

A Normative Rationale for the Charitable Tax Exemption*

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INTRODUCTION

What is the normative rationale for the federal income tax exemption for nonprofit charitable corporations? Even though this federal statutory exemption dates back to 1894, Congress has provided very little explanation for why it exists. Over the years, many scholars have pondered this normative question. However, the quest for an explanation of the charitable tax exemption has centered almost exclusively on economic efficiency. Thus, the charitable tax exemption is typically justified as an economically efficient means of providing certain goods and services to the public. Explaining the charitable tax exemption in economic terms is certainly appealing and deceptively comforting. Indeed, since taxation is facially concerned with money, why not explain tax exemption in money terms - hence, economic efficiency.

But no matter how appealing efficiency might sound, one must not lose sight of the fact that taxation, and more particularly tax law, is about much more than economic efficiency. Tax law is about broader conceptions of justice, fairness, and other aspects of a democratic society that extend beyond economic principles. Likewise, the tax exemption for charities is also about much more than money or economics. Indeed, the charitable tax exemption is principally about justice, fairness and many other democratic principles, in addition to money. While efficiency analysis may encompass *one* conception of justice or fairness, there are also many other non-economic conceptions of these basic normative principles that extend beyond economics. Thus, this Article does not dispute that traditional efficiency analysis adds to our normative understanding of tax exempt charity law. Economic analysis may, for example, aid in understanding the exemption's economic impact or in the search for a reason for the exemption. However, efficiency alone simply does not fully explain the varied and rich non-economic aspects of the charitable tax exemption. This Article explains the charitable tax exemption, in value and market terms, to demonstrate that the principal normative justification for the charitable tax exemption is embedded in the value of diversity - what this Article calls contextual diversity.

Diversity has long been recognized as globally beneficial. In nature, for example, diversity is seen as a key component for plant and animal species survival. In financial investments, diversity is seen as the principal means of reducing risk of capital loss and ensuring sustainable growth over the long run. Importantly, in education, society values diversity as imperative if one is to have a quality and well-rounded educational experience. This Article demonstrates how diversity is also the driving force behind the charitable tax exemption. Diversity breeds creativity, ingenuity and other things that

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stimulate society and, in turn, market growth and development.

Charities are just one of the many types of corporate entities that operate in the United States. A key distinction between nonprofit charitable corporations and for-profit corporations is the lack of shareholders in the former. This means that while for-profit corporations are generally presumed to be profit-motivated institutions, nonprofit charities carry no such presumption. Instead, nonprofit charities are mission driven and are legally prohibited by the nondistribution constraint from extracting profits from the corporation for private or personal gain. Thus, nonprofit charities provide a viable alternative to the for-profit way of running a corporation - mission focused as opposed to profit focused. This alternative corporate structure - indeed, this diversity in corporate structure - in turn, contributes to the possibility and actuality of diversity in output. For example, this diversity in corporate structure means that we have for-profit corporations performing research concerning potentially very profitable drugs for treatment of HIV and AIDS, while nonprofit charitable corporations search for a far less profitable vaccine for this same disease. Imposing a tax on income incidentally earned from these mission driven activities would only serve to slow accomplishment of the mission.

In addition to being an alternative to the corporate form of organization, charities also offer an alternative to government. Like nonprofit charities, government does not have shareholders and is mission driven. However, one key difference between government and all corporations - both for-profit and nonprofit - is government's ability to impose (through law) a tax as a means of financing the production of its goods and services. The government's ability to raise capital through taxation does not mean that government has an endless supply of money, nor does it mean that government can do whatever it wishes to do with this money. Indeed, a key limitation of government activity is the requirement to obtain political support. This means that, unless the public at large is willing to support the acquisition of particular goods or services with direct outlay of tax monies, then those goods or services will not be acquired by government and, hence, will not be supplied to the public *by government*. Thus, to the extent that provision of a particular good or service has some support amongst citizens, yet lacks sufficient political support to garner government backing, it will be up to nonprofit charities to supply the good or service - financing that supply with either tax exempt profits or tax deductible donations.

Diversity as a value, however, need not be thought of as an unprincipled process approach to law that is lacking in limits or principle. Diversity as a value should be considered in context. Here, context refers to that aspect of law that requires consideration of multiple points of interest - both public interests and private interests. For example, diversity as a value does not mean that charities should be able to advance any conceivable private purpose. Thus, tax exempt charities, because of the public policy doctrine, cannot engage in invidious racial discrimination against black people. Simply recognizing that racial preferences promote diversity is not enough. Law and market theory teaches us that law must also account for racial preferences in various contexts and from various perspectives - that is, law must contextually mediate

public/societal interests and private interests regarding racial preferences. For instance, a critical race perspective of law would indicate that there is a qualitative and meaningful difference between socially beneficial race-based affirmative action (equalizing opportunities) and the societal harm advanced by racial discrimination (perpetuating racial subordination). Thus, contextual diversity would suggest that even though racial preference in the context of racial subordination is not permissible in tax exempt charity law, racial preference in the context of affirmative action may be permissible.

