Public Policy and the Tax Treatment of Philanthropy

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Introduction

The question of whether a tax credit is a better device than a tax deduction for encouraging charitable contributions has given rise to a debate in Canada. A *tax credit* allows one to reduce one's tax bill by the amount of the credit. A *tax deduction* allows one to reduce taxable income by the amount of the deduction. This article provides an overview of that debate, highlighting the peculiar biases which have arisen in this policy area as a result of a preoccupation with taxation often divorced from its consequences for philanthropy. It suggests that the fundamental policy issue is whether to encourage more private giving or rely more heavily on direct public funding to meet increasing social demands. If it is determined to encourage increased individual contributions to the general welfare of society, then there is a broad range of tax measures designed to promote philanthropy which merit consideration.

At the outset, it is necessary to note that it is normally considered wise public policy to encourage charitable activity. The premises on which this policy is based vary but usually include the assumption that philanthropic institutions perform socially essential work that otherwise would have to be carried on by government agencies and that can be performed with more empathy, imagination, diversity, flexibility or economy by private groups. Private charitable action has certain qualities which are indispensable to an enlightened and free society. Private charitable institutions can provide freedom of choice and competition. They can set standards and experiment in areas too controversial for governmental bodies. Their independent status allows them to monitor and evaluate publicly governmental performance in the various areas of health, education, culture and social service. They can fill vital gaps in publicly provided services and offer a means for greater citizen participation in social action. They can help safeguard intellectual and artistic freedom and civil liberties. Finally, they can engage in the definition and preservation of society's highest values, especially those of a spiritual and religious nature.

Recently, public concern over the growth of our major public and private institutions has given rise to a widespread opinion that independent centres of power with a large measure of private control should be encouraged, even if their functions could not be assumed by governmental agencies in the absence of private support. Accordingly, private charitable institutions, relying heavily on tax-deductible contributions from the general public, have undertaken to perform services which the government should not or cannot provide. Critics of such tax deductions maintain that these tax deductions permit what is essentially "private" disposition of "public" funds. Such criticism fails to take into account that so-

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called "public" support of these private choices in effect means that money is directed to philanthropic activities that can command the support of independent private donors who are putting their own money on the line. Allowing a citizen's dollar to be a direct vote for the relative priority of charitable activities encourages diversity in the ways we achieve our social objectives ard provides a testing ground for public evaluation of communal goals.

There is a variety of means by which government can encourage such activity. Government can supplement direct aid programs with indirect financial assistance such as exempting charitable organizations from taxation or through the promise of matching funds and the provision of supplemental services. It can create a stable legal framework within which charity can operate with assurance. It can regulate and supervise charity in such a way that the public has confidence in it. It can help create a favourable climate of public opinion through dissemination of information concerning private attempts to meet social needs. It can also stimulate individuals, estates, and corporations to contribute to charity through special arrangements in the tax system.

Regulation by Taxation

Since the tax reform debate which began in the mid-1960's, the tax scene in Canada has been marked by intense study and frequent "reform". Yet there is little evidence that concern with the effects of taxation on private philanthropy has preoccupied the attention of policymakers during this period.

The deduction for charitable contributions first appeared in Canadian income tax laws in 1930 and has changed little since.[1] As is the case with so much of our tax law, the major rationale for the provision seemed to be a decision to follow the lead of the United States which had introduced a similar deduction in 1917.[2] The purpose of the deduction appears to have been to encourage wealthy taxpayers to contribute to charity.[3]

The ceiling for the charitable deduction, individual and corporate alike, was for many years limited to 10 per cent of income. Curiously, in light of the supposed rationale for the deduction, analysis of income tax returns reveals that taxpayers with the lowest incomes appear to be the group most likely to approach the ceiling.[4] Yet the Royal Commission on Taxation (the Carter Commission which reported in 1967) while stating that a tax credit would be more equitable than the tax deduction, nevertheless dismissed the tax credit proposal without discussion as tending " . . . to stifle charitable giving by upper-income individuals and families".[5] Similarly, it dismissed a floor on charitable contributions—only the excess was to be deductible based on the premise that "...a limit of this nature might tend to restrain charitable giving by upper-income taxpayers that the allowance is designed to encourage".[6]

