SECOND THOUGHTS ON THE TAX TREATMENT OF AMERICAN PHILANTHROPY

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The essays by William Dennis and Robert Atkinson suggest possible reforms of the tax treatment of American philanthropy. In this commentary I review and critique their proposals and identify some further problems these potential tax code changes would cause.

As things currently stand, nonprofit entities enjoy two kinds of tax advantages over for-profit entities. These roughly correspond to the expense and revenue sides of the nonprofit balance sheet. Nonprofit corporations need not pay income tax, need not pay property tax on the land and buildings they work in, and often need not pay sales tax. Regarding income (and donated capital) for nonprofits, donations to nonprofits enjoy tax-deductible status. These arrangements have grown up over a number of years through a variety of motivations—a classic camel as a horse put together by a committee.

Not So Different After All

One problem with this differential tax treatment is that nonprofit entities may not be quite as distinct from their for-profit counterparts in real life as they seem to be in the tax code. The distinction between nonprofits and for-profits is based on a combination of their purposes and the disposition of remaining funds after costs are paid out of revenues. Essentially, if the IRS deems the mission of a corporation to be a charitable one, broadly defined, and the residual claimant to any profits is the enterprise itself, the entity may be registered as a nonprofit. It makes little difference that some activities of a nonprofit might be more or less identical to those of a for-profit. Art museums operate small restaurants that can compete with nearby commercial restaurants. Goodwill Industries solicits donations of used cars that they refurbish and auction, much like any other used car dealer. The primary mission of such nonprofits, though, is supposed to be

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something in the public interest: to display great art to the public or to provide job training to the handicapped, for example. In addition to business activities, the financial strategies of for- and nonprofit firms also bear a close resemblance. Reinvestment of non-distributed profits is a common strategy of private, for-profit firms as well as nonprofits. The nonprofit's goal is not to earn profits for its owners, but it cannot run in "the red" consistently over a long period either, so striving for income to regularly exceed expenses is a necessity.

Further muddling the picture are situations in which for-profits and nonprofits are in direct competition with each other. As Dennis notes, art, science, and history museums often operate bookstores that sell titles related to the museum's exhibits. The impact of such competition is complex. On the one hand, tax-exempt status helps nonprofits compete against other bookstores; on the other, it was not museum bookstores living on impulse purchases that killed Borders. A thornier case in the same industry, however, involves university and privately operated stores that sell expensive textbooks to students. Why the university operation should not be taxed while the private firm next door pays taxes has no clear rationale.

In some industries for-profits and nonprofits contribute to more or less the same production process, but with no clear *a priori* rationale for the profit-making status of each component. Consider the health care industry. Not only do for-profit hospitals compete directly with nonprofits, but it is unclear why nonprofit hospitals enjoy tax-exempt status while closely related pharmaceutical and equipment manufacturers, physician practices, and health insurers bear the usual tax liabilities. Whatever a hospital does to contribute to public health and well-being, it could do little of it without surgical equipment, drugs, doctors, and money.

The point of these observations is to note that whether an enterprise is by some standard primarily philanthropic or primarily profit-making is a judgment call. In our polity we have left this judgment to the IRS. The papers presented here raise the question of whether that is the best we can do. Both authors, but particularly Atkinson, emphasize that there are two kinds of charitable activity. One promotes excellence in human creative activities, a good example of which would be an art museum; the other promotes the well-being of the poor and unfortunate, such as a soup kitchen. A vigorous civil society provides for both, and as things stand in the United States, both types of enterprises receive the same tax treatment, which is to say for the most part they are exempted from payment of most taxes (through the corporate tax-exemption), and gifts reduce their donors' tax liabilities (through the personal charitable deduction). In the end, however, Dennis and Atkinson present two very different alternative reforms.

Dennis proposes that the preferential treatment of nonprofits is unneeded and that they should receive identical tax treatment as for-profits. Atkinson proposes that tax exemptions be narrowed to the types of philanthropic activities that promote "neoclassical republican" ideals. I suggest that Atkinson's proposed reforms are poorly supported in argument, unclear in intent and operation, and overall a complete nonstarter. On the other hand, Dennis' proposals seem well-grounded in argument and at least worth considering in part.

