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Do the Math: Abolishing the Charitable Deduction Will Cost Charities Billions

By Robert Sharpe

Over its nearly 100-year history, the charitable deduction has become one of the most time-tested provisions in the Internal Revenue Code.

But it has also been a perennial target by people on both ends of the political spectrum who want to eliminate or restrict it.

Some on the left consider the deduction an unwarranted giveaway to the rich to subsidize frivolous and self-serving philanthropic interests. They think it would be better for government to allocate the money from its coffers.

Some on the right see the write-off as just one of many impediments to a flat tax, believing the best way to stimulate giving is to eliminate deductions and lower tax rates so people have more money to give rather than paying it to the IRS.

While economists have long studied the impact of the deduction, they have not reached a clear consensus on how much it matters. A new study, however, along with recently released IRS data make it quite clear that America's charitable organizations could be hurt greatly if donors lost all or part of the charitable income-tax deduction as lawmakers seek ways to avert the looming "financial cliff."

The new study of the wealthy and their philanthropy, released last month by Bank of America, asked affluent people (mostly with incomes of $200,000 or more and net assets of at least $1-million) how they might alter their giving if deductions were eliminated.

Just under 50 percent said their giving would remain the same. But nearly 49 percent said they would decrease their giving—and 20 percent of those people said they would "dramatically decrease" their giving. Less than 2 percent said their giving would increase.

To understand why the affluent think this way, consider what it costs a donor to make a $10,000 gift today. If she is in the 35-percent tax bracket, her after-tax out-of-pocket cost is $6,500.

If Congress abolishes the charitable deduction, the new cost is not just the $10,000 the donor gives but also the approximately $5,400 in increased taxes on the $15,400 she will have to shoulder to earn enough to make the $10,000 gift.

And if federal tax rates go up at the same time, that means an even higher after-tax cost of everything, not just charitable gifts. Even the wealthiest Americans have limits on how much they feel they can afford to give, and a sharp rise in the cost of charitable donations and the burden of new tax increases could reasonably cause many to give less.

If every donor of $10,000 feels the after-tax cost of giving go up (by as much as 50 percent for high-income donors), then many Americans, no matter how well intentioned, are no doubt going to give less.

Another way to think about this is that the federal government would essentially be asking charities to forgo a portion of the gifts they receive from individuals to help close the federal budget gap.

Some lawmakers and others like to point out that most donors wouldn't be affected by changes in the charitable deduction because 70 percent of Americans don't itemize. While it is true that people who don't itemize often give generously from their incomes, they don't provide the lion's share of the gifts that help fuel the nonprofit world.

Just look at the most recent statistics available: In 2010, the 30 percent of Americans who itemized their deductions provided $170-billion, or 79 percent of the money "Giving USA" reported that individuals donated to nonprofit organizations.

If a loss of the charitable deduction caused people who itemize deductions to reduce their giving by just 20 percent, that would mean a $34-billion drop in charitable giving, by far the largest decrease since the Great Depression.

To put that in perspective, $34-billion is more than three times the sum that individuals donated to all U.S. colleges received last year (not counting bequests).

If nonprofits suddenly had to reduce costs by $34-billion, they could well be expected to cut jobs—positions that now provide work to five times the number of people in the auto industry.

To deal with all the reduced giving in this way, they would need to eliminate 5 percent of their work force, or 680,000 jobs (assuming average pay rates of $50,000).

That could increase the unemployment rate in the United States from 7.9 percent to 8.4 percent.

To minimize the impact of any limits on deductions, the White House has repeatedly suggested limiting the charitable deduction for people who make more than $200,000 a year.

Unfortunately, that would hit hardest the very people who give the most.

In 2010, the most recent year for which data are available from the IRS, people with incomes over $200,000 made 41 percent of all gifts people deducted on their itemized returns.

Newly released IRS data show that it is those people who decreased their giving the most during the worst of the recession.

Fortunately, those people are now starting to give more generously and are helping many nonprofits begin to recoup the massive losses they suffered in the downturn.

It's not just the White House plan that is so disturbing. Another idea floated by lawmakers follows an idea Mitt Romney suggested during the presidential campaign—limiting the total amount of deductions people can claim.

That is essentially the same thing as ending the deduction for most affluent people because mortgage interest, state and local taxes, and other expenses that are essentially fixed costs that taxpayers can't control would absorb a good share of the deduction limit. So most people couldn't write off their charitable deductions and could still face out-of-pocket increases if they had high medical expenses or other items that caused them to exceed the deduction cap.

The recovery in philanthropy, like the overall economy, is still in a fragile stage. Lawmakers should very carefully weigh the wisdom of tackling the nation's deficit issue by imposing unprecedented new taxes on amounts donated to charity. If government cuts spending, charitable giving will have to play an even more important role in our society as those cuts inevitably put even more strain on the nonprofit infrastructure that enriches Americans' lives in countless ways.

A better idea might be to impose a "surtax" on high incomes and use that revenue to help close the deficit.

Then, to stave off any potential reduction in charitable giving, Congress could provide a credit against that tax for charitable donations so people would have the option of bypassing the surtax in whole or in part by contributing generously to their favorite nonprofit organizations.

That would achieve the goal of increasing taxes on America's affluent but limit the pain to those who do not choose to help others through charitable gifts.

That's not a new idea. In 1917, Congress imposed higher taxes on the wealthy to help pay for World War I. The charitable deduction was initially conceived at the time as a way to keep the higher war taxes from absorbing funds that would otherwise be devoted to charitable purposes at home.

Other ideas abound for how to change the tax system both to increase giving and to help close the deficit. But it's a mistake to think that tweaks in the current system that limit or end charitable deductions don't matter. That's why we need to make sure lawmakers and charity advocates understand this. It's not hard to fathom how taxes and charity work.

Just do the math.

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