Ain't Charity: Disallowing Deductions for Kept Resources

By Calvin H. Johnson

Calvin H. Johnson is a professor of law at the University of Texas. The author wishes to thank Lawrence Zelenak, Victor Thuronyi, Ellen Aprill, and Richard Schmalbeck without binding them to conclusions with which they disagree.

A deduction for a charitable contribution is a reasonable subtraction when the taxpayer has lost the amounts paid so it can no longer be used to support the taxpayer's standard of living. If a taxpayer receives services back, the payment is not charity or a reduction of standard of living but self-service, and the payment is not properly deducted. This proposal would create a floor of $1,000 per year to cover cases in which a payment is not strictly identified with the quid pro quo but the taxpayer attended services or events put on by the charity. Deductions would be allowed only for payments to the charity in excess of the floor.

Similarly, a deduction for unrealized appreciation of property given to charity is a way of sheltering gain that a taxpayer has accumulated and used for self-serving purposes. Thus the proposal would limit charitable deductions to basis. Under it, the taxpayer would sometimes want to sell property to take advantage of capital gains rates, but requiring a real sale avoids hard valuation difficulties.

This article is part of the Shelf Project, a collaboration among tax professionals to develop and perfect proposals to raise revenue. A recent overview appears in "How to Raise $1 Trillion Without a VAT or a Rate Hike," *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*.

Congress adopted its first Shelf Project on March 18, 2010. New section 871(l), enacted in the HIRE Act, is based on the Shelf Project proposal by Reuven Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34*.

The two proposals in this article have a common theme: Accounting for taxable income should reflect money a taxpayer has kept for his own self-serving uses. A charitable deduction is reasonable when the taxpayer has forfeited resources to others, but not when the taxpayer has consumed resources for self-use. Providing a subsidy by exempting resources that a taxpayer has kept for himself is not a reasonable way to promote an activity, in part because the subsidy is more valuable in high brackets than in low brackets and in part because Congress does not pay enough attention to off-budget subsidies to ensure that they are wise and efficient allocations of resources.[1]

Thus, if the charity provides goods and services in return for a payment, the taxpayer has not lost anything, even when the connection between the payment and quid pro quo is tenuous. A floor or threshold, here proposed at $1,000 a year, is a reasonable administrative remedy when the taxpayer has attended a service, a musical performance, or other event put on by the charity.

Similarly, a deduction in excess of the taxpayer's basis in contributed property means that gains the taxpayer has retained and is using for his own consumption are not taxed. This proposal would restrict the deduction for a gift of property to the taxpayer's basis in the property.

A. Goods and Services in Return

1. Current law. Section 170 allows a deduction for a charitable contribution or gift. The deductible gift or contribution, however, does not include a payment made to the charity in consideration for goods and services that the taxpayer receives or expects to receive in return.[2] The amount of the charitable deduction is reduced by the fair market value of the goods and services that the organization provides in return, including religious services the charity provides.[3] In *Hernandez v. Commissioner*,[4] for example, a taxpayer claimed a deduction for payments made for Scientology "audits," which are spiritual sessions between an auditor and a participant. Under Scientology doctrine, the participant must pay a fixed fee in exchange for the auditing services. The Supreme Court held that the payments in exchange for the auditing

[1]The proposal and argument is directly from William D. Andrews, "Personal Deductions in an Ideal Income Tax," 86 *Harv. L. Rev*. 309, 309 (1972), via Calvin H. Johnson, "Was it Lost? Personal Deductions Under Tax Reform," 59 *SMU Rev*. 689, 703-711 (2006).

[2]Reg. section 1.170A-1(h)(1); reg. section 1.170A-13(f)(6) (1996) (defining "in consideration for").

[3]Reg. section 1.170A-1(h)(2).

