Charitable Deduction Should Be Preserved

28 Percent Limit on Itemized Deductions and Tax Reform Would Both Reduce Charitable Giving; Impact on Charitable Sector Could Be Comparable to Sequestration

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By Patrick Lester [1]
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Congress is currently considering tax changes that could substantially reduce charitable giving in the United States. One threat is a proposal from President Obama to cap the deductibility of itemized deductions by high-income taxpayers at 28 percent. A second threat is less understood – tax reform that lowers tax rates. Tax rate changes like those in the tax reform plan proposed by Rep. Paul Ryan (R-WI) would reduce the tax benefit of charitable giving even *more* than the proposed Obama limit on itemized giving.

This report reviews the impact on charitable giving of both the Obama proposal and tax reform more generally. It concludes that both would substantially reduce charitable giving and that the impact on the nonprofit sector could be comparable to sequestration.

Should either of these proposals be seriously considered, policymakers should examine converting the existing charitable deduction into a tax credit, thereby severing the link to tax rates and protecting the incentive for charitable giving.[2]

The Impact of President Obama's 28 Percent Limit on Itemized Deductions

President Obama's FY 2014 budget includes a proposal to cap the deductibility of itemized deductions at 28 percent. The proposal would limit the value of deductions for individual taxpayers in the top three tax brackets (33, 35, and 39.6 percent).[3] This proposal would affect approximately the top two percent of households.[4]

About three-quarters of all charitable giving comes from individuals. The rest comes from foundations, bequests, and corporations.[5]

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[2] Additional information on the tax implications of charitable giving can be found in: Congressional Research Service, "Tax Issues Relating to Charitable Contributions and Organizations," March 13, 2013. Available at: http://www.independentsector.org/uploads/Policy_PDFs/CRSReportbyJaneGravelleandMollySherlockTaxIssuesRelatingtoCharitableContributionsandOrganizations3-13-13.pdf.

[3] Office of Management and Budget, Budget of the United States Government, Fiscal Year 2014, Analytical Perspectives, April 10, 2013, p. 197. Available at: http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/receipts.pdf.

[4] Center on Budget and Policy Priorities, "President Obama's Deficit-Reduction Package and Other Proposals in the 2013 Budget," April 11, 2013. Available online at: http://www.cbpp.org/cms/?fa=view&id=3952.

[5] Giving USA, "Giving USA 2012: The Annual Report on Philanthropy in the Year 2011," 2012. Available online at: http://store.givingusareports.org/Giving-USA-2012-The-Annual-Report-on-Philanthropy-for-the-Year-2011-P44.aspx.

According to the Urban-Brookings Tax Policy Center, if it is enacted, the president's 28 percent limit on itemized deductions would reduce individual charitable giving by an estimated 2.2-4.1 percent.[6] In its estimate, the Tax Policy Center projects that total individual giving in 2013 will be $219 billion, so the expected drop in giving that year would be $4.7-9.1 billion if the proposal was in effect.[7] Over ten years, the president's proposal would reduce charitable giving by an estimated $47-91 billion (this estimate would be slightly higher if adjusted for economic growth, but the difference would be small).

The president's proposal would also increase federal tax revenues by $529 billion over ten years.[8] According to Citizens for Tax Justice, charitable deductions would comprise about a fifth of these revenues,[9] so federal tax revenues would increase by about $100 billion over ten years due to the charitable component.[10]

Tax Reform Could Reduce Charitable Giving Even More

Tax reform that lowers tax rates would also reduce charitable giving. The best-known plan, one offered by House Budget Committee Chairman Paul Ryan, would consolidate the current seven individual tax rates into just two, 10 and 25 percent.[11] While the plan does not specify the income threshold between the two rates, the Urban-Brookings Tax Policy Center has assumed that the plan would reduce the current 15 percent statutory rate to 10 percent and would reduce all other rates above that to 25 percent.[12]

The impact of this proposal is shown in **Table 1**. As can be seen, the rate changes in the Ryan plan would reduce the value of the charitable deduction more than the president's 28 percent deduction limit. For taxpayers in the top three tax brackets, the tax benefit would be reduced from 28 percent to 25 percent of the amount of the charitable gift. Moreover, because the plan also affects some taxpayers in lower tax brackets, the tax incentive to give for those taxpayers would also be reduced.

