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IN FOCUS

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Key Issues in Tax Reform: The Charitable Deduction for Individuals

The charitable deduction is a long-standing feature of the individual income tax. It is also one of the largest individual income tax provisions in terms of annual forgone revenue, an estimated $56.9 billion in 2017. This In Focus provides background information on the charitable deduction for individual taxpayers and discusses the provision in the context of tax reform. Tax provisions for corporate contributions and charitable bequests are not addressed.

The Deduction

Under current law, taxpayers who itemize their deductions can—subject to certain limitations—deduct charitable donations to qualifying organizations. Qualifying organizations are generally "public charities" or "private foundations," with tax-exempt status under Internal Revenue Code (IRC) Section 501(c)(3); federal, state, or local governments; and other less common types of qualifying organizations.

Tax deductible donations to qualifying organizations can be in the form of cash or property. Property held for more than one year is often referred to as *long-term capital gain property*. Property held for less than a year is often referred to as *short-term capital gain property*. Depending on (1) the type of property donated and (2) the type of qualifying organization that receives the donations, there are limitations on the total dollar amount that can be deducted by the taxpayer in a given tax year. The limitations are defined as a percentage of the taxpayer's adjusted gross income or AGI (computed without regard to net operating loss carrybacks), as noted in **Figure 1.** If the amount deducted exceeds the taxpayer's AGI limitation, the excess can be carried forward and deducted on future years' tax returns for up to five years.

For non-cash donations, there are rules on how to value the property. Depending on the type of property and the recipient organizations, the property is generally valued at its basis (i.e., what the taxpayer originally paid for the property with adjustments) or its fair market value (how much the taxpayer would receive in an open market for the property at the time it is donated) as noted in **Figure 1**.

Selected Legislative Background

The charitable deduction was first enacted to offset the potential negative effects of increased income taxes on charitable giving as part of the War Income Tax Revenue Act of 1917 (P.L. 65-50). The overall amount that could be deducted was limited to 15% of net taxable income to prevent taxpayers from eliminating tax liability by claiming the deduction. The deduction has been changed dozens of times since enactment. Key legislative changes relevant to this In Focus are highlighted next.

Figure 1. Limitations on Charitable Contributions

Type of Donation	Recipient	Valuation Rules for Property	Limitation
cash or short-term capital gain property	public charity; private operating foundation; federal, state, local government	Basis of the property	50% of AGI
	private non-operating foundation; other*	Basis of the property	30% of AGI
long-term capital gain property	public charity; private operating foundation; federal, state, local government	Fair market value	30% of AGI
	private non-operating foundation; other*	Basis of the property	20% of AGI

Source: Internal Revenue Code (IRC) Section 170.

Notes: These are general rules, and there are numerous exceptions. *Includes qualifying contributions to veterans' organizations, fraternal societies, and nonprofit cemeteries. Not all non-operating foundations are subject to the 30% limit.

Over time, Congress has modified the maximum amount that can be deducted in a given year by changing the income limitation. In 1952, as part P.L. 82-465, Congress raised the limitation to 20% of AGI. In 1954, Congress increased the maximum deduction limit to 30% of AGI (P.L. 83-591) for donations to certain public charities. The Tax Reform Act of 1969 (P.L. 91-172) raised the deduction limit to 50% of AGI for donations to public charities and allowed deductions for contributions to private operating foundations. The 1969 act also imposed a 30% limit for contributions of appreciated property and imposed other restrictions on contributions of long-term capital gain property. The Deficit Reduction Act of 1984 (P.L. 98-369) raised the limitation on the deduction for donations of cash or short-term capital gain property to private non-operating foundations from 20% to 30% of AGI.

There were exceptions to these limits for particularly large gifts. The Revenue Act of 1924 (P.L. 68-176) specified that if a taxpayer made contributions exceeding 90% of net income in the tax year and each of the past 10 years, a full deduction was allowed. A phaseout of the unlimited deduction was included in the Tax Reform Act of 1969.

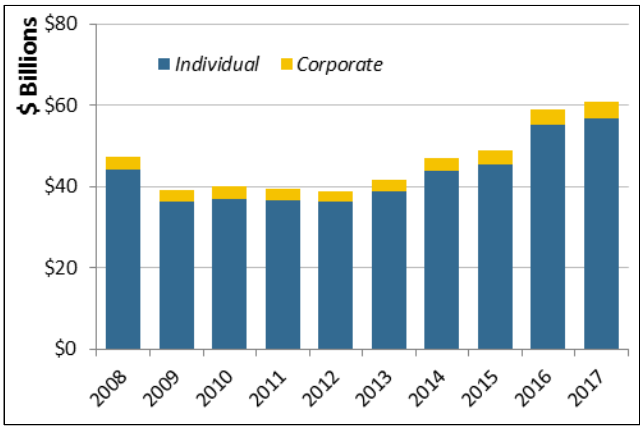
In the early 1980s, temporary changes provided a charitable deduction to non-itemizers. The Economic Recovery Act of 1981 (P.L. 97-34) allowed taxpayers who took the standard deduction to claim an additional deduction for charitable giving. This temporary provision went into effect in 1982, and was allowed to expire as scheduled at the end of 1986.