In the end, all the Carter Commission recommended was that the existing 10 per cent limit be raised to 15 per cent, for individuals only,[7] although ultimately this proposal was made more generous, with the new limit being set at 20 per cent for individual and corporate taxpayers alike. Throughout the debate which ensued after the Carter Commission Report until passage of the 1971 Tax Reform

Act, little mention was made of the charitable deduction. Instead, the political debate focused on whether or not to add certain kinds of organizations to the list of eligible recipients and whether or not to exempt donations to privately-owned museums open to the public from the 20 per cent ceiling, as was already the case for similar publicly-owned facilities.[8]

What emerges from a review of the tax reform debate is a clear preoccupation with tax issues, divorced from their consequences for philanthropy. Not surprisingly then, to the extent that philanthropy has been singled out for attention, the focus tends to be on the tax treatment of recipients, rather than on incentives for donors. Aside from the increase in the ceiling for charitable contributions as a deduction from income, the introduction of a capital gains tax with deemed realization at death or gift and the related abolition of federal estate tax and various provincial succession duties, post-Carter-Commission activity has primarily been confined to various responses to public concern about recipients.

As noted by one commentator, ". . . the tax administration system is more concerned about policing the organizations than they are (sic) about the charitable character of the gift".[9] Hence, following four years of study by an interdepartmental committee, the thrust of the proposals contained in a Disclosure Paper tabled with the June 1975 Budget was to require more public disclosure of the activities of registered charities and to limit possible spending abuses on the part of private foundations.[10] Similarly, (as reviewed in the Summer, 1982 issue of *The Philanthropist*), the government's most recent succession of budgets reflected a suspicion of the spending practices of foundations, rather than a commitment to promote, or even clarify, the broader policy objectives of philanthropy.

This bias should not be surprising. Indeed, proponents of tax incentives for philanthropy must recognize that there are drawbacks to any tax measures designed to apply specifically to private philanthropy. Because such incentives place philanthropy in a tax context, they render philanthropy, as a whole, subject to the perspective of tax administrators who tend to focus attention on the collection of tax revenues rather than the philanthropic objectives of tax incentives.

Tax Reform to Stimulate Private Giving

It is this vulnerability which, perhaps, explains the lack of political support which the National Voluntary Organizations' "Give-and-Take" proposal has been able to achieve. Certainly, the proposal is neither radical nor novel. As early as 1974, the Canadian Council on Social Development drew public attention to the lack of incentive to private giving inherent in the $100 standard personal deduction provision of the Income Tax Act.[12] Commenting on that study, a *Toronto Star* report suggested that personal donations be made creditable against tax payable instead of deductible from taxable income.[13]

Nor is there a lack of available methodology for analysis and research if the government were committed to a serious consideration of the policy issues underlying the "Give-and-Take" proposal. For example, an extensive econometric analysis of U.S. data concluded that a tax credit could be designed to be no more costly to the Treasury than the current deduction (without considering the policy arguments concerning whether it *should* be no more costly). Further, it suggested that such a credit would tend to reduce donations made to education, hospitals and social service organizations while increasing contributions of a religious nature. The study's reasoning was that shifting from a deduction to a credit of equal revenue cost could not increase overall giving but would change the distribution of giving from higher-income to lower-income taxpayers, who tend to favour religious causes.[14] Unfortunately, little such Canadian analysis has been undertaken.

The most compelling point made by the National Voluntary Organizations is the need for more explicit consideration of the tax effects on philanthropy following a comprehensive review of the role of private philanthropy as an instrument and objective of public policy. If, as we would urge, the government responds to such a mandate, it should not, at the outset, limit itself to considering the relative merits of deductions versus credits. First, the rationale or purpose for public policy favouring philanthropy must be clarified. Then there is a broad range of proposals designed to support private philanthropy through the income tax laws which may merit consideration.

Reforming the Deduction

Incremental reforms could be made to the current deduction for charitable contributions. Of these, two possibilities immediately come to mind. The first would be to repeal the percentage limits on the deduction. While such reform would have little immediate impact, since neither individual nor corporate donations have ever approached the current ceilings, it is difficult to understand the current limits other than as a compromise between those who believe in a deduction and those who would repeal it.

