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MONEY FOR NOTHING: CHARITABLE DEDUCTIONS FOR MICROFINANCE LENDERS

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ABSTRACT

The last five years have seen a huge increase in the general public's interest in microfinance, which provides financial services such as loans, insurance, and savings instruments to people living in poverty. At the same time, the popularity of social networking through the Internet has exploded. These two worlds intersect in the form of websites that permit a United States individual to use PayPal or a credit card to loan small amounts of money to poor people around the world. By far the most successful of these microcredit websites was also the first such website: Kiva Microfunds ("Kiva").

Although loans through Kiva are truly loans (that is, the lenders expect repayment), Kiva loans pay the individual lender no interest. The right to use money for a period of time has, of course, a real financial value, as the tax code recognizes in many places. But under current law, even though Kiva is a tax-exempt organization, lenders through Kiva receive no tax benefit for the interest they forego when they loan money interest-free through Kiva. This Article argues that the law should be changed to allow taxpayers who lend money through a microfinance organization that qualifies as a tax-exempt organization and who receive no interest or below-market interest on those loans the option of taking a charitable deduction for that foregone interest. The Article also proposes a novel and simple method for implementing this tax benefit.

The practical benefits of the deduction could be significant. Permitting a deduction for interest foregone on loans to Kiva and similar microcredit organizations will help these organizations thrive and thus, as the Nobel Committee stated about another microcredit institution, play a role as an "important liberating force" and a "major part" of eliminating poverty as we know it.

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I. INTRODUCTION

MILLIONS of people around the world who live in poverty would benefit from access to financial services such as loans, savings, and insurance. Microfinance aims to provide financial services to these individuals and their small businesses. Microfinance has existed in one form or another for many years, but the last five years have seen a huge increase in the general public's interest in providing financial services to the poor. At the same time, the popularity of social networking through the Internet has exploded. These two worlds intersect in the form of websites that permit an individual to loan small amounts of money to poor people around the world. By far the most successful of these microcredit websites was also the first such website: Kiva Microfunds ("Kiva").

In the three years since its creation, Kiva[1] has been wildly successful. Hundreds of thousands of people have made loans through Kiva, which has provided millions of dollars in loans to individuals living in poverty all

1. Kiva Home Page, http://kiva.org (last visited Aug. 23, 2008).

over the world.[2] The organization has been featured in the *Financial Times*,[3] the *Wall Street Journal*,[4] the *New York Times*,[5] *Fortune*,[6] and *Business Week*,[7] among many other places. Kiva lenders are a dedicated group, and they see themselves as part of a larger community that includes not only other Kiva lenders, but also borrowers who receive loans from Kiva.[8] Kiva lenders have created their own websites and message boards separate from Kiva, and some Kiva lenders have traveled thousands of miles to visit the individuals to whom they have sent loans.[9]

Loans through Kiva are truly loans—that is, the lenders expect repayment—but they lack one feature of loans, at least loans as understood by the U.S. tax code (the "Code"): Kiva loans pay the individual lender no interest. It is, of course, valuable to have access to money, even if for a limited amount of time. In other words, money has a time value. Thus, the Code generally does not respect the designation of a loan as interest-free; the time value of money appears in many places throughout the Code, including in provisions that recharacterize putatively interest-free loans by imputing interest even where the parties claim that there is none.[10] But lenders through Kiva receive no charitable benefit for the interest they forego when they loan money interest-free through Kiva because, under current law, foregone interest is considered a nondeductible "partial interest."[11]

This Article argues that current law should be changed, and taxpayers who lend money through a microfinance organization that qualifies as a tax-exempt organization and who receive no interest or below-market interest on those loans should be given the option of taking a charitable deduction for that foregone interest. Microfinance loans are of sufficient importance, both in general and to the goals of Kiva and similar organiza-

2. *See infra* text accompanying notes 43-45.

3. *See* Sarah Murray, *Charity No Longer a Cottage Industry*, FIN. TIMES, Jan. 12, 2008, *available at* http://us.ft.com/flgateway/superpage.it?news_id-fto011220080851401841&page=1.

4. *See, e.g.*, Ron Liber, *How to Be a Microfinancier: New Sites Use Nobel-Winning Tactics to Help You Give and Lend*, WALL ST. J., Oct. 21, 2006, at B1; Rachel Emma Silverman, *Young Money: A New Generation Reinvents Philanthropy*, WALL ST. J., Aug. 21, 2007, at D1.

5. *See, e.g.*, Nicholas D. Kristof, *You, Too, Can Be a Banker to the Poor*, N.Y. TIMES, Mar. 27, 2007, at A19; Sonia Narang, *Web-Based Microfinancing*, N.Y. TIMES, Dec. 10, 2006, at 84 (discussing Kiva in its annual "Year in Ideas" issue); Rob Walker, *Extra Helping*, N.Y. TIMES, Jan. 27, 2008, at MM22.

6. *See* Jeffrey M. O'Brien, *The Only Nonprofit That Matters*, FORTUNE, Mar. 3, 2008, at 37.

7. *See* Jeffrey Gangemi, *Making Microfinance Easier*, BUS.WEEK, Aug. 16, 2006, *available at* http://businessweek.com/smallbiz/content/ang2006/sb20060815_733434.htm?chan=search.

8. *See infra* Section II.C (discussing the Kiva community).

9. *See, e.g.*, Bad Dog Pip, http://baddogpip.blogspot.com/2006/12/mifex-neighborhoods-tres-trinitaria.html (Dec. 19, 2006, 17:44 EST) (describing, in a first-person account, a trip by two Kiva lenders from their home in Arlington, Virginia, to Guayaquil, Ecuador, to visit the people to whom they had loaned money through Kiva).

10. *See* discussion *infra* Section III.C.

11. *See* discussion *infra* Section III.B.

tions, that existing exceptions to the general rule should be expanded to include foregone interest on such loans. There are some objections to permitting such a deduction, but on further inspection, almost all these objections will reveal themselves to be objections to the charitable deduction in general, and not specifically to a deduction for foregone interest.

After this Introduction, Part II provides a very brief introduction to microfinance and then describes Kiva in particular. Part III looks more closely at Kiva's tax treatment, focusing on the tax treatment (that is, the nondeductibility) of the interest that Kiva's lenders forgo. Part IV proposes that the law should be changed in order to permit deductibility of that foregone interest and suggests a practical, not particularly complicated way to implement that deduction. Part V examines possible objections to permitting deductions for foregone interest and concludes that none of these objections is strong enough to override the argument for amending the law to permit a charitable deduction for foregone interest. Part VI concludes.

II. MICROFINANCE AND KIVA

This Part provides a very brief introduction to microfinance and then explains the structure of one particular microfinance organization, Kiva Microfunds, and the great success that Kiva has so far enjoyed.

A. What Is Microfinance?

The goal of microfinance is to give poor people access to formal financial services.[12] Many poor people do not have access to credit or savings services, and providing these services to the poor can help them earn more money, improve their lives, and increase their self-confidence.[13] Microfinance can also have a wider social impact, increasing the power of otherwise disadvantaged or excluded groups.[14] Many microfinance groups lend primarily to women—for example, as of June 2006, 96% of the borrowers from Grameen Bank, a prominent microfinance lender, were women.[15] Targeting women helps alleviate poverty because "women are the poorest of the poor," and putting money in the hands of

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12. *See, e.g.*, Marguerite S. Robinson, The Microfinance Revolution: Sustainable Finance for the Poor, at xxx (2001) (defining microfinance as "the large-scale provision of small loans and deposit services to low-income people by secure, conveniently located, competing commercial financial institutions").

13. *See id.* at 37-41; *see also* Martin Greeley, *Direct Material Impacts*, *in* 1 Money with a Mission: Microfinance and Poverty Reduction 46, 65 (James Copestake et al. eds., 2005) (stating that a group of microfinance providers was "able to demonstrate that their services are directly improving the material assets of client households," but noting that there was "insufficient knowledge about the progress" that the microfinance clients made over time).

14. *See, e.g.*, Naila Kabeer, *Wider Impacts: Social Exclusion and Citizenship*, *in* Money with a Mission, *supra* note 13, at 94, 94-95.

15. H. I. Latifee, The Future of Microfinance 6 (2006), http://www.microcreditsummit.org/papers/Plenaries/Latifee.pdf.

women also helps alleviate gender inequality.[16] Thus, microfinance may have nonfinancial as well as financial benefits.

Microfinance, in the sense of formal and informal finance opportunities for the poor, can be traced back hundreds of years, to Irish loan funds in the 1700s or even before.[17] Microfinance in its current form, with its emphasis on microcredit (that is, small loans to the poor), began in the 1970s, when various nongovernmental institutions began to create commercial microfinance programs.[18] The most famous of these is perhaps Grameen Bank, which was founded in 1976 as a research project by Muhammad Yunus, a university professor who wanted to investigate the possibility of providing financial services to the rural poor in Bangladesh.[19] Grameen Bank has since become an independent bank. As of July 2008, it had over $586 million in loans outstanding and claimed to have a 98% repayment rate.[20]

Microfinance, and particularly microcredit, have come to the attention of the general public more recently. The United Nations declared 2005 the "International Year of Microcredit,"[21] and microfinance became even more widely known when Yunus and Grameen Bank shared the Nobel Peace Prize in 2006. As the Nobel Committee wrote:

> Micro-credit has proved to be an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions. Economic growth and political democracy can not achieve their full potential unless the female half of humanity participates on an equal footing with the male.[22]
>
> Yunus's long-term vision is to eliminate poverty in the world. That vision can not be realized by means of micro-credit alone. But Muhammad Yunus and Grameen Bank have shown that, in the continuing efforts to achieve it, micro-credit must play a major part.[23]

As microfinance became more well-known, websites began to develop

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16. *See generally* Susy Cheston & Lisa Kuhn, *Empowering Women Through Microfinance*, *in* PATHWAYS OUT OF POVERTY 167, 167-228 (Sam Daley-Harris ed., 2002).