Cost

The charitable deduction is estimated to result in $60.9 billion in forgone revenue in FY2017, $56.9 billion from the individual income tax and $4.0 billion from the corporate income tax (see **Figure 2**). During the past decade, tax expenditures associated with the charitable deduction have fluctuated, largely following patterns in charitable giving. Individual charitable giving fell between 2008 and 2009, as a result of the Great Recession. The post-recession recovery in giving has increased in recent years, and is reflected in the tax expenditure estimates.

Figure 2. Charitable Deduction Tax Expenditures

FY2008 – FY2017



Source: Joint Committee on Taxation.

Distribution of Benefits

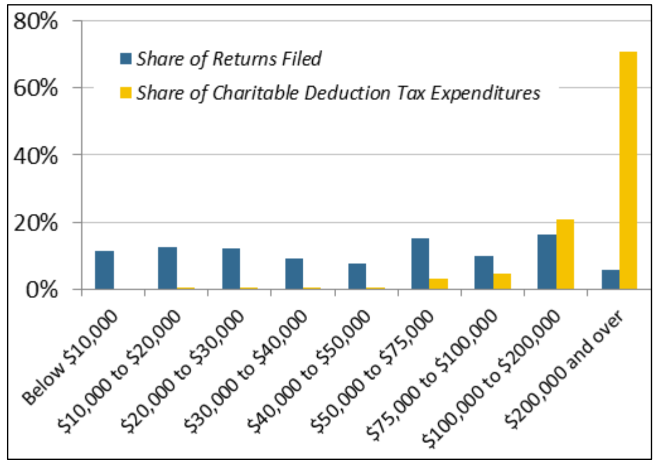
Tax expenditures for charitable deductions largely benefit higher-income taxpayers. Higher-income taxpayers tend to (1) have a greater ability to give; and (2) derive a larger tax benefit from each dollar given since they generally face higher marginal tax rates. An estimated 71% of tax expenditures for charitable giving in FY2017 will be claimed by taxpayers in the $200,000 and above income class (see **Figure 3**). Overall, an estimated 6% of returns fall into this class. In contrast, an estimated 8% of the charitable deduction tax expenditures are associated with tax returns filed in income classes of $100,000 or less (78% of tax returns filed fall into a $100,000 or less income class). Additionally, only taxpayers that itemize deductions can claim a deduction for charitable donations. In 2014, 93% of taxpayers with AGI above $200,000 itemized deductions, while 20% of taxpayers with AGI of less than $100,000 itemized.

Considerations for Tax Reform

There tends to be agreement that the tax code should support charitable giving. Tax reform, however, could result in changes to tax incentives for charitable giving. These changes could be direct. For example, the deduction could be modified to allow non-itemizers to receive tax benefits for donations. Alternatively, a floor could be imposed, restricting deductions for charitable giving to giving above some threshold. The deduction could also be converted to a credit, equalizing the subsidy for giving by individuals in different tax brackets. Another way to equalize the value of the deduction for taxpayers in different tax brackets is to cap (or make fixed) the rate of the deduction. Other changes to the deduction might include modified AGI limits or changes related to valuation of non-cash gifts.

Figure 3. Distribution of Returns Filed and Charitable Deduction Tax Expenditures, by Income Class

2017



Source: Joint Committee on Taxation.

Notes: Calculations use 2017 rates and 2016 income levels.

Changes in tax policy enacted as part of tax reform might also affect charitable giving incentives indirectly. Since the tax savings associated with charitable giving is a function of the donor's marginal tax rate, lower marginal tax rates reduce the tax incentive to give. Policy changes that reduce the number of taxpayers itemizing deductions (like increasing the standard deduction), while maintaining the charitable deduction as an itemized deduction, could reduce the number of taxpayers with a tax incentive for charitable contributions.

Any tax reform is likely to have provisions that will affect the tax incentives for charitable giving, either directly or indirectly. The Unified Framework for Fixing Our Broken Tax Code, issued by the Office of the Speaker on September 27, 2017, would retain tax incentives for charitable giving in tax reform.

Current tax reform legislation—H.R. 1, as reported, and the Senate Finance Committee chairman's mark—would make several changes to the charitable giving deduction. For example, both bills would increase the AGI limitation on cash contributions from 50% to 60%. In addition, both bills would repeal the deduction for contributions made to higher education institutions in exchange for the right to purchase seating at university athletic events. Both bills would also substantially increase the standard deduction, which would result in fewer taxpayers claiming itemized deductions such as the charitable deduction.

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