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The Possibility of Tax Incentives for Lending To Charitable Organizations

Seth M. Hendon†

The charitable nonprofit sector is in a state of financial distress. Although Congress has maintained the tax-advantaged status of nonprofit organizations, it has taken no affirmative steps to relieve the crisis. This Current Topic proposes that the federal government help ease the financial burdens of the charitable nonprofit sector by providing a new tax incentive that encourages individuals to lend to charities. Such a tax incentive would be an effective means of addressing the financial distress of the charitable nonprofit sector and is justified by several theories that support the existing tax status of this sector.

Part I of this Current Topic discusses the causes of the current crisis and reveals the inadequacy of the present tax structure for meeting the financial needs of the charitable nonprofit sector. Part II provides a rationale for a tax incentive for lending to charities. Part III introduces and examines three possible schemes for such a tax incentive.

I. The Financial Distress of the Nonprofit Sector

A. Sources of the Crisis

The financial condition of the nonprofit sector demonstrates the need for greater incentives in support of charitable organizations. In the late 1970s inflation and recession sharply increased the nonprofit sector's costs. But instead of attempting to remedy the resulting conditions, the Reagan Administration implemented its "New..."
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Federalism" strategy, which exacerbated the harmful effects of the rising costs. President Reagan's "New Federalism" sought to minimize the involvement of the federal government in what the Administration considered to be state and local matters. This meant turning over to state and local governments and to private nonprofit organizations social services that the federal government had previously provided. It also meant reducing federal support for many of the social programs provided by the nonprofit sector. Between 1982 and 1988, federal spending for social programs declined by an estimated $101 billion.

State and local governments, many of which have been confronting financial crises of their own, have had difficulties offsetting the reduction in federal funding. Government policies under the Bush Administration have continued to injure nonprofit groups, despite the President's call for "a thousand points of light" to help deal with society's problems.

B. Inadequacy of Current Tax Benefits

The "New Federalism" and "Thousand Points of Light" programs reflect a desire to expand the role of the private sector in providing social services. The federal government has traditionally relied on the nonprofit sector to provide many important social


4. Ehrlich, 'Tis The Season for Charities to Worry, BUSINESS WEEK, Dec. 1, 1986, at 70; ABRAMSON & SALAMON, supra note 3, at 50-52. See also Skloot, supra note 3, at 1-2.

5. This figure excludes health care programs, where Medicare and Medicaid have boosted federal spending. Lawrence, From Nonprofit Service Providers, A Package to Create Sources of Cash; Report Urges Stamp Surcharge for Charity, Business Tax Credits, Washington Post, July 19, 1989, § 1, at A21 (citing estimate of Lester M. Salamon, director of the Johns Hopkins Institute for Policy Studies).


7. See Government Penalizes Nonprofit Groups, N.Y. Times, May 21, 1989, § 4, at 26, col. 5 (letter to the editor from Allen R. Bromberger, director of the nonprofit law program of the Council of New York Law Associates). Cf. Feder, Cutting Big Government, Round 2, N.Y. Times, Feb. 12, 1989, § 3, at 4, col. 3 (city ed.) ("Leaders of nonprofit groups, including some of those Mr. Bush has named as part of his thousand points of light, say passive privatization is bound to continue if Mr. Bush tries to keep his pledge to reduce the budget deficit without raising taxes."). But cf. Steinbach, Those Points of Light, 20 Nat'l J. 3189 (1988) (statement of Bush aide Robert A. Mosbacher, Jr.) ("This [thousand points of light strategy] is not an effort to shift problem solving off the back of government or create unrealistic expectations that the private sector can fill in all the gaps. The two sectors have to complement each other.").
services. The government has used the tax system as a primary means of subsidizing this sector. The current tax status of the nonprofit sector, however, does not adequately fill the void created by the federal government’s reduction in direct expenditures for social services. In fact, the Reagan Administration’s overhaul of the Internal Revenue Code through the Tax Reform Act of 1986 produced changes in tax law that, although not aimed at charities, are harmful to the charitable nonprofit sector. A brief examination of the current tax subsidies for charitable organizations reveals their inadequacy.

1. The charitable contributions deduction. The charitable deduction, which allows certain contributions to be deducted from taxable income, has not encouraged adequate support for charitable organizations. Through 1986, private giving was not sufficient to fill the gap created by government cutbacks. And after the Tax Reform Act of 1986 (TRA), it is even less likely that private giving will fill that gap. The TRA increased the cost of giving to charities by: (1) reducing tax rates, thereby decreasing the value of the charitable deduction; (2) eliminating the charitable deduction for non-itemizers; and (3) including gifts of appreciated property in the alternative minimum tax (AMT).


9. Since the War Revenue Act of 1917, the federal income tax has provided a tax incentive for charitable contributions. 3 VA. TAX REV. 229, 229 n.1 (1984). The policy of exempting charitable organizations from taxation of income has its roots in the British Statute of Charitable Uses of 1601, and has been federal law, in one form or another, in the United States since 1894. Bittker & Rahlert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 YALE L. J. 299, 301 (1976). The provision for the charitable contributions deduction is contained in section 170 of the Internal Revenue Code. The exemption provision can be found in section 501 of the Tax Code.

10. See Abramson & Salamon, supra note 3, at 65-81.


12. Wash. Post, supra note 5. See also Museums Feel the Pinch of Tax Law Changes, N.Y. Times, Oct. 3, 1988, § C, at 22, col. 3 (city ed.).

