

STAYING WELL WHILE DOING GOOD:
A PROPOSAL TO COMBINE TAX INCENTIVES FOR
HEALTH CARE AND CHARITY

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This Article considers two unrelated tax provisions – the charitable deduction and the exclusion from income of amounts contributed to Flexible Spending Accounts (FSAs). Significant debate exists regarding the proper characterization of these provisions – either as necessary to the proper definition of income or a tax incentive. However, regardless of the position taken, virtually all agree they are underperforming. Prior attempts to fix these provisions separately have failed. This Article proposes increasing the efficacy of both by combining them and allowing taxpayers to donate unused amounts left in their FSAs at the end of the year to charity.

Amending the law in this way will increase the efficacy of both provisions by increasing the availability and financial incentives for the former and reducing the financial penalty associated with the latter. Perhaps more important, the proposal takes advantage of the “mental accounting” insights discussed in the behavioral economics literature to increase the attractiveness of the incentives without increasing the “rate” implicit in allowing a deduction or exemption. The net result is a more cost effective tax provision. This proposal thus serves as a model for Congress as it considers the design of other tax provisions.

INTRODUCTION

This Article considers two seemingly unrelated tax provisions: the charitable deduction and the exclusion of income deposited in Flexible Spending Accounts (FSAs) and then used to pay for healthcare. The former has been the subject of significant scholarly attention, while the latter has been largely ignored. Nonetheless, in both cases, there is some debate whether the provisions are necessary to measure income, *i.e.*, whether they are consistent with some ideal notion of income, or whether they represent a deviation from the ideal and instead should be considered

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“tax expenditures”¹ designed to promote some policy external to measuring the tax base, e.g. to encourage charitable giving or create incentives for people to save for future medical needs.

Whatever one’s position on this issue,² it is universally agreed that the two provisions are flawed. If allowing the deduction or exemption is considered consistent with ideal income definitions, then they should be available to all taxpayers, without limit. If, instead, the provisions are intended to create financial incentives for taxpayers either to donate to charity or save for healthcare needs, the provisions should similarly be available to all taxpayers. If they are not made available to all, there should be a clearly defined target group of taxpayers and a rational basis for limiting the provisions’ availability to that group. Neither of the provisions in question satisfies either of these standards.

¹ The concept of the tax expenditure was championed by Stanley Surrey, a Harvard Professor who served as Assistant Secretary of the Treasury under President Kennedy. He also championed the idea of compiling an annual tax expenditure budget so that it would be possible to assess how much money Congress spent indirectly by giving tax preferences to subsets of taxpayers. Surrey, Stanley S., *Pathways to Tax Reform: The Concept of Tax Expenditures* (1973).

Tax expenditures have received significant criticism for complicating the tax code, obscuring government spending, and distorting the budgeting process. *See, e.g.*, CITE example where tax expenditures bad for complexity; Edward D. Kleinbard, *How Tax Expenditures Distort Our Budget and Our Political Processes*, Tax Notes (May 18, 2009); Edward D. Kleinbard, *Tax Expenditure Framework Legislation*, (January 5, 2010). USC CLEO Research Paper No. C10-1; USC Law Legal Studies Paper No. 10-1. Available at SSRN: <http://ssrn.com/abstract=1531945> (exploring the difficulties that arise because tax expenditures occur outside the normal budget process). However, they have also been praised as possibly more efficient than direct spending programs. *See* Louis Kaplow and Steven Shavell, *Why The Legal System Is Less Efficient Than The Income Tax In Redistributing Income*, 23 J. Leg. Stud. 667 (1994); Lilly Batchelder, Austin Nichols and Eric Toder, *\$750 Billion Misspent? Getting More from Tax Incentives at 27* (Urban Institute – forthcoming) (arguing that the choice between direct subsidies and tax expenditures should depend on “how the choice affects the structure and administration of the program, and the relative advantages of coordination and specialization”). Regardless, they seem here to stay.

² For purposes of this Article, I need not choose between the competing theories. However, given the way in which both provisions are structured, it seems clear that Congress does not take the position that charitable donations and healthcare savings are properly excluded from income. Instead it treats the provisions as incentives. Accordingly, I refer to the provisions as tax incentives throughout this article. However, even if one takes the view that all taxpayers should be allowed to deduct and exclude all amounts in question, the analysis and proposal still makes sense. While the proposal does not go as far as some might want, it would still be an improvement over the current state of affairs.

The charitable deduction is not available to the approximately 65% of taxpayers who take the standard deduction.³ Moreover, for the 35% who can claim the deduction, the total amount deductible may be limited.⁴ FSAs, along with a host of other healthcare-related tax provisions, are available only to those whose employers offer them,⁵ and employees are only permitted to contribute \$2,500 per year to such accounts.⁶ Clearly, Congress does not view these provisions as integral to the definition of income, or, if it does, it has done a poor job of drafting. However, the provisions fare little better as tax incentives. No reason exists to limit the charitable donation incentive to itemizers or the ability to use FSAs to those lucky enough to have enlightened employers. The FSA incentive is further blunted because any FSA funds not used by year's end are forfeited. As a result, even those taxpayers eligible to participate often do not sign up for or underfund their FSAs.⁷

Whether one believes that amounts contributed to charity or saved for healthcare are properly excluded from income or that these provisions are tax incentives, the “fix” is quite similar: Make the provisions available to more people and remove as many impediments to their use as possible. However, to date, separate efforts to amend these provisions and make them more widely available have failed.

This Article proposes a novel approach that merges the two provisions, with the goal of improving both. Simply put, allow taxpayers to donate unused funds in their FSAs to charity. The proposal would likely increase savings for medical needs by diminishing one of the key disincentives to FSA participation – the risk of forfeiture. Taxpayers would likely be far more willing to participate and adequately fund their FSAs if they knew that any unused amounts would go to a charity of their choosing. At the same time, all taxpayers would receive the equivalent of an above-the-line deduction for amounts donated to charity through this

³ See I.R.C. § 63, 67 and 68. For data on the number of people who itemize, see Internal Revenue Serv., SOI Tax Stats--Individual Income Tax Returns Publication 1304 (Complete Report) tbls.1.2 & 2.1 (tax year 2005), available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134951,00.html>. The 35% who itemize accounted for 80.5% of all income tax revenue raised in 2005. See *id.* Thus, from a pure income perspective only about 20% of the income earned is not eligible to be offset by the charitable deduction.

⁴ See I.R.C. § 170.

⁵ See I.R.C. § 125 (allowing exclusion of health insurance premiums, FSAs contributions, and other amounts from income so long as they are part of an employer-sponsored healthcare plan).

⁶ As of 2002, approximately 12% of those eligible to participate in FSAs do so. Daniel Kadlec, *Inflexible-Spending Accounts*, *Time*, Oct. 21, 2002, at 86. HSAs have not been widely successful either. See pp. ___ below.

mechanism, thus broadening the tax incentive for charitable giving beyond itemizers and thereby likely increasing charitable donations.

Admittedly, this proposal may not be a “first best” solution. The easiest way to make charitable deductions available to all is to move all deductions above the line. The best way to address the forfeiture provisions in the FSA rules would be to allow taxpayers to roll over any unused funds. However, despite repeated efforts over the years, neither of these solutions has gained traction. This “second best” solution may offer a middle ground that captures some of the benefits of the first best solutions while avoiding some of the pitfalls, whether ideological, political, or financial, that have to date kept Congress from acting. Indeed, this is the type of proposal the non-profit sector and individuals could get behind, giving it some political traction that has been missing from earlier attempts to fix each provision separately.

My goal in writing this Article is not simply to try to improve these two provisions. Perhaps more important, the proposal illustrates how lawmakers can and should look beyond objective financial incentives when designing tax expenditures. The tendency in tax is to focus exclusively on the rates when designing provisions, though a review of the charitable deduction reveals how Congress uses a number of different tools beyond the mere setting of the rate to alter those incentives.

However, Congress has another set of tools that it has, to date, used sparingly. Over the past half century, behavioral economists have shown that people do not always act in economically rational ways. The framing and design of a provision can have a significant influence on how people perceive objective financial information. By taking advantage of these insights, lawmakers can increase a tax expenditure’s efficacy without increasing the objective financial incentive offered, thus reducing the cost of a given tax expenditure. This proposal does just that and could act as a model for the design of future tax expenditures.

Part I of this Article sets forth the academic justifications put forward for the charitable deduction and reviews the different means Congress has used, whether intentional or not, to alter the financial incentives associated with the deduction.

Part II of this Article sets forth the justifications offered in support of tax provisions designed to promote healthcare policy and reviews the different ways in which Congress has used the Code to do so, with special attention paid to the provisions designed to encourage people to save for medical expenditures.

Part III reviews the efforts to remedy the perceived flaws in both the charitable deduction and the FSA provisions

Part IV proposes tying the charitable deduction and FSA provisions together by allowing taxpayers to donate unused funds in an FSA at the end of the year to charity. I argue that, in doing so, not only can Congress

increase the financial incentives associated with both provisions, but it can also take advantage of the “mental accounting” insights provided in the behavioral economics literature.

I. CHARITABLE DEDUCTIONS

Although the Code has allowed a deduction for charitable donations since 1917,⁸ the rationale for the deduction is not entirely clear.⁹ The legislative history suggests that a key reason for including it was the fear that wealthy individuals would not otherwise donate to institutions of higher education, which had come to depend on donations for their survival.¹⁰ However, the charitable deduction was not limited to its ostensible purpose, and deductions were allowed for donations to all types of charitable organizations. The provisions have been amended numerous times over the past 90 years, further clouding the picture to be gleaned from the legislative history.

One might be tempted to work backwards, i.e., to discern the motivating purpose for the deduction by looking at its structure, but this approach would likely give too much weight to the idea that Congress has a clear purpose and that it has structured the law to carry out that purpose. Moreover, this approach focuses on what is, as opposed to what should be, thereby offering little help in deciding how best to amend the rules. Accordingly, we turn to examine the theories offered in support of the charitable deduction.

As described more fully below, some see the deduction as consistent with theoretical notions of income.¹¹ Others regard the deduction as a subsidy, with the subsidy rate set at a taxpayer’s marginal tax rate.¹² Regardless of one’s belief, the provisions governing charitable deductions seem deeply flawed, as the deduction is unavailable to the approximately 65% of all filers who take the standard deduction. As the appropriate “fix” depends on one’s view of the deduction’s purpose, Subpart A therefore

⁸ See War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917). An effort to have a similar provision included in the original 1913 act was unsuccessful. See J.S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS 1938-1861, at 945 (1938). For a discussion of the history of the charitable donation, see Ellen Aprill, Churches, Politics, And The Charitable Contribution Deduction, 42 B.C. L. Rev. 843 (2001).

⁹ See David E. Pozen, Remapping the Charitable Deduction, 39 Conn. L. Rev. 531, 547 (2006) (describing the theories of the charitable deduction as “underdetermined” and “undertheorized”).

¹⁰ 55 CONG. REC. 6728 (1917).

¹¹ See pp. ____, below.

¹² See pp. ____, below.

reviews the policy justifications adduced in support of the charitable deduction. Subpart B briefly describes the different ways the Code can be used to subsidize charity. Subpart C explores the current state of affairs and how Congress alters the availability and attractiveness of the charitable tax provisions by tinkering with both the rate¹³ and other non-financial elements.¹⁴

A. The Rationale for Allowing Deductions

Scholars have offered two basic justifications for a broad charitable deduction. The first is based on the notion that amounts given to charity do not constitute income and therefore should be excluded from the tax base. The second is that the deduction serves as a tax expenditure, an indirect subsidy to encourage people to donate to charity. In this subpart, I discuss these justifications, as well as the ramifications each has for how the deduction should be structured.

The first type of justification for allowing a broad charitable deduction depends on one's view of the ideal tax base. For instance, the most commonly used approach to income definition for tax purposes relies on the Haig-Simons formulation defines income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."¹⁵ Someone who earns money and then gives it away has no net increase in wealth. Thus, the question of whether amounts donated to charity should be included in the tax base depends on how consumption is defined. Those who believe charitable giving is not a form of consumption would allow an unlimited charitable deduction as a matter of income-measurement, while those who believe it is consumption would not.¹⁶

Several different definitions of consumption have been offered. For instance, Professor William Andrews defined consumption as the "private preclusive appropriation" of goods¹⁷ and, based on that definition, argued

¹³ As described below, some provisions, such as the decision to limit the total amount deductible in any given year, *see* IRC § 170(b), dampen the financial incentive, while others, such as the decision to allow taxpayers to deduct the fair market value of certain donate property, *see* IRC § 170(e), actually increase it.