[4]490 U.S. 680 (1989).

sessions were not gifts or contributions and thus were not deductible. Similarly, tuition payments for religious education are not gifts and contributions, and so are not deductible, even if a substantial part of the tuition goes to pay for intangible religious education.[5] A taxpayer's purchase of a Bible or prayer material is a payment for religious purposes, but the costs are considered to be personal consumption costs and are not deductible. In 1993 Congress required a charity to acknowledge substantial goods and services provided in return for contributions, but excluded "intangible religious benefits."[6] The acknowledgement rule, however, was not intended to change the underlying law on what is deductible.[7] Current regulations, however, allow a donor to take a deduction and disregard goods and services that have insubstantial value,[8] presumably on the grounds that tax law should not try to force an accounting when the revenue entailed is not worth the effort.[9]

While the deduction is reduced by benefits received in return as a matter of theory, the IRS has not been aggressive in associating payments with services for cases in which, unlike the Scientology audit, the connection between payment and services is less clear. If a taxpayer puts money in the collection basket as it is passed among the pews, the Service has acquiesced in the deduction of the money put in the basket. Because a taxpayer in theory could participate in the service without making a contribution, the services are considered to be free, and any money deposited in the basket is considered to be a loss to the donor. In 1919 the IRS also allowed the deduction of pew rents, dues, and assessments, on the grounds that these payments gave the taxpayer the same access to religious services as did the contributions to the collection basket.[10] The Service's 1919 ruling on pew rents and dues remains good law.

2. Reasons for change. Reducing the deduction by the value of the quid pro quo is key to the rationale for allowing the deduction. Charitable deductions are reasonable when they represent resources lost to the taxpayer and shifted to the object of the charity. Charitable contributions are not like ordinary and necessary business expenses that must be subtracted to compute business profits or income. In the case of a true gift or contribution, however, the taxpayer has lost the amount contributed and the deduction appropriately adjusts business profits to better reflect the remaining amount that the taxpayer can use to support his standard of living. Thus, for example, if King Wenceslas sees a poor man gathering winter fuel on the Feast of Stephen and (updating the Christmas carol) gives him a $100 bill, the $100 is now the poor man's and no longer supports the king's standard of living. King Wenceslas undoubtedly received intangible benefits from the gift, but on a tangible level it is the poor man rather than the king who will be using the resources represented by the $100 bill.[11]

Subtracting losses from business profits to determine taxable income is consistent with the goals of the tax system. Our tax bracket system uses a tax base that should reflect the standard of living of the taxpayer. The income tax is a progressive tax with brackets based on the standard of living for which the income is expected to be used. We impose the maximum tax rate, now set at 35 percent, on income expected to support the highest standards of living. Half of U.S. taxpayers fall into the 15 percent tax bracket. Subsistence income and income modestly above subsistence level are subject to 0 percent and 10 percent rates of tax. The justification for different rates based on a taxpayer's resources is the diminishing marginal utility of money. Every taxpayer spends dollars to cover the most critical needs first, so that the first dollars are most valuable. The bracket system applies the lowest tax rates to the income covering the most critical needs and the highest tax rates to income covering the least essential goods.

If King Wenceslas had spent the $100 on himself for luxuries, then we would want to tax the $100 at a higher tax rate. Similarly, if King Wenceslas had paid the $100 for a Bible or to his family chaplain in exchange for religious services, only the king's household would have access to the resources and there is no shift in resources to some other taxpayer. In the case of the gift to the poor man, however, the resources attached to the $100 were spent by the poor man, not the donor.

Using a charitable deduction as a means to deliver a subsidy is unreasonable in part because deductions have different values depending on the tax bracket of the contributor. Assume, for instance, that each of the four taxpayers in the following table is a member of a separate Protestant denomination, each is in the designated tax bracket, and each pays $100 to a minister for a service, baptism, or funeral. Assume also that each of the taxpayers is allowed to deduct the $100 against income in the given tax bracket, and so receives a subsidy from the government that reduces the given $100 cost of the

[5]*Sklar v. Commissioner*, 282 F.3d 610, 614 (9th Cir. 2002), *Doc 2002-2351*, *2002 TNT 20-10*.

[6]Revenue Reconciliation Act of 1993, P.L. 103-66, section 13172(a), 170 Stat. 312, 455 (enacting section 170(f)(8)(B)).

[7]Conference Committee Report on Revenue Reconciliation Act, Title XIII, Chapter 1, section 13172, at n. 17 (1993).

[8]Reg. section 1.170A-13(f)(8). *See also* Rev. Proc. 90-12, 1990-1 C.B. 471; Rev. Proc. 92-49, 1992-1 C.B. 987 (item given out in connection with fundraising and worth less than $60 and 2 percent of gift, and without an order by taxpayer, may be ignored as offset to the deduction).