According to our estimates, if the tax rate changes in the Ryan plan were in effect in 2013, they would reduce charitable giving by $6-11 billion, or about a quarter more than the president's 28 percent proposal.[13] Moreover, because Ryan's plan must also close or reduce existing tax incentives to achieve its lower rates, the charitable deduction could be directly reduced even further. Our estimate does not include the additional impact of such

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6 Joseph Cordes, "Effects of Limiting Charitable Deductions on Nonprofit Finances," Feb. 28, 2013, p. 6. Available at: http://www.urban.org/taxandcharities/upload/cordesv5.pdf.

7 Tax Policy Center, unpublished data, April 22, 2013.

8 Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2014*, Summary Tables, April 10, 2013, p. 201. Available online at: http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/tables.pdf.

9 Citizens for Tax Justice, "Who Loses Which Tax Breaks Under President Obama's Proposed Limit on Tax Expenditures?", March 29, 2013. Available online at: http://ctj.org/ctjreports/2013/03/who_loses_which_tax_breaks_under_president_obamas_proposed_limit_on_tax_expenditures.php.

10 The total cost to the U.S. Treasury of the charitable deduction is about $45 billion per year. See Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017," Feb. 1, 2013. Available online at: https://www.jct.gov/publications.html?func=startdown&id=4503.

11 House Budget Committee, "The Path to Prosperity: A Responsible, Balanced Budget," March, 2013, pp. 19-20. Available online at: http://budget.house.gov/uploadedfiles/fy14budget.pdf. The Senate has not yet made details of its plan public.

12 Urban-Brookings Tax Policy Center, "Table T13-0110: FY 2014 House Budget Proposal," March 15, 2013. See Footnote 1. Available online at: http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3868&DocTypeID=1.

13 The responsiveness of charitable giving depends on the price elasticity of giving, which is the percent change in giving associated with a one percent change in the "price" (the after-tax cost) of giving. This analysis, like most estimates, uses a range of -0.5 to -1.0. Our estimate assumes that most of the impact on giving will occur in the top tax bracket, where the highest level of giving occurs and where the change in the after-tax cost of giving would be highest (due to dropping the top rate from 39.6 percent to 25 percent). The Urban-Brookings estimate of the charitable impact of the Obama 28 percent proposal similarly finds that over 90 percent of the change in giving occurs among givers in the top one percent of income earners. Those in lower brackets would also experience lower giving, but the effects would be smaller due to lower levels of giving and a smaller change in the marginal tax rate. For more information on the price elasticity of giving, see: Congressional Budget Office, "Options for Changing the Tax Treatment of Charitable Giving," May 2011, pp. 7-9 at: http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12167/charitablecontributions.pdf.

TABLE 1 – Estimated Reduction in Charitable Giving Under the Obama 28 Percent Deduction Limit and Ryan Tax Reform Plan, by Income Group

Individual Annual Income [14]	Current Marginal Tax Rate	President's 28% Limit Proposal	Proposed Rate Changes in Ryan Tax Reform Plan
$0-8,925	10%	10%	10%
$8,925-36,250	15%	15%	**10%**
$36,250-87,850	25%	25%	25%
$87,850-183,250	28%	28%	**25%**
$183,250-398,350	33%	**28%**	**25%**
$398,350-400,000	35%	**28%**	**25%**
$400,000+	39.6%	**28%**	**25%**

Married Filing Jointly Annual Income [14]	Current Marginal Tax Rate	President's 28% Limit Proposal	Proposed Rate Changes in Ryan Tax Reform Plan
$0-17,850	10%	10%	10%
$17,850-72,500	15%	15%	**10%**
$72,500-146,400	25%	25%	25%
$146,400-223,050	28%	28%	**25%**
$223,050-398,350	33%	**28%**	**25%**
$398,350-450,000	35%	**28%**	**25%**
$450,000+	39.6%	**28%**	**25%**
Estimated Drop in Annual Individual Giving		$4.7-9.1 billion[15]	$6-11 billion[16]
Percent Drop in Total Annual Individual Giving		2.2-4.1%[17]	3-5%[16]

Notes: Under current law, the value of the charitable deduction depends on the marginal tax rate paid by a taxpayer.