13. Abramson & Salamon, supra note 3, at 90.

As a result of these changes in tax law, per capita giving, though increasing by 8.7% in 1985 and 11.2% in 1986, rose by only 1.4% in 1987 and 3.2% in 1988. The latter increases did not even keep pace with inflation, much less offset decreases in federal expenditures for social services. Furthermore, the average contribution per return from taxpayers most likely to donate—those earning $1 million or more—declined by almost 55% between 1980 and 1987, from $207,087 to $93,297.

2. Exemption of income. Another tax benefit for nonprofits is the exemption of their income from taxation. This benefit, however, has not been significant. Most nonprofits would have little taxable income if they were subject to taxation, rendering insignificant the actual amount of support which tax exemption provides. Moreover, if a tax-exempt nonprofit firm generates significant revenue, that income may be deemed “unrelated business income” and thereby subject to taxation.

To finance rising costs and to sustain current levels of service in the face of dwindling government support and inadequate tax subsidies, nonprofit organizations have increasingly turned to “nonprofit enterprise,” commercial endeavors that generate revenue. A museum, for example, may operate a gift shop and use the profits generated to maintain exhibits or pay employees’ wages. Unrelated business income rules regulate nonprofit enterprise and provide that any income from activities unrelated to the nonprofit organization’s purposes will be subject to taxation. Under IRS regulations, if “an inappropriate amount” of a charitable organization’s activities is not in furtherance of its tax-exempt purpose, that organization’s tax exemption may be revoked entirely. These regulations make “nonprofit enterprise” a risky venture, as far as a charity’s tax status is concerned. In addition, lobbying efforts of for-profit enterprises that complain of unfair competition from the nonprofit sector have prompted Congressional inquiries into the sufficiency of existing law in this area. The current restrictions and severe penalties of

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16. Id.
19. Skloot, supra note 9, at 1-3.
22. Id. at 24-25. See also HOUSE SUBCOMMITTEE ON OVERSIGHT, DRAFT REPORT DESCRIBING RECOMMENDATIONS ON THE UNRELATED BUSINESS INCOME TAX (UBIT),
the unrelated business income rules, combined with the possibility of even more restrictive regulations, make nonprofit enterprise an unlikely solution to the financial crisis of the nonprofit sector.

3. Qualified 501(c)(3) bonds. One tax incentive particularly pertinent to this Current Topic is the tax-exemption of the interest on certain bonds issued by charitable organizations. Section 103, in combination with section 145, of the Tax Code excludes from income the interest on “qualified 501(c)(3) bonds.”28 501(c)(3) bonds are publicly traded and are issued through state and local authorities for the benefit of charitable organizations. These bonds, however, do not solve the borrowing needs of the charitable nonprofit sector. The nature of the municipal bond market prevents nonprofit organizations from issuing small amounts of debt—less than $5 million—through state or local governments.24 Nonprofit organizations with relatively small borrowing needs therefore cannot take advantage of the tax-exempt debt made available under sections 103 and 145. Although the procedure for issuing 501(c)(3) bonds might screen poor credit risks,25 it also effectively eliminates these bonds as a means of financing for organizations with small borrowing needs, even those with low risk of default. If, as this Current Topic

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23. The Code, with certain exceptions, excludes “private activity bonds” from the tax-exempt treatment afforded State and local bonds. I.R.C. § 103(b)(1) (1989). Private activity bonds are bonds issued through a state or locality, the proceeds of which are used for various kinds of private investment. I.R.C. § 141 (1989). The Code makes an exception for a category of private activity bonds called “qualified bonds” and exempts interest on such bonds from taxation. I.R.C. §§ 141, 145 (1989). Under one of these exceptions, a private activity bond which is a “qualified 501(c)(3) bond” enjoys tax exempt treatment. I.R.C. § 141(e)(1)(G) (1989). A private activity bond is considered a “qualified 501(c)(3) bond” if (1) all of the property acquired by the net proceeds of such bond issue is owned by one or more section 501(c)(3) charitable organization or by governmental units, and (2) 95 percent or more of the net proceeds of such bond issue is used for a tax-exempt purpose. I.R.C. § 145 (1989).

24. To access national markets meaningfully, the minimum size of a debt issue needed is approximately $20 million. If marketed regionally, however, issues of $5 to $10 million can be arranged. Telephone conversation with Wallace C. Turbeville, Vice President, Goldman, Sachs & Co. (Feb. 5, 1990).

25. The issuing agency has a significant incentive to, and, as common practice, always does, thoroughly investigate the ultimate borrower. This is because the state and local agencies responsible for issuing 501(c)(3) bonds bear the ultimate responsibility to the bondholders. If the ultimate borrower is later found to have failed to meet the requirements of section 145, the tax exemption of the bonds will be revoked. Telephone conversation with Kenneth Miller, Associate General Counsel, Yale University (Apr. 3, 1990).
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proposes, improving the borrowing capabilities of the nonprofit sector is a practical means of addressing the financial crisis, it is an inadequate solution to facilitate borrowing for only those nonprofits large, sophisticated, or powerful enough to issue large amounts of public debt.

II. The Case for Tax Incentives for Lending to Charities

The present array of tax benefits for charitable organizations has not filled the funding gap created by government cutbacks and changes in the tax law. However, creating a tax incentive for lending to charities would be a viable means of filling this gap. Such a solution would be consistent with the “New Federalism”/“Thousand Points of Light” privatization of social services and would provide essential support for nonprofits who assume the social service burdens previously borne by government.