[9]*Cf.* section 132(e) (exempting de minimis fringe benefits from tax when the value of the goods and services is "so small as to make accounting for [them] unreasonable or administratively impracticable").

[10]A.R.M. 2, 1 C.B. 160 (1919). *See also* Rev. Rul. 70-47, 1970-1 C.B. 49 (rents, building fund assessments, and periodic dues paid to a church are deductible contributions).

[11]Ironically, this paradigm of charity would not be deductible by King Wenceslas unless he made it to a section 501(c)(3) charitable organization approved by the IRS. The requirement that deductible gifts must be made to charitable organizations, however, should be understood as a preventative rule to ensure that deductions are not taken for gifts to friends and sweethearts and gifts when favors are expected in return.

Subsidy and After-Tax Cost of Religious Services				
	(1)	(2)	(3)	(4)
	Tax Bracket	Pretax Cost	Tax Savings [(1)x(2)]	After-Tax Cost [(2)-(3)]
Episcopalian	35%	$100	$35	$65
Presbyterian	28%	$100	$28	$72
Baptist	10%	$100	$10	$90
Storefront Evangelical	0%	$100	$0	$100

payment. The table shows each tax bracket (column 1), pretax cost (column 2), the subsidy (column 3), and the after-tax cost (column 4).

The effect of the deduction subsidy among the tax brackets of the donors as shown in the table is unacceptable. If the subsidy in column 3 were thought of as real money, delivered by government spending, we would not give Episcopalians more than three times as much as a Baptist for the same contribution to a church service. As a matter of theology, common to four denominations, it is the widow's mite that is the most valuable,[12] and so it is the contribution of the poorest that be given the most weight.

There is no principled case for deduction of goods and services because of the religious nature of the services. If a taxpayer buys a Bible or other material for spiritual improvement, the costs are considered to be personal costs, which are not deductible under the income tax.[13] The law makes no distinction between spiritual materials and secular studies of Aristotle or poetry or even lewd comics. When people join together for religious purposes and ''consume'' the religious services as a group, however, the law has trouble matching the religious benefits with the contributions. Treating collective participation in worship the way we treat individual Bible-reading or worship would imply that the expenses of collective worship should also be considered section 262 personal expenses rather than subtractions to compute standard of living. Some worshippers may consider religious expenditures the greatest contribution to their standard of living and not losses in any sense.

Noting the pattern of subsidy shown in column 3, it is also clear that Congress did not think of the subsidy as real money and did not bother to ensure that it was well structured. The function of economics is to encourage the allocation of resources in the most productive manner. Individuals make informed choices about the allocation of resources only when the resources are treated the same for tax purposes. The government bears costs rationally only when it spends federal budget money if then. If a subsidy is on budget, it has been through a competitive process for expenditures. Federal spending is always treated with skepticism, even hatred. An activity should be subsidized only within an annually reviewed budget process that minimizes costs and considers the ratio of costs to benefits. Unless Congress takes responsibility for costs, the costs are never under rational control. As indicated by the pattern in the table, the subsidy to religious groups was not adopted by a rational process.

3. Explanation of the proposal.

a. The $1,000 annual floor. The proposal would create a $1,000-a-year threshold for contributions in which the contributor received a nontrivial benefit from the charity. Thus, if the taxpayer attended a service, musical performance, or other event or gained access to a museum from the charity to which the contribution was made, the contribution would be subject to the $1,000 floor. Although the first $1,000 would not be deductible, amounts in excess of the $1,000 floor would qualify as itemized deductions by taxpayers who do not take the standard deduction. Payments directly related to services such as tuition and Scientology audits would continue to be disallowed in full, whether more or less than $1,000 a year in amount. The proposal is not intended to make payments deductible that are not deductible under current law.