The president's proposal would limit the deductibility of charitable contributions to 28 percent for high-income taxpayers. Taxpayers affected by this proposal are highlighted in red in the middle column above. Taxpayers filing as head of household or married filing separately would be affected similarly.

The impact of the Ryan tax reform plan can be seen in the third column. Once again, affected taxpayers are highlighted in red. As can be seen, the rate changes in the Ryan tax plan would impact more taxpayers. It would also reduce the charitable incentive for upper-income givers more than the Obama 28 percent proposal. Overall, this proposal would decrease individual charitable giving by an estimated $6-11 billion per year, about a quarter more than the $4.7-9.1 billion reduction in giving attributed to the Obama 28 percent limit.

This estimate applies only to the rate changes, not to any additional potential reductions to the charitable deduction, nor to other effects of the Ryan tax plan, such as lower corporate tax rates or eliminating the estate tax – all of which would reduce charitable giving even more.

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[14] Income expressed as Adjusted Gross Income (AGI). Current marginal tax rates can be found at: http://www.taxpolicycenter.org/taxfacts/content/pdf/individual_rates.pdf.

[15] Urban-Brookings Tax Policy Center, unpublished data, April 21, 2013.

[16] Center for Effective Government estimate. This estimate would be substantially larger if other aspects of the Ryan plan, such as eliminating the estate tax, were also included.

[17] Joseph Cordes, "Effects of Limiting Charitable Deductions on Nonprofit Finances," Feb. 28, 2013, p. 6. Available at: http://www.urban.org/taxandcharities/upload/cordesv5.pdf.

changes, nor does it include the impact of several other proposals in the Ryan plan that would further depress charitable giving, such as lowering corporate tax rates and repealing the estate tax.

Of course, Ryan's plan is not the only possible proposal for income tax reform. The two chairmen of the Senate and House tax-writing committees, Sen. Max Baucus (D-MT) and Rep. Dave Camp (R-MI), have indicated that any tax reform proposal should be at least as progressive as the current tax code.[18] Unlike the Ryan plan, which gives most of the benefits of rate reductions to taxpayers in the highest income tax brackets, a more progressive Senate plan might reduce tax rates for all brackets by the same percentage.

A proposal like this would still reduce the value of the charitable deduction, but for *all* taxpayers, not just those in the top tax brackets. An across-the-board rate reduction of just four percent would depress charitable giving by the same amount as the Obama plan, or about $5-9 billion per year.[19] Moreover, like the Ryan plan, this estimate does not include the separate effects of directly limiting the charitable deduction, which would dampen giving even more.

False Choice: The Charitable Deduction versus Sequestration

Some analysts suggest that the impact of President Obama's 28 percent deduction limit on charitable contributions will be "modest" and that the proposal would help alleviate across-the-board spending cuts, called sequestration, that will place "substantial added burdens on the non-profit sector." [20] The implication is that charities may be better off if this tradeoff occurs. This is not true.

First, the damage done by sequestration and a reduction in charitable giving may be roughly comparable. A drop in charitable giving of $4.7-9.1 billion per year would be approximately $42-82 billion over nine years. By comparison, sequestration would reduce domestic (nondefense) federal spending by just under $500 billion over nine years. But sequestration would not just affect charities: the cuts would also be distributed among federal, state, and local public employees, schools, private contractors, and individual program recipients. Nonprofit organizations would absorb only a portion of those cuts.

Nationally, nonprofit organizations draw more funding from government grants and fees (32.2 percent) than from private contributions (13.3 percent),[21] but much of this government funding is state and local, not federal. Moreover, much of the federal funding for local service providers comes from entitlement programs like Medicaid and Temporary Assistance for Needy Families (TANF), which are exempt from sequestration.

