

Nonitemizers Charitable Deduction: The Administration's Floor Plan

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A charitable deduction for nonitemizers was recently proposed by President Clinton as part of his budget submission to Congress. Because a similar proposal has been put forward by some Republicans as well, including Governor George W. Bush of Texas, some form of additional deduction stands a good chance of being passed by Congress in the near future.

In a previous column, I examined ways to design such a deduction so that it maximizes incentives per dollar of revenue cost, loses minimal or no revenues, and minimizes additional administrative burdens for the taxpayer and the IRS. (See economic perspective, Tax Notes, Feb. 28, 2000, p. 1297.) In this column I examine in more detail the administration's proposal to set a separate floor for the nonitemizer deduction, trying to explain why certain choices were made either for political or technical reasons.

Separate or Common Floors?

A common floor on charitable deductions for nonitemizers and itemizers is crucial if one wants to minimize revenue losses and, in particular, administrative costs for any proposal. A separate floor for nonitemizers, on the other hand, increases complications significantly. Here is why:

With a common floor, the taxpayer normally does not really need to figure out whether he or she is better off taking the charitable deduction as a nonitemizer or as an itemizer. In general, the taxpayer simply reports the charitable deductions separately, with the potential itemizer following the same routine as any nonitemizer. Then the taxpayer merely checks to see if the remaining itemizable deductions add up to more than the standard deduction.

Maximum simplification is obtained by requiring that the charitable deduction be claimed by all taxpayers on the same line on all returns and with the same floor, while denying any choice of alternative ways or places to file.

With separate floors, simplification goes out the window. It is not possible for many taxpayers to determine whether or not to itemize all other deductible expenses simply by comparing their total amount to the standard deduction.

For example, assume a simple case in which the new charitable deduction for nonitemizers is fully phased in, and 100 percent of contributions are deductible to the nonitemizer above a floor of \$300, while the itemizer continues to face no floor. Further assume that the taxpayer has \$400 in charitable contributions, \$6,300 in other itemizable expenses that could be deducted (over and above any limits placed on those expenses, such as the medical expense floor), and the standard deduction is \$6,500.

The taxpayer might at first think that it is best to simply take the standard deduction, since other itemizable expenses are less than the standard deduction. But that would be wrong. If the taxpayer takes the standard deduction, he loses \$300 of his \$400 in charitable contributions, so that his total deductions equal only \$6,600 (\$100 in nonitemizer charitable deductions plus the standard deduction) versus \$6,700 if the taxpayer itemized deductions.

Millions of taxpayers would have to go through that type of calculation under the administration's proposal, and the problem is only exacerbated by the decision to allow nonitemizers to deduct only one-half of contributions in excess of a floor. Of course, if the administration had proposed 100 percent deduction and no floor at all for nonitemizers, then those taxpayers effectively would share the same treatment as itemizers, and this particular difficulty would have been avoided. Unfortunately, tens of millions of taxpayers giving away very modest amounts of money would then be required to keep track of their charitable contributions. That would include individuals filing even the simplest of tax returns.

Cheating would likely expand, perhaps even hurting charitable giving in the long run if stories of abuse became widespread. And the cheating simply could not be stopped by the IRS, which is not going to audit those millions of returns, and, if it did, would often be unable to prove its suspicions that the money had not been dropped in the collection basket as claimed.

Only a common treatment removes the tax filing complexity and avoids a significant increase in compliance problems at the same time. But such equalization is difficult for the politicians because for itemizers today there is no floor. That is, a taxpayer itemizing deductions would generally lose charitable deductions equal in amount to the floor (or less, if the contribution amount was less than the floor).

In the case of broader tax reform, political heat for this kind of a tax increase could be avoided for the most part—for instance, by increasing personal exemptions by the amount of the floor. Although broader reform is not currently on the table, with some leadership from Congress and the administration, there is no reason why providing a common floor for charitable contributions couldn't be fashioned in a way to deal with the type of problem just outlined.

Size of the Floor and 50 Percent of Giving Limit

The higher the floor, the more likely it is that the charitable incentives apply at the margin of the next dollar of contributions. But too high of a floor might eliminate most taxpayers from inclusion, and there is something to be said for trying to include a majority of taxpayers in the incentive. In particular, symbolism is probably as important as pure economic self-interest in enhancing the effectiveness of a charitable incentive. A deduction for the majority of taxpayers is one way that society announces the importance it attaches to charitable giving.

The administration has proposed that in addition to a floor, only one-half of charitable contributions above that floor will be deductible. This type of percentage limit is hard to rationalize from any perspective other than minimizing budget costs within a 10-year window while appearing, at least, to extend a benefit to a sizable number of taxpayers.

After all, in terms of increasing charitable giving, reducing taxpayer filing burdens, and limiting enforcement problems for the IRS, it is almost always superior to create a higher floor with a 100 percent deduction than to spend the same revenue on a deduction with a lower floor but a reduced percentage amount. The administration obviously decided that without a percentage limit either revenue losses would be too high or, if revenue losses were constrained, the floor would be too high to grant an immediate tax break to many taxpayers.

The administration's political compromise effectively would add several lines and calculations to tax forms during each year of the phase-in. A preferable route from a pure tax policy standpoint would be to delay implementation until a realistic 100 percent deduction above a floor could be allowed for a significant percentage of taxpayers. Note also that if the floor is extended to itemizers, then a lower floor can be extended to nonitemizers for the same total revenue cost.

In sum, a common floor for itemizers and non-itemizers with 100 percent deduction above that floor is superior on almost all tax policy grounds to the particular design of a nonitemizer deduction put forward by the administration. At the same time, symbolism is important enough that one would probably want a charitable incentive to apply to a majority, or close to a majority, of taxpayers. With some tweaking here and there, Congress could apply some solid tax policy principles to the goals sought by the administration and improve on the probability of achieving them.

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