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REFORMING CHARITABLE TAX INCENTIVES: ASSESSING EVIDENCE AND POLICY OPTIONS

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The federal tax treatment of charitable giving and the nonprofit sector is at an inflection point. Following enactment of the Tax Cuts and Jobs Act in 2017, the number of taxpayers who will claim a charitable deduction will decline substantially. What does that mean for charitable giving and the nonprofit sector? What principles should guide tax policies affecting the nonprofit sector, and what are the policy options going forward? This brief summarizes these and other questions discussed at a recent roundtable—comprised of national experts on the issues of tax policy and charitable giving, including researchers, academics, government administrators, and charitable organizations—cohosted by the Tax Policy Center and Independent Sector.

The income tax deduction for charitable contributions provides a subsidy to donors and the charities they choose to support. According to estimates from the Joint Committee on Taxation, the charitable tax deduction is worth roughly $40 billion in 2018 (down from roughly $60 billion in 2017). By reducing the amount of income subject to tax, the charitable deduction reduces the after-tax cost of donating to eligible nonprofit organizations for taxpayers who elect to itemize deductions. Research indicates, and roundtable participants agreed, that the income tax deduction increases overall giving, although the magnitude of its effect and its impact across different types of nonprofits remain uncertain. The deduction may also be an important signal of the value society places on the nonprofit sector.

Although total individual giving as a percentage of income has remained relatively constant over time, recent studies have found that the overall number of givers has declined. Researchers at Indiana University's Lily Family School of Philanthropy found that the share of US households who donate at least $25 to charity fell from 67 percent in 2000 to

56 percent in 2014.[1] Participants at the roundtable discussed the implications of a smaller pool of donors and an increasing reliance on large donors on the nonprofit sector.

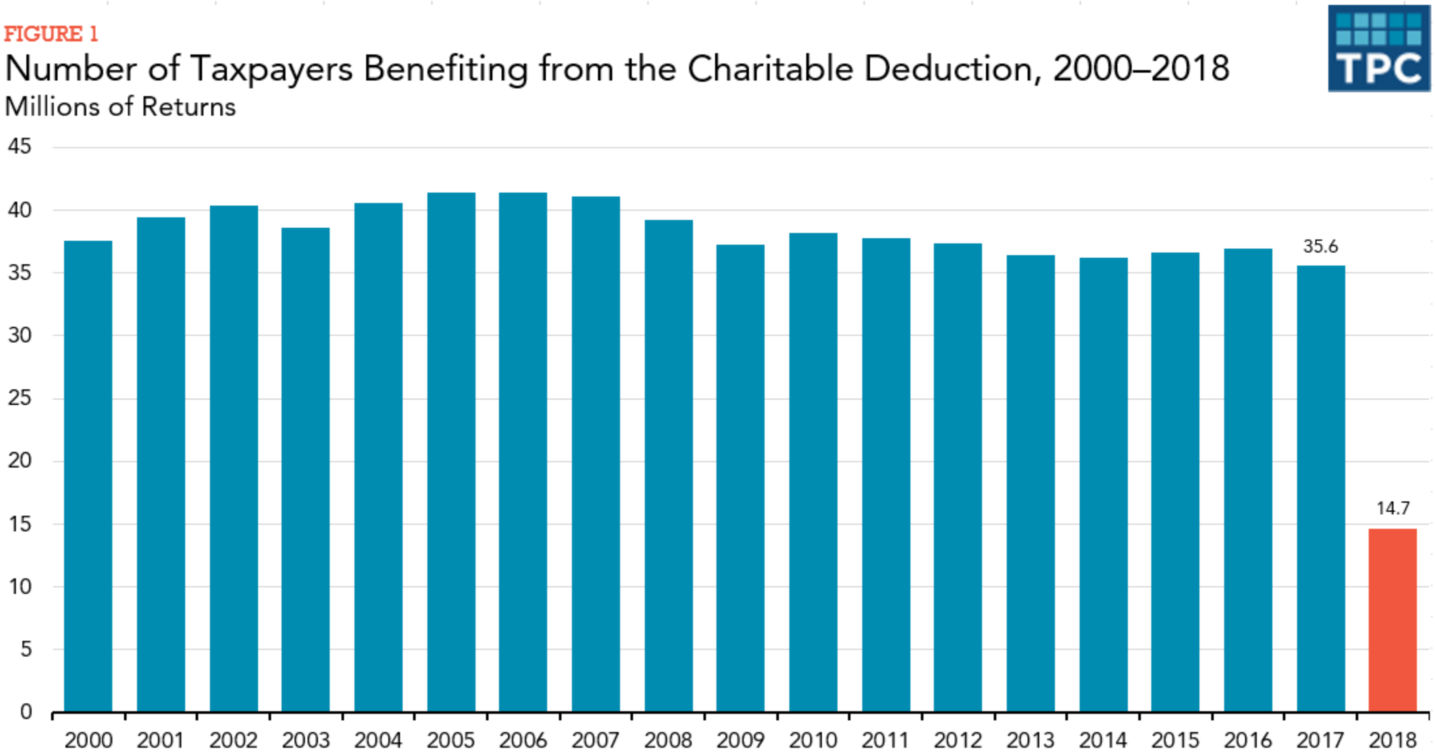
The Tax Cuts and Jobs Act and the Charitable Deduction