These sector-wide numbers mask considerable variation for individual charities. In general, charities that receive little or no federal funding would be affected more by a limit on charitable deductions. Other charities that receive substantial amounts of non-exempt federal funding may be affected more by sequestration. For the sector as a whole, both policies would cause considerable damage.

Suggesting that charities will only be modestly worse off under the Obama proposal also misses how much charities rely on private funding to make publicly-funded programs work. A 2010 study by the Urban Institute, based on a national survey of human service nonprofits with government contracts and grants, found that more than two-thirds reported that government payments were insufficient to cover costs.[22] A more recent survey by

[18] Sen. Max Baucus and Rep. Dave Camp, "Tax Reform Is Very Much Alive and Doable," *The Wall Street Journal*, April 7, 2013. Available at: http://online.wsj.com/article/SB10001424127887323611604578396790773598474.html.

[19] Based on a price elasticity of giving of -0.5 to -1.0 and the associated Urban-Brookings Tax Policy Center estimate of a reduction in giving of 2.2 to 4.1 percent for the Obama 28 percent deduction cap.

[20] Center on Budget and Policy Priorities, "Obama Proposal to Limit Tax Breaks for High-income Households Would Reduce Total Charitable Contributions By a Modest 1.6 to 3.0 Percent," April 16, 2013, p. 3. Available at: http://www.cbpp.org/files/3-3-09bud.pdf.

[21] Urban Institute, "The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering, 2012," p. 3. Available at: http://www.urban.org/UploadedPDF/412674-The-Nonprofit-Sector-in-Brief.pdf.

[22] Urban Institute, "Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants," October 2010, p. 13. Available online at: http://www.urban.org/uploadedpdf/412228-nonprofit-government-contracting.pdf.

the Nonprofit Finance Fund found similar results, with 83 percent of nonprofits that receive federal funding reporting that those funds do not cover the full cost of services.[23]

There are many reasons for these shortfalls, including matching requirements,[24] unrealistically low limits on administrative costs,[25] and late payments.[26] Charities fill in these gaps in many ways, but two of the largest – using funding from other funders and drawing down reserves[27] – ultimately rely on private philanthropy.

Charities should not be forced to choose between limiting charitable contributions and eliminating sequestration. Both are bad for the sector. Moreover, it is not just a bad choice, it is also a false one.

Although President Obama's FY 2014 budget poses such a tradeoff, it is unlikely that the president's proposal will be adopted in full. It is just as likely that permanent cuts in the charitable deduction would be exchanged for a temporary delay in sequestration-related cuts (as happened when the president signed tax legislation earlier this year).[28] If a similar deal were struck, charities would face ***both*** sequestration-related cuts ***and*** a reduction in private charitable giving after the temporary delay in sequestration expired.

Curtailing the charitable deduction is also bad politics. Charitable organizations are often the most vocal advocates for increased public investment and increased equity in the tax code. It makes little sense to invite opposition from hospitals, universities, the faith community, United Ways, and others in the charitable community to tax changes that would make the tax code more progressive. If threatened, the charitable sector will have the public on its side, with seven out ten Americans opposing eliminating the charitable deduction, according to an April 2011 Gallup poll.[29]

There are better options than this. Alternative tax proposals that would more than offset the approximately $100 billion cost (over ten years) of exempting charities from the president's 28 percent proposal include:

- Eliminating tax breaks that encourage corporations to shift jobs and profits offshore ($221-606 billion over ten years);
- Imposing a small (0.03%) tax on Wall Street trades ($353 billion over ten years); and
- Eliminating the tax loophole that allows the wealthy to avoid capital gains taxes when bequeathing assets to heirs (about $500 billion over ten years).[30]

Protecting Charities from Both the 28 Percent Limit and Tax Reform: Moving from a Tax Deduction to a Tax Credit

Changes to the charitable deduction should not be made lightly. While the charitable deduction could be improved, doing so now, while Congress is considering large-scale changes that would curtail tax deductions more generally, would be dangerous for the sector.

However, doing nothing could be even riskier. Should either the Obama plan or tax reform become a serious option,[31] policymakers and charity leaders may want to consider protecting the charitable deduction from these proposals by severing the link to tax rates – changing it from a deduction into a tax credit.