The theory that deductions should not be allowed for nonlosses when services are received is sound, but it is not always possible to identify a direct relationship between payment and the services the taxpayer receives from the charity. It is also often administratively impractical to value the services to reduce the amount of the deduction. If identified exchanges, as in *Hernandez,* are not deductible contributions, but more diffuse relations between the payment and services will support deductibility, then both the taxpayer and the charity will avoid the direct connection in favor of some fuzzier connection. Charities can usually circumvent the identified exchange and still obtain donations because of the good services they provide. A threshold is a workable administrative way to handle payments when the taxpayer receives services from the charity, but there is no direct enforcement of the exchange.

The $1,000 limit in the proposal is an assumed contribution of $20 a week for 50 weeks, allowing the taxpayer to miss two services a year. The threshold is generously low. Assuming the average church costs $2.5 million, has a 5 percent, 25-year mortgage and has 100 participants every week, and that the minister and staff get $52,000 total compensation, the cost of the service per participant would be $44 dollars a week, which would support a $2,200 annual threshold. The threshold can be adjusted in

[12]''And Jesus sat over against the treasury, and beheld how the people cast money into the treasury: and many that were rich cast in much. And there came a certain poor widow, and she threw in two mites, which make a farthing. And he called unto him his disciples, and saith unto them, Verily I say unto you, That this poor widow hath cast more in, than all they which have cast into the treasury. For all they did cast in of their abundance; but she of her want did cast in all that she had, even all her living.'' *Mark* 12: 41-44 (King James version).

[13]Section 262.

future years. A resident of the United States receives more than $1,000 worth of benefits from charitable payments just by being an American citizen. For those who did not get $1,000 worth of goods and services per year, denial of deductions up to the threshold amount is justified by a fallback theory dictating that when a contribution is voluntary, some kind of intangible return can be assumed to explain the contribution.

The $1,000 threshold will serve to increase charitable donations in some cases. A taxpayer who will get a deduction only for payments in excess of $1,000 will sometimes increase the donation to get the deduction. The $1,000 threshold espouses the good theory of disallowing deduction of nonlosses, while also relieving the taxpayer's record-keeping burdens and the IRS's audit burdens. Application of the threshold would not require a connection between payment and service or event, but the threshold would apply if the taxpayer has attended a service or musical performance or other event put on by the charity or received some other non-de-minimis benefits from the charity. A taxpayer could have some charitable payments subject to the floor and some not. For example, if there is a special collection for flood victims or battered women and children, and also a collection to support the religious services the taxpayer attended, the payment that went purely to others would be deductible without regard to the $1,000 threshold.

Some decisions need to be made about the application of the threshold, which do not necessarily change the core of the proposal. It is recommended that de minimis benefits — likely to be ignored, unlikely to influence anyone's behavior, and not worth accounting for — will be ignored in deciding whether a payment is subject to the threshold, but it is intended that benefits just above de minimis benefits would subject the donation to the $1,000 floor. It is recommended that payments by alumni to their college would not be subject to the floor, even when the alumni are in some sense paying the school retroactively for the costs of their education not covered by tuition. It is also suggested that if a school or hospital names a building or area after a donor, the benefit should be ignored. Benefits for which the taxpayer pays full public price should not subject other contributions to the floor. If, for instance, a taxpayer regularly attends the local symphony, paying for a ticket at the price available to the general public, the extra donation to the symphony above the ticket price would not be subject to the floor. If the benefits have a clearly ascertainable value, and that value is given to the taxpayer by the charity in the required acknowledgement sent by the charity to the taxpayer,[14] the benefit will reduce the charitable deduction by the acknowledged value of the benefit, but will not otherwise subject contributions to the $1,000 floor.

Consistent with the theory behind the proposal, it is recommended that contributions to public television would be subject to the threshold. Public television is available for free without payment, and yet the benefits of public television are valuable, even to taxpayers who only occasionally watch it. The threshold covers charity-provided services of all kinds from many sources, and it is fair to presume that a taxpayer gets $1,000 worth of benefit from public television and all other charities just by being a resident of the United States. Because of the benefits that all taxpayers get from charities, the floor operates as a general administrative rule. On this and other recommendations, however, the proposal can be modified without affecting its core.

b. Alternatives not adopted. An alternative to the floor for deductions would be to apply the $1,000 annual threshold to all charitable deductions. In critical commentary on this proposal, it was argued that the $1,000 threshold would be difficult to administer because it would depend on identifying some personal benefit the taxpayer has received. All charitable deductions are voluntary payments, indicating that the taxpayer was getting some intangible benefits as a quid pro quo. One could expect substantial noncompliance with a rule that the $1,000 floor applies if the taxpayer received some benefit from the charity. The IRS should not be spending its very limited audit resources on rules that are hard to enforce.

