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Fiscal Cliff Analysis Related To Charitable Deductions

by

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Both political parties have finally agreed that revenues need to be raised, and the budget cannot be balanced by cuts alone. However, there are two sticking points: The Democrats want to see an even balance between increased revenue and deductions in spending, while the Republicans want to see less increases in revenue and greater cuts in spending. On the revenue front alone, Republicans are also still insisting that tax rates on the wealthy need not increase. So, the only way for revenue to increase- and for the rates to stay the same- is to limit the amount of deductions one can claim. The three major categories of deductions are: mortgage payments and interest, state & local deductions, and charitable contributions. Deductions for charitable contributions are the focal point of this debate.

For example, if John Doe gave $100 to his church, he could document that donation and subtract it from the income on which he would be expected to pay taxes. Yet, wealthier Americans get the most out of the charitable tax deduction, because their rate of taxation is higher. So, if John Doe's income level puts him in a 35 percent income tax bracket, he would save $35 in taxes from his $100 gift. But if John Doe only pays 15 percent income tax, that same donation would only save him $15. Finally, John Doe can't deduct anything over 50 percent of his total taxable income.

Right now, the wealthiest can deduct up to 35%, while those in lower tax brackets can only deduct up to 28%. Obama would consider a cap for charitable deductions for people in the highest income-tax bracket. That would be at 28 percent, down from 35 percent today. That would affect individuals with incomes of about $200,000 and couples with incomes of $250,000. What this does is put the wealthiest at the same cap as other income levels. This proposal has been included in the President's FY 2013 budget and his other three annual budget proposals, the American Jobs Act, and his deficit reduction plan submitted to the super-committee.

Another possibility that has been floated is a hard cap (dollar amount) on the amount of contributions that can be claimed as deductions. As a new report by the National Economic Council (NEC) shows, the most prominent dollar cap proposals would effectively eliminate the charitable deduction for up to 13 million households and for as much as 60 percent of currently deductible giving.

The National Council of Nonprofits cites projections that Obama's proposal could reduce charitable giving to nonprofits by as much as $7 billion a year. Economist Martin Feldstein has written that, on average, a 10 percent cut in the cost of making a donation raises a person's charitable giving by about 10 percent.

Using Congressional Budget Office assumptions, the NEC estimates that a $50,000 cap would reduce charitable giving by about $150 billion over 10 years, while a $25,000 cap would reduce giving by about $200 billion over the next ten years. Even a $25,000 cap that applied only to high-income households would reduce giving by at least $10 billion per year. As the report discusses, a cap could impact nonprofit organizations in every sector and in every state.

Limiting the cap to those with incomes over $250,000 leaves only $800 billion in revenue, as opposed to the desired $1.56 trillion the White House is seeking from tax reform. The need to phase in a cap to avoid a "cliff" reduces revenues to around $650 billion. Excluding the charitable deduction reduces revenues to around $450 billion. Translation- if the charitable deduction stays in place as is, the White House can't hit the numbers they need on revenue.

With a $25,000 itemized deduction cap, 97 percent of households in the top 1 percent of income would lose any tax incentive for additional charitable giving (they would also lose a very large share of the state and local tax deduction). The loss of the charitable deduction would be expected to reduce giving by these households by at least $10 billion per year under the Congressional Budget Office's assumptions. The Tax Policy Center (TPC) estimates that exempting the charitable deduction reduces the revenue available from caps on itemized deductions by about 30 percent, with a similar reduction in the revenue raised from high-income households. This reduces the total revenue from a $25,000 cap to about $450 billion.

For comparison, there have been several studies on the impact of various proposed changes to the amount one can claim in deductions.

- 12% Tax Credit: The National Commission on Fiscal Responsibility and Reform (Bowles-Simpson Commission) empanelled by President Obama recommended significant changes to the federal tax code, including converting the current charitable itemized deduction into a 12-percent, non-refundable tax credit available to all taxpayers, but only for donations above two percent of Adjusted Gross Income (AGI).

- 15% Refundable Credit: the Bipartisan Policy Center's Debt Reduction Task Force issued its own set of recommendations for deficit reduction that included cutting individual income tax rates and reducing the number of tax brackets, and eliminating the charitable deduction and replacing it with a 15 percent refundable tax credit payable to nonprofits.

- The Congressional Budget Office issued a report in May 2011 projecting the potential impact of 11 proposals to alter the charitable giving incentive in the federal tax code. The report found that both charitable giving and federal tax receipts would increase if Congress either (a) applied the tax deduction to all taxpayers (itemizers and non-itemizers alike) but imposed a minimum floor on contributions of $500 for individuals and $1000 for couples, or (b) converted the deduction to a 25 percent tax credit for everyone who gave more than the $500/$1000 floor.

- The Washington Post has proposed capping itemized deductions at $25,000 for individuals and $50,000 for couples per year to raise $749 billion in new tax revenue over ten years, based on data from the Tax Policy Center. The approach, which is similar to one raised by Gov. Mitt Romney during the 2012 presidential campaign, would apply to all itemized deductions, including charitable donations, mortgage interest, and state and local taxes. The Post recognized that "There would be pushback from charities that depend on donations from the wealthy, and from high-tax states that rely on state and local tax deductions." It concludes, "But assuming legitimate issues can be addressed, capping deductions could be part of a red-blue compromise."

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- The New York Times reports that Third Way, a Democratic centrist group, has made Mitt Romney's campaign proposal to cap itemized deductions the centerpiece of their package of proposed tax expenditure changes that could produce nearly $1.3 trillion in revenue over 10 years. Third Way's proposal would limit all tax deductions to $35,000, with the exception of the charitable giving incentive.