17. *See* BRIGIT HELMS, ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS 2-5 (2006) (briefly describing the history of microfinance). The Irish loan funds provided credit to the poor without requiring collateral. *Id.* at 3, fig. 1.1. For a general history of the loan funds, see Aidan Hollis & Arthur Sweetman, *Microcredit in Prefamine Ireland*, 35 EXPLORATIONS IN ECON. HIST. 347 (1998), and Aidan Hollis & Arthur Sweetman, *Microfinance and Famine: The Irish Loan Funds During the Great Famine*, 32 WORLD DEV. 1509 (2004).

18. *See* HELMS, *supra* note 17, at 4-5; *see also* ROBINSON, *supra* note 12, at xxxi-xxxii.

19. Grameen Bank, A Short History of Grameen Bank, http://www.grameen-info.org/index.php?option=com_context&task=view&id=19&Itemid=114 (last visited Aug. 23, 2008).

20. Grameen Bank, Monthly Report: July 2008, http://www.grameen-info.org/index.php?option=com_content&task=view&id=453&Itemid=527 (last visited Aug. 9, 2008). There is some debate over the actual repayment rate of Grameen loans. *See, e.g.*, Daniel Pearl & Michael M. Phillips, *Grameen Bank, Which Pioneered Loans for the Poor, Has Hit a Repayment Snag*, WALL ST. J., Nov. 27, 2001, at A1.

21. G.A. Res. 53/197, ¶ 1, U.N. Doc. A/RES/53/197 (Dec. 15, 1998).

22. Norwegian Nobel Committee, The Nobel Peace Price for 2006 (Oct. 13, 2006), http://nobelpeaceprize.org/en_GB/laureates-2006/announce-2006.

23. *Id.*

that permitted individuals to participate directly in microfinance.[24] Some microfinance organizations have started websites that permit individuals to donate to microfinance lenders.[25] Other websites, however, allow individuals actually to lend through the website. Some of these websites pay their lenders interest.[26] This Article, however, focuses on a microfinance website that does not offer its lenders interest: Kiva, the first and largest microfinance website that permits individuals to participate in lending. The next Section explains Kiva's charitable structure.

B. Microfinance for Everyone: How Kiva Works

Kiva was created in 2005 to permit individuals to participate directly in microfinance lending.[27] Someone who wants to become a microfinance lender can go to Kiva's website, kiva.org. The website features pictures of and specific information about people in developing countries who are requesting loans for specific purposes. For example, the website recently featured a farmer from Tajikistan who wanted to borrow $1200 to purchase "mixed fodder":

> Juraboy Mahmudov lives in the J. Rasulov region of Tajikistan. He is married and has four children. He has been an active client of MicroInvest since 2004. His past loans have enabled him to greatly improve his business.
>
> He is engaged in the raising and selling of livestock. Mr. Mahmudov is also the machinist for the collective farm. Mr. Mahmudov is requesting a loan of $1200 to purchase mixed fodder for his large flock.[28]

The website also shows how much money has been loaned to the client (in Mr. Mahmudov's case, the entire $1200 requested had been raised after six days); how much money remains to be loaned; and, interestingly, the names and pictures of the people who have loaned money to date.[29] The minimum loan possible is $25; the maximum is the amount remaining until the borrower obtains the full amount he has requested.[30]

The lender transfers the loan using PayPal, which donates its services

24. These microfinance groups are a subset of charitable websites that allowed "focused charity" by permitting individuals to donate small amounts of money to particular individuals in need. Other such sites, such as Donors Choose (donorschoose.org), Global Giving (globalgiving.org), and Modest Needs (modestneeds.org), involve actual donations, however, instead of loans, and are therefore outside the scope of this Article.

25. *See, e.g.*, Village Banking Home Page, www.villagebanking.org (last visited Aug. 23, 2008); Accion Home Page, www.accion.org (last visited Aug. 23, 2008).

26. *See, e.g.*, MicroPlace Home Page, https://www.microplace.com/learn_more/faq (last visited Aug. 23, 2008); Prosper Home Page, http://www. prosper.com (last visited Aug. 23, 2008).

27. *See* Walker, *supra* note 5.

28. Kiva Description of Juraboy Mahmudov, http://www.kiva.org/app.php?page=businesses&action=about&id=35636 (last visited Aug. 6, 2008).

29. *See id.* For more on the "community" aspect of Kiva, see *infra* Section II.C.

30. Kiva Description of Juraboy Mahmudov, http://www.kiva.org/app.php?page=businesses&action=about&id=35636 (last visited Aug. 6, 2008).

to Kiva.[31] The money goes to Kiva, but Kiva does not loan the money directly to the ultimate borrower. Instead, Kiva transfers the money to a "Kiva Field Partner," an established microfinance institution that on-loans the money to the borrower.[32] The microfinance institution charges interest to the borrower at "prevailing interest rates" and retains the interest payments; Kiva does not charge the microfinance institution interest.[33] The individual lender also receives no interest.[34] Kiva has chosen not to pay interest to the individual lender because offering interest payments might subject Kiva to registration and reporting requirements related to issuing securities.[35] If the borrower repays the loan, the individual lender may either take the money out of Kiva, or may reinvest it in a different loan (that is, reloan it).[36]

Because Kiva has chosen not to charge its field partners interest, Kiva's only source of operating expenses and supplies is donations. Appropriately for a business that owes much of its success to the social networking power of the Internet, Kiva has many supporters in Silicon Valley who provide in-kind contributions. For example, PayPal provides free payment processing; Google and YouTube have allowed Kiva to advertise for free; Lenovo has donated computers; and the law firm of Orrick, Herrington & Sutcliffe LLP provides pro bono legal services.[37] Kiva has also received large grants from various foundations.[38] Some individuals donate to Kiva as well, many by adding "optional fees" to the loans that they make through Kiva.[39]

C. Kiva's Success

By any metric, Kiva has been tremendously successful in its three years of operation. As of August 2008, nearly 325,000 different people had loaned money through Kiva, funding over 38,000 loans.[40] Kiva partnered with 89 microfinance institutions in 42 countries.[41] The total value of all

31. Kiva, Completing the Payment Process, http://www.kiva.org/about/help/questions?subtopic=Completing%20the%20Payment%20Process (last visited Aug. 6, 2008).
32. Kiva, Information for Prospective Field Partners, http://www.kiva.org/about/pic (last visited Aug. 6, 2008).
33. *Id.*
34. *Id.*
35. Matt Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, 2 Innovations 31, 40-42 (2007) ("[I]f we return interest to users on the Internet, we run the risk of being seen as a securities issuer and should really seek legal counsel before doing so. . . . [I]f we remove the interest rates from the service, the SEC would be unlikely to take notice and consider the loans as securities. Given our lack of funding and the enormous complexity of issuing securities . . . [w]e would have to launch without interest rates on the site.").
36. Kiva, How Kiva Works, http://www.kiva.org/about/how (last visited Aug. 23, 2008).
37. Kiva, Supporters: Corporate Partners, http://www.kiva.org/about/supporters/ (last visited Aug. 6, 2008).
38. Kiva, Supporters: Institutional Supporters, http://www.kiva.org/about/institutional/ (last visited Aug. 6, 2008).
39. Kiva, General Questions, http://www.kiva.org/about/help/questions?subtopic=General%20Questions (last visited Aug. 6, 2008).
40. Kiva, Facts and Statistics, http://www.kiva.org/about/help/stats (last visited Aug. 9, 2008).
41. *Id.*

loans made through Kiva was over $38 million.[42] According to Kiva, as of August 2008, 98.36% of its loans were repaid, with a default rate of only 1.64%.[43] In December 2007, so many people wanted to make loans through Kiva that Kiva "sold out" of loans.[44] That is, people who wanted to lend money through Kiva.org were temporarily unable to make loans because all of the loans Kiva featured had been fully funded.[45]

Not unrelatedly, Kiva has also received an overwhelming amount of media coverage. As noted in the Introduction, many major newspapers have featured stories about Kiva.[46] In addition, the founders of Kiva, Matt and Jessica Flannery, have appeared on the Oprah Winfrey Show with former President Clinton.[47] Matt Flannery has been named one of *Smithsonian* magazine's "37 Under 36: America's Young Innovators in the Arts and Sciences."[48]

Finally, Kiva has created not just a flow of funds, but also a community of lenders. The idea of community is central to Kiva's mission and, arguably, to its success and popularity. Many Kiva borrowers are members of small communities, and many of Kiva's field partners—that is, the microfinance organizations to which Kiva loans, and which on-loan to poor individuals—explain that their goal is to "facilitate[ ] communities,"[49] or to promote "community development."[50] Individual borrowers also stress their "community" banks or other businesses.[51] Kiva creates links between lenders and borrowers as well. As one of Kiva's founders has written, Kiva's philosophy includes the tenet that "[l]ending is connecting," because "[l]ending to someone else creates an ongoing communication between two individuals."[52] Finally, Kiva links lenders. Kiva lenders view themselves as part of a community, and Kiva has taken

42. *Id.*
43. *Id.*
44. *See* Walker, *supra* note 5.
45. *Id.*
46. *See supra* text accompanying notes 3-7.
47. *The Oprah Winfrey Show* (ABC television broadcast Sept. 4, 2007).
48. 37 Under 36: America's Young Innovators in the Arts & Sciences, http://microsite.smithsonianmag.com/content/innovators/ (last visited Aug. 23, 2008); *see also* Amy Crawford, *I, Lender*, SMITHSONIAN MAG., Sept. 22, 2007, at 92.
49. *See, e.g.*, Kiva, Uganda: Share an Opportunity Microfinance Ltd., http://www.kiva.org/about/aboutPartner?id=37 (last visited Aug. 6, 2008) ("Mission Statement: To facilitate Communities to start and manage sustainable and responsive community-owned financial institutions that create economic opportunities.").
50. *See, e.g.*, Kiva, Nicaragua: ADEPHCA, http://www.kiva.org/about/aboutPartner?id=76 (last visited Aug. 6, 2008) ("Within the communities ADEPHCA has promoted community development."); Kiva, Vietnam: Mekong Plus, http://www.kiva.org/about/aboutPartner?id=41 (last visited Aug. 6, 2008) ("Mainly focusing on community development and individual participation in the community development process, Mekong Plus works together with the ultra poor to create a more equal and sustainable world.").
51. *See, e.g.*, Kiva, Kenneth Niwomujuni, http://www.kiva.org/app.php?page=businesses&action=about&id=2654 (last visited Aug. 6, 2008) ("Much interesting one to him is his involvement in the community activities like bracelet making. . . ."); Kiva, Nueva Santa Catarina Group, http://www.kiva.org/app.php?page=businesses&action=about&id=38065 (last visited Aug. 6, 2008) ("As a community bank, they are proud to have been together eight years, their bank was the first of the now four banks in their small community.").
52. Flannery, *supra* note 35, at 40.