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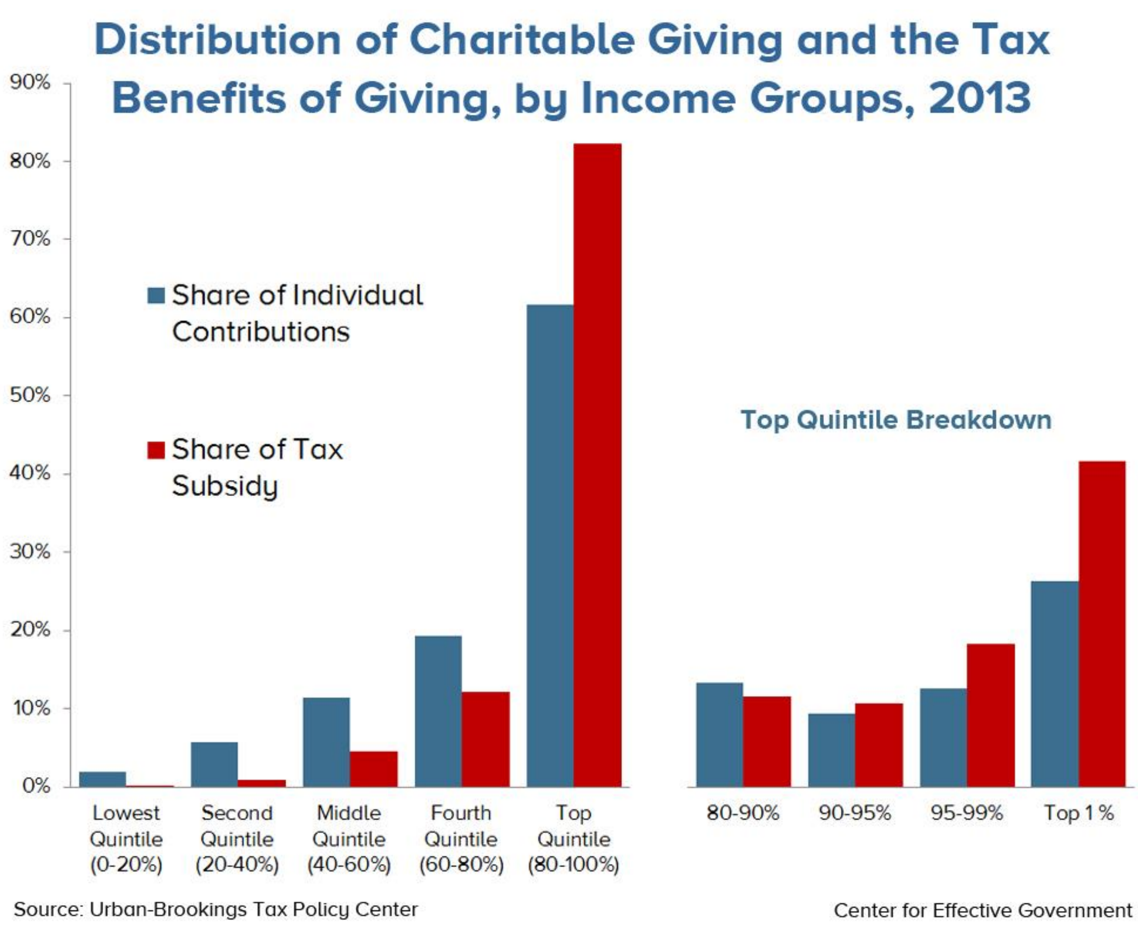
[23] Nonprofit Finance Fund, "2013 State of the Sector Survey Results." Available online at: http://survey.nonprofitfinancefund.org/2013/.
[24] Urban Institute, "Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants," October, 2010, p. 9. Available online at: http://www.urban.org/uploadedpdf/412228-nonprofit-government-contracting.pdf.
[25] Ibid., p. 10.
[26] Ibid., p. 14.
[27] Nonprofit Finance Fund, "2013 State of the Sector Survey Results." Available online at: http://survey.nonprofitfinancefund.org/2013/.
[28] American Taxpayer Relief Act (ATRA).
[29] Gallup, "Americans Oppose Eliminating Income Tax Deductions," April 15, 2011. Available at: http://www.gallup.com/poll/147125/americans-oppose-eliminating-income-tax-deductions.aspx.
[30] Americans for Tax Fairness, "Next Steps Toward Tax Fairness," 2013.

