

[admin](#) - Sun, 3/20/2011 - 00:00

In December 2010, Congress passed the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010. Among its numerous provisions, the 2010 Act extended the income tax rate reductions enacted during the Bush administration through December 31, 2012. This means that income and capital gains tax savings from lifetime charitable gifts of cash or other assets will remain unchanged at least until the year following the next presidential election.

In the event that Congress does not act in the meantime, on January 1, 2013 tax rates will revert to those in effect when President Clinton left office; the top income tax rate would be 39.6 percent, capital gains would be taxed at a 20 percent rate, and dividends would be taxed at ordinary income tax rates, potentially as high as 39.6 percent. These changes would increase the tax incentives for charitable giving.

However, the Administration and members of Congress have proposed a reduction in the tax benefits for making charitable gifts as one of the ways to reduce the federal deficit. President Obama's National Commission on Fiscal Responsibility has recommended eliminating most deductions, which could include both the charitable and mortgage interest deductions. The Obama Administration itself has proposed limiting the benefit from charitable deductions to a maximum tax rate of 28%. If that were to happen, donors in the highest income tax bracket would realize federal income tax savings of \$28,000, rather than \$35,000, from a \$100,000 donation.

Other deficit-reducing measures that have been mentioned are:

1. Limiting charitable deductions to the amount donated in excess of two percent of adjusted gross income (AGI);
2. Limiting the deduction to cost basis when appreciated property is contributed; and
3. Substituting a tax credit of 25 percent or less for the deduction.

It is far from certain that any of these proposals will be adopted, but it is worthwhile to consider what the implications of each one are likely to be for charitable giving.

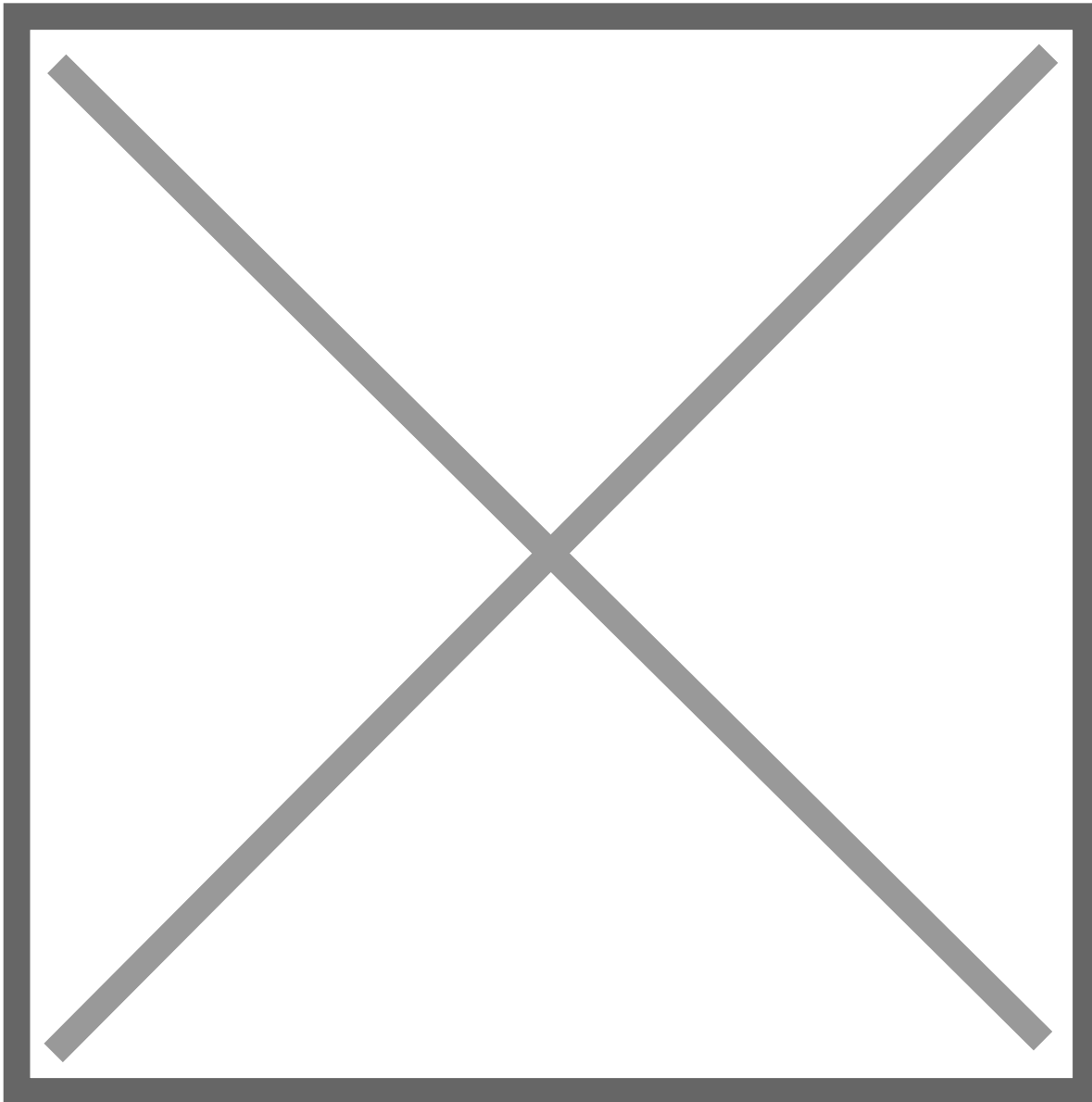
Limiting charitable deductions to a maximum rate of 28%

