

# A RADICAL REFORM FOR NONPROFIT TAX EXEMPTION: A THOUGHT EXPERIMENT

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*Already in America, government is tightening its grip on the independent sector. It is challenging the tax-exempt status of foundations making new efforts to “regulate” almost all private groups. An independent sector “regulated” by its competition has, at best, an uphill fight on its hands. . . . The foundation is an instrument forged by citizens who transfer profit from the commercial sector and put it directly to work as risk capital for the general betterment of the society. To say or imply that the foundation exists only on the sufferance of government is to reason from the premise that government is the whole of society.*

—Richard C. Cornuelle, *Reclaiming the American Dream*

The late economist Benjamin A. Rogge used to talk of “Rogge’s World,” that ideal arrangement of institutions which he would have established had he been in charge (not that he would have agreed to be put in charge if asked). This was a thought experiment he used to consider the implications of better social configurations from a free-market perspective. Rogge, I think, was aware of how difficult and even dangerous it is to approach social reform in a constructivist mode, because of unintended consequences and secondary effects. Institutions have been built up over long periods of time, and countless individuals have made life choices on the basis of existing arrangements. For many, radical changes will bring unexpected and undesired difficulties that will not be obviously balanced by the theoretically improved institutional setting.<sup>1</sup> Nevertheless, thought experiments exploring ideal worlds can demonstrate interesting possibilities and help guide more incremental change.

With this in mind, let us look into the institutional setting of tax-exempt philanthropy, with improvements in mind. This is a good time to do so, because various congressionally sponsored reforms of nonprofits—reforms which are not always friendly toward philanthropy—are circulating in political circles. A list of these proposals includes: requiring greater annual payouts from charitable endowments; requiring philanthropies to spend more on politically favored minorities or minority-managed

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enterprises; requiring minority and female “representation” on foundation boards; and increased auditing of philanthropic accounts. Most recently, some politicians have been considering limiting the tax deductibility of charitable giving by “the rich.”

### ***Government Entanglement***

This is a thought experiment about an ideal world. It is not a plea to increase taxes on nonprofits. Indeed, this writer believes that all of America is vastly overtaxed. What is needed, however, at whatever level of taxation we settle on, is a new consideration of the effect of tax exemption on the status of American philanthropy. Upon such examination, I think we will find that the tax-exempt status cannot be justified and is not needed in order to have a vibrant nonprofit sector.

Congress grants tax exemption to certain nonprofits on the condition that they spend their resources on activities in the public interest. This tax-exempt status of philanthropic organizations and other nonprofits sets them apart from other institutions of civil society, most notably families and for-profit businesses. From the point of view of the philanthropies, this suggests that they have some superior status, and it too often produces a “do-gooder complex” that separates them from the world of getting and spending that produces the wealth off of which they live. From their perspective, they are endowed by law with a lofty public purpose that leaves them unsullied by crass materialism. In recent years this status has encouraged many philanthropies to identify closely with the actions of government, because government, whatever its real purposes, always boasts of its special devotion to serving the public good. Note how many philanthropic leaders now argue that the main purpose of their organizations is to develop a case for the further expansion of government programs. Yet as recent scholarship indicates, government on net is an insatiable consumer of personal wealth far beyond what its positive effects on the public good can possibly justify. Furthermore, government actions, more often than not, actually promote explicit and identifiable private interests in opposition to any possible public good. This is one aspect of the problem of faction, famously discussed by Madison in the *Federalist Papers* and under scrutiny today both in public choice theory and in the investigation of cronyism.

To put this point more bluntly, both donors and recipients, whether acting privately or through public institutions, face the temptation of moral corruption in their efforts to do good. They do not need the added endorsement of tax exemption to increase this danger.

The growing alliance between philanthropy and government is unfortunate, for we should view our diverse nonprofit organizations as constituting just one aspect of

the vast civil society outside the realm of government, where work, savings, and private endeavor provide the great bulk of resources necessary for personal and social well-being and for economic and cultural progress. It is civil society, not government, that provides most of the heavy lifting that produces public goods. From this perspective, government, when confined to its proper role, should be viewed as a limited-purpose agent, or utility (as Dick Cornuelle often put it), of the larger civil society, a true servant of the people and not the dominant force in social life.

