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Obama Proposal to Limit Tax Breaks for High-Income Households Would Reduce Total Charitable Contributions By a Modest 1.6 to 3.0 Percent

Would Help Pay for Cancelling Sequestration, Which Is Harming Charities

By Paul N. Van de Water and Chye-Ching Huang

The President's fiscal year 2014 budget includes a proposal from previous Obama budgets to limit the tax subsidies that affluent Americans take for deductible expenses and some other tax expenditures. After the President made this proposal in previous budgets, some critics contended it would lead to substantial reductions in charitable contributions and hit charities hard at a time when they face increased need and decreased contributions due to the weak economy. Recent estimates by the nonpartisan Urban-Brookings Tax Policy Center (TPC) indicate, however, that total charitable contributions would decline only modestly — by an amount equal to between 1.6 and 3.0 percent of total charitable giving.

The additional revenue from the proposal would help to reduce the deficit and, of particular note, replace the crude, across-the-board spending cuts known as sequestration. Cancelling sequestration would benefit the charitable sector significantly.

How the Proposal Would Work

Currently, most middle-income Americans receive an individual income tax subsidy equal to 10 cents or 15 cents for each additional dollar of their deductible expenses (if they itemize deductions), while affluent Americans receive a subsidy of up to 39.6 cents for each additional dollar of deductible expenses. The Administration's proposal would cap the subsidy at 28 cents on the dollar — the same rate at which those expenses could be deducted during some of the latter Reagan years, when the top income tax rates were lower. As a result, the incentive to incur those expenses would be the same as under President Reagan in the late 1980s.

The proposal would affect only high-income taxpayers in the top three tax brackets, where marginal rates exceed 28 percent, as well as those who would be in these tax brackets if not for deductions and exclusions subject to the limitation. Citizens for Tax Justice estimates that just 3.6 percent of taxpayers would face a tax increase under the proposal.[1]

Effect on Total Charitable Contributions

The proposal would lead to some decline in charitable giving. That reduction would be modest for several reasons.

First, a substantial portion of charitable giving — more than one-fourth — derives from foundations, estates, and corporations. Charitable giving by individuals amounts to 73 percent of total charitable giving.

Second, some individual giving comes from individuals who do not itemize their contributions on their tax returns. Itemized contributions represent about 58 percent of total charitable giving.[2]

Third, as noted, the proposal would affect only people in the top three income tax brackets. TPC data indicate that these taxpayers account for only about one-third of the charitable contributions reported as itemized deductions.[3] Thus, only about *20 percent* of total charitable giving would be affected.

Reducing the tax subsidy for charitable giving increases the after-tax price of a dollar of contributions. Someone who is now in the 39.6-percent federal income tax bracket and lives in a state with a top income tax rate of 6.0 percent pays 54.4 cents after taxes for each dollar contributed to a tax-exempt charity. Under the proposal to limit the federal deduction to 28 percent, that person would face an after-tax price of 66 cents. TPC estimates that the change would reduce *individual* charitable giving by between 2.2 and 4.1 percent, depending on the responsiveness of giving to a change in its price.[4] That translates to a decline in *total* charitable giving of between 1.6 and 3.0 percent, or between about $5 and $9 billion per year.[5]

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[1] Citizens for Tax Justice, "State-by-State Figures on Obama's Proposal to Limit Tax Expenditures, Updated Figures Show 3.6% of U.S. Taxpayers would Face a Tax Increase," April 30, 2013, http://ctj.org/pdf/28percentlimit.pdf.

[2] Giving USA Foundation, *Giving USA 2012: The Annual Report on Philanthropy for the Year 2011*, http://store.givingusareports.org/2012-Giving-USA-The-Annual-Report-on-Philanthropy-for-the-Year-2011-Executive Summary-P43.aspx.

[3] TPC, Tables T09-0175 (http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2249) and T12-0418 (http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3740).

[4] Joseph Cordes, "Effects of Limiting Charitable Deductions on Nonprofit Finances," February 28, 2013, http://www.urban.org/taxandcharities/upload/cordesv5.pdf.

[5] TPC estimates that individual charitable giving in 2013 will be about $220 billion. See Joseph Rosenberg, C. Eugene Steuerle, and Katherine Toran, "What Does the Fiscal Cliff Deal Mean for Nonprofits?" Urban Institute Center on Nonprofits and Philanthropy and the Urban-Brookings Tax Policy Center, January 2013, as corrected on April 22, 2013. http://www.urban.org/taxandcharities/upload/What-Does-the-Fiscal-Cliff-Deal-Mean-for-Nonprofits.pdf.

The Effect of the "Fiscal Cliff" Deal

Compared to 2012 tax law, January's "fiscal cliff" deal — the American Taxpayer Relief Act of 2013 (ATRA) — will *increase* total individual giving by 1.5 percent, the Urban Institute estimates, or about 1.1 percent of total charitable giving.[6] This translates into an annual increase of $3.3 billion. This change is largely due to ATRA's increase in the top marginal tax rate from 35 percent to 39.6 percent, which expanded the marginal federal tax subsidy for charitable giving from 35 to 39.6 cents on the dollar.