Thus far, this Current Topic has assumed that the nonprofit sector’s financial distress should be a cause of concern for the federal government. This presumes, however, that the nonprofit sector is worthy of government support. One could argue that the fiscal problems of the nonprofit sector indicate that its economic costs outweigh its benefits and, therefore, that government should allow the free market to take its course. However, the legislative history of the Tax Code, the history of nonprofit tax policy in general, and the weight of tax scholarship suggest otherwise. They indicate that the favored tax status of charitable organizations is based on a policy decision recognizing that charities perform important functions and are therefore worthy of support. Three rationales for the tax

26. Because of the scarcity of economic research, it is difficult to generalize about solutions to the financial problems of the nonprofit sector. Unfortunately, there are no statistics available that reveal whether a shortage of debt is a component of the nonprofit sector’s financial distress. Although no research in the field is conclusive, this Current Topic posits that an incentive that promotes private support of charitable organizations through lending would help ease the burdens assumed by the nonprofit sector.

27. Simon supra note 17, at 68. But see Bittker & Rahdert, supra note 9, at 304. Professors Bittker and Rahdert argue that exemption of nonprofits follows from the Code’s definition of income, and not from any normative policy goals for the nonprofit sector. Their theory is grounded on the principle that receipts that do not represent income should not be subject to income tax.

According to another version of this tax base defining rationale, the charitable contributions deduction is not the result of a decision to subsidize nonprofits. Rather, charitable contributions are deducted because, based on norms of taxation, they cannot be included in the tax base of the donor. For tax purposes, income is customarily defined as the sum of consumption plus accumulation of wealth in a given period. With respect to the charitable contributions deduction, the tax base defining rationale suggests that the amount contributed to charity must be excluded from the tax base of the contributor since this amount represents neither consumption nor wealth accumulation. Hence,
status of the nonprofit sector are discussed below. Each of these subsidy rationales logically extends to justify tax benefits that support the borrowing needs of charities.

A. Subsidy Theories

1. Public good theory. A public good is a service or product that possesses two special qualities. First, a public good costs no more to provide to an entire community than it does to one member of that community. Second, once a public good is provided to one person, others cannot be prevented from also enjoying it.\textsuperscript{28} Public radio is an example of a public good provided by nonprofit organizations. Ordinarily, a consumer whose benefits from a product exceed his costs is willing to pay for it. If the product is a public good, however, the consumer has an incentive not to purchase it because she would receive the benefits for free if any other consumer purchases it. This "free rider" problem results in a consumer demand unrepresentative of actual preferences. Since producers supply goods according to consumer demand, producers of public goods provide a sub-optimal supply.

The optimal supply of a public good can be attained if government induces consumers to "reveal their true preferences and [compels them] to contribute to public revenues accordingly."\textsuperscript{29} This rationale applies to nonprofit organizations. Since, according to the public good rationale, these firms are in the business of providing public goods, government intervention is appropriate to boost production to the socially optimal level.\textsuperscript{30} Government may intervene by subsidizing, through tax benefits, nonprofits' production of public goods. The cost of this tax subsidy is shared by all taxpaying members of the community, each of whom benefits from the public goods.

The public good justification for the special tax status of certain nonprofit activities can be extended to justify tax incentives for lending to charity. Just as with existing tax subsidies, government
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can compel the community to subsidize the cost of producing a public good through a lending incentive. The existing tax incentives subsidize the cost of equity (i.e., donations and retained earnings); a lending incentive can subsidize the cost of debt.\footnote{31}

Though public good theory may justify government support for some nonprofit activities, the federal government also subsidizes nonprofits that do not produce public goods. For these nonprofits, an alternative justification for government support is necessary.\footnote{32}

2. **Capital formation constraint theory.** Professor Henry Hansmann has offered an alternative subsidy rationale which, unlike public good theory, does not depend on the assumption that the nonprofit sector is in the business of producing public goods. According to Hansmann, the exempt status of nonprofit organizations results from the role nonprofit firms play in the market and the constraints on capital formation that role imposes.\footnote{33} Hansmann suggests that nonprofit organizations are a response to a market phenomenon known as “contract failure.”\footnote{34} Contract failure occurs when, due to the type of goods or services purchased or the conditions under which they must be purchased, consumers have difficulty (1) comparing quality among competitors, or (2) ensuring that the service is actually performed after the purchase.\footnote{35} Because of this contract failure, consumers face an “inability to police producers by ordinary contractual devices.”\footnote{36} Contract failure leads consumers to purchase these goods from nonprofit firms, which are constrained by law from distributing profits and therefore have less incentive to exploit consumers.

Although the legally imposed “non-distribution constraint”\footnote{37} removes a nonprofit firm’s incentive for exploitive behavior, it also hinders its ability to raise equity capital. Hansmann suggests that the exemption of nonprofit organizations from income taxation compensates for this disadvantage in capital formation.\footnote{38}

\footnote{31. As discussed infra p. 22, in a noncompetitive market, a lending incentive might not reduce the cost of debt. It would nevertheless benefit charitable nonprofits by increasing the availability of debt.}
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\footnote{34. Id. at 845.
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\footnote{35. Hansmann, *Exempting Nonprofits*, supra note 32, at 69 (Hansmann cites the example of a consumer purchasing disaster relief from the Red Cross as a situation where contract failure exists).
}
}
\footnote{37. Id. at 838.
}
He claims:

Nonprofit organizations lack access to equity capital since, by virtue of the non-distribution constraint, they cannot issue ownership shares that give their holders a simultaneous right to participate in both net earnings and control. Consequently, in raising capital, nonprofits are limited to three sources: debt, donations and retained earnings. These three sources may, in many cases, prove inadequate to provide a nonprofit with all of the capital that it needs.\textsuperscript{39} Hansmann asserts that since debt, donations, and retained earnings do not satisfy nonprofits' capital needs, exemption is justified as a "subsidy to capital formation."\textsuperscript{40} A natural extension of Hansmann's theory supports other tax benefits that compensate nonprofit organizations for financial handicaps resulting from the non-distribution constraint.\textsuperscript{41} If the benefits of exemption do not fully remedy the harm caused by the non-distribution constraint, additional tax benefits may be necessary.