Seen in this light, it is clear that tax exemption for private philanthropy helps sustain a false sense of separateness that detracts from a proper understanding of the true place of philanthropy in a free society. It encourages the state to believe it has the power and the duty to give tax exemptions only to those nonprofits it deems as working in the public interest as defined by the state itself. It permits the government to funnel money to those nonprofits it favors (a sort of Solyndra-ization of philanthropy; see Husack 2011), while increasing the nonprofits' dependency on the state.

### *A Host of Harms*

There are additional harmful and less philosophic elements in the favored tax treatment of philanthropic enterprise. First, Government views Philanthropy, with its growing wealth, as a potential source of new tax funds, and the threat of the loss of tax-exempt status undermines philanthropy's independence.

Politicians continually threaten philanthropy with new taxes and regulations unless the philanthropies conform to what the politicians deem to be socially useful projects. Congressional hearings and IRS investigations of philanthropic wealth and expenditure have happened in the past. Political demagogues will surely be tempted to turn again to such tactics one day, especially if Congress really gets serious about government debts and deficits. The possibility of such threats may encourage philanthropies to be too complicit with the explicit pronouncements of their political supervisors. Because of the constant possibility of increased government supervision and regulation, many philanthropy executives govern more on the basis of unduly cautionary advice from their attorneys than by creative and bold thinking about how to carry out their philanthropic mission. In this they are not too different from many for-profit firms also fearful of government notice and greater regulation.

Second, tax-exempt philanthropies, with their ability to buy and sell securities free of the capital gains tax and the income tax paid by individuals and for-profit corporations, are able to unfairly compete with private taxable endeavors. This is a growing problem as the business wings of nonprofits increasingly engage in

commerce (such as bookstores and museum shops) and the provision of social services, widely conceived (including hospitals and educational institutions), and compete directly with private, for-profit ventures. If business income is to be taxed at all, it should be taxed everywhere.

Third, the tax-exempt status of philanthropies promotes ill-considered philanthropic investments and institutional arrangements. For instance, a property owner who gives land or buildings to a historical preservation or conservation nonprofit only to avoid burdensome taxation takes valuable property out of productive enterprise and freezes in place the status quo at the cost of some economic benefit to the society at large. Family fortunes may be turned into hastily conceived foundations run by non-family philanthropic professionals with purposes of their own, different from those of the original donor. Or worse, perhaps, run by family members with large salaries. Without tax-exempt status and death duties, such largely irreversible decisions would be less attractive, and fewer resources would be spent devising complicated trust arrangements.

These two problems—unfair competition and inflexible institutional arrangements—increase the suspicion with which both government officials and private individuals view the operations of many nonprofits.

Fourth, a related question is the problem of perpetuities, a suspect category under common law. Times change, but nonprofits, in theory at least, can go on forever. For-profit corporations appear also to be immortal, but they can be bought and sold, merged with other corporations, go bankrupt, or distribute their assets to their shareholders. Subject to competitive pressures, in practice no American for-profit corporation has the lifespan of a Harvard University, a Carnegie Endowment, or a Chicago Symphony Orchestra. Only one company on today's Dow Jones Index of thirty stocks, General Electric, was there at the beginning of the Dow Jones Averages. Without tax-exempt status, a philanthropic-minded individual might be willing to develop more flexible and less permanent institutional arrangements for his financial legacy, situations in which complexity and contingency could be more easily dealt.<sup>2</sup>

Fifth, as nonprofits increasingly become subjects of political controversy, civil peace should be improved by removing their tax-exempt status. People opposed to a particular group would no longer feel aggrieved that it was getting favored tax treatment at their expense, and the controversial group could no longer be threatened by hostile politicians seeking to punish them by removing their tax-exempt status. Consider, for instance, the controversy in the 2011 budget surrounding the government funding of Planned Parenthood.<sup>3</sup> Many hundreds of other tax-exempt groups get government grants as well.