advantage of social networking and "Web 2.0" approaches to build their support base.[53] Core to Kiva's strategy is developing what they call "a community of passionate lenders."[54] Kiva lenders have their own website, separate from Kiva, which, as the site itself explains, "supports Kiva's mission of 'connecting people, through lending, for the sake of alleviating poverty,' by creating a place where Kiva community members can connect with one another."[55] Kiva lenders also have their own MySpace page.[56]

III. TAX LAW AND KIVA: CHARITIES AND INTEREST-FREE LOANS

Although Kiva is in many ways an innovative organization, much of the tax law related to Kiva is straightforward. One aspect of Kiva's taxation, however, presents a fascinating puzzle. This Part first discusses Kiva's tax exempt status; the nondeductibility of loans to Kiva; and the appropriate tax treatment of defaults on Kiva loans, all of which are noncontroversial. This Part then turns to the tax treatment of lenders' foregone interest. The result—that the foregone interest is nondeductible—is clear, but the law that creates that result is fairly complicated, as interest-free loans to Kiva fall at the intersection of at least two areas of tax law: the taxation of charitable donations and the taxation of loans. To understand why the foregone interest is nondeductible, Section B examines the tax law relating to charitable deductions, and Section C turns to the tax treatment of below-market loans.

A. Kiva's Basic Tax Treatment

This Section addresses three simple aspects of how Kiva and its lenders are taxed. First, Kiva is a tax-exempt organization.[57] This means, obviously, that Kiva is not required to pay tax on its income.[58] But perhaps more importantly, Kiva is a tax-exempt organization described in Section 501(c)(3)—that is, it is a charitable organization, as opposed to another type of tax-exempt organization, such as a chamber of commerce or business league not organized for profit.[59] As a result, donors to Kiva may,

53. Silverman, *supra* note 4.

54. *See, e.g.*, Kiva, Kiva Lender: Rupa Moli, http://www.kiva.org/lender/rupa (last visited Aug. 9, 2008) (stating that her job is "Exploring East Coast Development for Kiva and building a community of passionate lenders"); Kiva, Kiva Lender: Liz, http://www.kiva.org/lender/liz6904 (last visited Aug. 9, 2008) (listing her occupation as Kiva Customer Service Manager and stating that she loves to share information with the "Kiva community"). The word "community" appears throughout the Kiva website. *See* Kiva Home Page, *supra* note 1.

55. Kiva Friends, About Kiva Friends, http://www.kivafriends.org/index.php?action=about (last visited Aug. 9, 2008).

56. MySpace.com-Kiva, http://www.myspace.com/kivaloans (last visited Aug. 9, 2008).

57. Kiva, Terms of Use Agreement, § 1.3, http://www.kiva.org/about/termsofuse (last visited Aug. 9, 2008).

58. *See* I.R.C. § 501(a) (2006).

59. *See id.* § 501(c)(6).

subject to certain limitations, deduct contributions to Kiva from their income.[60]

Second, even though contributions to Kiva are deductible, loans made through Kiva are not contributions to Kiva and are not deductible.[61] Loans in general are not deductible even if made for business purposes because a loan does not reduce total assets. A person who makes a loan has less cash, but he also has an offsetting note—that is, he does not have cash, but someone owes him cash, so his net worth has not changed. Thus, lenders are not permitted to take a charitable deduction for the amount they loan to Kiva.

Third, Kiva takes the position that if the borrower defaults on the loan, the individual lender may take a capital loss.[62] The lender was unable to take a deduction for the initial loan because his net worth did not diminish; he expected that his money would be returned to him. Once the borrower defaults and the lender knows that his own net worth has therefore diminished, he may then take a deduction. He did not enter into the loan to make a profit, however, so he would presumably take a short-term capital loss, as the loan would be considered a nonbusiness bad debt.[63]

The resolution of each of these tax issues is relatively straightforward. There is, however, one final piece of tax law related to Kiva that is more complicated: the treatment of the interest that the lender foregoes by lending money through Kiva interest-free. The lender cannot take a deduction for this foregone interest, but the underlying law is less than pellucid. To understand why no deduction is available to the lender, we must examine two different sections of the Code. The foregone interest is in the nature of a donation to charity, so we must understand why no deduction is permitted under the portion of the Code that discusses charitable deductions. But the Code also directly addresses tax treatment of below-market loans, so we must understand whether the Code's tax treatment of below-market loans applies to the lender's below-market (indeed, interest-free) loan to Kiva. Section B explains why the foregone interest is not deductible as a charitable donation, and Section C explains why the law relating to below-market loans does not apply to recharacterize Kiva loans, notwithstanding that Kiva loans are below-market.

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60. *See id.* § 170.

61. Kiva acknowledges this in its Terms of Use Agreement. Kiva, *supra* note 56, § 1.3 ("[B]ecause you are making a loan and not donating any money, you are not eligible to receive a tax deduction as might otherwise be available in connection with a charitable contribution to a tax-exempt public charity.").

62. *See* Kiva, Tracking Payments, http://www.kiva.org/about/help/questioons?subtopics=Tracking%20Repayments (last visited Aug. 9, 2008).

63. *See* I.R.C. § 166(d). If the loans are in registered form, lenders may be able to claim a long-term capital loss under Section 165(g). *See id.* § 165(g) (permitting a capital loss if a bond, debenture, or note issued by a corporation that is in registered form becomes worthless). No loss should be allowed under Section 165, because the loss is not incurred in a trade or business or in a transaction entered into for profit. *See id.* § 165(a) (permitting deduction of losses sustained in the taxable year); *id.* § 165(c) (limiting losses that may be taken by individuals to losses incurred in a trade or business, losses incurred in a transaction entered into for profit, and casualty losses).

B. Foregone Interest as Charitable Donation

As a general rule, a taxpayer who donates property to a tax-exempt organization is permitted to take a charitable deduction equal to the fair market value of that property.[64] What, though, is the thing of value that the donor gives to the recipient of the loan through Kiva? It is obviously not the full amount of the loan, because the borrower must pay that amount back. Rather, it is the right to use the money for a period of time. In short, the taxpayer donates the time value of his money.[65]

The right to use money for a period of time has value because money can be invested and can create more money. This is why loans are useful in the first place. The Tajikistani farmer who wants to borrow money to buy mixed fodder borrows that money because he thinks that investing in mixed fodder will, in the long run, provide him not only with enough money to pay back the loan, but also with additional benefits. Holding the money for a period of time allows him to generate more money. Closer to home, if I have $100 today, I can put it in the bank and earn interest on that money; $100 today will be worth $105 in a year if I earn 5% interest annually. I am being paid for the use of my money.

Thus, someone who loans $100 through Kiva and three years later receives his $100 back is foregoing the time value of that money. He could have invested that money—perhaps by depositing it in a bank where it would have earned interest. If he had earned 5% interest, compounded annually, after three years he would have had $115.76. If he loans through Kiva he therefore has $15.76 less at the end of three years that he would otherwise have had. This is what he has donated by loaning money interest-free through Kiva.

There are, however, limitations to the general rule that a taxpayer may take a deduction equal to the fair market value of property donated to a charity. In some situations, for example, the deduction is limited to the basis of the property.[66] (The taxpayer's basis usually represents post-tax dollars invested in the property and is often equal to the amount the tax-

64. *See id.* § 170(a), (c). For some limitations to this general rule, see *infra* text accompanying note 66.

65. In some sense, then, it is not true that a lender through Kiva "break[s] even," as the *Wall Street Journal* has suggested. *See* Liber, *supra* note 4.

66. If the property contributed would have generated ordinary income or short-term capital gain if sold, the donor's deduction is limited to the basis of the property contributed. *See* I.R.C. § 170(e)(1)(A). The donor's deduction is also limited to his basis if he contributes long-term capital gain property in four situations: first, if the property is tangible property and its use by the recipient organization is unrelated to that organization's tax exempt purpose; second, if he contributes the property to a private foundation, unless the foundation is a private operating foundation that promptly uses funds contributed to it; third, if the property is a patent, copyright, trademark, or other similar intangible property; and fourth, if the property is taxidermy property and the donor either stuffed the property himself or paid to have the property stuffed. *See id.* § 170(e)(1)(B); *see also* Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 Tax L. Rev. 1, 28-29 (2002) (arguing that all charitable deductions should be limited to basis).

payer paid for the property[67]). And of particular interest for this Article, no charitable deduction is available for the contribution of a partial interest in property.[68] For example, a taxpayer who owns an apartment building and donates the use of one floor of that building to a charity for one year may not take a charitable deduction for the value of the use of the floor.[69] Indeed, the taxpayer would not receive a deduction even if he let the charity use the entire building for one year because he did not donate his entire interest in the property.[70]

As the regulations make clear, an interest-free loan constitutes precisely the type of partial interest for which a deduction is prohibited: "D loans $10,000 in cash to a charitable organization and does not require the organization to pay any interest for the use of the money. Since D's contribution consists of a partial interest . . . he is not entitled to a charitable contributions deduction for the contribution of such partial interest."[71] Thus, even though the lender has doubtless given something of value through Kiva, he may not take a deduction for the interest he foregoes by lending money through Kiva interest-free.

C. Escaping Below-Market Loan Recharacterization

The Code provides another way to think of an interest-free loan, and thus another way to characterize the lender's donation to Kiva. The Code recharacterizes a variety of transactions to take into account the time value of money. Without this recharacterization, it would be all too easy to avoid taxes. One transaction that the Code recharacterizes is below-market loans. As the following discussion explains, the *statutory* recharacterization of below-market loans does not apply to interest-free loans to organizations such as Kiva because Kiva's interest-free loans do not have a significant effect on either the lender's or Kiva's tax liability, as will be discussed further below. The actual discussion will be somewhat technical, but perhaps also somewhat interesting, because the Code's *conceptual* approach to below-market loans may help us better understand the lenders' interest-free loans to Kiva.