The charitable deduction, for example, enhances the ability of charities to attract contributions.\textsuperscript{42} This tax benefit, like exemption, can supplement capital formation. If exemption does not sufficiently counterbalance the effect of the non-distribution constraint, the charitable contributions deduction can be justified by capital formation constraint theory. Hansmann's theory can be extended to justify a subsidy for lending to charities because nonprofits' ability to borrow, like their ability to raise capital, is effectively limited by the non-distribution constraint. Hansmann notes that:

the amount of debt financing that a nonprofit firm can obtain is proportional to some extent to the amount of revenue it can derive from retained earnings, since capital purchased with such earnings provides an extra margin of security for the debt, and since the cash flow from such earnings is evidence to lenders that interest payments on the debt can be covered.\textsuperscript{43}

Equity capital provides a margin of security for lenders. A lender will rarely lend for the entire amount of a borrower's financing

\textsuperscript{39} Id. at 72.
\textsuperscript{40} Id. at 74.
\textsuperscript{41} Hansmann specifically restricts his argument to a rationale for exemption. He asserts, "[T]he charitable deduction and the exemption raise different issues, and it would be quite conceivable for the tax system to embrace one without the other." Hansmann, Exempting Nonprofits, supra note 32, at 56. It is also conceivable for the tax system to embrace both exemption and other tax benefits based on his theory.
\textsuperscript{42} See generally C. Clotfelter, supra note 8 (discussing the general relationship between federal tax policy and charitable giving).
\textsuperscript{43} Hansmann, Exempting Nonprofits, supra note 32, at 73-74 (citing P. Ginsburg, Capital in Non-Profit Hospitals 184 (1970) (unpublished doctoral dissertation available in Harvard University Library)).
needs; lenders usually require a borrower to put up some of her own equity as security for the loan. Since the non-distribution constraint hinders formation of equity, a nonprofit's ability to borrow is thus also constrained.

3. **Altruism Theory.** Professor Rob Atkinson has recently proposed an alternative subsidy theory which, unlike public good theory and capital formation constraint theory, does not justify the tax status of nonprofits as a consequence of market forces. Rather, a non-economic factor, altruism, sets the nonprofit sector apart and warrants special tax treatment. Professor Atkinson claims that “the essence of altruistic organizations is the conferring of uncompensated benefits.”

Atkinson proposes that the attempt to characterize the nonprofit sector as a remedy for market inefficiencies overlooks the most distinctive function of charities: the altruistic supply of goods and services. Altruism theory justifies the exempt status of nonprofit organizations as “a deliberate social policy choice that must be made on non-efficiency grounds.” Favorable tax treatment of altruistic nonprofits is a subsidy for the “metabenefit” they provide: altruism. According to Atkinson, private nonprofit altruistic organizations “offer significant advantages over individual altruism, particularly in achieving economies of scale and continuity over time, institutional advantages that are not available through either for-profit firms or government.” Altruism theory supports the favorable tax treatment of nonprofit organizations since such treatment subsidizes their altruistic production of goods and services.

If altruism theory is accepted, a convincing case could be made for providing a tax incentive for lending to charity. Lending, like giving, supports altruistic organizations. Any tax benefit that encourages lending to charity will decrease the cost or increase the

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44. A lender may sometimes allow a deeply subordinated loan to serve as security; however, this subordinated loan represents a borrowing need subject to equity requirements of other lenders.


46. *Id.* at 69.

47. *Id.* at 130.

48. *Id.*

49. *Id.* at 12. Atkinson concludes that nonprofits can achieve economies of scale and produce a given good or service more cheaply than for-profit firms because nonprofits, unlike for-profits, can avoid the cost of capital. Atkinson also concludes that nonprofits have institutional advantages over government in catering to individual tastes, in part because nonprofits are not handicapped by bureaucracy or majoritarian constraints of collective decision-making. *Id.* at 75-85.
availability of borrowing, thereby promoting the welfare of charitable organizations.50

B. Rationale for Tax Incentives for Lending to Charities

Subsidy theories justify government support for charitable organizations; however, in order to justify the proposed tax incentive for lending to charities three questions must be answered affirmatively. First, since it is feasible that direct subsidy payments to charities could provide financial relief, should such support be provided instead through the tax system? Second, are subsidies that support debt needs an appropriate strategy for relieving the charitable nonprofit sector’s distress? Finally, will providing tax incentives to individuals support the debt needs of charitable organizations?51

1. Why support should be provided through the tax system. Even if providing additional government support is justified by subsidy theories, it is not necessary that this support take the form of tax subsidies. Direct government subsidies, for instance, might be the best method of providing support. In general, however, government support of the nonprofit sector has traditionally been accomplished through the tax system. The current system of tax subsidies for charitable organizations is favored over direct budget expenditures because it: (1) “permits decentralized decision making through individual taxpayer choice,”52 and (2) precludes tyranny of the majority by making the subsidies equally available to all charities.53 For the same reasons, subsidizing the debt needs of charitable organizations is best achieved through the tax system. Tax subsidies permit individual lenders and borrowers, rather than legislators, to determine the timing and amount of debt. Tax subsidies also prevent majoritarian selection of those charities that will receive support.