A related alternative would be to create a floor based on a percentage of adjusted gross income. Itemized deductions for casualty losses and for medical deductions are now both subject to a threshold measured by AGI (of 10 percent and 7.5 percent of AGI, respectively). Under those floors, extraordinary medical expenses and extraordinary casualty losses are taken into account in computing the ability to pay tax, but amounts of less than the floor are considered to be just ordinary costs of living that are reflected within the personal exemptions, the standard deduction, and by the tax brackets. Some level of charitable giving might be considered to be an ordinary part of the cost of living in a community or a society, so that only extraordinary charitable gifts need to be taken into account.

Under the proposal, however, it is considered worth the effort to distinguish unselfish gifts to others with no goods or services received in return from cases that look like group consumption of services. The author, however, has a great deal of respect for the alternative proposal of a simple percentage of AGI floor applied to all charitable deductions, whether they are losses or not.

B. Unrealized Appreciation

The charitable deduction, under current law, sometimes generates a sheltering deduction for dollars that the taxpayer has not lost, but has kept for purely selfish use. To describe the amount the taxpayer has lost when appreciated property is given to charity, the charitable tax deduction needs to be limited to the taxpayer's basis in the property. Allowing a combination of exclusion of unrealized gain and a deduction for the gain is double accounting. Tax law sometimes prevents sheltering deductions, for instance, by disallowing deductions for services rendered to a charity or for a contribution of blood, and by reducing the deduction to basis in many cases. Current law, however, is a patchwork of rules that sometimes allows sheltering deductions in excess of basis and sometimes does not. The charitable deduction for amounts lost is reasonable, but an exemption for resources the taxpayer has kept for self-use is not. The

[14]Section 170(f)(8)(B).

value of the sheltering deduction is contingent on a tax bracket, for example, in the greater value per $100 given to Episcopalians than for Evangelicals. Because the upside-down effect is so unreasonable, and because the justification for deductions in excess of lost basis is so opaque, the allowance of deductions in excess of basis appears to be just a tax accounting mistake made by people who either did not understand the tax accounting logic or were taking advantage of the error.

1. Current law. Current law is a patchwork of rules and exceptions, sometimes allowing the taxpayer to deduct only basis in property given to charity and sometimes allowing deduction of all or part of unrealized gain on the property. In 1920 the IRS ruled that the ''amount'' of the charitable deduction was basis, but then three years later decided, without any change in the underlying statute, that ''amount'' referred to value.[15] By contrast, the ''amount'' of the deduction for property that was lost or destroyed by casualty was interpreted consistently as only the taxpayer's adjusted basis and not value.[16] Since 1923, however, the FMV deduction has been reduced to basis but not in every case.

Section 170(e) generally reduces the deduction for a gift of property to charity by the amount of gain that would be ordinary income, including short-term capital gain, if the property were sold for its FMV. This is the same as allowing a deduction only for the taxpayer's basis.[17] The rule thus limits the deduction to basis if a taxpayer contributes inventory or an artist or author contributes works of art or literary or musical compositions he has made.[18] Similarly, if the taxpayer contributes stock or some other capital asset held for less than a year, the gain is short-term capital gain that reduces the deduction down to the taxpayer's basis.

There are, however, narrow special-favor provisions that allow a deduction of inventory in excess of basis. Section 170(e)(3) allows a deduction for inventory donated for the care of the ill, the needy, and infants. The special deduction has been allowed, for example, for contributions of four-day-old bread, and for pharmaceuticals shortly before their expiration.[19] The amount of the deduction allowed for section 170(e)(3) contributions is equal to the taxpayer's basis plus one-half of built-in gain on the inventory, not to exceed twice the taxpayer's basis in the inventory.[20] The twice-basis ceiling kicks in if basis is under one-third of FMV.[21] Similarly, section 170(e)(4) allows a deduction for contributions of inventory of scientific equipment or apparatus for research in the physical or biological sciences. The deduction is equal to the taxpayer's basis plus one-half of the built-in gain, not to exceed twice the taxpayer's basis in the inventory. Section 170(e)(7) at one time included a similar rule for gifts of computers to schools, but the provision was allowed to expire at the start of 2008.[22]