Section 7872 recharacterizes certain below-market loans to prevent tax avoidance.[72] For example, without the rules of Section 7872, it would be

67. *See, e.g.*, I.R.C. § 1012 (defining a property's basis as the cost of that property, adjusted as provided elsewhere in the Code); *id.* § 1016(a) (stating that a property's basis must be adjusted for certain events, such as depreciation).

68. *Id.* § 170(f)(3)(A).

69. Treas. Reg. § 1.170A-7(d), ex. 1 (as amended in 1999).

70. *Id.* § 1.170A-7(a)(1).

71. *Id.* § 1.170A-7(d), ex. 3.

72. *See* I.R.C. § 7872 (2006 & Supp. 2007); *see also* J. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 527 (Comm. Print 1985) ("A below-market loan is the economic equivalent of a loan bearing a market rate of interest, and a payment by the lender to the borrower to fund the payment of interest by the borrower. The Congress believed that . . . the failure of the tax laws to treat these transactions in accordance with their economic substance provided taxpayers with opportunities to circumvent well-established tax rules.").

easy to sidestep the prohibition on assignment of income.[73] If a parent earns $5 million a year, and his child earns very little, the child's marginal tax bracket will be much less than the parent's marginal tax bracket. It will therefore be in the parent's interest to assign income to his child, instead of including that income as his own. If he earns $50,000, he will pay $17,500 of federal income tax if he is in the highest tax bracket. But if the parent assigns his $50,000 earnings to his child, and the child, instead of the parent, earns the $50,000, the low-bracket child could pay as little as about $6000 of federal income tax (if she has no other income or deductions). The tax law does not permit this type of income-shifting. If the parent earns the money, the parent must include it in his income and pay tax at his income tax rate. After he pays tax on his income he may of course choose to give it to his child, but that gift will be nondeductible by the parent (and not includible in the child's taxable income).

Interest-free loans can create the same kind of income-shifting as the outright assignment of income. Imagine, for example, that a wealthy parent in the top tax bracket makes a $1,000,000 loan to his child, who is in school and earns no money. Under the terms of the loan, the child must repay the $1,000,000 in three years, but will owe no interest. If this transaction were respected as a simple loan, the transaction would not appear on anyone's tax return, as loans are neither deductible by the lender nor includible by the borrower. The child could invest the $1,000,000 and get an annual return of, say, 5%. She would earn $50,000 a year, all of which would be taxable at her tax rate, not her father's, just as in the scenario in which the father simply gives his child $50,000 a year.[74] If the high-earning parent had kept the $1,000,000 and invested it at a 5% return, he would have had to pay tax on the return at his marginal rate, which could be as high as 35% (or tax of about $17,500). But by transferring the $1,000,000 to his child, he has avoided this taxable income.

The Code prevents this by recharacterizing some interest-free loans as a series of payments between the two parties to the loan.[75] Below-market loans (that is, loans that bear an interest rate less than a specified rate)[76] are divided into two types: gift loans and demand loans on the one hand, and other interest-free loans on the other.[77] A gift loan is a "below-market loan where the forgoing of the interest is in the nature of a gift."[78] A charitable donation is, for these purposes, a gift.[79] A below-

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73. *See, e.g.*, J. Comm. on Taxation, *supra* note 72, at 527. For an explanation of the prohibition on assignment of income, see *Helvering v. Horst*, 311 U.S. 112, 116-20 (1940).

74. For purposes of this example, assume that the "kiddy tax" does not apply. *See* I.R.C. § 1(g) (2006) (taxing the unearned income of a child who is under eighteen, or who is a student and under age twenty-four).

75. Adding a third party does not prevent the recharacterization.

76. *See* I.R.C. § 7872(e)(1), (f)(2) (defining "below-market loan" and "applicable federal rate").

77. *Compare id.* § 7872(a) (addressing gift loans and demand loans), *with id.* § 7872(b) (addressing "other below-market loans").

78. *Id.* § 7872(f)(3).

79. J. Comm. On Taxation, *supra* note 72, at 527 ("In general, there is a gift [for gift-loan purposes] if property (including foregone interest) is transferred for less than full and

market loan to a charity such as Kiva is therefore a gift loan because the foregone interest is in the nature of a gift.

Section 7872 bifurcates gift loans. On the last day of each year, the foregone interest is treated as first transferred from the lender to the borrower, and then retransferred by the borrower to the lender as interest.[80] The foregone interest, which is compounded semiannually, accrues on the full amount of the loan at the "applicable federal rate,"[81] which is set monthly by the Treasury and is based on the market yield of U.S. bonds.[82] The taxation of the first transfer—from the lender to the borrower—is determined based on the underlying substance of the transaction.

Returning to our example of the parent lending his child $1,000,000, assume that the parent makes the loan on January 1, and that the applicable federal rate is 4.94% compounded semiannually.[83] In that first year, the parent is treated as having loaned the child $1,000,000, and also having transferred $50,000 to her. She is then treated as having transferred $50,000 in interest back to the parent. The taxation of the $50,000 transfer from the parent to the child is determined by looking at the underlying facts of the transaction. In this situation, the transfer should almost certainly be treated as a gift. (Gift treatment is not the only possible treatment, though; one could imagine, say, a transfer from an employer to an employee that is treated as compensation, or any number of other possibilities.) As a gift, the $50,000 is not deductible by the parent and is not includible by the child.[84] The child's interest payment is includible by the parent. At the end of the transaction, the parent has $50,000 of income, taxed at his income tax rate. If the child has invested the $1,000,000, she will also have $50,000 of income.

If Section 7872 applied to interest-free loans to Kiva,[85] foregone interest would be treated as first transferred from the lender to Kiva, and then from Kiva to the lender. The transfer from Kiva to the lender would be an interest payment, taxable to the lender. It might be deductible by Kiva, but that wouldn't matter, because Kiva is a tax-exempt entity and therefore is generally not concerned about how much otherwise taxable income it has. The interest would be includible by the lender.

To determine the appropriate treatment of the deemed transfer from the lender to Kiva, we must look at the underlying transaction. Here, the

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adequate consideration under circumstances where the transfer is a gift for gift tax purposes."). Charitable donations are gifts for gift tax purposes, although they are deductible in many instances. *See, e.g.*, I.R.C. § 2512(b) (2006) (defining a gift as a transfer "for less than adequate and full consideration"); *id.* § 2522 (permitting a deduction for gift tax purposes for gifts made to charitable organizations, under certain circumstances).

80. *Id.* § 7872(a).

81. *Id.* § 7872(e)(2)(A)-(B).

82. *Id.* § 1274(d).

83. This would be the short-term applicable federal rate compounded semiannually.

84. *See* I.R.C. § 102 (stating that "[g]ross income does not include the value of property acquired by gift").

85. Section 7872 does not apply to Kiva for several reasons, as will be discussed momentarily.

underlying transaction is clearly a charitable donation. It might initially appear that the lender would not be able to deduct the deemed charitable donation because of the prohibition on the deduction of the donation of partial interests.[86] However, as the Joint Committee on Taxation has explained, this is not accurate. Rather, "Congress intended that, [in] the case of a below-market loan to a [S]ection 501(c)(3) organization, the deemed payment from the lender to the borrower be treated as a contribution of cash and not as a contribution of a partial interest in property to which [S]ection 170(f)(3)(A) would apply."[87] Therefore, if Section 7872 applied to interest-free loans to Kiva, the deemed interest payment from Kiva to the lender would be offset by the deemed charitable deduction of the payment from the lender to Kiva. In other words, the lender's taxable income would not change (because the interest payment would be entirely offset by the charitable deduction), and Kiva's taxable income would not change (because Kiva does not pay tax).[88]

Section 7872 does not, however, apply to loans to Kiva. Gift loans to a charitable organization such as Kiva are generally considered to have no "significant effect" on the federal tax liability of either the borrower or the lender,[89] and thus escape the recharacterization imposed by Section 7872.[90] This result is consistent with an analysis of the individual factors considered to determine whether a below-market loan has a significant tax effect. These factors include "whether items of income and deduction generated by the loan offset each other"; the amount of the income and deduction items; the cost of complying with Section 7872 (if compliance were required); and "any non-tax reasons for deciding to structure the transaction as a below-market loan . . . ."[91]

In the case of loans to Kiva, the lender's interest income would be offset entirely, or almost entirely (depending on the application of percentage limitations), by the charitable deduction. The amount of foregone interest is not large, at least as Kiva currently operates. The average total loaned by a Kiva lender is about $100.[92] The current applicable federal

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86. *See* discussion *supra* Section III.B.; *see also* S.J. Willbanks, *Interest-Free Loans Are No Longer Free*, 47 MONT. L. REV. 39, 69-70 (1986) (citing Section 170(f)(3)'s prohibition on a deduction for donations of partial interests to support the claim that "[i]f the taxpayer-lender loans a charitable organization $500,000, interest-free, payable on demand, when the applicable interest rate is ten percent, he is deemed to make a non-deductible contribution of $50,000").

87. J. COMM. ON TAXATION, *supra* note 72, at 530.

88. It is possible that the charitable deduction would not completely offset the interest income if, for example, the taxpayer's total charitable contributions exceeded a certain percentage of his income. *See* I.R.C. § 170(b).

89. Treas. Reg. § 1.7872-5T(b)(9) (as amended in 1988). This exception applies only if the aggregate amount of loans by the lender to the organization outstanding during the year does not exceed $250,000. *Id.*

90. *See* I.R.C. § 7872(c)(1)(E).

91. Treas. Reg. § 1.7872-5T(c)(3); *see also* J. COMM. ON TAXATION, *supra* note 72, at 531-32 (listing the same four reasons).