Sixth, without annual payout requirements, both donors and recipients would

be released from the pressure of annual deadlines to complete gifting and expenditures and could be expected to make more considered judgments on what projects to fund or develop.

Looking at philanthropies as if they are categorically different from other institutions of civil society generates such problems. If we instead view philanthropies as more generically part of the civil order, engaged in many of the same endeavors as private individuals and businesses, we begin to see that they are not as different from the for-profit world and from private families as usually assumed. Like businesses, philanthropies provide jobs and social services (employment bureaus, credit counseling, retirement plans); purchase and sell goods (museum calendars or “fair trade” coffee); run medical care and research facilities (hospitals and laboratories); and provide cultural and environmental amenities (fine architecture, art collections, universities, libraries, golf courses, nature preserves, and office parks). Both may charge fees for goods and services, though the nonprofit may give away many of its services. However, for-profit businesses also donate many goods and services to worthy causes and persons and contribute time and money to nonprofit entities. The nonprofit, like the heavily taxed family, may provide most of its goods free of charge, yet the family in a free society is by far the more important social service “agency,” providing most of our education, cultural upbringing, medical care, food, clothing, and shelter. We usually think of these as private goods, and truly they are, but the successful delivery of such goods also has profound social implications for the overall health and well-being of the social order. Considering the family’s greater contributions to society, it is not clear why they should bear the brunt of taxation while nonprofits, which are much less important to society, remain tax-exempt. It would be better to tax both at some low, uniform rate.

### ***Tax Reform for the Philanthropic Sector***

A tax structure that acknowledged the similarities between the philanthropic sector and the rest of the private sector, indeed the overlapping and intertwined functions and duties of the two forms of corporations, as well as the associations, clubs, and families (which taken altogether constitute civil society), would look much different from what we have today. By reforming the tax structure, we would bring the activities of the two sectors into harmony instead of continuing to perpetuate rivalry between them, and would serve, over time, to blend them together into the one sector that they truly constitute, different from government, because they are based on voluntary rather than coerced relationships. Such a harmonization of interests would strengthen the institutions of the free society in

general while restraining the tendency of government toward unchecked growth. Philanthropies should stop being the compliant handmaidens of government and resume their rightful place in the civil society.

Another benefit of moving the nonprofit, for-profit, and private institutions closer together would be the mitigation of various troubling social conflicts. For example, consider the following questions, a few from a long list: By what criteria are 501(c)3 applications for tax-exempt status to be judged? What institutions deserve 501(c)3 status by these criteria? Who determines which organizations these are? Does the IRS harass politically unpopular nonprofits, or do Congressmen, through threats of their own, implicit or explicit, attempt to influence nonprofit giving? How far may nonprofits go in advocating social change or proposing or opposing a particular political agenda without calling their tax-exempt status into question? Do political leaders use the IRS to investigate and intimidate their political enemies among the nonprofits? For taxation purposes, what is a church? What government regulations should be applied to church activities? What revenues of tax-exempt entities should be designated “unrelated business activities?” What actions of foundations should be prohibited as self-dealing? Should the names of donors to nonprofit organizations be publicly disclosed?

All these questions are frequent subjects of public controversy. Absent tax exemption, none of these questions would need answers. With tax exemptions, the chance of inflammatory political and partisan answers to these questions becomes increasingly likely.

When we begin to think about such issues, the usefulness of our thought experiment becomes clear. In the ideal world of the thought experiment, there should be no nonprofits. All income on investments and sales of goods and services by any entity would be taxed at the same low, flat tax rate. Nonprofits would pay local sales and property taxes like any other organization. Groups without endowments, living off of annual giving alone, would still be largely de facto tax exempt because there would be no retained profits to tax. The main tax revenues they would generate would come from taxes on the income of their employees, as is the case today. Churches might have to pay property taxes, if any existed, but local governments could provide property tax exemptions to churches, museums, open space, nature preserves, and historic properties if they cared to do so, on a nondiscriminatory basis. An even better policy would be to attempt to keep property taxes controlled at some low level through constitutional restraints, in order to reduce political meddling and social engineering. To maintain equal tax treatment, there would be no death duties and no capital gains taxes on anyone. In

order to make this new system of taxation work and to keep income tax rates low enough to encourage productive endeavor and discourage new reasons to create tax-favored entities, deductions on personal income taxes for charitable giving, mortgage interest, medical expenses, and so forth should be abolished also. Only deductions for local and state taxes paid would remain, in order to avoid double and triple taxation of income. There could also be some “basic living” exemption for each member of a family.