Context also explains other aspects of charitable tax exemption law which limit lobbying and political campaigning, private profit taking and private benefit, competitive business functions and private endowments. Granted, each of these limitations imposed on charities - including the public policy limitation - appears to impinge on what a charity may do and, thus, seem to hamper certain types of diversity. One must bear in mind, however, that the aim of the charitable tax exemption is to allow for activities that benefit public interests, not private ones. Thus, as explained in this Article, the various limitations imposed on charitable activity are all aimed, in one way or another, at contending with the individual human tendency to seek out authoritative influence to advance private objectives. In other words, the purpose of these limitations is to mediate between the private individual tendency for authoritative control and the public interests advanced by the charitable entity. Thus, the diversity value advocated in this Article is not unbridled diversity; rather, it is contextual diversity in the sense that the scope of permissible charitable activity is not without limits.

In addition to understanding that diversity as a value is not unlimited in scope, one must also appreciate the fact that the theory espoused in this Article is just that - a theory of the charitable tax exemption. Like all theories, it is not perfect and is not intended to necessarily reflect every aspect of the charitable tax exemption. Contextual diversity is not a description of charitable exemption law, but rather, an explanation of it. Indeed, just as economic analysis admittedly does not explain all that bears on the marketplace, the contextual diversity theory outlined in this Article does not profess to explain every aspect of the charitable tax exemption. However, what contextual diversity does do is offer a framework that explains many aspects of the indeterminate nature of the charitable tax exemption that are not explained, or explainable, by traditional economic theories. Contextual diversity also complements, and in many cases extends, other theories of the charitable tax exemption that also seek explanation outside of economics, such as Rob Atkinson's altruism theory and Evelyn Brody's sovereignty theory. Thus, just as the altruism and the sovereignty theories were not intended to replace the base-defining theory or the capital formation theory, neither is contextual diversity intended to replace altruism, sovereignty or any of the aforementioned economic theories of charitable tax exemption.

In the end, contextual diversity offers a normative explanation for the charitable tax exemption that can also assist - in conjunction with economic analysis - in better outlining the contours of charitable exemption law. Consider again the example of tax exempt law's public policy doctrine and its limitation of charitable activity to activity that

is not inconsistent with established public policy. Established public policy is often conceived of in application as federal governmental policy or majoritarian compliance. Contextual diversity would suggest that the adoption of the public policy doctrine was inappropriate in the sense that it was overkill. Indeed, established public policy - whatever it means - does not define the bounds of charity due primarily to the uncertain nature of what benefits the public. Instead, law and market theory suggests that the scope of charitable activity is varied, diverse and necessarily indeterminable. Charitable activity may be consistent with, have nothing to do with, or, most importantly, be completely contrary to established public policy as presently conceived. When faced with the issue of the permissibility of invidious racial discrimination by tax exempt charities, a careful consideration of the context of this type of racial preference reveals that mere racial preference was not the problem in *Bob Jones University*. The problem, as critical race theory teaches us, was the continued racial subordination of blacks long after the official end of legalized slavery. Accordingly, prohibiting racial subordination, instead of prohibiting acts that are contrary to some notion of established public policy, seems to better advance contextual diversity.

Part I of this Article provides a detailed outline of the charitable tax exemption - explaining both the affirmative aspects of the exemption and the negative aspects of the exemption. The purpose of this detailed outline of the charitable tax exemption is to position the exemption as not simply a financial free pass on the obligation to pay income tax. Rather, the charitable tax exemption is the gateway to an alternative means of operating an enterprise, with many burdens and benefits flowing therefrom that often have nothing to do with economics. These non-economic aspects of the charitable tax exemption often concern the many non-economic aspects of justice, fairness, political authority and other basic normative principles.

Part II of this Article presents Robin Paul Malloy's Law and Market Economy theory as the basis for a normative explanation of the charitable tax exemption. Law and Market Economy Theory explains the relationship between law, markets and value. Thus, using law and market theory, this part demonstrates how traditional law and economic analysis, premised on self-interest and wealth maximization, simply does not capture the essence of the many non-economic values that impact the marketplace and the market exchange process. Instead, law and market theory - which approaches legal analysis in a broad market context and is premised on sustainable wealth as opposed to maximizing wealth - proposes an alternative explanation for how law works in the social marketplace. As an illustration of law and market theory, Part II uses the example of critical race theory to show how that theory can work in conjunction with economic analysis in discerning normative rationales for law that enable richer reflections of justice and fairness that are not necessarily connected to economics.