92. Kiva, *supra* note 39 (stating that the average total amount loaned per Kiva lender is $127.48) (last visited Aug. 28, 2008).

rate is less than 2%.[93] So even if we assume that the Kiva lender loans that $100 in a single year, the average foregone interest each year that would have to be included and deducted if Section 7872 applied is approximately $2.[94] The cost of complying with Section 7872 could be significant for the lenders, as they might have to pay someone for tax advice to understand how Section 7872 applied to their situation. And finally, the loans to Kiva are structured as interest-free loans for non-tax reasons: to avoid running afoul of securities regulations.[95]

Thus, Section 7872 does not apply to recharacterize the interest-free loans to Kiva. However, as we will see in the next Part, the concepts underlying Section 7872's general rule of recharacterization will come into play as we discuss reforming the law that applies to interest-free loans to charities.

IV. REFORMING THE LAW OF PARTIAL INTEREST DONATIONS

This Part argues that the law should be changed to permit charitable deductions for interest-free loans to microfinance charities such as Kiva. Section A describes why microfinance loans should be added to the exceptions that already exist to the general rule denying a deduction for donation of partial interests. Section B describes several ways this change could be implemented and concludes that the simplest and best way to permit deductions for interest-free loans to microfinance organizations is to permit the lender to deduct the amount of the loan in the year it is made and require the lender to include that amount in his taxable income the year the loan is repaid.

A. Changing the Law for Interest-Free Microfinance Loans

This Section explains why the law should be changed to allow charitable deductions for interest foregone on loans to microfinance charitable organizations such as Kiva. First, microfinance should be supported from a policy perspective. Second, foregone interest on microfinance loans is conceptually consistent with the other exceptions that already exist to the general rule barring charitable deductions for the donation of partial interests. And third, administrative problems that might vitiate against permitting deductions for partial interests in general do not exist when it comes to permitting deductions for foregone interest.

The Code already contains three exceptions to the general rule forbidding deductions for donations of partial interests, so adding an exception would not be unprecedented. As originally enacted, the rule included two exceptions: deductions were permitted for the contribution of a remainder interest in a personal residence or farm, and for an undivided

93. Rev. Rul. 2008-20, 2008-14 I.R.B. 716 (stating that the short-term AFR compounded semiannually was 1.84% for April 2008).

94. The foregone interest on $118.45 at 1.84% compounded semiannually is $2.19.

95. *See supra* note 31 and accompanying text.

portion of the taxpayer's entire interest in property.[96] Additional exceptions were added over the years. In 1976, new exceptions were added for donation of a lease, option, or easement with respect to real property of at least thirty years, to be used exclusively for conservation purposes, and for donation of a remainder interest in real property.[97] "Conservation purposes" meant the preservation of land for outdoor enjoyment, the preservation of historically important land or buildings, or the protection of natural environmental systems.[98] Finally, in 1980, the two 1976 exceptions were combined to permit a deduction for a partial interest if that partial interest was a "qualified conservation contribution,"[99] which was defined as a contribution of certain real property to certain tax-exempt organizations exclusively for conservation purposes.[100]

Legislative history does not explain the initial reasons for these exceptions, but presumably Congress believed that these types of donations were particularly important and should be encouraged. As discussed above, microfinance appears to be a powerful way to alleviate poverty.[101] There is also a distinct shortage of lenders: the worldwide "demand for loans . . . far outstrips [the] supply."[102]

An additional impetus for the conservation easement exception also supports creating an exception to the general partial interest deduction ban for loans to charitable organizations such as Kiva. Congress shed some light on the thinking behind the conservation easement exception when it extended that provision in 1977:

> [I]t is intended that a contribution of a conservation easement or remainder interest qualify for a deduction only if the holding of the easement (or, in the case of a remainder interest, the property) is related to the purpose or function constituting the donee's purpose for exemption (organizations such as nature conservancies, environmental, [sic] and historic trusts, State and local governments, etc.) and the donee is able to enforce its rights as holder of the easement or remainder interest and protect the conservation purposes which the contribution is intended to advance. The requirement that the contribution be exclusively for conservation purposes is also in-

96. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(a), 83 Stat. 483, 549 (codified as amended at I.R.C. § 170(f)(3)(B) (2006)).

97. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2124(e)(1), 90 Stat. 1520, 1989 (codified as amended at I.R.C. § 170(f)(3)(B)).

98. *Id.* (codified as amended at I.R.C. § 170(h)(4)(A)). The provision was initially temporary, but then was extended to June 14, 1981. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 309, 91 Stat. 126, 154 (codified as amended at I.R.C. § 170(h)(2)(C)).

99. Pub. L. No. 96-541, § 6(a), 94 Stat. 3204, 3206 (1980) (codified as amended at I.R.C. § 170(f)(3)(B)(iii)).

100. Pub. L. No. 96-541, § 6(b), 94 Stat. 3204, 3206 (1980) (codified as amended at I.R.C. § 170(h)).

101. *See supra* Section III.A.

102. Thomas Kostigen, *Microfinance Ignored: Demand for Loans Around the World Far Outstrips Supply*, MARKET WATCH, Oct. 19, 2007, *available at* http://www.marketwatch.com/news/story/demand-micor-financing-far-outstrips/story.aspx?guid=%78F1278BD-4F93-40B0-A12E-502219813149%70.

> tended to limit deductible contributions to those transfers which require that the donee hold the easement (or, in the case of a remainder interest, the property) exclusively for conservation purposes (i.e., that they not be transferable by the donee in exchange for money, other property, or services).[103]

In other words, a deduction for the donation of a conservation easement is permitted only if the partial interest is itself for conservation purposes and does not merely support conservation. This description also applies to loans to Kiva. Unlike many other partial interest donations, the benefit that Kiva supplies is precisely a partial interest. This is a different situation than someone permitting a soup kitchen to use a floor of a building rent-free for a limited period of time. In that situation, the provision of the building permits the soup kitchen to pursue its ultimate tax-exempt purpose, feeding the hungry. But the provision of funds for a limited period of time is precisely Kiva's tax-exempt purpose. Thus, adding an exception to the partial interest deduction ban to permit a deduction for foregone interest on loans to charities such as Kiva would be consistent with current exceptions to the general provision.

Additionally, administrative problems that might plague other deductions for partial interests, problems relating to valuation and control, would not be an issue for a deduction for foregone interest. The value of foregone interest is easy to measure (and indeed, if the method suggested in Section B were adopted, there would be no valuation issue at all[104]), and there would be no question that the lender had given up control of the partial interest.

There are at least two problems related to the valuation of property donated to charity. First, a taxpayer who may deduct the fair market value of property donated to charity has a strong incentive to overvalue that property for purposes of his tax return. Second, and relatedly, taxpayers and the government can value property available on the open market with relative ease, but it is more difficult to value property not generally offered in the market, whether because that property is unique or because that type of property is not widely traded. The government has attempted to address the fact that taxpayers may overstate the value of property donated to charity by, among other approaches, imposing various substantiation requirements for property that is not "readily valued."[105] One can certainly imagine, however, that valuing partial interests might be particularly difficult; for example, it might be possible

103. H.R. Rep. No. 95-263, at 30-31 (1977) (Conf. Rep.), *reprinted in* 1977 U.S.C.C.A.N. 287, 295.

104. *See infra* Subsection IV.B.2.b.

105. *See, e.g.*, I.R.C. § 170(f)(11) (2006) (requiring, for charitable deduction purposes, appraisal and documentation of the donation of certain property that is not "readily valued"); *see also* Matthew L. Wald, *Tax Scheme Is Blamed for Damage to Artifacts*, N.Y. Times, Feb. 4, 2008, at E1 (describing a scheme in which "smugglers and art dealers were selling prehistoric artifacts to Americans, who were provided with inflated appraisals. Then the art dealers arranged for the items to be donated to museums, so the donors could take a tax deduction.").

to determine the market value of a used car donated to a charity, but it would be more difficult to determine the market value of permitting the charity free use of that car for a few days a week. And if a taxpayer could find an appraiser who would put a high value on that use, it might be difficult for the government to challenge successfully the taxpayer's deduction.

Permitting a deduction for foregone interest would not raise such valuation concerns, however. The market rate for money (that is, the interest rate) is readily available, and in fact, as described above, the IRS already issues a monthly interest rate that taxpayers must use to address various tax timing issues.[106] (Thus, unsurprisingly, the IRS does not require appraisal of cash donated to charities; cash is, of course, the quintessential "readily valued" property.)[107] Moreover, as discussed below, separate valuation of the foregone interest might be completely unnecessary, depending on how the deduction is implemented.[108]

Taxpayers may also abuse the charitable deduction by retaining control over putatively donated items. For example, taxpayers have attempted to claim charitable deductions for property transferred to foundations and churches over which the taxpayers retained control.[109] This is of course impermissible; as the Eleventh Circuit has explained, a deductible charitable contribution "must be one over which the contributor has surrendered dominion and control."[110] Donations of partial interests seem particularly likely to trigger this concern. For example, it would be extremely difficult for the government to know that the charity really had full use of a car a few days a week, as opposed to the charity's having to bring the car back to the donor if he decided that he needed to use it on a particular day.[111]

Permitting a deduction for foregone interest would not, however, create control monitoring problems for the government. Below-market lenders like Kiva lenders transfer their funds to a separate entity, an entity over which they have no control. And not only do the lenders not control the entity, they also do not control the funds while the money is with the tax-exempt organization (that is, the borrower). Thus, allowing a charitable deduction for foregone interest would avoid the control con-

106. *See supra* notes 80-82 and accompanying text.

107. *Id.* § 170(f)(11)(A)(ii) (excepting from the rules requiring appraisal "readily valued property," which includes cash).

108. *See infra* Subsection IV.B.2 (discussing the "Deduct-Include" method).

109. *See, e.g.*, United States v. Estate Pres. Servs., 202 F.2d 1093, 1101-02 (9th Cir. 2000) (foundations); Pollard v. Comm'r, 786 F.2d 1063, 1066-67 (11th Cir. 1986) (churches).

110. *Pollard*, 786 F.2d at 1067.

111. *Cf.* Miller v. Comm'r, 34 T.C.M. (CCH) 1207 (1975) (denying a charitable deduction for radios purchased for use in the taxpayer's home for Civil Air Patrol activities, on the grounds that the equipment "could . . .be inexpensively converted to frequencies other than those assigned to the Civil Air Patrol. . . . A change in crystals would allow petitioner to maintain and use the equipment in any manner. . . . [I]t was petitioner who controlled use of the equipment.").

cerns that might attend charitable deductions for partial interests in general.