The Tax Cuts and Jobs Act made few direct changes to the charitable deduction. But several provisions of the new law will have dramatic effects on the deduction going forward. By substantially increasing the standard deduction, capping the state and local tax deduction, and limiting or eliminating many other itemized deductions, the new law will sharply reduce the number of taxpayers who itemize their deductions. The Tax Policy Center (TPC) estimates that the number of taxpayers who will receive a tax benefit from the charitable deduction will decline from roughly 36 million (21 percent of taxpayers) in 2017 to about 15 million (9 percent of taxpayers) in 2018 (figure 1).

FIGURE 1

Number of Taxpayers Benefiting from the Charitable Deduction, 2000–2018

Millions of Returns



Source: IRS, Statistics of Income, Individual Complete Report Table 2.1 (2000–2016); Tax Policy Center estimates (2017–18)

Although the largest donors will continue to itemize and claim the charitable deduction, the amount of charitable dollars that will receive a deduction will decline roughly 20 percent. TPC projects that the share of total contributions claimed as a deduction will decline from 81 percent in 2017 to 60 percent in 2018 (figure 2). And most of the change will be concentrated among middle- and upper middle-income taxpayers because most lower-income taxpayers did not previously itemize and most very high-income taxpayers will continue to itemize. For example, TPC projects that just 22 percent of total giving by households in the middle-income quintile will be taken as a deduction in 2018, down from 53 percent in 2017. For households between the 90th to 95th income percentiles, the share will decline from 92 to 67 percent. By contrast, nearly all taxpayers in the top 1 percent will continue to deduct their charitable contributions.

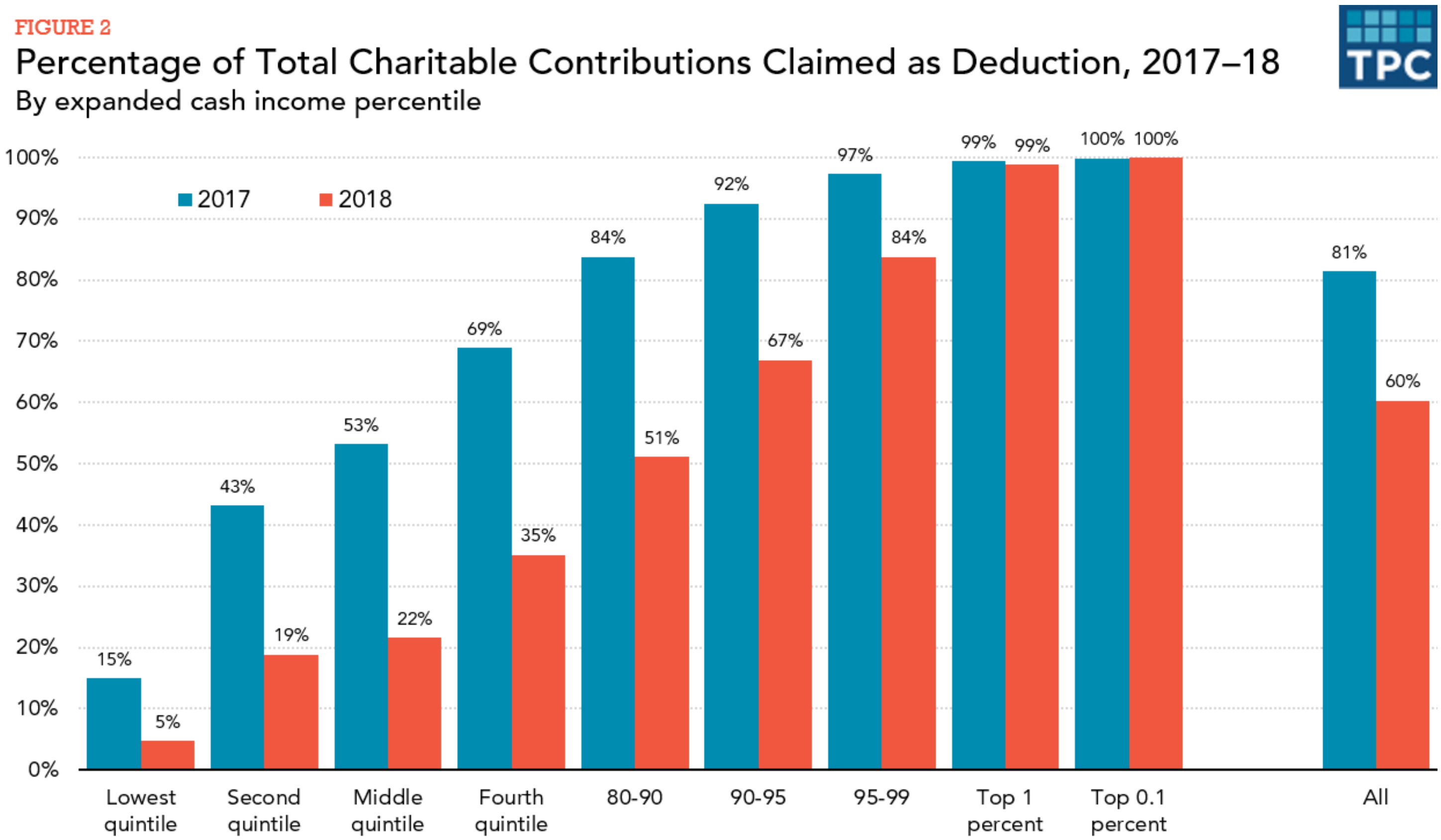
Overall, the 2017 tax bill can be expected to reduce charitable giving by about 5 percent ($15 billion in 2018), relative to the situation if no tax changes had occurred.