¹⁴ *See, e.g.*, provisions requiring appraisals.

¹⁵ Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* 50 (1938).

¹⁶ As the income tax is structured, the way to exclude amounts donated to charity from the tax base is to give the donor a deduction for the amount of the donation, i.e., of expenditures that do not constitute consumption.

¹⁷ William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 309, 313 (1972).

that making gifts or charitable donations should not count as consumption because such acts merely transfer property from one person to another who can then consume it.¹⁸ Other scholars reject this definition, insisting that donating to charity properly qualifies as consumption. For instance, Professor Kelman argues that, not only is it difficult to define “private preclusive appropriation,” but it is also not clear that charitable contributions qualify as such.¹⁹ The pleasure one presumably receives from spending on charitable giving is hard to distinguish from the pleasure received from spending on a vacation, thus making it difficult to justify a deduction in one case and none in the other. The possession of funds reflects the resources at a person’s disposal and the gratuitous transfer is no different from any other type of disposition.²⁰ Thus, he would reject a charitable deduction on income-definition grounds.

Not all scholars look to the Haig-Simons definition, and another approach to the question of income definition for tax purposes focuses on the purported goals of the income tax. Under this approach, taxing income is not a goal in itself but rather a proxy for getting at some underlying taxpayer attribute, such as “ability to pay” or welfare.²¹ Income is simply a tool to approximate these attributes, and any effort to define income for tax purposes should focus on whether the definition yields a result consistent with our understanding of a given taxpayer’s ability to pay or welfare. In other words, one should look to the goals of the income tax, as opposed to trying to flesh out some ideal definition of income.

Professor Boris Bitker noted that those who give to charity are worse off than those who do not because they have divested themselves of assets. Accordingly, such people should pay less in taxes than those who earn money and keep it.²² The difficulty with this argument is that someone

¹⁸ See also, Douglas A. Kahn & Jeffery H. Kahn, “Gifts Gifts and Gefts” - The Income Tax Definition and Treatment of Private and Charitable “Gifts” and a Principled Policy Justification for the Exclusion of Gifts from Income, 78 Notre Dame L. Rev. 441, 461 (2003). Professor Warren takes a different path to a similar conclusion, arguing that the sum of personal income should match total societal income. Thus, consumption must refer to the ultimate use or destruction of resources. Alvin Warren, Would a Consumption Tax be Fairer Than an Income Tax?, 89 Yale L. J. 1081, 1084 (1980).

¹⁹ Mark G. Kelman, Personal Deductions Revisited: Why They Fit Poorly in an ‘Ideal’ Income Tax and Why They Fit Worse in a Far From Ideal World, 31 Stan L. Rev. 831 (1979).

²⁰ See also, Marjorie Kornhauser, The Constitutional Meaning of Income and the Income Taxation of Gifts, 25 Conn. L. Rev. 1, 29-30 (1992) (arguing that charitable giving contains an element of personal consumption).

²¹ Cite Dodge article on Ability to Pay. Adam Chodorow, Ability to Pay and the Taxation of Virtual Income, 75 Tenn. L. Rev. 695 (2009).

²² Boris I. Bittker, Charitable Contributions: Tax Deductions or Matching Grants?, 28 Tax L. Rev. 37 (1972).

who spends money on a fancy vacation also has divested himself of funds and has a lesser ability to pay taxes. It is clearly necessary to distinguish between different types of expenditures. One approach is to look at total welfare. In return for spending the money, the vacationer has received the value of the vacation so that he is no less well off in terms of overall welfare. In contrast, the charitable donor has arguably received nothing in return for his donation²³ and so is less well off as a result of the donation. This latter claim is somewhat dubious, as donors often receive return benefits, whether a name on a building, religious services, or the chance to listen to NPR. Other intangible benefits may be the satisfaction received from having helped others.

Another way to approach this question is to consider the nature of the expenditure, and in particular whether it is voluntary. The deduction for alimony paid provides a good illustration. When rates are high, one who pays alimony might find it impossible to pay his taxes.²⁴ To rectify this problem, in 1942 Congress amended the Code to allow a deduction for alimony paid,²⁵ requiring the receiving spouse to include the amount in income.²⁶ While paying alimony reduces the payor's welfare and a deduction could be defended on that ground, it is also court-ordered. It seems wrong to include in a taxpayer's welfare or ability to pay money he is not entitled to keep or use. Bitker notes that charitable giving for many is seen as a moral obligation and therefore should arguably be seen as involuntary. Given that many do not feel such compulsions, yet nonetheless give to charities, this seems a weak justification for the deduction.

While not couched in the language of "consumption," this type of argument ultimately reduces to the need to distinguish between different types of expenditures. Whatever the justification offered, those who argue that amounts donated to charity are properly excluded from income as a matter of income-measurement support an unlimited deduction for all amounts donated.

²³ The existence of a quid pro quo is a key element to finding a charitable donation. *See, e.g.,* _____. The jurisprudence on this topic is at best muddled. Luckily it is not necessary to delve into it for purposes of this Article. Instead, it is sufficient to note that the receipt of benefits in return for a donation may cause a disallowance of some or all of the amount donated.

²⁴ A simple example illustrates the point. Imagine someone who earns \$100,000 but gives away \$40,000 to charity, leaving him with \$60,000 to live on. If the tax rate is 60% and no deduction is allowed, he will owe \$60,000 in taxes, leaving him with nothing to live on. In contrast, if the \$40,000 is deductible, he will only have to pay tax on \$60,000. While the tax is still high (\$36,000), he still retains \$24,000 on which to live.

²⁵ *See*, I.R.C. §215.

²⁶ *See*, I.R.C. § 71.

The second type of theory supporting a charitable deduction rests on the notion that the charitable deduction is a government subsidy. Justifications for a subsidy are many, but they generally fall into two categories. Modern theorists suggest that “subsidizing charities is necessary to assist them in providing public goods that would otherwise be under-produced due to market and governmental failures.”²⁷ More traditional theories focus on the benefits received, whether by the government, which may be absolved from providing benefits, or the people who receive them directly. However, as Professor Miranda Fleischer has noted, even these traditional notions focus on the use of charity to produce public goods. Thus, we turn first to consider such goods.

Public goods have two key characteristics. First, they are non-rivalrous, meaning that the use of a public good by one person does not reduce availability of the good for use by others. Second, they are non-excludable, meaning that people cannot be effectively excluded from using them. As a result of this second characteristic, makers of public goods often cannot capture the value they create - the so-called free-rider problem – leading to the sub-optimal creation of such goods.²⁸ Thus, the market fails to produce the level of such goods that one would expect from an overall cost-benefit analysis. In light of the market’s failure to produce the appropriate level of public goods, the government often steps in to supply such goods, using the power of taxation – not available to private actors – to force people to pay for them. The charitable deduction is simply a way to induce private actors to provide such goods by giving them an indirect subsidy.

Theorists have articulated a number of reasons why society would subsidize non-governmental actors in their quest to provide public goods, rather than provide those goods themselves.²⁹ First, charities may be more efficient at providing public goods than the government.³⁰ Charities can function as laboratories for ideas, much as the states purportedly do in our

²⁷ Miranda Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 *Minn. L. Rev.* 165, 183 (2008).

²⁸ This is the opposite problem that arises with externalities, i.e., costs created by an activity that the actor does not bear.

²⁹ Many people undertake charitable giving as a religious or moral obligation and will donate to charity regardless of a government subsidy. However, it is not clear that such giving will be sufficient to meet the needs identified in the text above. Hence the need for a subsidy. For a discussion of the Judeo-Christian obligation to do charity, see Adam S. Chodorow, *Maaser Kesafim and the Development of Tax Law*, 8 *Fla. Tax Rev.* 153 (2007).

³⁰ If, by efficient, one refers to the ability to deliver public goods, the government would not need to subsidize charity by others to capture the efficiency so much as hire the private sector to carry out government programs, much as it does in other areas.

federal system, and reliance on private actors could allow the market to identify needs and develop means of fulfilling them far more efficiently than a centralized government. Second, it may not be possible for the government to provide the goods because of constitutional or other limits, e.g., the separation of church and state. Allowing third parties to provide such goods is the only alternative, and a subsidy for such activities may be the only way to ensure that sufficient goods are created given the free-rider problems that the private charities will face.

Third, for structural reasons, the government itself may fail to provide the optimal level of public goods.³¹ Where the demand is homogeneous, it is not hard to optimize the level or mix of public goods. However, where the demand is heterogeneous, optimizing the supply of public goods gets more difficult. Different people want different things and it will be almost impossible to determine the precise mix and level of goods that would maximize welfare. Moreover, it is not at all clear that governments would even try to maximize welfare. Those in power might act to satisfy personal preferences or those of their supporters. A government subsidy for private charity could correct both of these problems because private actors are more likely to discern and pursue their interests, thus maximizing the provision of the goods they desire. In many regards, this is similar to the efficiency argument discussed above.

In a democratic society, government subsidies for private charity based on a theory of market failure may make less sense. If the democratically elected government sets a mix or level of public goods that is sub-optimal, it nonetheless is supposed to reflect the “will of the people” and should therefore be respected. It seems inconsistent to have the majority decide the mix and level of spending on public goods, while at the same time funding private efforts that would change the mix and level. However, subsidizing private charity can readily be justified on democratic grounds as well. The decision to subsidize charity may reflect a collaboration among different minorities whose public goods needs are not being met by government action.³² While no majority exists for any one group’s preferences, together they form a majority for the proposition that taxpayers should be allowed some discretion to spend government money to supplement the level of public goods provided through democratic means. Thus, the subsidy makes room for pluralism, which is much valued in our society.³³

³¹ See Mark P. Gergen, *The Case for a Charitable Contribution Deduction*, 74 Va. L. Rev. 1393, 1397-98 (1988).

³² Miranda P. Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 Minn. L. Rev. 165, 185-86 (2008).

³³ Saul Levmore, *Taxes as Ballots*, 65 U. Chi. L. Rev. 387, 405 (1998).

The production of public goods is not the only reason one might choose to subsidize charity. For instance, as Professor Levmore has argued, pluralism is a democratic value that the deduction may foster.³⁴ Professor Miranda Perry Fleischer has recently argued that the charitable deduction is redistributive at heart, an aspect that has been largely lost in the modern focus on efficiency and pluralism.³⁵ Public goods are not desired for their own sake, but because they enhance welfare, however that term is defined. As a result, she argues, any consideration of the proper scope of the subsidy must bring such goals into the open and take them into account.

Other justifications for the subsidy include the claim that the charitable deduction fosters diversity³⁶ and that it may encourage people to engage in acts that foster compassion, civility, and interpersonal connectedness.³⁷ Recent studies suggest that such acts benefit not only the recipients of such acts, but also the actors themselves.³⁸ More important, charitable acts serve to reinforce the social bonds that create and maintain a civil society. However, as with the efficiency and pluralism types of arguments, diversity and compassion are simply means to an end, i.e. the effort to maximize welfare.

Regardless of justification offered for the subsidy, the underlying connection between all these different theories is that society gains more from the subsidy, whether economically or in other intangible ways, than the costs to the government fisc.

B. Accounting for Charitable Donations within the Tax Code

Accepting, *arguendo*, that amounts donated to charity should be excluded from income or that charity should be subsidized, the question arises how best to do it. If the rationale is that donated amounts are not income, a simple deduction or exemption of amounts donated will work. However, if the rationale is subsidy, several options exist.

³⁴ *Id.*

³⁵ Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 Wash U. L. Q. 505 (2010)

³⁶ Alice M. Thomas, *Re-Envisioning the Charitable Deduction to Legislate Compassion and Civility: Reclaiming our Collective and Individual Humanity Through Sustained Volunteerism*, 19 Kan. J.L. & Pub. Pol'y 269 (2010). Professor Thomas goes so far as to suggest allowing an above-the-line deduction for time volunteered, up to a cap, to further increase the subsidy for charity.