The Obama Administration has proposed capping the benefit of itemized deductions,

including the charitable deduction, at a 28% tax rate. This would mean the donors in the 28% tax bracket or lower would enjoy the same income tax savings from charitable gifts that they enjoy today. In 2011, this group would include all jointly filing married couples with a taxable income of \$139,350 or less. Donors in the 33% or 35% tax bracket would be able to save only 28 cents in income tax for each dollar donated, rather than the current 33 cents and 35 cents, respectively.

According to IRS statistics for 2008, only 2.4% of taxpayers were in the 33% or 35% income tax brackets (IRS, Statistics of Income Division, July 2010). However, the table below, which was compiled for a study by The Center on Philanthropy at Indiana University ("Patterns of Household Charitable Giving by Income Group, 2005"), shows that over half of all dollars given to charity are donated by individuals with household income of \$200,000 or more. It is not clear from the study how household income relates to taxable income, but it seems reasonable to suggest that most households with income of \$200,000 or more would be in the 33% or 35% tax bracket, except for the roughly half who pay the alternative minimum tax (AMT). The AMT rate is assessed at 28%, so a 28% cap on deductions would not reduce the tax benefits for donors who pay this tax. This leaves the donors of roughly a quarter of all charitable dollars who actually pay 33% or 35% income tax rates. It is this quarter that could shrink, most likely modestly, due to the increased cost of making charitable gifts.

To the extent that donors in the 33% and 35% tax brackets curtailed their giving, the table strongly suggests that arts organizations, health-related organizations, educational institutions, and combined philanthropies (such as United Way and donor advised funds at financial institutions) would be far more affected than religious or basic needs charities.