50. See infra p. 22.

51. Clotfelter’s economic analysis suggests that, with respect to charitable contributions, a tax deduction results in a greater amount being donated to charities than is foregone in tax revenues. C. CLOTFELTER, supra note 8, at 273-79. See also Jencks, Who Gives to What?, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 321, 328 (W. Powell ed. 1987). Similarly, it may be possible that more lending would be encouraged by providing tax benefits to lenders than would be encouraged by direct payments to nonprofits to defray interest expenses. Whether this is true can only be answered by as yet unperformed economic analysis.

52. Simon, supra note, 17 at 78 (citing Hochman & Rodgers, The Optimal Tax Treatment of Charitable Contributions, 30 Nat’l Tax J. 1, 2-3 (1977) (recommending a tax credit as a means of subsidizing the nonprofit sector)).

53. Simon, supra note 17, at 78.
2. Why support for borrowing needs of charities is appropriate. As the balance sheets of virtually all successful for-profit firms indicate, debt is vital to the efficient operation of a business. Debt financing allows a company to leverage off its equity and raise the capital necessary to finance projects it could not otherwise afford. For example, a hospital with plans to undertake a $10 million renovation may not be capable of raising more than $2 million of equity. With that $2 million of equity, however, the hospital can borrow $8 million of debt to finance the project. Similarly, a nonprofit can leverage off its equity through the use of debt.\textsuperscript{54} While additional government support of private giving might raise the equity holdings of nonprofits, a lending incentive can provide access to significantly more capital through leveraging. Thus, if government makes borrowing more accessible, it will enhance the ability of charitable organizations to pursue their projects.

Encouraging lending is sensible also because some benefactors of charity may prefer lending to giving. Some taxpayers may have reached their limit for contributing in a given year, but may still have an ability and a desire to provide additional support.\textsuperscript{55} Consequently, a combination of giving and lending incentives may be the best means of fully exploiting the supportive resources of the private sector.

Still, one could argue that the reason borrowing is difficult for charitable organizations is that charities do not represent the highest and best use of debt. This argument claims that incentives to encourage more lending would be inefficient. Charities, however, may be unable to pay the market rate for reasons unrelated to their ability to use debt efficiently. Specifically, charities may suffer from free rider problems associated with the business of selling public goods.\textsuperscript{56} This implies that charitable organizations cannot pay the market rate because they produce public goods—not because they use debt inefficiently. Alternatively, charities may be unable to pay the market rate for debt because legal constraints imposed on nonprofit organizations prevent them from raising sufficient amounts of

\textsuperscript{54} A nonprofit's equity consists of donations and retained earnings. Although these sources of capital are referred to here as equity, technically, they cannot be considered equity because a nonprofit is prohibited from distributing earnings to its financiers.

\textsuperscript{55} This ceiling on a taxpayer's willingness to give may be the result of either legal limits on deductibility of contributions, or personal preferences.

\textsuperscript{56} Although many people benefit from the operations of a charitable organization, not everyone pays for the benefits he or she receives. For a discussion of the free rider problem, see supra notes 28-29 and accompanying text. If all beneficiaries paid for the services they enjoyed, charities might have sufficient resources to pay the market rate for debt.
The restrictions placed on a charitable organization’s ability to distribute profits may inhibit its ability to raise the equity required by lenders as security for their loans. Under either explanation, charities may be a better use of debt than their present ability to pay indicates.

3. How tax incentives for lenders will support charities. Tax incentives for lenders will subsidize charitable organizations in much the same way current tax benefits do. A tax incentive for lending would encourage individual taxpayers to lend to charity by increasing their rate of return. The increased rate of return would encourage more taxpayers to lend. In a perfectly competitive market, the resulting increase in the supply of debt would lead to a decrease in the cost of borrowing. Ultimately, the entire value of the tax benefit would be passed on to the charities that borrow. If, on the other hand, the market for loans to charities is not perfectly competitive, the number of individuals willing to lend to charities would still increase, although the cost of borrowing might not decrease by the full amount of the tax benefit. Nevertheless, this growth in the supply of lenders would, assuming a shortage of debt, benefit the charitable nonprofit sector. Thus, a tax incentive for lending would subsidize charities by increasing the availability of debt financing, reducing its cost, or both.

C. Principles of Taxation

Each subsidy theory discussed in section A can be extended to justify a tax incentive for lending to charitable organizations. Moreover, section B demonstrates that a tax incentive for lending is a rational way to address the financial distress of the charitable nonprofit sector. Nevertheless, any lending incentive must be reconciled with established principles of taxation. Lending incentives raise concerns with respect to three of these principles: (1) that the

57. See discussion of Hansmann’s theory supra notes 33-44 and accompanying text.
58. The foregoing analysis focuses solely on economic return. This may be inappropriate to the extent that individuals who lend to charity have mixed economic and altruistic motives for lending. For these lenders, an incentive is likely to encourage below market rate loans. This is because an individual who needs no incentive to lend to a charity will do so at a lower rate if she is given a special tax benefit.
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tax system should not provide benefits to individuals who have sacrificed nothing for charity,59 (2) that there should not be a deduction for amounts loaned because loans do not decrease wealth,60 and (3) that all income as defined by the Code, including interest on loans, should be subject to taxation.61 Exceptions to these principles, however, are frequent.

1. No tax benefits if nothing sacrificed. One fundamental objection to tax incentives for lending is that individuals lend money because they are paid interest, and thus any additional incentives are superfluous and an improper use of tax dollars. In other words, the tax system should not give charity-related benefits to a taxpayer who, because she has earned interest, has sacrificed nothing for charity. This argument, however, begs the question of whether, on a macro level, the compensation is adequate. Even if a particular individual has not sacrificed anything, incentives may still be necessary where the level of lending to the nonprofit sector is sub-optimal.62 Tax incentives may be an appropriate way to encourage a healthy supply of debt to the nonprofit sector, despite the rewards that such incentives may confer upon lenders who have sacrificed nothing.