In conclusion, an exception for interest foregone on microfinance loans should be added to the rule barring charitable deductions for partial interests for at least three reasons. Microfinance should be supported; an exception for foregone interest on microfinance loans is consistent with already extant exceptions to the rule; and the nature of foregone interest avoids administrative problems that might plague other deductions for the donation of partial interests.

B. Implementing the Change

This Section examines two possible ways that the deduction for foregone interest could be implemented and concludes that the best way to implement the deduction would be to permit a lender to deduct the loan when it is made and require him to include it in income when it is repaid.

1. *The Deemed Interest Method*

One way to permit a charitable deduction for foregone interest would be to modify the approach already used for certain below-market loans, but to eliminate the deemed interest payment from the borrower to the lender. As discussed above, Section 7872 of the Code recharacterizes some interest-free loans (though not interest-free loans to charities) as two transfers: first, a transfer from the lender to the borrower, characterized to reflect the underlying substance of the transaction, and second, a transfer from the borrower to the lender of a deemed interest payment.[112] One way to implement a deduction for foregone interest on below-market loans to Kiva and similar microfinance charities would be to allow a deemed yearly transfer from the lender to Kiva of the amount of foregone interest and permit this to be recharacterized as a charitable deduction. As discussed above, this would not run afoul of the rule against the deduction of partial interests because the Code considers such a transfer to be a transfer of cash, not a transfer of a partial interest. Of course, for this recharacterization to benefit the lender, the second part of the transaction—the deemed transfer of interest from borrower to lender—would have to be eliminated. We might call this approach the "Deemed Interest Method."

There are, however, several problems with this method of providing a deduction for Kiva lenders. First, it would be difficult for lenders to implement. The provisions of Section 7872 are not easily understood. The same can be said about many provisions of the Code, but a simpler way of implementing the deduction might still be preferable.

The second problem with the Deemed Interest Method, however, is more serious: it might provide a benefit to taxpayers who should not actually receive a benefit. To see why, think for a moment about why the

112. *See supra* Section II.B.

lender receives a charitable deduction for his foregone interest: he receives that deduction because he is giving away something of value that he would otherwise have gotten the benefit of. But not all lenders will receive income from their money if they do not lend it to Kiva. Think of a lender who is trying to decide whether to loan $100 to Kiva. There are many things he could do with the money if he did not lend it to Kiva. He could deposit it in a bank and receive interest on it. He could invest in some other way—perhaps in the stock market—and earn a return on it. If those were his only options (loan to Kiva, deposit in interest-bearing account, invest in stock market), he is giving up money by loaning it to Kiva instead of taking the other two options. He has given up something of value, and a deduction is appropriate.

But what if he is choosing between either loaning the money to Kiva or depositing it in a non-interest-bearing account? In that case, he is not giving up income by loaning the money to Kiva. This year he has $100. Whether he deposits the money in a non-interest-bearing account or loans it to Kiva, in two years he will have $100. He has given up nothing by loaning the money to Kiva. He would not have derived any time value from the money because it would have been sitting in a non-interest-bearing account.

It is even possible that our imaginary lender has no plans to keep the money at all if he does not loan it to Kiva. He might be choosing between loaning the money to Kiva and buying himself a nice dinner. Instead of using the money to generate income, he is using the money for consumption in the current year. In that case, he certainly is not giving up anything by loaning the money interest-free to Kiva.[113]

In either of the latter two cases, the lender would not be taking advantage of the time value of money if he did not loan to Kiva. Therefore, allowing him a charitable deduction would not be appropriate, as he would be giving up nothing by lending the money to Kiva.

113. It may be more accurate to say that he is not giving up anything financial. He may be reducing his overall welfare, if eating a steak dinner this year would give him more net pleasure than eating a steak dinner in three years. Alternatively, he may be increasing his overall welfare by loaning the money to Kiva, if the anticipation of a nice dinner three years hence provides him with increased utility in the three years leading up to the dinner, or if he would have squandered the money had he not loaned it to Kiva, and so is increasing his utility by assuring himself that he will have cash in the future. The latter might be why some people are happy to receive tax refunds, even though someone who receives a tax refund gets that money only because he has, in effect, made an interest-free loan to the government. The question of whether and how much a person prefers something today over something in the future is the question of "discounting." For a general discussion of discounting, see, for example, Daniel A. Farber & Paul A. Hemmersbaugh, *The Shadow of the Future: Discount Rates, Later Generations, and the Environment*, 46 VAND. L. REV. 267, 277-79 (1993). For a more in-depth discussion see, for example, the essays collected in the Intergenerational Equity and Discounting Symposium issue of the University of Chicago Law Review, 74 U. CHI. L. REV. 1 (2007).

2. *A Better Approach: Deduct and Include*

a. The Method

A different method of structuring the deduction would be easier to implement, would effectively deny a deduction to anyone who would not have taken advantage of the time value of money absent the loan to Kiva, and would accurately capture the actual time value of the lender's foregone interest. Specifically, the lender should be permitted to deduct the loan from his income in the year in which he makes the loan and required to include it in his income when it is repaid.[114]

Take, for example, our $100 lender. Assume his tax rate is 20%. Consider five possible options: (1) he holds his money and neither invests it nor loans it through Kiva, (2) he invests his money and receives a 5% return, (3) he loans his money through Kiva and, as under current law, receives no interest, (4) he loans his money through Kiva and is permitted to deduct the foregone interest each year (this is the Deemed Interest Method discussed above), or finally, our preferred option, (5) he loans his money through Kiva and is permitted to take an ordinary deduction in the amount of the loan in year one, but must include the return of principal as ordinary income in year two (we might call this the "Deduct-Include Method").[115]

If, as in option one, the taxpayer does not invest his money at all, he will have $100 in year one and $100 in year two.

If, as in option two, he invests his money and receives a 5% annual return, he will receive a $5 return in year one, on which he will owe tax of $1 (20% of $5). In year two, he will therefore have $100 (his initial amount) plus $5 (the amount of interest he earned) minus $1 (the tax he owed on the interest he earned), or $104.

Now imagine that current law applies, and the lender lends the money through Kiva and receives no interest or charitable deduction. (This is option three.) He will have $100 in year one, and when he gets his money back in year two, he will also have $100. He has lost the time value of his money which, after tax, was $4.

114. This is analogous to two different ways to implement a consumption tax: a government can forbid expensing but not tax yield, or the government can permit expensing and tax yield. *See, e.g.*, Daniel N. Shaviro, *Replacing the Income Tax with a Progressive Consumption Tax*, 102 TAX NOTES 91, 99-100 (2004) (discussing the "Cary Brown Theorem").

115. To be more precise, the law could provide that the lender would be required to include the return of principal in income only if he received a tax benefit from the deduction in year one. Someone who does not itemize his deductions, for example, would have received no tax benefit from the year-one charitable deduction and thus should not be required to include the principal in his income when it is repaid. This could be implemented in terms similar to the current tax benefit rule. *See* I.R.C. § 111 (providing that "gross income does not include income attributable to the recovery . . . of any amount deducted in any prior taxable year to the extent" that the prior year's deduction resulted in no tax benefit). For the sake of simplicity, consistent with the current approach in Section 111, the Deduct-Include Method as proposed here does not adjust for rate changes. Thus a taxpayer who is in a lower tax bracket in year two enjoys a windfall, and a taxpayer in a higher bracket in year two pays more tax than he saved in year one.

Options four and five, the Deemed Interest Method and the Deduct-Include Method, respectively, are two different methods of implementing the proposed change in law that would permit a deduction for foregone interest.

Under option four, the Deemed Interest Method described above in Subsection 1, the law would change to permit a charitable deduction of the foregone interest. The lender will have $100 in year one. He will forego $5 of interest in year one, and will thus receive a charitable deduction of $5. This will offset $5 of other income, which will save him $1 in tax. Therefore, in year two, he will have $101 as a result of his loan.

Imagine now that, as in option five, the Deduct-Include Method, we permit the lender to deduct the $100 in year one, but require him to include that amount in year two, when his principal is returned. At first, this seems to provide a different result than option four, the Deemed Interest Method. If he loans $100 in year one and can deduct that amount, he will be able to offset his income by $100, and thus will save $20 in tax (20%, his tax rate, times $100, the amount of his deduction). He can invest this $20. At a 5% rate of return, he will receive $1 of income. But he will be taxed on this income, so he will net only $0.80. In year two, when he is required to include the return of principal in his income, he will have to pay an additional $20 of tax. He can, of course, just use the $20 he saved in year one, so that tax should not cause him any concern. But his total at the end of this whole process will be $100.80, not $101.

The lender can get the identical net result under the Deduct-Include Method as under the Deemed Interest Method, however, if he lends $125 instead of $100.[116] (We can call this option 5b.) In that case, he will be able to deduct $125 in year one. This will save him $25 in tax. He can invest this, and, at a 5% rate of return, will receive $1.25. He will owe tax on this amount, of course. Specifically, he will owe 20% of $1.25, or $0.25. Thus he will net $1. In year two, he will be required to include the $125 in income, at which point he will owe $25 in tax. But this won't be a problem; he can use the $25 of tax he saved in year one. And he will have netted $101. In other words, the lender can receive exactly the same treatment as if he loaned $100 and was permitted to deduct the deemed foregone interest each year.

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116. This assumes that the lender has enough liquidity to loan $125 instead of $100, knowing that in a few years he will be in precisely the same net position as if he had loaned $100. Obviously, if the lender has no additional funds to lend, he cannot increase his loan to arrive at the same net result under the Deduct-Include Method as under the Deemed Interest Method.