³⁷ David A. Brennan, *A Diversity Theory of Charitable Tax Exemption--Beyond Efficiency, Through Critical Race Theory, Toward Diversity*, 4 Pitt. Tax Rev. 1 (2006).

³⁸ *Id.* at 304-306.

One option is for the government to subsidize charity directly by issuing grants. However, if the justification for government support of private charity rests on notion that the government has failed to produce the appropriate mix or level of public goods, direct subsidies controlled by the government make little sense. The process that led to government failure in the first place will likely lead to similar failures because the government decides which organizations or activities get grants. While some room for innovation exists, such an approach would not fully unleash the potential of the market and achieve the efficiency, diversity and other benefits purported provided by a vibrant non-governmental non-profit sector.

If the goal is to identify individual preferences to maximize the supply of public goods and ultimately public welfare,³⁹ reinforce our pluralistic values,⁴⁰ ensure diversity,⁴¹ or foster communitarian sentiments,⁴² allowing individuals to choose where their public good dollars are spent makes more sense. The question is how best to do this. This leads to the second option, using the Code to provide indirect subsidies to charity by giving subsidies to individuals who support them.

Using the Code to provide subsidies affords two options. The first is to allow taxpayers to deduct or exclude amounts donated to charity.⁴³ The second is to award tax credits for the same activity. Under a deduction model, a taxpayer who gives away income deducts it, thus lowering his income and reducing his tax liability by his marginal rate. One who donates and receives a deduction is still worse off financially than he would have been had he kept his money, but he is partially compensated with reduced taxes. Because the subsidy rate implicit in this approach is equal to a taxpayer's marginal rate, those in higher tax brackets receive a greater

³⁹ See, e.g., _____ (arguing that subsidizing individuals will identify the nature and quantity of desired public goods better than direct government subsidies).

⁴⁰ See, e.g., Saul Levmore, Taxes as Ballots, 65 U. Chi. L. Rev. 387, 405 (1998) (arguing that subsidizing individuals promotes pluralistic values)

⁴¹ See, e.g., David A. Brennan, A Diversity Theory of Charitable Tax Exemption--Beyond Efficiency, Through Critical Race Theory, Toward Diversity, 4 Pitt. Tax Rev. 1 (2006).

⁴² See, e.g., Alice M. Thomas, Re-Envisioning the Charitable Deduction to Legislate Compassion and Civility: Reclaiming our Collective and Individual Humanity Through Sustained Volunteerism, 19 Kan. J.L. & Pub. Pol'y 269 (2010)

⁴³ While some have called for allowing a deduction or credit for donated time, see Alice M. Thomas, Re-Envisioning the Charitable Deduction to Legislate Compassion and Civility: Reclaiming our Collective and Individual Humanity Through Sustained Volunteerism, 19 Kan. J.L. & Pub. Pol'y 269 (2010), Congress to date has refrained from so doing. Accordingly, I will focus in this Article only on donations of money or property.

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subsidy than those in lower tax brackets.⁴⁴ This approach yields a result consistent with that urged by those who argue that amounts donated to charity are properly excluded from the tax base.

Under a credit model, taxpayers determine their income and tax liability without regard to the donation. Instead, they receive a tax credit that directly reduces the amount of tax owed. Under this approach, all taxpayers receive the same subsidy. Unlike the deduction approach, it is necessary under the credit approach to set the amount of the subsidy explicitly. Tax credit amounts could be set in any number of ways. A credit set at the taxpayer's marginal rate would match the subsidy afforded by the deduction approach. A dollar-for-dollar credit would make the taxpayer indifferent from a purely economic perspective. He would be equally well off donating or not donating to charity.⁴⁵

Significant debate exists regarding the propriety and wisdom of using the Code to distribute government subsidies. Tax expenditures significantly complicate the Code and lead to a number of difficulties, such as the upside down subsidies mentioned above. While this could be eliminated by using credits,⁴⁶ other problems exist, such as the difficulties of targeting subsidies to the intended beneficiaries. While Congress has increased its use of tax credits in recent years, the deduction remains the primary means of handling charitable donations. I thus turn now to consider the charitable deduction.

C. The Charitable Deduction in Action

Allowing a full deduction for all donations functionally excludes such amounts from income and therefore is appropriate if one accepts the claim that amounts donated to charity should not be included in the tax base.⁴⁷ If one views the charitable deduction as a form of subsidy, the deduction sets

⁴⁴ For instance, a taxpayer at the 30% rate who donates \$100 will reduce his tax liability by \$30. Another taxpayer in the 20% bracket would reduce his tax liability by only \$20.

⁴⁵ For an example of this type of credit, see AZ Law. Under this provision, taxpayers who donate to certain charities that fund private schools are given a dollar-for-dollar tax credit against their state taxes.

⁴⁶ See Lilly L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orzag, *Efficiency and Tax Incentives: The Case for Refundable Credits*, 59 *Stan. L. Rev.* 23 (2006) (arguing that tax credits are a better vehicle for tax expenditures than deductions).

⁴⁷ Where income is earned in one year and the donation made in another, if the taxpayer is in the same tax bracket in both years, the deduction effectively recovers the tax that was previously paid by reducing current income, thus putting the taxpayer in the same position he would have been in had he never earned the income in the first place.

the subsidy rate at the taxpayer's marginal tax rate and limits it to the amount of tax already paid or that would have been paid on the donated amounts. However, the nominal rate for the subsidy is only one small piece of a much larger puzzle. Congress has a number of other tools at its disposal that can and do significantly affect the incentive effect of the subsidy. Perhaps the most important of those are rules that affect the amounts that may be deducted, the timing of deductions, and the placement of the deduction below the line.

The first way in which Congress has affected the subsidy without adjusting the nominal rate is by regulating the amount taxpayers are allowed to deduct. This arises both with regard to individual items donated and the total amount deductible in any one year. With individual items, the issue arises primarily when taxpayers donate appreciated property to charity. As a result of the realization requirement, taxpayers do not pay tax on appreciation until the property has been sold or otherwise disposed of.⁴⁸ Donating to charity is not considered a realization event, and taxpayers need not pay tax on any appreciation when they donate. If taxpayers are allowed to deduct the fair market value of appreciated donations, they receive a tax windfall, putting them in a position even better than they would have been had they not earned the original income in the first place.

An example may help illustrate the point. Assume that A and B are both in the 40% bracket. A earns \$100 and later donates it to charity. A will owe \$40 of tax on earning the income and be entitled to a \$100 deduction on donating it. The \$100 deduction will reduce A's taxes by \$40, thus offsetting his earlier tax liability, and putting A in the same position he would have been in had he never earned the \$100. In contrast, assume B earns \$100 and purchases a painting. He will owe \$40 in tax on earning the \$100. When the painting rises in value to \$150, he donates it to a charity. If B is allowed to deduct the full \$150, he will receive a tax savings of \$60. When offset against his earlier \$40 tax liability, he is \$20 better off than he would have been had he never earned the initial \$100.⁴⁹

⁴⁸ IRC § 1001(a).

⁴⁹ Even though B might be better off from a tax perspective, he is still worse off from an economic perspective. When he earns the \$100 and pays \$40 in tax, he is net up \$60. When the value of the painting goes up to \$150, he is net up \$110, but there is a latent \$20 tax due, which would be triggered if he sold the painting. This yields a net \$90 gain. If he donates the painting to charity and is allowed to deduct the entire amount, he need not pay the \$20 in tax associated with the unrealized appreciation. Indeed, he receives a reduction in his tax liability of \$60. However, he no longer has the \$150 item (\$110, when previously paid taxes are netted out). Thus, he loses \$110, but gains only a \$60 benefit. Thus, there is a net loss to the taxpayer of \$50.

He would also be in a better position than someone who earned \$150 and then donated it to charity.⁵⁰

To prevent this result, Congress generally allows taxpayers to deduct only an item's basis.⁵¹ However, Congress has created several exceptions to this rule. For instance, where the use by of the donation by the recipient is related to the basis for the recipient's tax exemption under IRC § 501, a donor may deduct the full fair market value.⁵² Thus, if one donates an appreciated painting to an art museum for display, the donor may deduct the full fair market value. However, were one to donate the same painting to the Red Cross, which sold it to raise funds for disaster relief, the donor would only be allowed to deduct his basis. Thus those who donate to museums generally receive a greater subsidy than those who donate to disaster relief.⁵³

⁵⁰ Were B to sell the painting and donate the proceeds to charity, the sale would generate a tax which would theoretically be offset by a deduction of the full amount donated. In fact, the gain on the sale might be taxed at capital gains rates, while the donated amount would reduce ordinary income, so the subsidy rate might actually exceed tax paid when property is donated to charity. However, this strategy will not necessarily work if the goal is to get the asset into the hands of the charity, as opposed the asset's value.

⁵¹ While framed in the language of capital gain, another way to think of this is that only amounts previously subject to tax, i.e., basis, may be deducted. IRC 170(e).

⁵² IRC 170(e)(1). Those who donate appreciated stock receive similar benefits. IRC 170(e)(5).

⁵³ Allowing some taxpayers to deduct the full fair market value of appreciated property has been attacked on several fronts. Some raise equity-based arguments. It seems unfair to limit the subsidy to previous tax paid for some donors, while allowing a larger subsidy to others. CITE Others argue that allowing a deduction for untaxed appreciation is inconsistent with sound tax policy, which suggests that only basis be deductible. Cite to Cal Johnson. For a discussion of the role and function of basis, see Adam S. Chodorow, *Tracing Basis Through Virtual Spaces*, 95 *Cornell L. Rev.* 283 (2010). While the basis argument makes sense under internal tax logic, if the goal here is to provide a subsidy, there is simply no reason why the level of the subsidy should be limited to the amount of tax already paid. The taxpayer may be better off from a tax perspective than he would have been had he never earned the income, he is still worse off from a pure economic perspective. *See* n. 49, above.

Indeed, one could easily envision a provision that allowed a deduction of 200% of the amount donated. So long as the tax rates were below 50%, a taxpayer would be worse off from an economic perspective. Were the tax rate to rise above 50%, taxpayers would be better off donating than not, a situation that should generally be avoided. An example might help. Imagine a taxpayer who donates \$100 to charity. If he is allowed to deduct 200%, he will claim a \$200 deduction. If the tax rate is 50%, he will receive a \$100 reduction in tax liability and be indifferent to whether he donates the money or keeps it. If the rate were 60%, he would receive a tax reduction of \$120, and he would actually be better off donating

A second way in which Congress affects the incentive to give without adjusting the nominal rate is by limiting the total amount deductible in any year. Under current law, taxpayers may deduct charitable donations up to a maximum of 50% of income.⁵⁴ Taxpayers are allowed to carry over excess amounts into subsequent tax years for five years, so, except for those who have little income, this provision mostly affects timing. There is no way to know what affect the limit has on donation decisions, but statistics from 2003 reveal that approximately 500,000 returns claimed carryover deductions.⁵⁵ It is not possible to know how many people refrained from donating because of the limits.⁵⁶

money than keeping it. At that point, taxpayers would have too great an incentive to donate.

⁵⁴ IRC § 170(b). The Code actually refers to “contribution base,” which is a modified version of Adjusted Gross Income, defined in IRC § 62. To keep things simple, I use the term income. This limit has changed numerous times over the past 90 years, but has always trending ever higher from the original 15 percent of “net taxable income.” For a brief history of how the limits have changed, see Miranda Fleischer, at 170-173.

⁵⁵ Michael Parisi & Scott Hollenbeck, *Individual Income Tax Returns, 2003*, in 25 *Statistics of Income Division, IRS, SOI Bulletin 9*, 44 tbl.3 (Fall 2005). Check for more recent figures.

⁵⁶ Limits may serve other important functions as well, making it difficult to discern Congressional intent. For instance, if the incentive is structured as deduction, limits may blunt the effect of the upside down nature of the subsidy and help preserve the progressivity found in the Code. To the extent that the wealthy donate to different charities than the poor, limits could affect the mix of charities receiving donations. Limits could also act as a crude Alternative Minimum Tax, ensuring that all taxpayers pay something even when availing themselves of legitimate tax preferences.