Parts III and IV of this Article build on Part II by demonstrating how existing theories of charitable tax exemption just do not capture the full essence of the normative aspects of the exemption. Part III analyzes the traditional theories of charitable tax exemption which rely principally on economic efficiency as a guidepost for discerning an appropriate rationale. While these traditional theories have a sexy

law and economics appeal, the Article demonstrates how they fail to fully explain many non-economic aspects of the charitable tax exemption. Part IV analyzes other theories of the charitable tax exemption that focus less on economic efficiency and more on non-economic values. Though these more recent theories certainly add to our collective understanding of the existence of tax exempt charities, they still do not fully explain everything.

Part V presents a theory of the charitable tax exemption based on the value of diversity. This contextual diversity theory uses law and market theory to build on the traditional economic analysis, extends the other exemption theories that are less efficiency focused and presents an alternative value based explanation for the charitable tax exemption. Part V concludes by explaining that using contextual diversity as a principle value based explanation for the charitable tax exemption not only captures the essence of the exemption, but it also provides direction for potentially reforming and re-inventing various aspects of tax exempt charity law.

I. THE CHARITABLE TAX EXEMPTION

This section of the Article describes the many varied and complex aspects of the charitable tax exemption. The purpose of this section of the Article is to demonstrate that the charitable tax exemption is more than just relief of a financial obligation to pay a federal tax on net income. Indeed, many charities arguably do not have net income or, if they do, they seek tax exempt status primarily for reasons that have nothing to do with the federal income tax exemption. Thus, the purpose of this section of the Article is illuminate the vastness and the complexity of the charitable tax exemption - to show the important and vital role that the charitable tax exemption plays in our lives from the standpoint of justice, fairness and other non-economic values. The purpose is also to point out that, along with the general exemption from the obligation to pay income tax, tax exempt charities receive many other benefits and must bear many, many burdens. In short, the purpose of this section is to emphasize the point that the charitable tax exemption is about much more than economics. The charitable tax exemption is about market impact; it is about how the market benefits from having corporations that are profit-focused, and hence pay a tax on those profits, while also having corporations that are mission-focused, and hence, generally pay no tax on any potential profits.

II. INTERSECTIONS OF ECONOMIC AND CRITICAL THEORIES OF LAW

This section of the Article outlines two theoretical approaches to law that come together to partially explain the basis for the contextual diversity theory of charitable tax exemption: an economics based theory called law and market theory and critical race theory. Sub-part A explains the traditional process of economic analysis of law, elucidating the concepts of the economic model, economic efficiency and economic self-interest. Sub-part B presents a theory of law that is based on economic principles,

but which extends beyond traditional economic analysis to incorporate aspects of non-economic principles into an explanation of law and social interaction. This so-called law and market theory posits that law is more fully explained when economics is combined with other approaches to legal analysis to demonstrate the dynamic and ever changing aspects of human interaction. As one example of how other theories of law might compliment economic explanations of the law, sub-part C shows how critical race theory might be used as a means for explaining aspects of law that are not fully explained by economics alone. Overall, this section demonstrates how traditional law and economic analysis could be more accommodating of other approaches to law, such as critical race theory. Such accommodation could better explain the structure of law and potentially improve future development of law.

III. EFFICIENCY THEORIES OF CHARITABLE EXEMPTION

This section of the Article outlines the traditional theories for the charitable tax exemption, which are principally based on concepts of economic efficiency. These efficiency based theories explain the charitable tax exemption as either a subsidy by government for public goods, a necessary result of using net income to define tax liability, a means of compensating charities for capital constraints, payment for an entity's ability to garner donative support, or a means of compensating charities for the risk they assume in providing public goods. As this section demonstrates, each of these economic theories for the charitable tax exemption has its strengths and its weaknesses. In terms of explaining the economics for why charities are tax exempt, these traditional theories do a pretty good job. These theories are also somewhat useful in sculpting the contours of the charitable tax exemption. However, these traditional theories lack non-economic components which, ultimately, make them incomplete. These economic theories for the charitable tax exemption do not explain the existence of the many non-economic aspects of the exemption. This explanatory deficiency also means that these efficiency theories cannot fully guide us in sculpting the contours of the charitable tax exemption.

IV. EFFICIENCY PLUS THEORIES OF CHARITABLE EXEMPTION

This section of the Article outlines other theories of charitable tax exemption that go beyond economic efficiency in explaining the charitable tax exemption. These theories draw on philosophy and political theory as a means for complementing the traditional economics focus. Thus, these other theories explain the charitable tax exemption from the perspective of the selflessness (as opposed to self-interest) of the donor and the alternate political authority offered by the charitable form. These other theories of the charitable tax exemption come closer to articulating the type of contextual diversity contemplated in this article. For they implicitly recognize that much of the justification for the charitable tax exemption is not about economic efficiency. Many aspects of the exemption concern notions of justice, fairness and opportunity -

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concepts that are not necessarily translatable into economic terminology.

V. A DIVERSITY THEORY OF CHARITABLE EXEMPTION

CONCLUSION