		Year 1				Year 2		
		Return on Investment (Taxable)	Deduct	Tax	Net Year 1	Include in Income	Tax	Total Gain
Baseline Scenarios	Option 1 No Investment	$0	$0	$0	$0	$0	$0	$0
	Option 2 Invest $100, 5% Return	$5	$0	($1)	$4	$0	$0	$4
Current Law: No Charitable Deduction	Option 3 $100 Loan to Kiva, No Interest	$0	$0	$0	$0	$0	$0	$0
Proposed Law: Charitable Deduction of Foregone Interest	Option 4: Deemed Interest Method $100 Loan to Kiva	$0	$5 (imputed foregone interest)	$1 (tax savings from income offset by deduction)	$1	$0	$0	$1
	Option 5a: Deduct-Include Method $100 Loan to Kiva	$1 ($20 saved tax invested at 5% return)	$100 (amount of loan)	$20 + (0.20) = $19.80	$20.80	$100	($20)	$0.80
	Option 5b: Deduct-Include Method $125 Loan to Kiva	$1.25 ($25 saved tax invested at 5% return)	$125 (amount of loan)	$25 + ($0.25) = $24.75	$26	$125	($25)	$1

In conclusion, as the above chart shows, a taxpayer who loans $100 to Kiva under current law is in the same position as a taxpayer who does not invest his money at all. If the law were changed to permit a charitable deduction for the Kiva lender's foregone interest, that deduction could be implemented in two different ways—either the Deemed Interest Method or the Deduct-Include Method. As the next Subsection explains, the Deduct-Include Method is the superior approach.

b. Advantages to the Deduct-Include Method

There are a number of advantages to using the Deduct-Include Method rather than permitting deduction of foregone interest each year. The Deduct-Include Method is simpler to implement than the Deemed Interest Method; it is more accurate; and it simplifies the tax situation if the borrower defaults while leaving largely unchanged the ultimate tax effect of a default.

First, the method is simpler to implement for both the IRS and the taxpayer. The IRS need be concerned about only one year: the year of inclusion. And the taxpayer does not need to file a separate form or try to figure out how much imaginary interest he should deduct each year. Because the method is simpler for the IRS to monitor, it would be less likely to result in underpayment of tax. And because it is simpler for the taxpayer, taxpayers would be more likely to use it, which might in turn mean that the charitable deduction performed the job it was meant to perform: encouraging charitable donations.

Second, the Deduct-Include Method is more accurate than deeming interest payments each year in two ways, one IRS-friendly, one taxpayer-friendly. The IRS should prefer the Deduct-Include Method over the Deemed Interest Method, which would permit a yearly deduction for deemed foregone interest, because the yearly deduction under the Deemed Interest Method would give all taxpayers a tax benefit, even those who would have, say, let their $100 sit in an interest-free account.[117] In contrast, the Deduct-Include Method would provide no benefit to taxpayers who would not have gotten any financial time value from their money had they not lent it to Kiva. In other words, these taxpayers are not actually giving anything up by loaning money through Kiva, and therefore they should not receive a charitable deduction. This is the case because any benefit to the lender depends on that lender's investing the money he saves from deducting the principal amount of his loan in year one. If he does not invest his saved taxes, his tax savings in year one will be completely offset by the inclusion of principal when the loan is repaid and he will have no benefit from the loan at all.

The Deduct-Include Method can also be more accurate in a way that helps taxpayers. The examples above assume that the deemed interest rate would equal the rate of return the taxpayer would have received had he not made the charitable loan and had instead invested his money. But if the Deemed Interest Method followed current Section 7872 and many other Code sections that impute interest, the imputed interest rate would equal the applicable federal rate. The applicable federal rate is the market yield on outstanding marketable securities of the United States.[118] Securities of the United States, that is, Treasury bills and the like, have zero default risk and therefore have a relatively low yield.[119] A taxpayer who is willing to bear some default risk would be able to invest his money and receive a better yield.

Let us compare the Deemed Interest Method and the Deduct-Include Method again, but this time, imagine that the deemed interest rate and the rate of return available on the market do not match. We have seen that if the rate of return is zero (which is, of course, less than the deemed interest rate), the taxpayer does better using the Deemed Interest Method and the IRS does better if the taxpayer uses the Deduct-Include Method. But what if the rate of return the taxpayer would have obtained

117. *See supra* Subsection IV.B.1.

118. I.R.C. § 1274(d).

119. For example, the short-term applicable federal rate for April 2008 for semiannual compounding was 1.84%. Rev. Rul. 2008-20, 2008-14 I.R.B. 716. In other words, the average market yield for outstanding marketable obligations of the United States with remaining periods to maturity of three years or less was 1.84%. Putting the saved tax in a money market account would provide a 2.52% annual yield; buying a five-year CD would provide a 3.27% yield.

is greater than the deemed interest rate? Imagine, for example, that the deemed interest rate is 5%, but the taxpayer could actually invest the money and receive a rate of return of 10%.

Nothing would change for the taxpayer under Option 4, the Deemed Interest Method. Whatever the taxpayer did, he would be deemed to have foregone $5 of interest in year one and would receive a charitable deduction of $5, saving him $1 of tax. He would still have $101 in year two.

Now let us go to the equivalent implementation of the Deduct-Include Method, in which the lender lends $125 in year one and saves $25 in tax. If he can get a 10% rate of return investing on the market, he will receive $2.50 in interest, on which he will owe tax of $0.50. He will therefore net $2, as opposed to the $1 he receives under the deemed interest deduction method. Why is this? It is because the taxpayer is getting the actual time value of his money, not the imaginary time value that the deemed interest provides. Just as the Deduct-Include Method requires the taxpayer who does not invest his money to live with the consequences of that decision (by providing him no tax benefit for allowing Kiva to use his money), so it permits the taxpayer who invests his money well to obtain the benefits of that investment.

Finally, if the borrower defaults, the taxpayer need do nothing to receive the appropriate tax treatment under the Deduct-Include Method; he simply never includes the principal in his income. Under current law, if the borrower defaults, the taxpayer takes a bad debt deduction in the year of default.[120] This is appropriate under current law because there was no donative intent with regard to the principal when he made his initial loan, and therefore, he should not receive a charitable deduction for that amount.[121] Under the Deduct-Include Method, the taxpayer would take the deduction in the initial year of the loan instead of in the year of default. The only difference between taking the deduction in the initial year of the loan instead of later in the year of default is that taking the deduction in the initial year gives the taxpayer the benefit of the time value of the earlier deduction. And under the proposed change in law, the taxpayer should receive a benefit for giving up the time value of his money.

Let us look at an example involving default. Under current law, a lender who lends $125 in year one takes no deduction.[122] If the borrower defaults in year two, the borrower is permitted a $125 deduction. What would have been his advantage to taking the deduction in year one, instead of year two? It is simply the post-tax time value of the tax he would have saved: that is, as discussed above, $1. This is precisely the benefit we want the lender to receive if we permit a deduction for foregone

120. *See* I.R.C. § 166(d) (2006).

121. *See supra* note 61 and accompanying text.

122. *See id.*

interest.[123]

In sum, the Deduct-Include Method is a simple and accurate way to implement the deduction for foregone interest.

V. OBJECTIONS

Several objections might be raised to permitting the deduction of foregone interest for loans to microfinance charities. However, on further inspection, none of these objections is strong enough to overcome the benefits of putting microfinance organizations on an equal footing with other charities.

A. Tax Deductions Are Not Neighborly

One objection to permitting deductions for foregone interest in this context is that people may actually prefer not to take a charitable deduction related to their loans to Kiva. It may seem less noble, and thus less attractive, to donate money if you receive some benefit from the donation. This may be particularly true in the context of microfinance, which emphasizes people doing things for themselves instead of taking handouts. Kiva is already a tax-exempt organization under Section 501(c)(3)—that is, it is already a charity—but the fact that loans through Kiva are not tax deductible may obscure that from lenders in a positive way.[124]

There are several responses to this objection. First, the charitable deduction would not be required; it would simply be a possibility. Perhaps foregoing an available deduction seems more noble than selecting an organization that does not even make deductions available.

Second, people may not understand that taking the charitable deduction is like having the U.S. government pay part of the contribution.[125] Someone who might object to taking a personal benefit for the donation might not object if the deduction were framed as a donation to Kiva from the U.S. government. Indeed, some people choose to make loans through Kiva exactly because they want to offset the way their tax dollars are spent. For example, one lender writes, describing why he loans, "I am a war tax resister and want to take money that would have gone to bombs and give it to people who are building a future."[126] Someone else lends because "I would like some of my income to go to helping others[,] espe-

123. There is one additional difference between the way current law handles default and the way the Deduct-Include Method would handle default: current law provides a short-term capital loss, whereas the Deduct-Include Method would result in an ordinary deduction.

124. *See supra* Section III.A.

125. For example, if the tax rate is 35%, deducting a $100 charitable donation reduces tax revenue by $35. Disregarding transaction costs, making a $100 charitable donation that is deductive is thus identical to earning $100, paying $35 tax to the government and $65 (nondeductible) to the charity, and having the government transfer the $35 to the charity.

126. Kiva, Kiva Lender: NTodd, http://www.kiva.org/lender/ntodd1493 (last visited Aug. 8, 2008).

cially as my US tax dollars are often spent on causes that I do not agree with."[127] And a third person writes that she loans because "I work for the federal government. This is my way of guaranteeing that US tax dollars (my paycheck) fund social causes!"[128] These people, at least, might be glad to take a deduction if they understood that a tax deduction is in many ways the equivalent of directing their tax dollars to Kiva.

Finally, a lender could use the charitable deduction to donate more to Kiva. Someone who would have donated $100 if no charitable deduction were available might decide to donate a few dollars more, enough to completely offset any personal advantage he might have derived from the charitable deduction. In other words, he could pass the advantage of the charitable deduction to Kiva instead of keeping it for himself. Increasing the donation to Kiva could put the lender in exactly the situation he would have been in with no charitable deduction.

These are practical, financial arguments, however. A more intangible argument is more difficult to answer: perhaps permitting a charitable deduction would harm the sense of "community" that Kiva lenders value.[129] It might be more difficult to imagine communal bonds among lenders if the lending experience were made more financial instead of seemingly stemming purely from the goodness of the lenders' hearts.

But educating the lenders about the possible benefits of the charitable deduction to Kiva and the individuals who eventually borrow from Kiva should help alleviate that concern. If a charitable deduction is available for lenders to Kiva, then lenders could increase the amount of their loans so that all of the tax savings is passed on to the ultimate borrowers. Indeed, while Kiva itself should probably avoid giving tax advice to its lenders, the community could publicize the tax deduction among itself and let people know that taking the tax deduction would allow them to loan more money to Kiva. One can imagine, for example, a web calculator that would permit people to enter their yearly taxable income and find out exactly how much more they could afford to loan to Kiva if they take advantage of the charitable deduction.

