

## Charity Deduction for Nonitemizers: Where Do You Draw the Line?

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In today's tax code, complexity grows because of political compromises and attempts to hide what is being done. Those complications compound or grow in exponential fashion as each new patch is added to the overall tax system.

The Clinton administration's proposed charitable deduction for nonitemizers is a perfect example. Among the problems confronted by the designers of the proposal in the Treasury Department was where on the tax return the deduction should be taken?

It turns out the administration's decision to provide a different floor for nonitemizers than for itemizers who take the charitable deduction interacts with other unnecessary complications in the tax code. That requires that the new deduction would have to be taken in a unique place on the tax form. Moreover, because of the administration's inability to deliver tax policy straight-up, it will likely miss an opportunity to enhance the value of the deduction by making it available against most income tax rates—both those that are direct and those that are hidden.

As the tax code has grown over time, it has allowed two groups of deductions, which are labeled loosely as "above-the-line" and "below-the-line." The "line" is drawn where adjusted gross income (AGI) is calculated. Below-the-line deductions are combined in the itemized deduction schedule to reach "taxable income," the final income on which tax is assessed before the allowance of credits (personal exemptions also are subtracted after the calculation of AGI).

Above-the-line deductions, are items such as deposits to individual retirement accounts and self-employed retirement plans. Unlike itemized deductions, they reduce the measure of AGI. The rationale is usually that such deductions should be treated similarly to exclusions already in the law, such as for employer-provided pension contributions that also are not counted immediately in the taxpayer's income or AGI.

In the midst of this bifurcated world of deductions comes something known as the itemized deduction phaseout or "Pease," named for a Congressman Pease. Although labeled as a reduction in itemized deductions, for the most part the phaseout doesn't operate that way. For most taxpayers subject to its provisions, it is nothing more than an additional tax of a small percent of AGI above a base. The only relationship to itemized deductions is that the phase-out only applies to itemizers. The phase-out is capped so that it can apply only to a maximum of 80 percent of all itemized deductions. Below the cap the phase-out operates essentially to increase taxable income by 103 percent of any increase in adjusted gross income.

Which brings us back to the charitable deduction for nonitemizers. If it were placed "above the line"—that is, where most deductions not reported on the itemized deduction schedule are taken—then a deduction of \$1 of charitable contributions would reduce AGI by \$1, which would reduce taxable income by \$1.03 for a person subject to the itemized deduction phaseout. On the other hand, if a charitable deduction is taken on the itemized deduction schedule, then only \$1 can effectively be deducted. That difference would make the comparison of where to take the deduction even more confusing for those whose world already has been made complex because the law would provide different floors for nonitemizers and itemizers.

Although we have focused here on the itemized deduction phase-out, there are other provisions of the law based on AGI. Hence a whole variety of disparities would arise if the nonitemizer deduction was above-the-line (where the charitable contribution would reduce AGI), while at the same time the itemizer deduction was below-the-line (not reducing AGI). Allowing taxpayers to reduce AGI directly would be especially beneficial to those with substantial losses in deductions due to Pease or to, say, the personal exemption phaseout known as PEP.

The administration, therefore, proposed to make the new deduction "between-the-line," or to be more precise

in a geometric sense, it created a new line. The nonitemizer deduction would be below the AGI line even though still above another line where itemized deductions were reported. That would remove most of the disparities discussed above and save on revenue cost.

If the administration had been willing to bite the political bullet and create a common floor for itemizer and nonitemizer alike, it could have put the charitable deduction in one place only, thereby avoiding most of this mess. A real opportunity missed, moreover, was to enhance even more the value of the charitable deduction for those itemizers subject to the itemized deduction phase-out. After all, the purpose of the proposed changes in the first place was to increase charitable giving.

Recall that the itemized deduction phase-out counts an additional \$1 of AGI as \$1.03 of taxable income for most taxpayers subject to its provisions. Effectively, that means the tax rate is really 103 percent of its stated amount—for example, 31.93 percent instead of 31 percent. But a dollar given to charity is only currently deductible against the lower rate, 31 percent in the example. It is as if there are two income taxes, a small one of 0.93 percentage points based on AGI (the itemized deduction phaseout) and one based on the statutory rate schedule applied to taxable income.

Charitable contributions are currently allowed only against the statutory rate schedule. If all charitable deductions could be taken above the line (that is, one way or the other, be allowed to reduce AGI and taxable income), then someone subject to the itemized deduction phase-out would be allowed to take a charitable deduction against his true effective marginal tax rate of 31.93 percent rather than the statutory, but misleading, 31 percent rate. That is, another dollar of income earned and given to charity would not, as under current law, still add three cents to taxable income. In the extreme case, for a few taxpayers at the Pease 80 percent limit, an extra dollar earned and given to charity now adds about 32 cents to taxes (a tax of 40 cents less a charitable incentive of about 8 cents).

Allowing a single deduction for itemizers and nonitemizers alike to reduce AGI could have significantly increased charitable incentives. Whatever the progressivity sought, it would be simpler to put all the rates directly into the statutory rate schedule itself, rather than establish hidden rates such as the itemized deduction phase-out in the first place. In effect, the unwillingness of lawmakers to do things in the simplest fashion—whether with respect to making tax rates transparent or setting up one, rather than two, charitable deduction opportunities—has created the need for a new type of deduction, one neither above nor below the line. Perhaps only non-Euclidean geometry can teach us how to be "between the line!"

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