The principle of no reward for no sacrifice implies that equal rewards should be provided for equal sacrifices. However, the Code already disproportionately rewards benefactors of charity. An individual who contributes certain kinds of appreciated property to charity does not pay tax on the gain, and she can deduct the full appreciated value of the property contributed.63 A taxpayer who contributes unappreciated property does not enjoy that benefit. For example, if a taxpayer in the 28% bracket donated to a museum a painting worth $100 that she purchased for $10, she would escape tax on the $90 of gain (a benefit worth $25.20) and would receive a deduction for the full $100 value (a benefit worth $28). If a similarly situated taxpayer had worse luck in the art market, but still wanted to bestow a benefit of $100 on the same museum, he might donate a

59. See, e.g., Hernandez v. Commissioner, 109 S. Ct. 2136 (1989) (holding that taxpayers were not allowed a charitable contributions deduction for payments made to the Church of Scientology where the taxpayers received services in exchange for their payments).
60. See Bittker & Rahdert, supra note 9.
62. Many individuals do sacrifice by lending to charity at below market rates. Just as taxpayers who make contributions to charitable organizations are rewarded, these below market rate lenders should be rewarded at least with respect the amount of interest they have effectively donated to charity.
painting worth $100 that he purchased for $100. As with the first taxpayer, his donation would result in no capital gain, and a $100 deduction. But since the dollars he paid for the painting were after-tax dollars, the second taxpayer, unlike the first, has effectively paid taxes on $100 of the value of his painting. Because of the appreciated property rule, the first taxpayer has escaped tax on all but $10 of the value of her painting. Although both taxpayers sacrificed $100 paintings, one taxpayer has reaped a greater reward.

The appreciated property provision remains in the Code, despite its apparent violation of an accepted principle of taxation, since it provides a great incentive for wealthy benefactors to donate to charities. Apparently, the policy decision to subsidize nonprofits overrides the fact that some taxpayers are rewarded more handsomely than others for bestowing the same benefit on a charity. Thus, the real principle at work here may be that when the result supports the nonprofit sector, the general principle of rewarding in proportion to sacrifice can be ignored.

2. No deduction without corresponding decrease in income. In general, the underlying norms of the Tax Code do not allow the deduction of an item from the tax base unless that item reduces income, as defined for tax purposes. Income may be defined as the sum of wealth accumulation and consumption in a given period. In order to qualify for a deduction, a loan to charity must somehow decrease the lender's wealth without concurrently increasing her consumption. According to this definition, the lender to charity has not actually reduced her wealth. The loan is not regarded by the Code as a decrease in wealth because it is exchanged for the borrower's obligation to repay. This obligation is equal in value to the amount loaned and thus the lender suffers no net decrease in wealth. A loan to a charitable organization, therefore, does not merit a deduction, since it does not represent an actual decrease in the lender's income.

Although principles of taxation militate against deductions for loans, there are some exceptions. The charitable contribution deduction, for example, rewards those who support charitable organizations with their contributions, and thereby subsidizes the

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65. See Bittker & Rahdert, supra note 9.
66. The Tax Code implicitly accepts this conceptualization—known as the Haig-Simons definition—of income. See Andrews, supra note 27, at 320.
charitable nonprofit sector. A deduction for lenders to charities would similarly subsidize the nonprofit sector by encouraging individuals who support the nonprofit sector. Just as subsidy theories justify the tax status of nonprofits as a rational exception to principles of taxation, they also justify deductions for lending.

Other areas of the Tax Code also contain exceptions to the principle that deductions are allowed only when income has been reduced. For example, Section 169 allows a taxpayer to amortize rapidly the cost of certain pollution control facilities in lieu of normal depreciation. The allowable deduction will generally exceed any proportionate decrease in value of the facility. This exception to the principle that deductions must correspond to decreases in income is nevertheless accepted as an incentive for investment in certain types of assets. A deduction for loans to charity could likewise be viewed as an incentive for investment in charity.

3. All income is subject to taxation. According to principles of taxation, income from any source is taxable. It follows that interest income, since it represents an increase in wealth, must be subject to taxation. The Tax Code, however, treats interest income differently depending on its source. For example, the Tax Code excludes from income the interest on state and local bonds. Moreover, as discussed earlier, Congress has allowed exemption of interest income on certain bonds issued by charitable organizations. Despite purported principles of taxation, Congress already subsidizes numerous types of borrowing in violation of those established norms, including borrowing by some charitable organizations. Thus, the issue here is ultimately not one of principle, but policy.

III. Proposed Tax Incentive Schemes

There are numerous ways to design a tax incentive to encourage lending to the charitable nonprofit sector. This section introduces and compares three possible schemes: (1) exempting interest on loans to charitable organizations, (2) deducting interest foregone on

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67. But see Andrews, supra note 27 (arguing that the charitable deduction is not an exception, but a logical result of the internal logic of the Tax Code).
70. See supra note 66 and accompanying text.
72. See supra note 23 and accompanying text for discussion of tax treatment of “qualified 501(c)(3) bonds.”
below market rate loans, and (3) combining the first two approaches. These schemes are not formal proposals for amending the Tax Code; rather, they are intended as a starting point for considering the impact of lending incentives on individual taxpayers and on charitable organizations.