Professor Miranda Fleischer offers yet another justification, based on democratic theory. _____. Allowing a taxpayer a deduction or tax credit for charitable donations effectively allows a taxpayer direct how the government spends its money. For instance, if the subsidy is structured as a dollar-for-dollar tax credit, as is the case in some states, absent limits, a taxpayer could determine his tax liability, donate that amount to charity, and use the resulting credit to satisfy his tax obligation. The result is that the entire amount he would have paid to the government now goes to the charity of his choice. This is tantamount to allowing a taxpayer to designate that his taxes should only be used for education spending or medical research.

If we conceive of the decision to allow a deduction as compromise between the majority voters who set the government’s agenda (the classic majority) and the second majority (the new majority), comprised of minority groups who have different preferences but cannot coalesce around one that outstrips the classic majority, allowing unlimited deductions would upset the compromise, as it would allow the minority taxpayers to withdraw their money from the government and use it for their own means.

Despite this general rule, Congress has created a number of exceptions in a clear effort to promote certain types of giving. In some cases, those exceptions are permanent fixtures in the Code. For instance, if the donor of a conservation easement is a qualified farmer or rancher, the maximum amount of the donation rises from 50 percent to 100 percent of income.⁵⁷ In others, the provisions are temporary and aimed at specific events. For instance, after Hurricane Katrina, Congress lifted the limits on charitable contributions in cash made between August 28, 2005 and December 31, 2005.⁵⁸

Congress has also tinkered with the limit for overall deductions by allowing some taxpayers to exclude the amount donated from income. For instance, those who win certain types of prizes, such as the Nobel Prize, may exclude the prize from income so long as they donate their winnings to a charitable organization.⁵⁹ Similarly, a recent provision permits those 70 ½ and older who donate their IRAs to charity to exclude up to \$100,000 of the donated amounts from income.⁶⁰ Excluding the income avoids the deduction limitations contained in IRC § 170(b), thus permitting the equivalent of a full current deduction.

Yet another way in which Congress has tinkered with the subsidy is by changing the timing for charitable deductions. Normally, deductions are taken in the tax year in which donations are made.⁶¹ However, in response to natural disasters, where the need for charity is great, Congress has altered the rules, allowing donors to take deductions against a previous year's income for current donation. For instance, on December 26, 2004, a massive earthquake occurred in the Andaman Sea, off the coast of Indonesia. The quake caused a massive tsunami that wiped out entire villages, ultimately leading to an estimated death toll of 230,000. In

⁵⁷ IRC § 170(b)(E).

⁵⁸ Katrina Emergency Tax Relief Act of 2005, [Pub. L. No. 109-73, 119 Stat. 2016](#), 2022-23. Interestingly, Congress did not limit the exception to donations related to Katrina. Congress also temporarily repealed the limitations on itemized deductions found in IRC § 68 for charitable contributions and increased the corporate limit on contributions from five to ten percent for contributions to hurricane-related charities. See *id.*

For another example of a temporary lifting of the limits for limited purposes, see IRC § 170(b)(3) (allowing a temporary suspension of the limits for certain contributions of food).

⁵⁹ IRC § 74(b).

⁶⁰ IRC § 408(d)(8), added by P.L. 109-280 § 1201. Originally set to expire on December 31, 2007, this provision was extended to December 31, 2009 by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (P.L. 110-343 §205(a). See IRS Notice 2007-7 (Jan 10, 2007) for a discussion of how this provision operates.

⁶¹ IRC § 170(a). Different rules apply to accrual method corporations. However, the bulk of American charity is from individuals. **CITE?**

response, Congress passed a law allowing people to deduct in the 2004 calendar year donations made through January 31 of 2005.⁶² More recently, on January 12, 2010, a massive earthquake hit Haiti, killing approximately 220,000. Again, Congress passed a law allowing cash donations to benefit the Haiti earthquake survivors to be deducted in 2009, so long as they were made between January 12, 2010 and March 1, 2010.⁶³

Finally, and perhaps most important, Congress has significantly limited the incentive effect of the charitable deduction by placing it “below the line.” The line in question is one that differentiates deductions used to determine Adjusted Gross Income (AGI) and those that are not. AGI is used as an interim measuring stick to determine whether taxpayers should be entitled to a host of tax preferences, such as the student loan deduction and the Earned Income Tax Credit.⁶⁴ Originally, the notion was that AGI should reflect a form of net income so that taxpayers could be readily compared. Accordingly, the AGI deductions initially differed in type from those that fell below the line, with below the line deductions more likely to be tax preferences or other expenditures that were not considered essential when calculating relative incomes.⁶⁵

With the introduction of the standard deduction in 1944, placement above or below the line took on additional significance.⁶⁶ Those who took the standard deduction were not allowed to take the itemized deductions as well. Thus, above-the-line deductions remained available to all taxpayers,⁶⁷ while below-the-line deductions were available only to those

⁶² See P.L. 109-1, 119 Stat. 3.

⁶³ See P.L. 111- 126, 124 Stat. 3. See also IRS Notice 1396. Another example of how Congress has used the Tax Code to promote charity in the face of natural disasters can be found in IRC § 139. This provision works indirectly by allowing victims of qualified disasters to receive certain types of help tax-free. Moreover, when such disasters occur, private foundations can provide such support without risk of losing their tax-exempt status. The most recent example of the IRS invoking this provision occurred on March 9, 2010, when the IRS declared the 8.8 magnitude earthquake that struck Chile to be a qualified disaster. See Notice 2010-26, 2010-14 I.R.B. __ (Apr. 5, 2010). Legislation has also been introduced to allow contributions through April 15, 2009 to be deducted against 2009 income. See Nicole Duarte, Levin-Camp Bill Would Allow Taxpayers to Claim Chile Contributions on 2009 Returns (Mar 9, 2010), 2010 TNT 46-3.

⁶⁴ See, e.g., IRC §§ 221 and 32.

⁶⁵ For a discussion of the above/below the line distinction and how it has changed over time, see Jeffrey H. Kahn, Beyond The Little Dutch Boy: An Argument For Structural Change In Tax Deduction Classification, 80 Wash. L. Rev. 1 (2005).

⁶⁶ For a discussion of the debates surrounding the adoption of the standard deduction, see Ellen Aprill, Churches, Politics, And The Charitable Contribution Deduction, 42 B.C. L. Rev. 843, 850-2 (2001).

⁶⁷ IRC § 62.

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who itemized.⁶⁸ The effect was to blunt any incentives associated with the now displaced deductions. Indeed, approximately 65% of all taxpayers take the standard deduction, meaning that they receive no tax incentive to give.⁶⁹ As a result, the financial incentive associated with charitable deductions is denied to the majority of American taxpayers.⁷⁰

In 1986, in an effort to raise tax revenues without affecting the nominal rate, Congress added IRC § 68 to the Code. This provision limits the amount of itemized deductions taxpayers over certain income thresholds may take.⁷¹ As a result, even those who itemize may not get the full benefit of their charitable deductions. Unlike IRC § 170, which permits taxpayers to carryover amounts above the limits, IRC § 68 contains no carryover provision, so any amounts disallowed are lost for good.

Whatever one's position on the nature of the charitable deduction, it is almost universally agreed that problems exist in the current structure. Efforts to fix these problems are discussed below in Part III.

II.

HEALTHCARE POLICY IN THE TAX CODE

The Code contains a number of provisions allowing taxpayers either to deduct or exclude from income amounts spent on medical care and insurance. As with the charitable deduction, some argue that these provisions are appropriate as a matter of income definition because medical spending should not count as consumption⁷² or reduces one's ability to pay.⁷³ However, most agree that provisions in the Code related to health care spending are subsidies designed to encourage people either to acquire health insurance or save for medical needs. It is also hoped that some

⁶⁸ IRC § 63.

⁶⁹ See Internal Revenue Serv., SOI Tax Stats--Individual Income Tax Returns Publication 1304 (Complete Report) tbls.1.2 & 2.1 (tax year 2005), available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=134951,00.html>. Nonetheless, the 35% of itemizers accounted for 80.5% of all income tax revenue raised in 2005. See *id.*

⁷⁰ Of course, if the taxpayers give enough money, their itemized deductions will exceed their standard deduction. As of 2010, the standard deduction for a married couple was set at \$11,400. Rev. Proc. 2009-50. Thus, depending on a taxpayer's other itemized deductions, a taxpayer would be required to donate significant amounts to charity to take advantage of this possibility.

⁷¹ As currently structured, this provisions disappears in 2010 only to reappear in 2011. Thus, there is no threshold amount for this year. Rev. Proc. 2009-50 § 2.06. The threshold for 2009 was \$166,800. Rev. Proc. 2008-66 § 3.11.

⁷² See ___ (arguing that the deduction for medical expenditures in excess of 7.5% of AGI is consistent with an ideal notion of income)

⁷³ ___. This is similar to IRC § 165(c)(3) and (h), which permit deductions for personal losses.

provisions will create incentives for people to manage their healthcare costs and help slow the rapid rise of medical spending.

Healthcare provisions in the Code break into three main types. The first allows a deduction for medical spending above a set floor. The second allows taxpayers to exclude the value of employer provided health insurance from income. The third allows taxpayers to exclude from income amounts they save and then spend on medical expenses. As with the provisions regarding charitable donations, despite the financial incentive nominally provided, many of these provisions have failed to live up to their promise. This Part considers both the structure and efficacy of the three types of health care provisions found in the Code.

A. Deductions for Medical Expenses

The Code prohibits the deduction of personal expenses.⁷⁴ Medical expenses are generally seen to be personal in nature and therefore are not normally deductible. Nonetheless, IRC § 213 permits taxpayers to deduct certain medical expenses above 7.5% of their AGI.⁷⁵ As with the charitable deduction, the medical expense deduction falls below the line,⁷⁶ meaning that it is available only to those who itemize.

As with the charitable deduction, there has been much debate as to its propriety. Purportedly relying on the Haig-Simons income definition, Professor William Andrews argued that medical spending should not be considered a form of personal consumption, and therefore should not be included in the tax base.⁷⁷ Others disagree, arguing the Andrews's definition of consumption is too narrow.⁷⁸ Still others point out that

⁷⁴ IRC §§ 262 and 163.

⁷⁵ IRC § 213. Originally, taxpayers were allowed to deduct amounts in excess of 3% of AGI. _____. As part of the recent healthcare reform, Congress amended § 213 to increase the floor from 7.5% to 10%, beginning in 2013. The Patient Protection and Affordable Care Act of 2010, P.L. 111-148, § 9013. Special rules apply to taxpayers who turn 65 before _____.

⁷⁶ IRC §§ 62 and 67. Unlike charitable donations, medical expenditures are not limited by IRC § 68.

⁷⁷ William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 *Harv. L. Rev.* 309, 314 (1972) (“As between two people with otherwise similar patterns of personal consumption and accumulation, a greater utilization of medical services by one is likely not to reflect any greater material well-being or taxable capacity, but rather only greater medical need.”). *See also* Laura Cunningham, *National Health Insurance and the Medical Deduction*, 50 *Tax L. Rev.* 237 (1995) (arguing that the existence of national health insurance would strengthen the theoretical argument for a health expense deduction)

⁷⁸ Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an ‘Ideal’ Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 *Stan L. Rev.* 831 (1979).

Andrews actually seems to justify the medical deduction based on ability to pay or welfare and that allowing a deduction for medical expenses better matches the tax burden to the taxpayer's well being.⁷⁹ The propriety of using this standard has also been challenged.⁸⁰ The existence of the relatively high 7.5% floor (moving to 10% in 2013) suggests that Congress may be concerned with catastrophic events that significantly affect a taxpayer's welfare and ability to pay taxes, while not fully accepting the claim that deducting such amounts is truly required as a matter of income-definition.

If one rejects the argument that a deduction for medical expenditures is appropriate under ideal conceptions of income, it is difficult to conceive of the deduction as a tax incentive. The point after all is not to provide a financial incentive for people to incur medical expenses. However, as Professor Thomas Griffith has argued, allowing a deduction or credit for medical expenses may well enhance societal utility, whether under traditional definitions or the maxmin formulation offered by John Rawls.⁸¹ Thus, the deduction functions as a subsidy that is justified because it produces greater societal gains than losses.