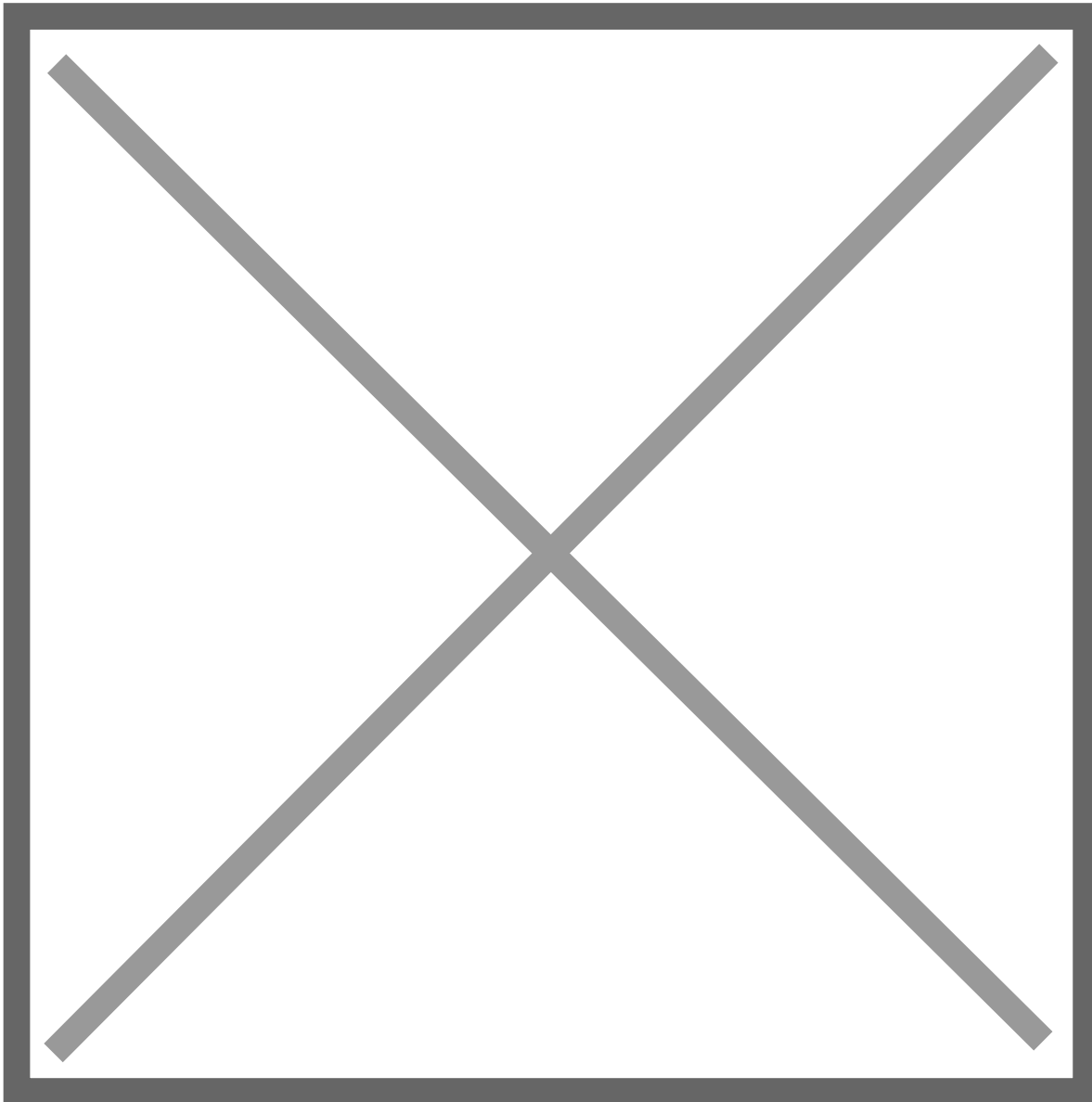


Limiting deductions to amounts in excess of 2% of AGI

Limiting the charitable deduction to donations in excess of two percent of adjusted gross income would eliminate the income tax benefits of charitable giving for all but the most generous. A taxpayer would enjoy no reduction in income tax from making charitable contributions unless those contributions were greater than 2% of AGI. For example, a donor with an AGI of \$50,000 would need to give more than \$1,000 during the year before he or she would be able to save any income taxes as a result of his or her donations. A donor with an AGI of \$250,000 would need to give five times as much, \$5,000, before enjoying any income tax savings.

A 2% threshold would reduce income tax savings for all donors, regardless of their tax bracket, but only if they itemize their deductions. While at first blush it might seem that donors with low AGIs would be most affected by a 2% threshold, the reality is that these taxpayers are much more likely than high AGI taxpayers to take the standard deduction rather than itemize. Taxpayers who don't itemize don't enjoy any income tax benefit from making charitable donations anyway, so the existence of a 2% threshold shouldn't change their giving habits at all.

An analysis of 2010 tax returns from the Tax Policy Center, shown in the table below, found that only 37% of taxpayers in the 15% bracket itemize their deductions. This group included married couples who file jointly and have taxable income of \$16,750 - \$68,000. Some gift annuity donors are likely to be in this group. The fraction of taxpayers who itemize increases substantially at higher tax brackets, leaping to 65.5% for those in the 25% bracket (which includes jointly-filing married couples with taxable income of \$68,000 - \$137,300), and reaching almost 90% for those in the 35% bracket (such as jointly-filing married couples with taxable income over \$373,650). These higher-bracket taxpayers are almost certainly the donors of most charitable remainder trusts, as well as many gift annuities and bequests.



While the above facts might lead one to conclude that donations to charitable remainder trusts would be most negatively affected by a 2% threshold, quite the opposite may occur. Charitable remainder trusts are large gifts, typically \$100,000 or more, that generate tax deductions of at least five figures. A deduction this size is likely to be well over 2% of the donor's AGI, which would allow the donor to derive a substantial income tax benefit from the gift. In contrast, a donor who funds a gift annuity that results in a deduction of only \$2,000 might derive little or no income tax benefit from the gift. The hardest hit donors would be those who make a handful of annual gifts each year that amount to less than 2% of their AGI. On the other hand, even under current law most of these donors make their gifts for reasons other than saving income taxes.