A. Exemption of Interest on Loans to Charitable Organizations

As discussed earlier, sections 103 and 145 provide tax-exempt treatment for certain types of “private purpose” bonds, including those issued for section 501(c)(3) charitable organizations. The policy judgment behind 501(c)(3) bonds is clearly based on a subsidy rationale. This judgment should apply equally to all lending that supports worthwhile projects pursued by charitable nonprofits. Unfortunately, nonprofit organizations with relatively small borrowing needs are unable to issue tax-exempt bonds. The tax-exempt interest approach would remedy this problem by providing a mechanism that would, in effect, extend the Tax Code’s treatment of qualified 501(c)(3) bonds to any charitable organization, no matter how small its borrowing needs.

Many of the possible complexities in implementing this scheme already exist as part of the Code without posing catastrophic administrative problems. In addition, Congress has already approved the extension of the subsidy rationale to justify incentives for lending to charitable organizations through municipal bond issues. Implementing the broader tax-exempt interest proposal is simply a matter of screening potential borrowers similar to the procedure performed by the State or local issuing agency. Such a system could be prescribed in Treasury Regulations.

73. The viability of any of these schemes depends on the specific borrowing needs of the charitable nonprofit sector and the impact that each incentive would have in fostering increased lending. Presently, no studies are available that conclude whether the distress of the nonprofit sector includes an inability to raise debt or whether decreased costs of borrowing and increased supply of debt will ameliorate the plight of charitable organizations. The desirability of implementing the tax-exempt interest proposal, the below market rate interest deductions, or a combination of the two, is dependent on the results of much needed research into both the actual and the optimal supply of borrowing by charitable organizations.


75. See supra notes 23-25 and accompanying text.

76. An extension of 501(c)(3) bonds should include a means of screening potential borrowers similar to the procedure performed by the State or local issuing agency. See supra note 25. Such a system could be prescribed in Treasury Regulations.

77. The schemes discussed herein would not, however, screen potential borrowers, unlike the procedure for issuing “qualified 501(c)(3) bonds.” See supra note 23. Any such screening would create additional administrative complexity.
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of treating all riskworthy nonprofits equally, regardless of their borrowing capabilities or political influence.

1. Tax effects. Under the tax-exempt interest approach, the interest income from loans to charities would be exempt from taxation. For example, assume that a lender in the 28% tax bracket extends a $1,000 loan to a charity at a 10% interest rate. Under the current scheme, her income in the first year will be $100, or $72 after taxes. Under the tax-exempt interest approach the lender’s $100 interest income would be exempt and her after-tax yield would be $100, or 10%. In the first year of the loan the value of this tax benefit would be $28.

In a competitive market, the benefit of exempt interest would be passed through to borrowers, lowering their cost of borrowing. The increased return would attract more lenders and thus increase the supply of debt. The increase in supply would, in turn, drive down interest rates, which would directly benefit the borrowing charities. Even in a non-competitive market, this lending incentive would attract more individuals to lend to charity, which would also support the charitable nonprofit sector as a whole.

2. Inadequacies. Although the tax-exempt interest scheme would encourage more individuals to lend to charity, it would not necessarily promote low interest rate lending. In fact, the tax-exempt interest scheme might create an incentive to lend to charities at high rates, since lenders who charge a higher interest rate would receive a greater benefit from tax exemption. If the lender in the previously example had charged 11% on her $1,000 loan, the value of the tax benefits would have been $30.80, $2.80 greater than for a 10% loan. This problem could be ameliorated by placing a ceiling on the amount of interest exempted. If the tax-exempt interest scheme imposed a 10% ceiling, for example, all interest income in excess of 10% would be taxable.

A problem still remains, however, for those who lend at below market rates. An interest rate ceiling does not encourage lending at below market rates. Under the tax-exempt interest scheme, a 5% lender would, regardless of the ceiling, receive a smaller benefit than would an 8% lender. Thus, the more altruistic the lender, the smaller the benefit she would receive.
B. The Below Market Interest Deduction

The Code currently exempts from taxation the imputed interest on below market rate loans to charitable organizations.\textsuperscript{78} In other words, the interest income that a lender chooses to forego is exempt from taxation. This provision is not, however, an incentive to encourage lending to charity. Rather, it is a means of avoiding the disincentive that would result from taxing imputed interest income.

While a market rate lender may pay the taxes on interest income out of the interest she earns, a below market rate lender may not have earned enough (or any) interest to cover taxes imposed on imputed interest income. For example, assume a charitable lender in a 28% tax bracket lends $1,000 to a charity at 10%, the market rate. She will have $100 in interest income in the first year of the loan and will owe $28 in taxes. She can pay her tax bill out of the $100 in interest income and be left with $72. If a similarly situated lender extends a $1,000 loan at 1% to the same charity, his earned income is $10 and his imputed income is $90 (i.e., he has chosen to forego $90 of income). If he were taxed on both imputed and earned income, he would, like the market rate lender, have a tax bill of $28. However, he would only have $10 in earned income to cover the tax bill, leaving a deficit of $18.

Exemption of imputed interest on loans to charitable organizations avoids this problematic result.\textsuperscript{79} Since the below market rate lender is taxed only on earned income, his tax bill is $2.80, which he can pay out of the $10 he actually received. Although the policy of exempting imputed interest income avoids punishing the below market rate lender, it does not affirmatively reward him for foregoing interest income for the benefit of charitable organizations.

\textsuperscript{78} I.R.C. § 7872 (1990), Treas. Reg. § 1.7872-5T(b)(9) (1990). Although the general purpose of Section 7872 is to prevent tax avoidance by taxing the imputed interest income on below market rate loans, section 7872 and the regulations thereunder effectively provide for the exemption of imputed interest on loans to charitable organizations. This policy of exemption of imputed income from charities also applies to the imputed income from voluntary services. That is, when a taxpayer donates services to a charity, she is not taxed on the imputed income from those services. Furthermore, no deduction is allowed for contribution of services. Treas. Reg. § 1.170A-1(g) (1990).