B. Employer Provided Health Insurance

By far the largest tax subsidy for healthcare can be found in IRC §§ 106, 3101(a)-(b), and 3121(a)(2), which exclude the value of employer-provided coverage under an accident or health plans from income and payroll taxes.⁸² However, as one history of health insurance benefits recounts, these provisions were not originally intended as subsidies. Instead, the genesis of these provisions can be traced to the National War Labor Board's decision to freeze wages during World War II. Given the shortage of workers, employers sought creative ways to get around the wage controls. One option was to offer health insurance.⁸³ In 1943, the Internal Revenue Service held that employees were not required to pay tax on the value of health insurance premiums that their employers paid on

⁷⁹ Thomas Griffith, *Theories of Personal Deductions in the Income Tax*, 40 *Hastings L. J.* 343 (1989).

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⁸¹ Thomas Griffith, *Theories of Personal Deductions in the Income Tax*, 40 *Hastings L. J.* 343 (1989).

⁸² By one estimate, the government subsidy created by this provision amounted to \$202 billion in 2004. It is routinely the largest tax expenditure found in the Code. See Richard Kaplan, *Who's Afraid of Personal Responsibility? Health Savings Accounts and the Future of American Health Care*, 36 *McGeorge L. Rev.* 535, 543-4 (2005).

⁸³ *History of Health Insurance Benefits, Facts from EBRI (Employment Benefit Research Institute, Washington D.C.), Mar. 2002, at 1.*

their behalf,⁸⁴ which Congress later codified as § 106. The result is that many employees prefer to receive expanded health benefits in lieu of additional wage compensation, while employers are indifferent because both expenditures are tax-deductible.⁸⁵ The net economic effect is that Congress has ended up subsidizing the purchase of health insurance, at least for those lucky enough to be employed and/or making enough money to afford to divert some of it towards health insurance.

Despite the subsidies, the efficacy of this approach is limited. Only taxpayers whose employers offer such plans are eligible. Costs have risen dramatically, with more and more employees asked to shoulder more and more of the costs.⁸⁶ By one recent estimate, approximately ___ million people in the US remain without health insurance.⁸⁷ While the recently passed health care law should address some of this problem, it still relies heavily on employer sponsored insurance and their associated tax incentives.

C. Tax-Favored Savings Accounts

Over the years, Congress has also created a number of different vehicles designed to encourage people to save for their medical needs and to help rein in medical costs. These are generally made available through one's employer and are described below.

1. Flexible Spending Accounts

The first saving vehicle employers may provide is the "Flexible Spending Arrangement." In some cases, employees elect to have money withheld from their paychecks. In others, employers make direct contributions to FSAs. In either case, the money is exempt from income and payroll taxes.⁸⁸ Until recently, the law imposed no limits on the amounts that could be contributed to FSA, though employer plans often set a \$5,000 limit.⁸⁹ As part of the recent health care reform, Congress has

⁸⁴ Special Rule, 433 Standard Fed. Tax Serv. (CCH), P 6587.

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⁸⁸ If employees elect to contribute, the plan is part of a "Cafeteria Plan" and governed by IRC § 125. If, instead, employers contribute to the plans, they are covered under IRC §§ 105 and 106.

⁸⁹ IRC § 129 imposes a \$5,000 limit for dependent care FSAs, and it appears that many plans similarly limit contributions to healthcare FSAs. *See, e.g.*, Prop. Treas. Reg. § 1.125-2 Q&A-7(f) Ex. 2 (1989). Prop. Treas. Reg. § 1.125-5(c). The Federal FSA plan limits contributions to \$5,000. *See*, Congressional Research Service RL32656 (May 11, 2010).

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limited the amount that can be contributed to and FSA to \$2,500, starting in 2013.⁹⁰

Participating employees submit receipts to seek reimbursement from this account for qualified medical expenses, as that term is defined in IRC § 213(d).⁹¹ Recently, non-prescription drugs were included as qualified expenditures, thus significantly broadening covered expenditures.⁹² However, the recent healthcare reform rescinded this rule, starting in 2011.⁹³ Thus, only prescription items will be covered. Reimbursed amounts are tax-free.

Under rules promulgated by the IRS in 1984, if money is left in the account at the end of the year, it is forfeited.⁹⁴ In 2005, the IRS allowed taxpayers an extra 2.5 months to use unused funds.⁹⁵ As spelled out by the current regulations, forfeited amounts may be retained by the employer maintaining the cafeteria plan, used to reduce salary reductions for employees for future years on a “reasonable and uniform basis, returned to employees on the same basis, or used to defray the costs of administering the plan.”⁹⁶ I am unaware of any study on the topic, but anecdotally, I can say that I have not yet heard of any FSA plan that actually returns the money to the employees, whether in the form of future-year reduced salary deductions or direct payment.

While forfeiture is a problem in and of itself, it is compounded by the fact that employees must estimate before the tax year begins their likely medical expenses and instruct their employers as to the appropriate amounts to withdraw.⁹⁷ This decision may not be changed absent a change in employment, i.e., a switch in employers, or where there is a change in family status, e.g., a divorce, marriage or birth, as set forth in the plan

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⁹¹ Prop. Treas. Reg. § 1.125-5(k).

⁹² See IRS Publication 969.

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⁹⁴ Prop. Treas. Reg. § 1.125-2 Q&A-7(b)(7). This ruling is based on a prohibition in the statute that disqualifies any plan that leads to “deferred” compensation. Apparently, it was believed that allowing amounts to roll over to the next year would effectively lead to deferred compensation because those amounts would be consumed in years subsequent to their being earned. See Letter from Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy) (Jun 22, 2006), available at 2006 TNT 124-31. The Tax Relief and Health Care Act of 2006 permits taxpayers a onetime rollover of any unused FSA amounts into a Health Savings Account. See Part III.C.4. below for a discussion of such accounts.

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⁹⁶ Prop. Treas. Reg. § 1.125-5(o)(1). Are forfeited amounts subject to tax in the hands of the companies that keep the money? What happens to returned money? If both are taxed, is the latter subject to payroll taxes while the latter is not?

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rules.⁹⁸ Thus, someone who set the deduction amount at a high level assuming he would have surgery in coming year would not be allowed to change it if he later learned the surgery was unnecessary. As a result, he would be at great risk of forfeiting the saved amounts unless he experienced other unanticipated medical expenses.

The intent of this provision is to create tax incentives for people to save for medical emergencies. However, it has generally been viewed as a failure. According a recent Bureau of Labor Statistics National Compensation Survey, as of 2007, only 33% of all workers were eligible to enroll in such plans.⁹⁹ As of 2002 only about 12% of those eligible to enroll in such plans do.¹⁰⁰ The trend has been an increase in participation. However, a 2008 Mercer Survey revealed that only 21% participated in 2007, while 22% participated in 2008.

According to the 2008 Mercer Survey, the average contribution for those who do participate was \$1,380.¹⁰¹ Unfortunately, no data is available on whether these amounts reflect actual medical expenses or how many people underfund their accounts to avoid the forfeiture penalty. Nor is there any data on the amount of time people spend trying to calculate with some degree of accuracy anticipated medical expenses so as not to overfund their FSAs. However, if my own experience is indicative, those numbers are very high. Finally, no data is available on the number of unnecessary or accelerated expenditures made simply to avoid forfeiting amounts left in the account at year-end.¹⁰²

2. Health Reimbursement Accounts

A second type of medical savings account, the Health Reimbursement Account, is covered under IRC §§ 105 and 106 and associated IRS

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⁹⁹ Bureau of Labor Statistics, Table 24. Pretax benefits: Access, private industry workers, National Compensation Survey, March 2007. The numbers were skewed heavily towards those in companies with more than 100 employees, with approximately 83% of all such companies offering FSAs, Mercer Human Resources Consulting, National Survey of Employer-Sponsored Health Plans 2008, comprising 51% of all workers. Bureau of Labor Statistics, Table 24. Pretax benefits: Access, private industry workers, National Compensation Survey, March 2007.

¹⁰⁰ Daniel Kadlec, *Inflexible-Spending Accounts*, Time, Oct. 21, 2002, at 86.

¹⁰¹ Mercer Human Resources Consulting, National Survey of Employer-Sponsored Health Plans 2008 at ____.

¹⁰² See Daniel Kadlec, *Inflexible-Spending Accounts*, Time, Oct. 21, 2002, at 86, available at <http://www.time.com/time/magazine/article/0,9171,1003493-1,00.html> (describing the purchase of new eyeglass frames and other medical services at the end of the year to avoid forfeiting amounts remaining in FSAs).

pronouncements.¹⁰³ As with FSAs, amounts contributed to such accounts are tax free. However, only employers may contribute to them. Employees may use funds contributed to these accounts for unreimbursed medical expenses. However, employers may designate the types of expenditures for which reimbursements are allowed. Like FSAs, there is no legal limit to contributions, but employers often impose caps. Unlike FSAs, amounts not used at year-end may be rolled over to the next year.

3. Archer Medical Savings Accounts

The Health Insurance Portability and Accountability Act of 1996 created a new experimental type of account called Medical Savings Accounts (“MSAs,” later renamed “Archer MSAs”).¹⁰⁴ Billed as a means to reduce the rapid growth in healthcare costs, the notion was that high-deductible plans would be less expensive than traditional health insurance. Moreover, consumers would be more cost conscious if they had to pay for medical costs out of pocket, at least until their deductible was used up. To encourage taxpayers to elect such plans, the MSAs allowed consumers to put away the money to be used to pay such deductibles and other qualified medical costs tax-free, i.e., they could deduct amounts contributed to MSAs from their income.¹⁰⁵ Any unused amounts were rolled over to the next year, and any appreciation in value, whether through dividends, interest, or an increase in the value of investments would be tax-free. Finally, amounts spent from such accounts would be tax-free so long as they were qualifying medical expenses.¹⁰⁶ Amounts not spent on such expenses were subject to tax and a penalty.¹⁰⁷

As noted, the MSAs were experimental. As a result, they had a number of features that likely hampered their acceptance. They had a definite end date,¹⁰⁸ only a limited number of accounts could be created,¹⁰⁹ and only self-employed individuals or those who worked for companies

¹⁰³ See, e.g., ____.

¹⁰⁴ ____, adding § 220 to the I.R.C. For the provision renaming the accounts, see Community Renewal Tax Relief Act of 2000, P.L. 106-554, Appx. G., § 202, 114 Stat. 2763A-587, 2763A-628 to 2763A-629.

¹⁰⁵ IRC §220. The Code provides a series of deduction limits not relevant here. For those participants on Medicare, direct contributions by Health and Human Services were also excluded from a taxpayer’s income. IRC § 138.

¹⁰⁶ IRC 220(f); 220(d)(2).

¹⁰⁷ IRC 220(f)(1), (2) and (4).

¹⁰⁸ The end-date was ultimately extended twice, for a total of 3 years. Community Renewal Tax Relief Act of 2000, P.L. 106-554, Appx. G, § 201(a), 114 Stat. 2763A-587, 2763A-628 (two-year extension); Job Creation and Worker Assistance Act of 2002, P.L. 107-147, § 612(a), 116 Stat. 21, 61 (one-year extension).

¹⁰⁹ I.R.C. § 220(j)(2)(A)(ii)

with fewer than 50 employees were allowed to create them.¹¹⁰ In all, only about 80,000 accounts were ever set up.¹¹¹

4. Health Savings Accounts

The most recent effort in this direction occurred with the Medicare Prescription Drug Improvement and Modernization Act of 2003 (MMA), which allowed individuals to create health savings accounts (HSAs).¹¹² These accounts are quite similar to MSAs, in that they were to be used in conjunction with high-deductible insurance policies. However, they are to be a permanent feature of the Code.¹¹³ Like MSAs, funds left over at the end of a year could be rolled over to the next year, thus avoiding the risk of forfeiture present for Flexible Spending Arrangements.