Converting the tax deduction into a credit would not just protect charitable giving from proposals like the president's deductibility limit and lower tax rates due to tax reform, it would also address one of the primary reasons why it is so vulnerable to such changes: its inherent regressivity. Under current law, upper-income taxpayers receive a disproportionately greater share of the associated tax benefits than would seem warranted based on their share of overall giving (see **Figure 1**). The primary reason is that it is structured as a deduction, which means that it is worth more to taxpayers in higher tax brackets.

Unlike a deduction, a tax credit's value does not vary depending on the giver's tax bracket. It would apply equally to all taxpayers, regardless of income, and would apply equally to both itemizing taxpayers and non-itemizers (taxpayers that take the standard deduction), the latter of whom now receive no tax benefit for charitable giving.[32]

FIGURE 1



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[31] Senate Finance Committee Chairman Max Baucus has indicated that he would like to move a tax reform plan by August, 2013. See Lori Montgomery, "Sen. Max Baucus moves to reshape the tax code," *The Washington Post*, April 8, 2013. Available at: http://www.washingtonpost.com/business/economy/sen-max-baucus-moves-to-reshape-tax-code/2013/04/08/e7f3435a-9dff-11e2-9a79-eb5280c81c63_story.html?wprss=rss_politics&wpisrc=nl_wonk.

[32] Making such a tax credit refundable, like other tax credits such as the Earned Income Tax Credit, would make it even more progressive. See Century Foundation, Demos, and Economic Policy Institute, "Investing in America's Economy: A Budget Blueprint for Economic Recovery and Fiscal Responsibility," Century Foundation, New York, NY, p. 32. Available at: http://old.tcf.org/publications/2010/11/investing-in-americas-economy-a-budget-blueprint-for-economic-recovery-and-fiscal-responsibility

According to a study by the Congressional Budget Office, if the charitable deduction were converted into a 25 percent nonrefundable tax credit that applied equally to both itemizers and non-itemizing taxpayers, overall giving would increase slightly at a small net cost to the U.S. Treasury.[33] Although changes to the tax code enacted earlier this year may change these estimates somewhat, the changes are not likely to be large. A similarly-sized tax credit could be created that would be revenue-neutral and maintain current levels of giving.

Of course, any change in the charitable deduction would inevitably create winners and losers in the charitable sector. Charities that benefit disproportionately from gifts from high-income givers – including arts organizations, institutions of higher education, and health organizations such as hospitals – would stand to lose some giving with a tax credit rather than the existing charitable deduction. On the other hand, organizations that depend more on middle- and low-income donors – including religious organizations, basic needs-focused organizations, and United Ways – would receive *more* in giving from a tax credit than under the current deduction.

However, these distributional issues pale in comparison to the damage that could be done by the Obama 28 percent limit or by tax reform. The net impact on the sector of a properly-designed tax credit would be zero, while the Obama proposal and tax reform would both substantially reduce charitable giving. Converting the tax deduction to a tax credit should receive more consideration if either of these two proposals becomes likely.

Conclusion

As Congress considers changes to the existing federal tax code, it should take care not to implement changes that will substantially reduce charitable giving. Charities are important institutions that serve valuable public purposes. They also play a critical role in implementing many public programs.

President Obama's proposed 28 percent limit on itemized deductions and tax reform would both substantially reduce charitable giving. While changes in the charitable tax incentive should not be made lightly, if either of these proposals moves in Congress, serious consideration should be given to converting the existing deduction into a tax credit.

[33] Congressional Budget Office, "Options for Changing the Tax Treatment of Charitable Giving," May 2011, pp. 17-18. Available at: http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12167/charitablecontributions.pdf.