\textsuperscript{79} This result is only problematic where the borrower is a charity. Where the borrower is an employee of the lender, for example, and the purpose of the below market rate loan is compensation, the Code taxes the lender/employer on his imputed interest income. See discussion of I.R.C. § 7872, supra note 78. This taxation of imputed interest is not quasi-punitive because the value of the foregone interest was actually part of the borrower/employee's taxable compensation.
A below market rate lender provides more support to the borrower than does a market rate lender. A deduction for foregone interest would encourage taxpayers to lend to charitable organizations at below the market rate.

1. Tax effects. The below market interest deduction would provide the lender with a deduction in the amount of the interest she has foregone. If, for example, the annual market rate is 10% and a lender in the 28% bracket extends to a charitable organization a $1,000 loan at 1%, under the below market interest deduction she would receive a deduction of $90 in the year the loan was made. This amount represents the difference between what she could have earned at the market rate and what she actually charged the borrower. The lender enjoys a double benefit because, in addition to escaping tax on $90 of imputed interest income, she receives a $90 deduction.

The lender in the above example has interest income of $10 which is worth $7.20 after taxes. She also receives a $90 below market interest deduction, which, if charged against other income, is worth $25.20. While the borrower has paid the lender only a 0.72% after tax interest rate, the lender has effectively earned a 3.24% after tax return because of the below market interest deduction. Unlike the exempt interest approach, the below market rate deduction provides a greater benefit to those who lend at lower rates. Thus, if the lender in the above example had charged a higher interest rate, she would have received a smaller tax benefit. Under this scheme (assuming a 10% market rate) the deduction for a 1% loan is worth $25.20, the deduction for a 5% loan is worth only $14, and there is no deduction at all for a 10%, market rate loan.

2. Inadequacies. The below market interest deduction may fail to satisfy an essential objective of lending incentives: promoting increased lending to the charitable nonprofit sector. Specifically, the

80. According to the Talmud “He who lends without interest is more worthy than he who gives charity and he who invests in the business of a poor man is the most worthy of all.” Quoted in THE BOOK OF UNUSUAL QUOTATIONS 200 (R. Flesch ed. 1966).
81. A variation on this approach would be to provide the lender with one, larger, deduction at the time the loan is made. This would be accomplished by giving the lender a deduction for the present value of all the future foregone interest, discounted at the market rate. Thus, in the case discussed herein, if the lender extended her $1,000 loan to be repaid at the end of five years, her current deduction would be $341.17 This equals the present value of $90 per year for five years, discounted at 10%. Another way of expressing this number is as the difference between the present value of the debt service payments discounted at the below market rate charged and the present value of those payments discounted at the market rate (i.e., $1,000 - $658.83).
below market rate lending incentive does not provide any tax benefits to market rate lenders, who may hold much of the capital available to charitable organizations.

The tax-exempt interest proposal was defective in that, although it offered an incentive for lending to charitable organizations, it offered no incentive for lending at low rates. The below market interest deduction, on the other hand, does offer an incentive for lending to charities at low rates; however, it offers no incentive for market rate lenders, and therefore may result in only a small increase in the supply of debt available to the charitable nonprofit sector. If the purpose of providing a lending incentive though the tax code is merely to reward those who sacrifice for the benefit of charity, then the below market rate interest deduction is appropriate. If, as is more logical, the goal is to increase the amount of debt available to charitable organizations, then an incentive for market rate lenders, like the exemption of interest income, may be necessary.

C. Combined Exemption and Deduction Approach

It is, of course, possible to combine the preceding goals. We may want both to reward below market rate lending and to encourage market rate lending. The combined approach offers both exemption of interest income on loans to charity and a deduction for the amount of interest foregone. Assume, for example, the market rate is 10% and a taxpayer in the 28% bracket lends a charitable organization $1,000 at 1%. In the first year of the loan the lender under the combined approach would deduct $90 (foregone interest) and receive $10 of tax free interest income. These tax benefits are worth $25.20 and $2.80, respectively, totalling $28. The higher the interest rate the lender charges, the lower will be her deduction for foregone interest. But this is offset by the increased amount of taxes saved on exempt interest income. If, for example, the lender charged 3%, her deduction for foregone interest would be worth only $19.60 but the exemption of interest earned would be worth $8.40, totalling, again, $28. Under the combined approach, regardless of the interest rate (assuming it is equal to or less than the market rate) the lender will receive the same amount of tax benefits. Thus, the combined approach provides the same benefit to both those who lend at the market rate and those who lend below the market rate.
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**IV. Conclusion**

In the shadow of a huge federal budget deficit, proposals that reduce tax revenues are generally unappealing. In the case of the private nonprofit sector, however, such proposals are worth considering because the aggressive cutbacks in federal spending on social services has expanded the importance of this sector. The philosophies underlying the "New Federalism" and the "Thousand Points of Light" suggest that additional support for nonprofits should come from the private sector. But largely because of the TRA's decrease in tax rates, charitable donations are not keeping pace with the needs of charitable organizations. Indeed, the financial condition of the nonprofit sector indicates that government has gone too far in privatizing social services.

Tax incentives for individuals represent the necessary spirit of cooperation between federal and private support of the nonprofit sector. Such incentives send a signal that if individuals do their share to support charitable organizations, the federal government will do its share as well. Recently, individual support of the nonprofit sector has been insufficient. This does not mean that government must assume complete responsibility for services provided by the nonprofit sector. Instead, it may be a warning that the federal government must devise new ways to stimulate private support. Implementing a tax incentive for those who lend to charity is an expedient partnership of private and government support that will help sustain the charitable nonprofit sector.