New, Uneven Burdens

Dennis proposes that both culturally creative and social welfare enterprises be taxed, and taxed in similar fashion, though at a lower corporate rate than currently prevails. I think there are hidden problems in this proposal that perhaps not even Dennis would want to see come to pass. The hidden problems concern the distinction between the two kinds of philanthropies. The charities that promote excellence tend to be rich, and those that provide social services tend not to be rich. Well-endowed foundations, hospitals, and universities, as well as nationally known charities such as the Red Cross or the USO, could probably manage the increase in their costs that taxing would represent, without dramatic consequences. On the other hand, the truly Tocquevillean efforts, such as local soup kitchens, churches, Boy Scout troops, Little Leagues, homes for the mentally challenged, and the like, would find the increased fixed costs that new tax accounting rules would impose to be more burdensome. Little tax revenue would be obtained by taxing such close-run operations, so it is questionable to saddle them with new burdens of reporting and compliance. It would be reasonable to respond that such mom-and-pop charities spend about what they receive in donations, and so are likely to face little tax exposure under Dennis' proposal. Still, arranging to pay taxes accurately must be more expensive than applying for nonprofit status, and to that extent the costs of this proposal fall disproportionately on the smaller, Tocquevillean charities. In addition, wealthier institutions are funded and managed by people who already know how to minimize their tax exposure, and that kind of human capital would make it easier to minimize the tax exposure of their philanthropies. As a result, tax treatment of nonprofits would end up looking much like the current treatment of for-profit corporations: the largest find ways to avoid paying. A better way toward tax equality might be to eliminate the corporate income tax entirely and focus on personal income taxes.

Dennis points out another potential problem with tax exemption for nonprofits: the politicization of the process by which the government designates an enterprise as tax-exempt. At present it is much more likely that a nonprofit will lose its tax-exempt status through a paperwork snafu than because it offended the government. But the sword of Damocles is there, and the state could easily identify a nonpolitical charity as having violated some political rules that would lead to the loss of its exemption. An art museum might want to sponsor an exhibit that some find obscene or blasphemous—or it might want to cancel an exhibit some find obscene or blasphemous. The Boy Scouts might want to exclude homosexuals from leadership positions. An African American church might wish to invite an ordained politician to preach at a service. The possibilities are numerous. In each case, the possibility of losing its tax exemption may make a nonprofit less likely to act according to its original purpose, and more likely to submit to the government's desires when deciding on a public course of action. If exemption were removed, the government could no longer threaten a charitable entity with dire financial consequences. Charities then could do as they pleased without concern for the state's reaction, at least in tax code terms. Uniform taxation of for- and nonprofits might actually, then, lead to a greater degree of free speech. Another rather indirect benefit would be the end of abuse of nonprofit status, as businesses such as the National Football League and various political groups were reclassified as for-profits (*Forbes* 2012). Still, as I urge above, we should hesitate to give the state one more reason to impose new kinds of taxes. Dennis' arguments for equal treatment, which I extend here to First Amendment considerations, could easily be seen by government tax authorities as an opportunity to raise additional revenue from an unexpected source. Recently, European governments have proposed taxing church properties—primarily Catholic (*Washington Post 2012*). Local 5officials note that the Church holds substantial properties in its churches, schools, hospitals, and other operations, and they argue that "costs of the crisis should be borne equally" by Church and people alike. However, it is not clear that the European fiscal crisis is a result of the churches contributing too little instead of the state spending too much. In addition, Catholic Church assets, like many of those belonging to charities, are illiquid and probably in the best hands available to manage them. Should the Vatican really sell the Sistine Chapel to Disney, so that Italian or European Union politicians can have more tax revenues to spend on their cronies?

Advantage: State

This question brings us to Atkinson's proposal, which in effect might actually accomplish just such a political takeover of cultural endowments. Atkinson proposes that the deep problem is not that nonprofits are tax-exempt but that the *wrong* nonprofits are tax-exempt. In place of the messy and very Tocquevillean diversity that characterizes the present-day nonprofit sector, he would organize tax favoring of charities according to "neoclassical republican principles." This dispensation would not favor just any old charity, but would recognize only "the most efficient provider in terms of real productive efficiency." And which organizations must surely be among those most efficient providers in terms of real productive efficiency? They would not likely be religious, as such entities are encumbered with those ridiculous "purported divine revelations." In Atkinson's view, removal of "the current system's heavy hand on the private side of the scale" would make the logical choice of manager the state (2012, 19).