A second proposal, which would have immediate impact, would be to enact a modest floor, permitting the taxpayer to deduct contributions only if they exceed this amount. Empirical analysis[15] suggests that a modest amount of charitable contributions would be forthcoming regardless of the deduction so that a "floor" related to the taxpayer's income (such as is currently applicable to the deduction for medical expenses) would contribute to administrative simplicity and, arguably, have a minor positive effect on government revenue, without significantly impairing the incentive effect of the deduction. National Voluntary Organizations reports that 90 per cent of taxpayers claim the standard $100 deduction which, in their view, offers taxpayers an incentive not to give to charities.[16] A modest floor would eliminate this perverse result.

Corporate Giving Through Shareholders

Public policy concern with issues relating to corporate accountability has recently focussed on the use of existing proxy mechanisms to facilitate shareholder participation in corporate decision-making. This mechanism could easily be invoked to encourage corporate charitable contributions made in accordance with the wishes of individual shareholders in proportion to their interest in the corporation. One such proposal, recently tabled in the U.S. Congress, would provide that dividends paid by a corporation directly to charitable organizations at the direction of a shareholder shall be treated as a charitable contribution to the organization and excluded from the income of the shareholder.[17]

Under the current income tax structure, corporate charitable giving is encouraged because corporations can give out of pretax income up to the 20 per cent ceiling. As noted in a recent study prepared by The Canadian Centre for Philanthropy,[18] very few Canadian corporations approach even two per cent. If, however, companies pay dividends to individuals or foundations which subsequently make charitable gifts, in effect, nearly half of the corporate earnings are diverted to taxes.

To avoid this result and encourage direct shareholder participation in corporate charitable decisions, shareholders might be afforded the opportunity to forego one or more quarterly dividends and, instead, instruct the corporation to forward it to a particular charity augmented by an approximately equal amount from the corporation's pretax earnings. Assuming a 50 per cent marginal rate and that the shareholder would have otherwise donated an amount equivalent to the dividend to the charity, the corporation and its shareholders are not prejudiced by such a proposal. The charitable organization, however, would become eligible for twice the funds it currently receives while the corporation's tax payment would be reduced by half that amount. So long as the shareholder was not imputed to have constructive receipt of the dividend, the net effect would be to produce less support for the federal government and more for charitable organizations which can convince corporate shareholders that their programs are worthwhile. In addition, the proposal would introduce a small element of corporate democracy as shareholders would be able to direct funds from the corporation to the charities of their choice.

Matching Grants

It has been suggested that private, as opposed to government, "philanthropy" is much less important in Canada than in the United States.[19] Indeed, the same authors postulate that one reason there has been little concern with the effects of taxation on private philanthropy in Canada may be because private philanthropy is, on the whole correctly, not considered to be very important. We argue that this observation, if accurate, should reflect a deliberate policy choice rather than the path of least resistance. It does, however, explain why Canada appears to have somewhat more experience than the United States with matching-grant programs for contributions to charitable organizations.[20]

Referring to the English matching-grant system,[21] several U.S. commentators have recently urged the formulation of a model for a direct system of federal support to charity to replace the tax deduction.[22] Setting aside the merits or otherwise of such a proposal. it should be noted that its tax and non-tax objectives are of sufficient importance to be stimulating a lively debate in the U.S.[23]

Mandatory Giving

A somewhat more radical proposal was put forward several years ago in our submission to the Charities Study Group the interdepartmental committee whose deliberations resulted in the 1975 federal Discussion Paper concerning the tax treatment of charities.[24]

We took the view that the current deduction should be viewed as a mechanism for permitting taxpayers to direct, within modest limits, the social benefits to be supported by their payments. It has been customary to defend the tax exemption for charitable organizations and tax deductions for their benefactors as a means by which they can function as independent, decentralized centres of power. Our proposal that a minimal level of charitable donations be made mandatory was intended to permit taxpayers to divert funds that would otherwise be allocated by Ottawa to other socially-approved benefits of their (the taxpayers') choosing.

The proposal[25] assumed that the public interest is best served through a strong dual system of private giving and government funding of social benefits. It made government the "participant of last resort" providing funds to meet particular social needs only if insufficient private support were forthcoming and maintaining a high degree of flexibility so that its could be phased out when such needs attracted private support.

Conclusion

What clearly emerges from the sort of debate in which Goodman[26] and the National Voluntary Organizations are engaged is the need for serious consideration of alternate conceptual models for the support of charitable activities. This must be preceded by clarification of the public policy objectives served by philanthropy in our society.