The hope was that making the accounts permanent would spur the market for high deductible plans. However, to date, the use of such plans with an HSA remains below expectations. According to one study, in 2005, only 2% of employers offered such plans. While the number jumped to 6% in 2006, it is still fairly low.¹¹⁴ To the extent that the goal was to encourage low-income uninsured to obtain insurance, it has also been a disappointment, as users tend to be higher income individuals.¹¹⁵ In addition, by one account from 2005 to 2007 between 42% and 49% of people who have a high deductible plan have failed to open HSAs, thus suggesting that the tax incentive is unnecessary for those participants or that they simply do not have the funds available to contribute.¹¹⁶

While high-deductible medical insurance plans may make economic sense for the healthy, the chronically ill will almost certainly spend through their deductible each year, thus eating up any possible savings that might be associated with such plans. Accordingly, they are far more attractive to some than others, causing self-selection among participants and thereby

¹¹⁰ I.R.C. §§ 220(c)(1)(A)(iii)(I) and (II), 401(c)(1)(B).

¹¹¹ Announcement 2002-90, 2002-2 C.B. 684 (78,913 MSAs).

¹¹² P.L. 108-173, 117 Stat. 2066 (2003) (primarily amending 42 U.S.C. § 1395 (2000)). The MMA added § 223 to the Code.

¹¹³ Unlike MSAs, these accounts permit contributions from both employees and employers in the same year. IRS Pub. 969.

¹¹⁴ The Kaiser Commission on Medicaid and the Uninsured, *Health Savings Accounts and High Deductible Health Plans: Are They An Option for Low-Income Families?* (2006).

¹¹⁵ 2008 Tax Notes Today 95-5, May 15, 2008.

¹¹⁶ *Id.*

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skewing the risk pools.¹¹⁷ It would be an understatement to say that this approach to healthcare cost management is controversial.¹¹⁸

III.

EFFORTS TO REFORM THE CHARITABLE DEDUCTION AND FSA PROVISIONS

Over the years, numerous efforts have been undertaken to reform both the charitable deduction and the FSA provisions.¹¹⁹ To date, none have succeeded. This Part describes those efforts.

A. The Charitable Deduction

When Congress created the standard deduction, it was fully aware that those who chose it would lose the tax incentive to give to charity. There was significant concern for the financial welfare of charities; however, those in favor of the proposal reasoned that the simplicity gains were worth the costs, taxpayers were in fact getting a benefit because any charitable donations would be included in the standard deduction itself, and taxpayers would likely give regardless of the tax incentive.¹²⁰

Despite losing the debate in 1944, those in favor of a charitable deduction for all taxpayers continued to push to move the deduction above the line. They briefly succeeded, between 1982 and 1986, until Congress returned the deduction below the line as part of a major overhaul of the tax

¹¹⁷ The Kaiser Commission on Medicaid and the Uninsured, *Health Savings Accounts and High Deductible Health Plans: Are They An Option for Low-Income Families?* (2006).

¹¹⁸ See, e.g., Written Statement of Gail Shearer, Director, Health Policy Analysis, Washington Office, CONSUMERS UNION, Before the Health Subcommittee Committee on Ways and Means United States House of Representatives on Impact of High Deductible Health Insurance And Health Savings Accounts on Consumers (May 14, 2008), available at [http://services.taxanalysts.com/taxbase/eps_pdf2008.nsf/DocNoLookup/10663/\\$FILE/2008-10663-1.pdf](http://services.taxanalysts.com/taxbase/eps_pdf2008.nsf/DocNoLookup/10663/$FILE/2008-10663-1.pdf); Statement of Linda J. Blumberg, Ph.D., Principal Research Associate, The Urban Institute, Testimony Before the Subcommittee on Health of the House Committee on Ways and Means (May 14, 2008), available at [http://services.taxanalysts.com/taxbase/eps_pdf2008.nsf/DocNoLookup/10658/\\$FILE/2008-10658-1.pdf](http://services.taxanalysts.com/taxbase/eps_pdf2008.nsf/DocNoLookup/10658/$FILE/2008-10658-1.pdf).

¹¹⁹ Much of the debate has been framed in the context of tax incentives, and so I will use that terminology here. However, any reforms to enhance incentives would also be consistent with the belief that excluding charitable donations and amounts spent on healthcare are required as a matter of internal tax logic.

¹²⁰ See Ellen Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. Rev. at 850-2.

system.¹²¹ Since then, the push to move the deduction back above the line has continued.¹²² Both scholars¹²³ and politicians¹²⁴ have argued for changing the law, citing both incentive and fairness concerns.¹²⁵ Some proposals call for allowing all charitable deductions above the line, while retaining a sizeable standard deduction.¹²⁶ Others have offered more complicated solutions. For instance, one proposal called for 100% of all charitable deductions to be allowed above the line up to the amount of the standard deduction.¹²⁷ Another called for allowing a deduction for cash contributions to charity to the extent such contributions exceeded \$500, but not to exceed \$1,000, for joint returns.¹²⁸ Still another called for an above-the-line deduction for all charitable contributions in excess of \$2,000 (for

¹²¹ Economic Recovery Act of 1981, P.L. 97-34 § 211. For 1982 and 1983, individuals were allowed to deduct 25% of the first \$100 of charitable donations, or \$25, above the line. For 1984, the cap raised to \$300, for a maximum \$75 above-the-line deduction. For 1985, individuals were allowed to deduct 50% of their charitable donations with no cap. In 1986, the amount deductible above the line was raised to 100%. The provision expired at the end of 1986.

¹²² See, e.g., Congressional Budget Office Report, *The Effects of Allowing Non-Itemizers to Deduct Charitable Contributions* (Dec 2002). The report was prepared at the request of the ranking member of the House Ways and Means Committee and provides a history of the standard deduction, a profile, examines patterns of giving, and the tax incentives provided in the Code. **Add something here about Independent Sector.**

¹²³ See, e.g., M. Todd Henderson and Anup Milani, *Corporate Philanthropy And The Market For Altruism*, 109 Colum. L. Rev. 571, 611 (2009) (arguing for above-the-line deduction for all charitable contributions); Joseph Cordes et al., *Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options 3* (Urban Inst., Charting Civil Society Series No. 7, 2000), available at <http://www.urban.org/url.cfm?ID=310338> (modeling several possibilities).

¹²⁴ See, Ellen Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. Rev. at 854 (describing President Clinton's 2001 proposal to allow 50% of deductions above a certain floor to be taken above the line, President Bush's 2001 proposal to allow the charitable deduction to non-itemizers); Joint Committee on Taxation's report describing President Bush's Fiscal Year 2005 Budget, JCS- 3-04 NO 3, 2004 WL 5389733 (I.R.S.); Community Solutions Act of 2001, H.R. 7, 107th Cong. (2001) (allowing for 2 years an above-the-line deduction for cash contributions to charities in excess of \$500 and up to \$1,000 for joint returns); Charitable Giving Relief Act, H.R. 777, 107th Cong. (2001) (permitting 100% of charitable deductions above the line, up to the amount of the standard deduction); Charitable Giving Act of 2003, H.R. 7, 108th Cong. (2003) (containing the same provisions as the Community Solutions Act of 2001) (87 co-sponsors);

¹²⁵ See, Ellen Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. Rev. at 854-6.

¹²⁶ M. Todd Henderson and Anup Milani, *Corporate Philanthropy And The Market For Altruism*, 109 Colum. L. Rev. 571, 611 (2009).

¹²⁷ Charitable Giving Relief Act, H.R. 777, 107th Cong. (2001).

¹²⁸ Charitable Giving Act of 2003, H.R. 7, 108th Cong. (2003).

those filing jointly) for 5 years, with the floor reducing to \$1,000 after the 5 year period.¹²⁹

A 2000 Urban institute study modeled a number of different possibilities, including allowing full deductions above the line, allowing itemizers to deduct above the line in excess of floor up to a set amount, and allowing all taxpayers to deduct all contributions above the line in excess of a floor, to show anticipated revenue effects and additional charitable giving.¹³⁰ Assuming 1995 income levels, their model predicted increased donations ranging from \$2.2 to \$8 billion and revenue losses ranging from allowing all charitable deductions to be taken above the line to range from approximately \$5.6 to \$6.7 billion. The report also modeled proposals that would allow some or all taxpayers to deduct above the line amounts donated in excess of a \$500 (\$250 for individuals) floor. Depending on who would be allowed to deduct, the model predicted increased giving from \$1.9 to \$7.8 billion. Finally, the report determined a revenue neutral way to increase giving. By setting the floor at \$650 (\$325 for individuals), the model predicted giving would increase between \$1.6 and \$5.7 billion without a corresponding loss in revenues.

Perhaps in light of the anticipated costs or complications associated with using a floor or moving some, but not all of the deductions above the line, none of these efforts have succeeded. As a result, the charitable deduction remains a blunted instrument, unavailable to a large swath of Americans who either won't or cannot donate sufficient funds so as to make itemizing attractive.

B. FSAs

Significant efforts have also been made to change the rules governing FSAs to allow unused amounts to rollover into the next year, thus removing a key disincentive to participation. Eight different bills that would have allowed rollovers have been introduced in the House, with several actually passing. So far, none has made it all the way through the legislative process.¹³¹

¹²⁹ See Treasury Explains Clinton Budget Revenue Proposals, 2000 TNT 27-26 (Feb. 9, 2000).

¹³⁰ Joseph Cordes et al., Extending the Charitable Deduction to Nonitemizers: Policy Issues and Options 3 (Urban Inst., Charting Civil Society Series No. 7, 2000), available at <http://www.urban.org/url.cfm?ID=310338>.

¹³¹ In 2001, Representative Ed Royce, along with 7 co-sponsors introduced a bill that would do just this, but the bill died in committee. 107th Congress, H.R. 167. Later that year, he introduced another bill, this time with 11 co-sponsors, to the same effect and with the same result. H.R. 3105. In 2003, he tried again, garnering 12 co-sponsors. H.R. 176. Later that year, Jim DeMint introduced a bill that allowed carryovers, but limited the amount to \$500. This bill garnered 73 co-

In late 2004, apparently frustrated by the lack of legislative action on this matter, Senator Grassley, then Chairman of the Senate Finance Committee, wrote a letter to the Treasury Department asking whether they could administratively allow for carryovers.¹³² However, the Treasury department took the position that allowing a rollover would violate the rule found in IRC § 105 prohibiting deferred compensation, arguing that Congress had had effectively ratified its construction of the statute.¹³³ Thus, any efforts to fix this rule would need to come from the legislature.

Nonetheless, in mid-2005, the IRS issued Notice 2005-42, which allows taxpayers a 2.5 month grace period for incurring medical costs beyond the end of a year, provided their plans allow it.¹³⁴ The Treasury Department reasoned that a limited carryover of this duration would not implicate the “deferred compensation” limitation contained in IRC § 125.¹³⁵ Despite this accommodation, the fact remains that the FSA has failed miserably in its stated goal to subsidize and therefore create incentives for taxpayers to save for their anticipated medical expenditures.

Congress’s failure to act here is particularly surprising in light of its decision to allow taxpayers to rollover unused amounts in the other three medical savings accounts (MRAs, MSAs and HSAs). Given the similar purposes underlying both – creating a tax incentive to encourage people to save for and manage their healthcare – one would expect the same treatment. The net result is that those healthy enough to receive the financial benefits associated with high-deductible health plans and also wealthy enough to contribute more than their annual needs receive tax benefits that are unavailable to FSA participants.

sponsors. Still later that year, Bill Thomas introduced a bill that mainly addressed Health Savings Accounts. H.R. 2351. During the markup of this bill, the language suggested by Rep. DeMint was added in. Eventually, a form of this legislation was included in the MEDICARE PRESCRIPTION DRUG, IMPROVEMENT, AND MODERNIZATION ACT OF 2003. Unfortunately for proponents of carryovers, this language was dropped from the final version.

In 2004, Rep. Royce again introduced his bill to allow carryovers, this time garnering only 4 co-sponsors. H.R. 4007. A similar bill, H.R. 4279, was introduced later that year with 16 co-sponsors. It found itself attached to another piece of legislation, the Help Efficient, Accessible, Low-Cost Timely HealthCare Act of 2004. H.R. 4280 and 4281. While the combined bills passed the House, the Senate did not act on them. In 2005, Royce again introduced his bill to allow unlimited carryovers. H.R. 1805. He also introduced bills in 2007 (no co-sponsors) and 2009 (1 co-sponsor). H.R. 3306 and 544.