The expansive array of problems inherent in this notion begins with questions regarding the standard by which nonprofits are to be judged. Apparently Atkinson is counting on the revelation of some esoteric expertise in devising a metric for efficiency in charitable service provision that has not been revealed to other mortals. Here we run squarely into the economic problem of nonprofit management: there is no robust way to determine outputs of philanthropic activity, and hence no such measure of "real productive efficiency" exists. Nonetheless Atkinson claims that private charity, by this nonexistent yardstick, falls well short of government provision of said services. This is simply argument by assertion, and Atkinson does not even offer any examples. Is Yale less productively efficient than Berkeley? Is the Cleveland Orchestra brass section less productively efficient than the Marine Corps Band? Are church-run soup kitchens less productively efficient than school lunches? Perhaps the best lesson to be drawn from Atkinson's essay is that we might expect dire consequences for the nonprofit sector if experts are put in charge of revising our tax code.

I would also caution the reader to judge with great care the few factual tidbits that Atkinson's essay does adduce in support of its thesis, which is in essence a new apologetic for the ubiquitous paradigm of "public-private partnerships." Much as President Obama recently remarked that the entrepreneur is not responsible for his own success, Atkinson proposes that government has played an important role in the development of institutions such as Yale University that was overlooked by Tocqueville. Indeed, the colony and then state of Connecticut proved to be a generous donor to the school, but to paraphrase Mickey Mantle on naming his son Mickey Jr., at that time Yale wasn't Yale yet. Yale was similar to many such collegiate institutions that hopeful towns founded as a way to draw people in, and as such was indeed a Tocquevillean venture. The early Yale College was a struggling school for prospective Congregational clergy, at a time when Congregational institutions throughout the state were subsidized. By the time Tocqueville published the first volume of *Democracy in America* both Massachusetts and Connecticut had disestablished the Congregational church. Yale's success, then, depended on the success of its early administrations in developing a workable business strategy that brought together market forces (students eager to learn, books being published, the possibility of large-scale construction, etc) and the philanthropic motivations of Congregationalist donors and others.

Atkinson also profoundly misrepresents Thomas Jefferson's approach to publicly funded education. Jefferson did not found the University of Virginia simply to have a taxpayer-supported university that he could view from his front porch. He wanted a university in Virginia that was dedicated to public service (rather than ministerial preparation) and could see no other way to provide one than to found it himself, with the aid of the state government. But Jefferson in no way believed that the purpose of public education was to "[e]nable everyone in the Republic to become a leader of the Republic," as Atkinson suggests. That is a facile reading of his intent; Jefferson was no democrat. He wanted to educate an elite. His university was to take in very few young folk from the lower sort. According to *Notes on the State of Virginia* (Query XIV; emphasis added), under Jefferson's educational plan "twenty of the best geniuses will be raked *from the rubbish* annually," after which the remainder of the rubbish presumably would return to being ground into dust (1984 [1787], 272). Jefferson's attitude toward the general populace of the Republic suggests why we need a tax policy that will enable a broadly based philanthropy to thrive, one that responds to social needs and opens real doors for opportunity by engaging as many people as possible as contributors of money and time to participate in the creation of culture and the provision of social welfare.

In the end, the broadening of opportunity will not happen by giving the state greater discretion in judging the merits of specific corporations or voluntary associations. The merit of such enterprises may not be in their economic efficiency but in the willingness of people to voluntarily participate in them. The entities that survive will be the real schools of citizenship. Whether we can realize the promises of American freedom to provide opportunity for all citizens by taxing nonprofits on the same basis as for-profits, as Dennis suggests, or if the status quo is the best we can expect, remains to be seen. This much is clear, however: to narrow the playing field by giving more power to government to determine which activities merit public preference, as Atkinson suggests, is a step in the wrong direction.

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