Once there is a clear understanding of the most desirable goals for philanthropy, coupled with informed representation at senior policy levels (which, as recently as the 1981 Budget fiasco, appears to have been lacking) the way will be cleared for a serious consideration of alternative tax incentives that could stimulate the flow of more private resources into philanthropy. This policy discussion should not take place primarily among those concerned with the collection of tax revenues. It must first be addressed by those who understand the social consequences of philanthropy. The fundamental issue, in our view, should be a democratization of social welfare expenditure through decentralized decision making and increased citizen participation which would permit charitable activities to be more responsive to communal needs.

Debate should be encouraged and will, we believe, lead to formulation of a more coherent rationale for philanthropic policy. This, in turn, could be expected to result in new or improved tax incentives for charitable giving.

FOOTNOTES

1. For a more thorough treatment of tax measures related to philanthropy, see R. M. Bird and M. W. Bucovestsky, "Canadian Tax Reform and Private Philanthropy", *Canadian Tax Papers No. 58*, Toronto: Canadian Tax Foundation, March 1976.
2. G. McGregor, "Charitable Contributions", *Canadian Tax Journal,* 9, (1961), p. 441.
3. See J.A. Randall, "Taxation of Contributors to Charitable Organizations Under the Income Tax Act", *1973 Conference Report*, Toronto: Canadian Tax Foundation, 1974, 153.
4. Bird and Bucovestsky, *supra*, 18.

5. Canada Royal Commission on Taxation, *Report,* Ottawa: Queen's Printer, 1966, Vol. III, 222.
6. *Ibid,* 224.
7. *Ibid,* 239. The Carter Commission also recommended that the limit be restated as a percentage of income before the deduction of medical and charitable expenses but after the deduction of losses carried forward.
8. See, for example, Senate of Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce,* 1960-1970, No. 23, May 12, 1970 and the *Cultural Property Export and Import Act,* S.C. 1974-75, c. 50 as amended.
9. John G. Smith, "Taxation of Charitable Organizations Under the Income Tax Act", *1973 Conference Report* Toronto: Canadian Tax Foundation, 1974, 175.
10. Canada Department of Finance, *The Tax Treatment of Charities,* Ottawa: Queen's Printer, June, 1975.
11. The Canadian Centre for Philanthropy, *The Philanthropist* Toronto: Summer 1982, 25-48.
12. N. Carter, *Trends in Voluntary Support for Nongovernment Social Service Agencies,* Ottawa: Canadian Council on Social Development, 1974.
13. M. Weirs, "Charities Face Problem of Showing They Really Help", *Toronto Star,* February 25, 1975, 84.
14. M. Feldstein, "The Income Tax and Charitable Contributors", 28 *National Tax Journal,* March 1975, 81-100.
15. Feldstein, *supra.*
16. Coalition of National Voluntary Organizations, *Voluntary Action,* Ottawa: 1982, 10.
17. R. S. Sprould, "Cost Effective Way to Spur Private Giving", *Harvard Business Review,* March-April 1982, 62.
    See also United States, Bills s. 1834 (referred to Committee on Finance) and H.R. 4979 (referred to Committee on Ways and Means) introduced in the 97th Congress, 1st Session.
18. E. Waitzer & J. Berman, *An Analysis of Corporate Giving,* Toronto: The Canadian Centre for Philanthropy, 1982.
19. Bird and Bucovestsky, *supra,* 2.
20. For example, the Canadian International Developent Agency has developed an extensive matching grant system to support approved non-governmental organizations.
21. Great Britain, Royal Commission on Taxation of Profits and Income, *Final Report,* Cmnd. 9474, London: HMSO 1955, ch. 7.
22. P. R. McDaniel, "An Alternative to the Federal Income Tax Deduction in Support of Private Philanthropy", *Tax Impacts on Philanthropy* Princeton: Tax Institute of America, 1972, 171-209.
23. See, for example, S.S. Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures", 83 *Harvard Law Review,* February 1970, 705-738.
24. Department of Finance, *supra.*
25. J. Berman, *Submission to the Charities Study Group Concerning the Tax Treatment of Charities,* Toronto: October 1975.
26. See page 13.