[1] Lilly Family School of Philanthropy, "2017 Giving Trends Released," news release, July 10, 2018, https://philanthropy.iupui.edu/news-events/insights-newsletter/2018-issues/july-2018-issue1.html.

FIGURE 2

Percentage of Total Charitable Contributions Claimed as Deduction, 2017–18

By expanded cash income percentile



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

PRINCIPLES OF CHARITABLE TAX INCENTIVES

The goal of reforming charitable tax incentives should be to better align charitable incentives to the underlying principles of charity tax law. Roundtable participants discussed the following concepts:

- **Equal justice:** Tax incentives should treat equal taxpayers equally.
- **Efficiency:** Tax incentives should maximize the amount of giving for a given revenue cost.
- **Progressivity:** Tax incentives may differ across taxpayers at different income levels, affecting the overall distribution of tax burdens.
- **Simplicity and salience:** Tax incentives should be simple to understand and salient to taxpayers.
- **Administrability and enforcement:** Tax incentives should be effectively administrable through the tax system and foster tax compliance.

Even where principles might conflict, many proposals can be made to adhere more closely to one principle without sacrificing others. For instance, it may be possible for any given degree of progressivity to find ways to allocate tax subsidies more efficiently in order to increase the amount of charitable giving per dollar of subsidy.

POLICY OPTIONS

General Issues

BREADTH OF INCENTIVE

Roundtable participants discussed the value of expanding the charitable tax incentive to more households, not only in terms of the possible increases in giving it might generate but also its more democratic inclusion of a wider diversity of donors. Although the current income tax deduction is available to any taxpayer who elects to itemize his or her deductions and covers roughly 60 percent of all contributions, less than 10 percent of households—mainly those at the highest income levels—will ultimately claim the deduction. This may have long-term effects that are not easily captured by existing empirical evidence and might erode broader political support for the charitable tax deduction. Participants also discussed the implications across different types of nonprofits. For example, religious and social service charities might be disadvantaged relative to colleges, hospitals, and cultural institutions.

DEDUCTION VERSUS CREDIT

A deduction reduces taxable income and can be justified as an appropriate adjustment on "ability-to-pay" equity grounds. A deduction emphasizes that a person's taxable income is reduced by the amount given away. That is, it treats someone who makes $60,000 and gives away $10,000 more like a person who makes $50,000 and gives away nothing than a person who makes $60,000 and gives away nothing. The subsidy rate of the deduction is generally equal to the taxpayer's marginal tax rate, which means it provides a larger per dollar tax savings to higher-income households than to lower-income households. A deduction might be better at increasing giving levels, particularly if high-income donors are more sensitive to the tax incentive.

