanthropy. Finally, it provides a superior oversight function to ensure proper reporting and validity of charitable donations.

The creation of a charitable flexible spending account would be an opportunity for symbiotic cooperation between government, the private sector, and philanthropy. Working together, government tax support for private contributions to charitable organizations can secure more robust funding of public goods and services for the benefit of society. The current charitable income tax deduction fails to leverage the substantial benefits the business sector has to offer in terms of providing a platform for charitable giving and institutionalized oversight to minimize abuse. In short, charitable giving tax incentives need work.