To avoid a charitable deduction in the name of community when that deduction could increase funds ultimately transferred to the borrowers seems to sacrifice what one hopes is the ultimate goal of Kiva lenders—helping the borrowers who live in poverty—for the sake of the lenders' personal benefit—an increased sense of community among themselves. In other words, refusing the charitable deduction is more selfish than accepting it and increasing one's loan to Kiva.

127. Kiva, Kiva Lender: David, http://www.kiva.org/lender/david6844 (last visited Aug. 8, 2008).
128. Kiva, Kiva Lender: Holly, http://www.kiva.org/lender/PokrChick (last visited Aug. 8, 2008).
129. *See* discussion *supra* Section II.C.

B. Donations to Kiva as Foreign Aid

Another possible objection to making foregone interest deductible is that Kiva has an international focus. In particular, Kiva on-loans money interest-free to its "field partners," all of whom are based outside the United States.[130] Just as individual lenders to Kiva donate the time value of their money, so Kiva passes on this benefit in the form of interest-free loans to the field partner microfinance lenders, who in turn do charge interest to the individual borrowers.[131] Kiva characterizes this as "compensating" these partners by "allowing them to keep the interest charged on these funds provided by Kiva."[132] Some might argue the United States government should not be funding foreign aid through charitable deductions.[133] (Recall that when an individual takes a tax deduction for a charitable donation, the government is essentially funding a portion of that individual's donation.)[134] But this cannot be an objection to Kiva in particular. Many U.S. charities send money overseas, and donations to these charities can be tax deductible.[135] Indeed, the amount spent by the United States (in the form of tax expenditures) due to the deduction of foreign-bound donations may be well over $1 billion.[136] Kiva is far from unique in this regard.

C. No Bang for the (Compliance) Buck

All this may seem like more trouble than it is worth. Let us return to the Deduct-Include Method.[137] Assume that a lender can get a 5% return on his investment (which may be optimistic) and that he is in the 25% tax bracket. If he loans $100 (the average amount a Kiva lender loans), the net benefit to him of this deduction will be less than $1.[138] It hardly seems worthwhile for the lender to bother investing the $25, and

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130. *See* Kiva, Kiva's Field Partners, http://www.kiva.org/about/partners/ (last visited Aug. 8, 2008) (listing Kiva's field partners).

131. *See* Kiva, *supra* note 29.

132. *See* Application for Recognition of Exemption, I.R.S. Form 1023, Kiva Microfunds (Oct. 2004).

133. *See, e.g.*, David E. Pozen, *Hidden Foreign Aid*, 8 Fla. Tax Rev. 641, 649, 672-79 (2007) (describing how a "foreign aid subsidy occurs any time individuals or corporations make contributions to a U.S.-based nonprofit that runs or supports appropriate programs outside the country," and noting both drawbacks and advantages to this sort of foreign aid subsidy).

134. *See supra* note 106 and accompanying text.

135. Donations to these charities are deductible if the U.S. charity reviews and approves the grants to foreign organizations and maintains control over the donated funds and discretion as to their use. Rev. Rul. 63-252, 1963-2 C.B. 101. According to Kiva, "Kiva will retain full control and authority over which microbusinesses are selected by . . . Kiva Partners, to ensure that each microbusiness selected furthers Kiva's mission." Application for Recognition of Exemption, *supra* note 132.

136. Pozen, *supra* note 134, at 662-63 (suggesting, based on "casual empiricism," that the charitable deduction may result in between $1.4 billion and $2.8 billion in overseas tax expenditures).

137. *See supra* Subsection IV.B.2.

138. The deduction in year one is $100, saving him $25 in tax. If he invests this money at a 5% annual return, he will get $1.25, on which he will pay $0.31 tax, leaving him a net benefit of $0.94. When the loan is repaid he will, of course, have to pay tax on the returned

the lender might be happy to pay more than $1 to avoid the paperwork that will inevitably accompany the charitable deduction.[139]

It is true that the current average loan is relatively small. But this is the size of loan made when no charitable deduction is available for the foregone interest. The average size of the loans might well increase if lending through Kiva fit with standard charitable planning. And the value of the deduction will increase as interest rates increase. If interest rates climb back to their 1980s levels—say, 15%—the value of a deduction will also climb. In our example, if a lender could get a 15% return on his investment, the net benefit to him of the deduction would be almost $3.[140] Judging the deduction based on its current value is thus short-sighted, as this relatively low value is not intrinsic, but rather is contingent on circumstances—the value of the loans made and the applicable interest rate—that may well change.

D. Unproven Microfinance

Someone might also make the objection that there is no proof of the effectiveness of microfinance, particularly microfinance such as Kiva's, in which individual lenders send small amounts of money to particular poor people. In particular, some argue that microcredit standing alone—as opposed to microfinance, which includes other financial services such as insurance and savings programs—provides little benefit to the very poor.[141] Thomas Dichter, who has worked in microfinance for many years, has called Kiva a "totally unnecessary organization that exists to please the people who are participating and isn't making any real difference."[142]

There is no doubt that microfinance's effectiveness deserves further study—and indeed, it is receiving further study—though there is also reason to believe that microfinance is effective and powerful.[143] But, in the meantime, the question is whether the United States should provide a charitable deduction for donations to an organization whose effectiveness is not proven. Again, this is a larger question, and the current U.S. approach to charities is clear: the United States does not closely investigate the methods that charities use to implement their goals and does not revoke tax-exempt status simply because a particular charity's approach is

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principal under the Deduct-Include Method, thus erasing the initial $25 savings and leaving him only the benefit of the time value of that savings.

139. Presumably Kiva will send the lender a letter with respect to the year he makes the loan, telling him he can deduct the amount of the loan, and will file some type of Form 1099 in the year the principal is repaid, telling both the lender and the IRS that this amount needs to be included in income.

140. The deduction in year one is $100, saving him $25 in tax. If he invests this money at a 15% annual return, he will get $3.75, on which he will pay $0.94 tax, leaving him a net benefit of $2.81.

141. *See, e.g.*, Hugh Allen, *Finance Begins with Savings, Not Loans*, *in* What's Wrong with Microfinance 49 (Thomas Dichter & Malcolm Harper eds., 2007).

142. Daniel Dale, *Anyone Can Lend a Hand via Web*, Hous. Chron., Apr. 14, 2007, at Bus.1.

143. *See* discussion *supra* Section II.A.

not particularly effective, as long as the charity is organized and operated for the appropriate purpose (and certain other requirements are met, including, for example, a ban on political activity for certain tax-exempt organizations).[144] Indeed, the United States granted tax-exempt status to Kiva notwithstanding the arguably unproven benefit of its microcredit program.[145] Whether Kiva itself is effective does not answer the question of whether there should be a distinction, from a tax perspective, between loans to Kiva and donations to Kiva. If Kiva and its microcredit approach turn out to be ineffective, people can stop lending or donating money to Kiva. The United States lets the market for donations resolve the effectiveness of a charity.

E. Plenty of Demand

Finally, it may seem that there is no need to increase the attractiveness of loans through an organization like Kiva. After all, Kiva has been wildly successful and indeed actually "sold out" of loans in December of 2007.[146] In January 2007, individual loans were temporarily capped at $25 to permit more people to participate.[147] One main reason for the charitable deduction is to increase donations, and it seems that Kiva has plenty of people willing to lend; if Kiva is limited by anything, it is by its capacity to find appropriate borrowers. There is, it appears, no need to increase donations.

But the question is not whether Kiva is operating to capacity. If the charitable donation makes lending more desirable, perhaps more organizations like Kiva can form (because there will be more demand for the organizations). Indeed, if microfinance is a preferable form of charity, there should be more organizations like Kiva.

Additionally, Kiva is currently a popular charity, but there is some concern that microfinance in general, and U.S. interest in microfinance in particular, is not sustainable—that is, that microfinance will not generate enough money and attention to remain viable.[148] This is not unique to Kiva; sustainability is always a concern of nonprofits, which generally rely on donations for support.[149] But if loans through Kiva become financially comparable to other charitable donations, Kiva may become part of regular financial and charitable planning instead of being merely the flavor of the month.

Finally, when interest rates increase (as they doubtless will eventually), loans to Kiva might decrease, especially if no charitable deduction is

144. *See* I.R.C. § 501(c)(3) (2006).

145. I.R.S., Search for Charities, http://www.irs.gov/app/pub-78 (search "Organization" for "Kiva Microfunds") (last visited Aug. 10, 2008).

146. Walker, *supra* note 5.

147. *Id.*

148. *See* Allen, *supra* note 142, at 49-50.

149. *See* J.D. Von Pischke, *Methodenstreit and Sustainability in Microfinance Generalizations Describing Institutional Frameworks*, *in* What's Wrong with Microfinance, *supra* note 141, at 144.

available for foregone interest. Interest rates currently hover in the lower single digits, so foregoing interest is not so painful now. But if interest rates increased substantially—thirty years ago interest rates were 15% or more—loans to Kiva would suddenly become much more expensive. In the absence of a charitable deduction offsetting some portion of the cost of forgoing interest, Kiva and similar organizations might be at risk of disappearing.

VI. CONCLUSION

This Article has argued that taxpayers should receive a charitable deduction for the interest they forego when they loan money interest-free to the poor in developing countries through microfinance organizations such as Kiva. This deduction for foregone interest would be consistent with current exceptions to the general rule barring a charitable deduction for the donation of partial interests and would not create compliance concerns that might attend donations of partial interests in general. Moreover, the practical benefits of the deduction could be significant, especially because the deduction could be relatively simple to implement and could mirror the lenders' actual financial cost of lending. Permitting a deduction for interest foregone on loans to Kiva and similar microcredit organizations will help these organizations to thrive and thus, as the Nobel Committee stated about another microcredit institution, to play a role as an "important liberating force" and a "major part" of eliminating poverty as we know it.[150]

150. Norwegian Nobel Committee, *supra* note 22.