If the built-in gain would be capital gain if the property were sold, the usual rule is that the full FMV of the property may be deducted in full. Thus, for example, a donor is allowed a deduction equal to the FMV of stock given to a charity supported by the general public. Corporations get no rate reduction for their capital gain, but the status of property as capital gain property or section 1231 property does allow a corporation to avoid reduction of basis by the amount of the built-in gain.

The charitable deduction is reduced by capital gain in limited cases. For a donation of tangible personal property for uses unrelated to the charitable use, or when the charity sells the property within three years after the gift, the deduction is reduced by built-in capital gain.[23] The deduction is reduced by capital gain built into stuffed taxidermy animals,[24] musical compositions,[25] and copyrights, trade names, trade secrets, and similar property.[26] A donor to a private foundation, formed by one taxpayer or a few related taxpayers, will generally not be allowed to deduct the capital gain built into the donated property,[27] but Congress significantly liberalized deductions to private foundations by allowing deductions for stock

---

[15]L.O. 979, 2 C.B. 148 (1920) (allowing only adjusted basis as deduction for charitable contribution of property); L.O. 1118, II-2 C.B. 148 (1923) (amount of a charitable deduction is FMV).

[16]Revenue Act of 1918, P.L. 65-254 section 202(a), 40 Stat. 1057, 1060.

[17]Assume a taxpayer gives property worth $120,000 with a basis of $50,000 to charity. The property would produce $70,000 in ordinary income if sold. The deduction for basis only would be $50,000. The gain that would be recognized if the property were sold would be $120,000, less $50,000 basis, or $70,000, and reducing the deduction from $120,000 down to $50,000 necessarily allows a deduction of basis only.

[18]Under section 1221(a)(1), gain on inventory is ordinary income and under section 1221(a)(3), gain on artistic, musical, or literary compositions is ordinary income if held by the maker or donor. Musical compositions are capital gain assets under section 1221(b)(3), as of 2005, but section 170(e)(1)(A) treats that gain as ordinary so as to reduce the deduction for musical compositions down to basis.

[19]*Lucky Stores, Inc. v. Commissioner*, 105 T.C. 420 (1995), *Doc 95-11258*, *95 TNT 247-11* (four-day-old bread); Rev. Rul. 85-8,

(Footnote continued in next column.)

1985-1 C.B. 59 (pharmaceuticals shortly before expiration). The courts, however, did reduce the FMV of the inventory because of the near end of its life.

[20]Rev. Rul. 85-8, 1985-1 C.B. 59, interpreting section 170(e)(3)(B).

[21]The calculation that basis of one-third of value is the break-even point is as follows:

FMV - ½ (FMV - Basis) = 2 * Basis,
so
½ FMV = (2 - ½) Basis
so
FMV = (1 and ½ / ½) * Basis
and
FMV = 3 * Basis.

[22]Section 170(e)(6)(G).

[23]Section 170(e)(1)(B)(i); section 170(e)(7). Sales after the year of donation cannot be known in time to ascertain the amount of the deduction, so paragraph (e)(7) of section 170 ''recaptures'' the deduction if the charity sells the tangible personal property in the three years following the gift.

[24]Section 170 (e)(1)(B)(iv).

[25]Section 170(e)(1)(A) (treating income from musical compositions eligible for capital gain under section 1221(b)(3) as if it were ordinary income that reduces the charitable deduction down to basis).

[26]Section 170(e)(1)(B)(iii).

[27]Section 170(e)(1)(B)(iii).

for which there were readily available price quotes from trades on an established market.[28]

2. Reasons for change.

a. The principle of no double deduction. A deduction for a charitable gift that is in excess of the taxpayer's basis in the property shelters income the taxpayer has kept for his own selfish use. The sheltering deduction is a double deduction, in principle like a cash-method taxpayer deducting amounts he has not received or like a deduction for services.