¹³² CITE.

¹³³ 2006 TNT 124-31.

¹³⁴ Notice 2005-42.

¹³⁵ Id.

IV.

COMBINING FSAS WITH CHARITABLE DEDUCTIONS

Given the repeated failures to reform both the charitable deduction and the FSA forfeiture provisions, it seems clear that another way forward is needed. In this Part, I propose combining the charitable deduction with the exclusion for amounts contributed to FSAs with the goal of improving the efficacy of both. In particular, taxpayers should be allowed to designate that any unused funds in a FSA be donated to charity at the end of the year. Plan administrators would simply forward any money left in FSAs at the end of the year to the designated charities.

Not all charities or charitable purposes are created equal, and some may object to money saved for healthcare needs going to the local opera company. To counter any such concerns, Congress could limit the types of charities to which donations could be made. Consistent with the purpose for which the FSA amounts were originally set aside, Congress could provide that taxpayers be allowed to designate only healthcare related charities or those that help the poor. Or, Congress could provide that unused amounts be directed to help subsidize the now-mandatory health insurance for those who cannot afford it.

While this proposal may not be a “first best” solution with regard to either provision considered alone, combining these two provisions offers several benefits that the stand-alone fixes do not. From a charitable giving perspective, donors will receive the functional equivalent of an above-the-line deduction for such donations, thus giving them a financial incentive to give, regardless of whether they itemize. Because the funds had already been subtracted from FSA participants’ salaries and excluded from income, there would be no need for taxpayers to report the donation or claim a deduction. Thus, it would be far less complex than existing proposals to move the charitable deduction above the line. It is also likely to be less costly than moving the deduction wholesale above the line.

From a health care perspective, if taxpayers know that unused funds will go to a charity of their choosing – as opposed to the pockets of their employers – they may be more likely to save more for medical needs. This includes both a likely increase in the number of eligible people electing to set aside funds and in the amounts set aside. The proposal would also likely reduce the time spent each year determining how much to set aside. Finally, it may lessen the mad dash at the end of the year to spend unused money on unneeded items or services.

This Part sets forth the benefits of allowing unused FSA amounts to be donated to charity.

A. The Charitable Deduction

The proposal to allow unused FSA funds to be donated to charity must be considered in light of the stand-alone reform proposals. It is never clear precisely why a proposal fails in Congress, but those opposed to moving the deduction above the line have generally raised three arguments. The first is economic. Putting the deduction above the line will cost too much money. The second is based on fairness. The standard deduction was set at a level that includes presumed donations to charity. Allowing taxpayer to take above the line charitable deductions and the standard deduction would allow double dipping. The third is that the incentive is not really necessary. Those who donate to charity would do so without an incentive, and therefore it is not necessary.

In comparing the proposal to this failed first best solution, it seems appropriate to evaluate the proposal in light of these and any other arguments against moving the deduction above the line. In a 2001 article, Professor Ellen Aprill considered whether moving the deduction above the line would be in the best interests of religious organizations and society more generally. While addressed primarily to religious organizations and focused on donations to such, the article provides a good roadmap to explore the issue of whether allowing people to donate unused amounts in FSAs to charity might be superior to simply moving the charitable deduction above the line.

The first objection to moving the charitable deduction above the line is that it would be too costly.¹³⁶ At a time of great deficits, one must be careful not to exacerbate the problem by giving away more money. This argument rings hollow in light of current legislative behavior. Despite large deficits, both parties have clambered for tax cuts and additional tax expenditures, which will only exacerbate the deficit. Moreover, if the subsidy provides public goods, it may still be worth the cost. Nonetheless, accepting such arguments as valid, this proposal is superior to moving the deduction above the line wholesale because it necessarily limits the total amount of charitable deductions allowed above the line. The impact depends on how people respond to the proposal, but for any individual it is capped at the average tax rate times the contribution limit.

¹³⁶ By one estimate, the revenue loss of a proposal that would have allowed above-the-line deductions but phase the maximum deduction up to \$1,000 in 2011 would cost the Treasury \$32.6 billion over 10 years. The Joint Committee on Taxation estimated that the proposal would cost \$29.3 billion. CBO Report at Summary and Introduction. *See also* Urban Institute Report (calculating that the revenue loss would range from \$5.6 to \$6.7 billion per year, depending on assumptions about taxpayer sensitivity to the incentives).

If taxpayers do not respond in any way to the incentive, i.e., they contribute no more to FSAs than they otherwise would, the effect on the public fisc is likely to be quite limited. Amounts currently forfeited have already been excluded from the taxpayer's tax base. Presumably, they would be included in the plan administrator's tax base, and their contribution to charity instead will keep them out of the tax base altogether. Some taxpayers might contribute the same amount each year but not creatively find ways to spend the money leftover, knowing that it will go to charity. It is hard to know how much this occurs or what affect the loss of such purchases would have on the economy. However, it seems likely that the net tax and economic loss is likely to be quite small under this scenario.

If taxpayers increase their savings with their healthcare needs in mind and either use those amounts for healthcare or donate leftover funds to charity, it will cost the fisc an amount equal to the excess amounts contributed to FSAs times the taxpayers' marginal rate. However, encouraging savings for healthcare is precisely what the current law is designed to do. It would be odd to argue against the proposal because it was made more effective, in line with its underlying purpose.

Finally, some may "take advantage" of the proposal by intentionally contributing money to an FSA with the goal of donating the entire amount to charity in lieu of other donations. By considering this "worst case" scenario, it is possible to get a sense of the potential cost of such behavior. The recent healthcare reform bill sets the maximum contribution to FSAs at \$2,500. Imagine a person who takes the standard deduction and currently donates \$2,500 each year to charity. He does not fund his FSA. In response to the proposal, he fully funds his FSA but uses none of it to pay for health care. At the end of the year, he donates the \$2,500 to charity. He makes no other charitable deductions. As a result of this behavior, donations to charity stay constant and the taxpayer effectively receives an above the line \$2,500 deduction that he would not normally have received.

Of course, were taxpayers to do this, they would necessarily save money and have it available for any health related expenses during the year, even if they did not intend to use the funds that way. As this is one of the goals underlying FSAs, it is a benefit that should not be ignored. In the end, it is not possible to know how many taxpayers would engage in this activity, and therefore impossible to know with any certainty what it would cost.¹³⁷

Another common objection to moving the charitable donation above the line is administrative.¹³⁸ The whole point of the standard deduction was

¹³⁷ Of course, if the cost goes up because of additional giving, it is a result of the incentive working as intended and any costs are presumably offset by the resulting public goods that the contributions fund.

¹³⁸ See Aprill at 859.

to eliminate the need to track itemized deductions. Were the charitable donation moved above the line, many of the simplification benefits would be lost. Donating unused FSA amounts to charity would avoid all of these problems because the amounts would have been withheld and subtracted from employee income. They would automatically be transferred to charities at the end of the year if they were unclaimed. As a result, there would be no need for employees to document amounts or recipients, thus avoiding administrative difficulties normally associated with above-the-line and itemized deductions.

The proposal to allow taxpayers to donate directly to charitable institutions also avoids some of the administrative problems that would arise under the proposals that employ a floor or maximum amount or that would adjust the standard deduction to account for charitable deductions taken above the line.¹³⁹ Such provisions add complexity to the Code, making tax planning difficult. This proposal is far easier to grasp and plan for. You set money aside each month. You may use it for eligible health care costs. Any money left over will automatically be transferred to a charity of your choice. There is no need to determine a floor or do any math to try to figure out whether making a donation will carry you over a threshold that will end up costing you more money than anticipated.

Finally, Professor Aprill identifies two efficiency-based objections to moving the deduction for charitable donations above the line.¹⁴⁰ Those who take the standard deduction tend to be lower income taxpayers, and they tend to give to religious organizations. Such taxpayers may give regardless of whether they receive a government subsidy. Thus, the subsidy is not necessary. In addition, religious deductions arguably benefit the donor more than they do society in general, thus making them different in kind from other types of donations and therefore less worth of government subsidy. As Professor Aprill notes, the evidence on these two questions is contradictory.¹⁴¹ The elasticity of religious donations is a subject of great debate, and the extent of self-serving donations and the corresponding benefits to society cannot really be known.

This proposal avoids or at least lessens these concerns. Given the contingent nature of the donation, in many cases, the charitable giving associated with unused funds will be in addition to whatever giving the

¹³⁹ One of the objections to putting the charitable deduction above the line is that the standard deduction was increased to take into account people's charitable giving. Thus, allowing an above-the-line deduction to those who don't itemize would effectively allow double dipping. This could be addressed by reducing the standard deduction, either a set amount or by some percentage of one's charitable contributions. Any dynamic change that takes into account actual charitable giving would add complexity to the Code and uncertainty for taxpayers.

¹⁴⁰ See Aprill at 856-859 and 865-867.

¹⁴¹ See Aprill at 859.

taxpayers would otherwise do over the course of the year. While some taxpayers might fund their FSAs at higher levels with the intent of displacing donations they otherwise would have made and for which no tax incentive was available, this scheme will work only if they do not need such funds for medical purposes over the course of the year. The fact remains that people are not taking advantage of FSAs despite the existing financial incentives. By layering on the ability to donate to charity and the tax benefits that come with it, people may be more likely to save for medical emergencies.

If one is concerned that taxpayers will donate to institutions for which either no incentive is necessary or warranted, one could limit the types of charities eligible to receive such funds. The money in FSAs is ostensibly set aside for a taxpayer's medical expenses, and it would make logical sense to limit the recipients of such funds to charities associated with health and medicine. This could include hospitals, medical research foundations, support for those who cannot afford health insurance, and other charities that provide medical services or otherwise advance medical knowledge.¹⁴²

B. FSAs

If the goal of reform is simply to eliminate the risk of forfeiture, allowing taxpayers to rollover unused amounts is clearly the first best solution. Indeed, given that Congress has expressly provided for unlimited rollovers for Archer Medical Accounts and HSAs, there seems to be no principled reason why taxpayers should not be allowed to roll over amounts left unused in an FSA to the next year. However, the inability of Congress to pass such legislation despite repeated efforts suggests recourse to a second best solution. Congress could require FSAs to return unused funds

¹⁴² Aprill identifies another concern about moving the charitable deduction above the line, that it may affect volunteerism by making charitable donations more attractive relative to volunteering. This concern is addressed to primarily to churches, which rely heavily on volunteerism and could stand to lose if people donate in lieu of volunteering. One who foregoes income by volunteering has no income and no deduction. In contrast, a taxpayer who earns money and then donates it to charity must report the income but gets no corresponding deduction if he takes the standard deduction. Thus, he is worse off than if he volunteers. Allowing an above-the-line deduction "fixes" this problem.

Aprill ultimately rejects this concern, concluding that donations and volunteering are more likely complements than substitutes. However, to the extent that this concern may have validity, this proposal avoids the tradeoff to some degree because the donation is residual, determined as of the end of the year. Volunteers cannot wait until the last day of the year to decide whether or how much to volunteer. Thus, it seems unlikely that allowing taxpayers to contribute unused FSA funds to charity will unduly suppress volunteering.

to taxpayers, but that would require including such funds in income, leading to administrative hassles. Rational taxpayers would simply fund these accounts to the extent possible and then recover any unused money at the end of the year. It would be far simpler, fairer, and probably more cost effective, to do away with FSAs and simply allow all taxpayers to deduct funds spent on medical care up to a point.¹⁴³ This is especially true if nonprescription drugs are treated as eligible expenses, given that all taxpayers presumably incur some quantum of such expenses.¹⁴⁴ However, such a plan would not entail *ex ante* saving.

If the goal is to induce taxpayers to fund FSAs, but taxpayers are not allowed to keep unused funds for themselves, either by rolling them over or by having the funds returned, allowing taxpayers to donate unused funds to charity seems far superior to simply forfeiting it. For those who regularly donate to charity, this is nothing more than an extension of a practice in which they already engage. For those who do not normally donate to charity, the ability to direct such funds to others provides them more benefit than simply losing the money. Even if they do not derive great benefit from such charitable acts, as described more fully below, they may perceive the loss of the funds differently and therefore be more willing to risk or endure it.