Time and careful design would be necessary in order to engineer the transition to this new system with a minimum of disruption and unfairness. No doubt tax policy experts would perceive other problems and difficulties in this proposal that should be addressed. There probably are some undesirable and unintended consequences that would emerge. A serious discussion of such matters should lead to a more complete understanding of needed reform.

### ***More Money for Philanthropy***

Would such a radical reform mean the death of nonprofits and the loss of their important contributions to overall public well-being? Not at all. “Nonprofit” need not be synonymous with “not taxed.” Increased national wealth from a more efficient tax system and the elimination of the huge economic loss created by estate planning, tax avoidance schemes, income tax preparation, and consultant fees to accountants and lawyers would leave both individual donors and nonprofit organizations with more money to spend on charitable activities. Here in the United States, at least, the amount of personal disposable income, not tax avoidance, is the primary determining factor in the amount of charitable giving. Certainly the removal of tax exemption would change the nature of nonprofit activity in unpredictable ways. Nonprofits might be more willing to spend down their resources. They might be more adaptable to changing circumstances. Public charities might come to rely more on annual giving and become less concerned with building endowments. Most Americans with discretionary income would continue to support their favorite philanthropic institutions and would be able to do so more generously than before.

Viewed in this way, reform of the tax-exempt portions of the tax code becomes one phase of the larger question of reform of American taxation in general. Everyone acknowledges that whatever the total incidence of taxation should be, our tax code needs radical simplification. Despite this widely held understanding, so far politicians have largely remained unwilling to do much about this scandalous situation, surely in violation of the spirit of the Constitution. They appear to believe that handing out tax advantages to favored groups is a key

to their political success. In recent years a few members of Congress, political candidates, and public intellectuals have questioned this conventional political wisdom and have begun to advocate a major overhaul of the structure of our tax system, though there is hardly a strong movement in this direction. This may be the right time to reconsider the issue of tax exemption for nonprofits as well.

Perhaps only constitutional reform can ever bring major changes in the nation's tax structure. In the meantime, further research and thought experiments may help, over time, to influence the public discussion of the place of nonprofits in our society. While we contemplate, as Professor Rogge would have had it, the ideal structure of larger institutional changes, we should be sure to include in this discussion an investigation of the tax status of the nonprofits. Indeed, this would be a good project for a forward-looking foundation to fund as part of its own philanthropic reform efforts.

#### NOTES

<sup>1</sup>For instance, making mortgage interest deductible ostensibly to help homeowners probably increases the listing prices of home sales, and whatever financial benefit exists may largely accrue to the lender, seller, and the real estate agents rather than the homebuyer. Once such a system is in place, however, it becomes difficult to unwind it in a fair way.

<sup>2</sup>Some foundations have dealt with this problem by intentionally sun-setting their operations.

<sup>3</sup>For instance, this appeared on *National Review Online* while I was revising this essay: Planned Parenthood to Be Investigated September 27, 2011 4:07 P.M. By Charmaine Yoest. Sarah Kliff of *Newsweek* just broke the news that Cliff Stearns (R., Fla.), chairman of the subcommittee on oversight and investigations for the House Energy and Commerce Committee, has launched an investigation into Planned Parenthood. She links to a detailed two-page letter that outlines eight in-depth questions the abortion giant must respond to, including a release of all of their internal audits for national Planned Parenthood and their affiliates since 1998.

#### REFERENCES

Husack, Howard. 2011. "The Solyndra-ization of Philanthropy." *The Wall Street Journal* (October 28, 2011). <http://www.manhattan-institute.org/html/miarticle.htm?id=7569#.UT9rqFetqM0>