To illustrate the sheltering deduction, assume a cash-method lawyer has two clients, one that he bills for $50,000 and another that he bills for $70,000. Also assume the lawyer collects his bill only from the client who owes $50,000. The lawyer's income for the year is $50,000 because no deduction is allowed for the $70,000 never received. If we exclude the unrealized $70,000 from income and also give the lawyer a $70,000 loss deduction for the unpaid bill, the lawyer ends up with no net income for the year and an extra $20,000 net operating loss to carry over to another year — not withstanding the lawyer has consumable cash income of $50,000 for the year. It is an accounting mistake to allow both an exclusion of the unpaid $70,000 bill and a deduction for it. Current law fixes the problem by allowing a deduction for basis only, and a cash-method lawyer has no basis in unreceived client bills.[29] It is an accounting mistake to argue that the lawyer should get a deduction for the value of the receivable when the client does not pay. The mistake is common, however, and hard to fix. Over the years, more than half my students miss the point on my taxation final exam and allow the lawyer a deduction, even though I try hard to explain the right result.

Similarly, a taxpayer cannot take a deduction for services given to charity.[30] Assume that a taxpayer's services are worth $10,000 a month, the taxpayer works at his job for five months for $50,000 cash, and then works for seven months for a charity. The full and accurate accounting remedy is to not tax the taxpayer on the seven months of salary he does not have. Allowing a deduction for $70,000 in services in addition would exempt the taxpayer's wages and would also generate another $20,000 charitable deduction that could be carried over to other tax years as an NOL. This is not a valuation issue, but rather an accounting-logic issue: double counting should not be allowed. The lawyer has the $50,000 salary used for self-serving purposes and we must tax it, notwithstanding his charitable work. Current law cures the problem by providing that the value of services is not deductible no matter how much they are worth.[31] A gift of blood is in principle the same — the deduction should not exceed the cost of the blood — and indeed the IRS treats a donation of blood as a gift of services.[32]

Finally, the principle is the same for unrealized appreciation on property. Assume a taxpayer invests $50,000 in property that appreciates to $120,000 by year-end when he gives it to charity. A deduction of $50,000 would describe the amount of cash the taxpayer has lost by transfer to the charity. A deduction of the $120,000 FMV would allow the taxpayer to shelter $70,000 of cash that the taxpayer has kept for use for himself, either this year or in a carryover year. The question is not a matter of valuation of the property. Section 170(e)(5) permits a deduction for stock given to a private foundation if the stock has a quoted market price on an established market, as if the issue were a matter of value. The appropriate deduction to avoid sheltering amounts the taxpayer has kept for self-serving uses is basis only. If we mean to adjust the level of tax to the standard of living of the taxpayer, then only the basis of contributed property would be deducted.

The Bush administration advisory panel on tax reform recommended continuation of the deduction for unrealized appreciation to the extent it is allowed under current law.[33] The panel worried about valuation difficulties of deductions working off FMV, but it decided nonetheless to recommend retention of at least the current-law rules for donations of noncash property because they provide "added incentive" for taxpayers to make charitable deductions.[34] That position is unprincipled. The incentive is a subsidy distributed upside down to the tax bracket of the donor. The taxpayer has kept the amount sheltered by the deduction and not lost the resources. The subsidy is not subject to a rational competitive budgeting process. By what rationale does the bracket of the donor determine the appropriate level of the subsidy? Do higher-income donors need more reward to give up $100 because they are more mean-spirited? If it costs more to subsidize charitable donations from the rich, then our money will go further when poorer people contribute. There is also no reason to think that a gift of untaxed

[28]Section 170(e)(5). The qualifying stock cannot in the aggregate exceed 10 percent of a corporation, counting contributions by family members.

[29]Section 165(b). *See, e.g.*, Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 25, 30 (2d ed. 1989).

[30]Reg. section 1.170A-1(g) (2005); *Etheridge v. Commissioner*, 36 T.C.M. (CCH) 724 (1977).

[31]*Id.*

[32]In Rev. Rul. 162, 1953-2 C.B. 127, the IRS ruled that donation of blood was a service and that no deduction would be allowed for the value of the blood. Even if blood is considered property, it is ordinary property with a zero basis because it is manufactured by the taxpayer. Capital gain is appreciation of capital and there is no appreciation of invested capital in the case of the blood. High-income blood is not any more valuable for the medical system than low-income blood, even considering the breeding in the high-income blood — or at least the private market has not been willing to pay more for high-class blood, and I presume the government would buy blood (for military hospitals, for example) at a higher price for upper-bracket blood than for lower-bracket blood.