A credit provides a dollar-for-dollar reduction in taxes based on the amount donated and can be justified as a means of granting an equal subsidy for each dollar donated. For example, a 15 percent charitable tax credit would provide a $15 dollar subsidy for every $100 donated, regardless of the donor's income level or tax bracket. Credits could be nonrefundable or refundable (i.e., the taxpayer would receive a refund even if he or she owes no income tax liability). Some evidence suggests that a credit makes the subsidy more salient to taxpayers, making it more likely to affect their giving behavior.

CAPS VERSUS FLOORS TO LIMIT COST

A more universal charitable incentive could be quite expensive and difficult to administer. To reduce cost, proposals could introduce additional limits stricter than the current income limit (60 percent of adjusted gross income).

One approach is to cap the incentive, either by restricting the maximum dollar amount of contributions that qualify or by limiting the rate of subsidy (e.g., limiting the value of the deduction for taxpayers in higher tax brackets). An alternative approach is to impose some type of floor on the incentive and limit the subsidy only to contributions above that amount. Floors could be structured either as a specified dollar amount or a percentage of income (e.g., 1 or 2 percent of adjusted gross income).

Most economists believe that floors are more efficient than caps or maximum limits because a floor better targets tax incentives at the margin to encourage donors to give more, while limiting the subsidy for contributions they would make even without a subsidy. Limits—especially floors—would also improve tax administration and compliance because many smaller contributions are not subject to third-party reporting and therefore not well monitored by the IRS.

Options Beyond a More Universal Incentive

The "April 15 option" would allow taxpayers to take charitable deductions for the previous year up to the time of filing their tax return or April 15 (Steuerle 2013). This provision would increase the salience of the deduction and provide donors with more accurate information about their actual taxable income and subsidy rate on charitable contributions. It would also be relatively efficient in the sense that it would only reduce federal revenue if it increased overall giving.

The roundtable noted several options to improve compliance as ways to improve the functioning of the tax system and help reduce the total revenue cost of charitable incentives. These included an improved reporting system by charities to taxpayers, electronic filing with the IRS so the agency could cross-check claims of deductions, and greater limits on deductions of in-kind gifts where the net benefits to charities are low.

Participants also discussed reforming and simplifying excise taxes that apply to foundations and universities. The excise taxes impose high administrative costs (especially on small foundations), are generally viewed as inefficient, and may provide perverse incentives that discourage giving to avoid being penalized in later years.

Other proposals discussed included allowing a full deduction for lottery winnings given immediately to charity and expanding the exclusion for contributions made directly from individual retirement accounts.

Political Landscape

Participants discussed the time frame for further changes to the charitable deduction and noted that more large-scale tax legislation is unlikely in the short-term. Some feared that modest short-term changes might deter more substantial reform over the longer term. Although the nonprofit sector might desire an unlimited universal charitable deduction by moving the deduction above the line or adding a deduction for nonitemizers, that remains an unlikely possibility because of revenue and other constraints. More fundamental reforms to the tax treatment of charitable contributions will likely require trade-offs and might create losers even if it produced significant net gains for charities as a whole. However, there was significant uncertainty about whether advocates would unite on an improvement in compliance or on a modest constraint on deductibility of small and hard-to-enforce amounts of charitable giving, even if those constraints made it possible to help pay for an overall incentive that would be more universal and might significantly increase charitable giving.

CONCLUSIONS

Overall, several main conclusions from the roundtable stood out:

- Research demonstrates that tax policy influences giving behavior and that existing tax incentives encourage charitable giving.
- Participants believe that the 2017 tax bill will reduce individual charitable giving by about 5 percent (roughly $15 billion). They wanted more information on the effect of the recent tax law changes and other proposals, particularly how they would affect different types of nonprofits and charities.
- Participants noted the decline in the number of donors, the increased concentration of giving at the very top of the income spectrum, and the value in creating a more democratic sector that has greater participation across the population.
- Reforming tax incentives for charitable giving, including proposals that would expand tax incentives to more households, is one lever for policymakers that are concerned about the nonprofit sector.
- Principles and evidence matter greatly for proper design of tax incentives for charitable giving. This includes making incentives more salient and easier to understand.

REFERENCE

Steuerle, C. Eugene. 2013. "Extending the Charitable Deduction Deadline to Tax Day." Washington, DC: Urban-Brookings Tax Policy Center.

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