This recent change should be taken into account when evaluating the impact of the proposed 28-percent limit. *In combination*, the proposed 28-percent limit on total charitable giving *and* ATRA would reduce total charitable giving by 2 percent or less.

Other Proposals in President's Budget Would Benefit Charitable Sector

The President's budget proposes using the revenues raised by the 28-percent limit to help replace the sequestration cuts in 2013 through 2021. If sequestration remains in effect, the harsh cuts it will impose on a range of domestic investments — including programs that reduce poverty as well as education, environmental protection, health research, the arts, and other areas — will place substantial added burdens on the non-profit sector. Many nonprofit organizations receive government grants or contracts to provide needed services through an array of federal programs that will face substantial cuts under sequestration — especially non-defense discretionary programs that are operated through state or local governments. Sequestration will impose a double burden on nonprofits — it will increase the demands on nonprofits for services, even as it slices their revenues. Cancelling sequestration is of considerable importance to the nonprofit sector.

The President's budget also proposes to return the estate tax to its 2009 parameters rather than continue it at the shrunken levels enacted in the "fiscal cliff" deal. The estate tax operates as a powerful incentive for charitable giving, and charitable contributions by estates would rise under the President's proposal.

[6] Rosenberg, Steuerle, and Toran.

Other Ways of Limiting Tax Expenditures and Their Effect on Charitable Giving

A key reason that the President's proposal would reduce total charitable giving by only 1.6 percent to 3 percent is that it retains marginal incentives to make tax-deductible contributions. Wealthy taxpayers would still receive a deduction of 28 cents on the dollar for charitable giving and other deductible expenditures. Some other proposed across-the-board tax expenditure limits lack this feature.

During the "fiscal cliff" negotiations, House Speaker John Boehner initially suggested raising $800 billion in revenues from reducing tax expenditures, as an alternative to raising tax rates for high-income people. (Boehner later raised the figure to about $1 trillion before abandoning the negotiations.) Although Speaker Boehner did not make a specific proposal, congressional Republican staff pointed to a Committee for a Responsible Federal Budget (CRFB) paper that outlined three basic options.[a] The first of these was similar in design to the President's proposal. The second would cap itemized deductions at a set dollar level, and the third would cap deductions and certain other tax expenditures at a certain percentage of a tax filer's adjusted gross income (AGI).

Unlike the President's proposal, a cap on itemized deductions at a specific dollar amount or percentage of AGI would *eliminate* the tax incentive for many high-income filers to make more contributions. Once filers had reached the cap, they would receive no deduction (and therefore no tax subsidy) for further charitable giving. Their marginal tax incentive to give more would fall from 39.6 cents on the dollar to zero. Many wealthy taxpayers would effectively receive no tax incentive to donate, with a dollar in a charitable giving costing them a full dollar.

Moreover, a cap on itemized deductions would eliminate incentives for all charitable giving — not just *additional* charitable contributions — among the many high-income taxpayers who would hit the cap *before* making *any* charitable contributions. If these taxpayers' deductions for other items such as mortgage interest and state and local taxes consumed the full amount allowed under the deductions cap — as would often occur — they would receive no tax benefit from making any charitable contributions. In general, taxpayers who lived in states with relatively high taxes (or who had relatively large mortgages) would have a smaller incentive for charitable giving, because they would be more likely to hit the cap before any charitable contributions were taken into account. The President's approach would avoid these harsh outcomes.

An alternative approach to limiting itemized deductions would be to subject charitable contributions to a different, tailored limit that would raise the same amount of revenue as if these contributions had been included under the 28-percent limit. For example, a "floor" could be placed under the deduction, such that only charitable giving above a certain percentage of a tax filer's income would be deductible. Such a limit would leave in place a 39.6-percent subsidy for all contributions above the floor made by filers in the top tax bracket. It would eliminate the deduction for contributions below the floor.[b] Such an approach may merit consideration if it can raise an equivalent amount of revenue while having a smaller effect on charitable giving.[c]

[a] See Jackie Calmes, "Tax Deduction Limits May Trim Deficits, But Not Easily," *New York Times,* December 4, 2012. The CFRB paper is "Raising Revenue from Higher Earners through Base Broadening," Tax Working Paper, November 15, 2012, http://dev.crfb.org/sites/default/files/raising_revenue_from_higher_earners_11_15-2_1.pdf.

[b] C. Eugene Steuerle, Testimony Before the Committee on Ways and Means United States House of Representatives Hearing on Tax Reform and Charitable Contributions, February 14, 2013; http://waysandmeans.house.gov/uploadedfiles/steuerletestimony02.14.2013fc.pdf; Joseph Cordes, "Effects of Limiting Charitable Deductions on Nonprofit Finances", February 28, 2013, http://www.urban.org/taxandcharities/upload/cordesv5.pdf.

[c] Other design issues, such as whether such an approach would encourage donors to "bunch" their giving rather than to give evenly over time (which may have implications for some charities) should also be examined.