[33]President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," at 77 (Nov. 2005), *Doc 2005-22112*, *2005 TNT 211-14*. Section 170(e)(6), which allowed deductions of up to twice the basis of inventory computers given to schools, has since been allowed to expire.

[34]*Id.*

appreciation is especially desirable. Indeed, most charities just want and need the cash. The deductions for inventory given for the ''ill, the needy, and infants'' and for scientific research do limit the taxpayer's deduction to twice its cost. Still, why allow twice the cost to be deducted for some kinds of charity, when only the amount of the taxpayer's cost is permitted in the computation of profit or income under ordinary principles? The deduction for FMV arose from an accounting fallacy because as a matter of tax accounting, only the basis should be deducted.

Section 170(e), which governs deductions of basis of property or deductions in excess of basis under current law, is a bramble bush. Sometimes, the deduction for ordinary-income property is reduced to basis and sometimes it is not. Sometimes the deduction is reduced by capital gain and sometimes it is not. The distinctions seem arbitrary or at least not based on universal norms of any kind. The inconsistent treatment of nearly identical cases undercuts the legitimacy of current law. The proposed rule allowing deduction of basis only is far simpler than current law to administer because it avoids hard determinations regarding the value of the contributed property.

b. Capital gain property. If a taxpayer is not allowed a deduction for capital gain, then it would often be in his interest to sell the property and donate the sale proceeds. For example, assume a taxpayer has property worth $100 with a basis of $10. The proposal would allow the taxpayer only a $10 deduction, saving tax of no more than 35 percent * $10 or $3.50. If the property would produce ordinary income when sold, sale of the property would provide an advantage no better than the $10 deduction. If the $90 is capital gain, however, the taxpayer would be better off selling the property for its FMV than donating the property directly. A sale and gift of the proceeds would save $35 (35 percent of $100) for a taxpayer in the top bracket, and incur capital gains tax of $13.50 (15 percent of $90), for a net tax saving of $21.50. A direct gift that allowed deduction of basis only would provide a tax savings of only $3.50.

It is an accounting mismatch to allow the taxpayer capital gain of 15 percent on the $90 and then 35 percent on the same $90 is available by sale. The sale and donation of the proceeds incorrectly matches a 15 percent tax on the sale receipts with a 35 percent tax savings on the donation, for a net savings of 20 cents less tax for every dollar that the donor receives and donates to the charity. When $1 or $90 goes in and out of the taxpayer's hands, the net effect on standard of living is zero. The right tax answer is no net tax savings on the sale and contribution, which has no net cost or economic impact. The tax savings of 20 cents is a windfall on a transaction that before tax had no net effect.

A possible remedy is to disallow the charitable deduction to the extent of capital gain, so that the taxpayer cannot receive both an ordinary deduction and capital gain treatment. The taxpayer would then only have to realize the capital gain in one year and the charitable deduction in another. Going beyond the year might well put together a gain and a gift that had no known relationship to each other. Allowing both capital gain and an ordinary deduction is a loophole, a windfall from a transaction with no net pretax impact, but the remedies will probably have to be partial ones at best.

Requiring the taxpayer to sell property to take advantage of the loophole would have some administrative value. If the taxpayer really had to sell the capital gain property, at least the value of the deduction would depend on the real value that a willing buyer in fact paid, rather than self-reported assessments of sale value when there is no sale. Thus it makes sense to allow only basis to be deducted for a charitable gift, just as basis alone is deducted if the property is lost to theft or casualty. A taxpayer who wanted to sell the property to report capital gain and give the sale proceeds to charity would do so, but the sale, made to exploit a loophole, would at least generate information about the real market value and avoid all disputes about valuation.

3. Explanation of the proposal. The proposal would amend section 170(e) to provide that in the case of a contribution of property, the deduction cannot exceed the taxpayer's adjusted basis in the property. Paragraphs (e)(1)-(e)(7) would be repealed.