There is one constituency that would oppose this proposal: those who currently provide FSAs and keep the forfeited amounts. However, to the extent that they use the proceeds to help fund running the program, fees could readily be used to replace such income, as is done with HSAs. Using fees to fund the program would in fact be an improvement over the current system, as it would apportion the costs fairly, on a per person basis, and not based on the luck of the draw involved in estimating one's medical expenses. If plan administrators simply keep the money, no possible justification exists for allowing them to continue doing so.

From a political perspective, the forces supporting the proposal would not only include the unorganized individuals with little incentive to become involved, as has been true in the past, but also the charities who would stand to gain. Charities have generally shown themselves to be well organized and politically savvy. Thus, this proposal likely has a greater chance to be enacted than prior rollover proposals.

¹⁴³ The one benefit of using FSAs is that a third party verifies the validity of the expenses before reimbursing taxpayers, thus increasing compliance. However, numerous other deductions are simply listed on the return, and there is no reason to believe that these types of deductions should be treated any differently.

¹⁴⁴ Recall that Congress has changed this rule starting in 2011, thus weakening the strength of this argument.

V.

MENTAL ACCOUNTING AND TAX INCENTIVES

When discussing tax provisions it is only natural to focus on objective financial consequences. This is especially true with tax incentives, which are designed to induce taxpayers to engage in behavior they otherwise would not by lowering their taxes. However, over the past 30 years, studies in behavioral economics have revealed the extent to which perception dominates decision-making. Thus, the framing of an issue or design of a tax provision may have equal or greater impact than the objective fact of how much taxpayers might save forfeit as a result of their behavior.

In a 1999 article, Richard Thaler attempted to summarize the basic insights from behavioral economics, as well as the then current state of the research.¹⁴⁵ He posited that, by combining objective financial incentives or penalties with the insights offered by the mental accounting literature, Congress could create laws more likely to achieve their intended results. He explicitly identified examples from tax law where he believed this had already occurred.¹⁴⁶ Combining the charitable donation with FSAs offers yet another opportunity to combine objective financial incentives with mental accounting insights to create a better tax incentive. Not only will it likely increase participation in both FSAs and charitable donations, but it may do so less expensively than alternate methods. My hope is that the proposal serves as a model for future legislation.

Before wading into a discussion of behavioral economics and how we might apply the insights from that field to design better tax provisions, it may help first to spell out more clearly why we should care. Imagine a world of 10 taxpayers, all of whom are in the 30% marginal tax bracket. Charitable donations are deductible, and 3 taxpayers make such deductions, at a total cost of \$90 to the government fisc. Assume further that the participation rate did not produce the optimum level of public goods. Several options exist for increasing participation. For instance, one could simply increase the financial incentive, say by allowing taxpayers to deduct 150% of the amount donated. If none of the remaining 7 taxpayers donate, the total cost to the government is now \$135. If the increased incentive causes 2 more taxpayers to donate \$100, the total cost to the government rises to \$225.

¹⁴⁵ Richard H. Thayer, *Mental Accounting Matters*, 12 *J. Behav. Decision Making* 183 (1999).

¹⁴⁶ See pp. ___ below for a discussion of how the 401(k) and IRA provisions use both financial incentives and the insights of mental accounting to encourage people to save for retirement.

Another option may be to redesign the incentive so that it appears more attractive to taxpayers, without actually increasing the rate. In this case, assume that Congress simply makes it easy for taxpayers to donate by creating a system that allows taxpayers to have \$10 withdrawn from their paycheck over 10 months. Further assume that, as a result, 2 more taxpayers decided to donate \$100. While the total number of taxpayers donating is 5, as with the prior example, the total cost to the fisc is only \$150. It is still more expensive than having only 3 people donate, but less than paying all 5 people more for doing so. The reason is that the increased cost reflects only the marginal costs of the new participants, as opposed to additional subsidies to those who were already going to donate. When the number of potentially affected taxpayers is in the millions, as it is with FSAs and charitable donations, the potential cost savings are significant.

One of the key insights of the behavioral economics literature is that people use “mental accounts” to track their finances and evaluate choices. Because money in these mental accounts is not fungible, how an issue is framed can have a significant impact on decision-making and behavior. For instance, research shows that people are far more willing to drive 20 minutes to save \$5 on a \$15 purchase than they are on a \$125 purchase, basing their decision on the percent discount involved, as opposed to the absolute amount of the discount.¹⁴⁷ The question in both cases is whether driving 20 minutes is worth \$5, and the answer to both should be the same.

Perhaps more germane to this analysis, Thaler and Professor Hersh Shefrin suggest that, although money is fungible, people have a hierarchy of savings, where funds sitting in a checking account are psychologically easier to spend than those sitting in less liquid accounts that reflect either equity or future income.¹⁴⁸ Moving money up the hierarchy makes it more likely people will save it. According to Thaler, the beauty of the 401(k) provisions is not simply that it pays people to save and penalizes them for early withdrawal, but it also causes them to move money into segregated accounts labeled as retirement accounts. As a result, the disincentive to tap into these accounts is greater than can be accounted for solely by the financial penalty.

In his 1999 article, Thaler made several points about mental accounting that are relevant to the proposal to allow unused FSA amounts to be donated to charity. First is the observation that some amounts may be so small that they fall under the radar, i.e., they are simply not included in one’s mental accounting.¹⁴⁹ Thus, breaking an expense into small pieces may ease the pain of the expense because each piece is too small to notice.

¹⁴⁷ See Thaler (describing an experiment by ____).

¹⁴⁸ Richard H. Thaler and Hirsh M. Shefrin, *An Economic Theory of Self-Control*, 39 *J. of Political Economy* 392-406 (1981).

¹⁴⁹ Thaler at 194.

The classic example of this is the advertising or fundraising claim that the cost is only “pennies a day.” Pennies are simply too small to account for, whereas an annual bill for the total amount would be hard to ignore. If one can reframe an expenditure in terms of pennies or other small amounts, it may be psychologically easier to bear and therefore more likely to occur.

Even if amounts are not so small as to fall under the mental accounting radar when considered alone, if they are compared to larger amounts they may not be deemed substantial enough to worry about.¹⁵⁰ People also appear to dislike large losses, preferring instead to separate them into smaller events over time.¹⁵¹ Apparently, people account for the smaller losses separately, i.e., they do not aggregate them in their mental accounting systems.¹⁵²

Another observation found in the mental accounting literature is that timing matters. People tend to depreciate costs over time,¹⁵³ and, if a cost can be separated in time from an asset’s disposition, the asset’s cost will seem cheaper, making it more palatable. Thaler recounts an experiment he conducted with wine collectors, who routinely spend money on wine and delay consumption until many years later. Collectors generally viewed their purchases as investments. When asked about how they viewed their later consumption, a surprising number indicated that they felt the cost to be \$0. Thinking about the cost and consumption in this way makes

¹⁵⁰ Sensitivity to marginal loss decreases as the amount of the loss increases. Thus, a \$5 addition to a \$10 loss is felt much more than a \$5 addition to a \$100 loss. This is apparently what happens in the example above, where people deem it worth their while to drive 20 minutes to save \$5 when the discount is relatively large, but lose interest when the amount to be saved is small relative to the total being spent.

¹⁵¹ Theory suggests that aggregating losses so that they are experienced together might be desirable because it gets the pain over in one fell swoop. However, experimental evidence suggests otherwise.

¹⁵² The tax withholding rules arguably take advantage of this phenomenon. Although the rules were introduced in 19__ to ensure the government a steady supply of dollars, they act to break up the pain of paying taxes into smaller chunks. The French economist and Finance Minister Jean Baptiste Colbert once famously described taxation as “The art of... so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.” ____ The withholding provisions arguably lessen the pain of having one’s feathers plucked, and it is precisely for this reason that some have argued for doing away with withholding. ____ If taxpayers had to pay their taxes all at once, they would experience the burden differently and might well more actively lobby for lower taxes.

¹⁵³ Id. at 190-193.

collecting and drinking the wine far easier than if one believes the cost to be the current fair market price of the bottle when consumed.¹⁵⁴

Finally, research suggests that the source of income matters. Those who receive windfalls are more inclined to spend them on luxury items, while those whose income comes from hard work tend to spend it first on necessities.¹⁵⁵

The current FSA provisions already take advantage of many of these insights. Contributions are automatically made over the course of the year, breaking the total amount deducted into smaller, easier-to-digest amounts. For employees paid weekly, this means that a decision to contribute \$2,500 to an FSA manifests as slightly under \$50/week. Those who decide to contribute less have correspondingly less withdrawn from their paychecks. When compared to the total paycheck, these amounts can seem even smaller, to the point of insignificance. If taxpayers truly segregate each paycheck, then the mental anguish of saving will be far reduced compared to taking the entire amount out of one or two paychecks.

Allowing unused funds in FSAs to be donated to charity simply makes further use of this phenomenon. The amounts donated to charity are saved up over time, thus making the financial hit seem less daunting. Indeed, this is precisely the strategy many charities have employed to woo prospective donors. In addition to the “pennies a day” pitches, a number of charities now offer automatic monthly payment options. Some encourage donors to set up automatic withdrawals from checking accounts, while others, such as the United Way, have gone so far as to arrange for employers to withhold pledged amounts from employee paychecks. There is no reason why the government cannot do the same to both encourage savings for medical needs and promote charitable giving.

Donations of unused FSA funds to charity at the end of the year would also take advantage of the timing difference between saving the money and disposing of it. Contributions to the FSA are made over the course of the year. The donation of any amounts remaining in the FSA would need to occur at some point after March 31 of the next year, the last day on which claims for reimbursement for the prior year’s expenditures could be made. Thus, significant time will have passed between the deduction from income and the contribution. Just like the wine collectors who fully depreciated the cost of their wine over time so that drinking the wine was seen as costless, those who donate unused FSA funds may find it psychologically easier to give, given the long time between the original saving and the ultimate disposition of the funds.

¹⁵⁴ Edward Shafir and Richard H. Thaler, *Invest Now, Drink Later, Spend Never: The Mental Accounting of Advanced Purchases*, *CITE* (1998).

¹⁵⁵ Koorman 1997.

Finally, instead of using tax incentives to move money up the savings hierarchy, as is done in 401(k) plans and IRAs, combining charity with FSAs may help move money down the hierarchy, into accounts from which charitable spending may be easier to make. The FSA represents a fund dedicated to current medical needs. Money contributed to such accounts are expected to be spent. Accordingly, it may be easier for taxpayers to donate excess funds from such accounts to charity than it would be to have them write a check out of savings at the end of the year. On some level, the money has already been segregated and may no longer be considered part of one's wealth. Thus, spending it may be easier. Or, if the taxpayer truly thought of the money as spent when contributed to the FSA, any unused amounts could be seen as a windfall, making it far easier to part with.¹⁵⁶

CONCLUSION

The charitable deduction and tax provisions affecting U.S. healthcare policy have been the subject of both scholarly and political debate for as long as they have both existed. Some view them as consistent with accepted notions of income, while others view them as subsidies. Regardless of the position one takes on the nature of such provisions, almost all agree that they are flawed. To date, efforts to reform them independently have failed.

This Article offers a new way forward. Combining the charitable deduction with FSAs to allow taxpayers to donate unused funds in an FSA at the end of the year to charity may improve the efficacy of both provisions. The proposal not only addresses the objective financial incentives associated with the proposals, but it also takes advantage of the “mental accounting” people use to evaluate choices and make decisions.

Because tax law regulates economic activity, it is only natural that Congress focuses on objective financial incentives when designing tax expenditures. However, as demonstrated above, Congress can and should look beyond those incentives and incorporate the insights from behavioral economics. Doing so will not only improve the efficacy of such provisions, but it may also reduce their costs.

¹⁵⁶ Several years ago, a chain email went around asking people to change one letter of a word and then devise a definition for the new word. One of the purported winners was “intaxication,” defined as the “euphoria at getting a tax refund, which lasts until you realize it was your money to start with.” This is precisely the windfall sentiment that might be engendered by discovering that the money you set aside for medical care wasn't actually spent. The empirical question is whether one would continue to think of it as a windfall or in fact come to see it merely as your own money being returned to you.