Limiting deductions to cost basis of appreciated property

Limiting the charitable deduction available to donors of appreciated property to their cost basis in the property would act as a strong disincentive against giving this sort of property to charity: the lower the cost basis the stronger the disincentive. For example, imagine a donor considering a gift of \$25,000 in stock that cost him only \$5,000. Assuming the donor itemizes deductions and is in the 33% income tax bracket, this gift would reduce his income tax just \$1,650. If she were to give \$25,000 in cash instead, he would reduce his income tax \$8,250, five times as much. Were she to fund a gift annuity instead, the tax savings would be lower in each case, but the ratio would be the same: \$1 of savings when funded with the appreciated property for each \$5 of savings when funded with cash.

If the tax on capital gains continues to be lower than the tax on income, the current wisdom of giving appreciated property and letting the charity sell it would be turned on its head. It now would be tax advantageous to sell the property first, pay the capital gains tax, and then donate the fully deductible cash proceeds.

Then again, many will decide to forgo funding a planned gift at all. In a 2008 survey of wealthy donors (average net worth of \$12.6 million) sponsored by Bank of America and conducted by the Center on Philanthropy, fully 60% of respondents reported that their attorney, accountant, or financial advisor influenced their decision to create a charitable remainder trust (CRT) or charitable lead trust. Under rules that limit the charitable deduction to cost basis, these professional advisors would likely steer their clients away from funding CRTs, since an important motive for making this recommendation – a deduction based on full value coupled with postponement and possible elimination of the capital gains tax – would no longer exist. Fewer CRTs would be funded – perhaps far fewer. Gift annuities would also decline, but likely to a lesser degree.

The decline in appreciated property gifts would by no means be limited to planned gifts. For example, Fidelity Investments reports that half of the record \$1.6 billion in donations its Fidelity Gift Fund received in 2010 were in the form of appreciated securities and that contributions in the form of non-publicly traded assets, such as privately-held C- and S-Corporation stock and real estate, nearly tripled in 2010. Sarah Libbey, the Fund's president, offers the following quote on the Fidelity Investments website: "Appreciated securities and non-publicly traded securities are the most strategic assets one can give — and the Gift Fund makes donating these types of assets easier." With the donation of appreciated assets no longer so

"strategic," outright gifts of these assets would shrink substantially. The shrinkage would be attributable in part to donors who choose to sell these assets first and give the cash proceeds instead, but also to those who would choose not to donate at all because of a lack of tax incentive.

Substituting a tax credit of 25% or less for the deduction

Supporters of a charitable tax credit argue that it would benefit taxpayers more equitably than the existing charitable tax deduction. They observe that the charitable tax deduction offers the greatest tax savings to donors who are in the highest income tax bracket. Under the current scheme, a donor who itemizes and is in the 15% income tax bracket saves only 15 cents in tax for every dollar donated, whereas a donor who itemizes and is in the 35% income tax bracket saves 35 cents in tax for every dollar given, more than twice as much. The charitable deduction approach, in effect, rewards donors with high incomes more than donors with modest incomes.

If a 25% income tax credit were to replace the income tax charitable deduction, all itemizers would save 25 cents in tax for every dollar donated, regardless of their tax bracket. For donors in the 15% income tax bracket, such a credit would represent an increase in the taxes they can save from their charitable gifts. For donors in the 28% bracket or higher, a 25% credit would mean a decrease in the taxes they can save from their charitable gifts, with those in the 35% bracket witnessing the greatest decrease.

To the extent that donors are motivated by tax incentives, a move to a 25% income tax credit would lead those in the highest income tax brackets to curtail their charitable giving the most. As with the Obama Administration's proposal to cap charitable deductions at a 28% rate, a 25% income tax credit would dampen donations from this cohort. The size of the affected group would be larger, 6.3% of taxpayers versus 2.4%, and the magnitude of the decrease in tax benefit would be greater by three cents of each dollar donated. Unlike the Obama Administration's proposal, however, a 25% income tax credit would give donors in the lowest tax brackets, those under 25%, more encouragement to give. While relatively few of these taxpayers itemize deductions, they comprise over 70% of all filers.

Nevertheless, it seems likely that the lure of increased tax savings would inspire these donors to increase their charitable giving modestly at most. Overall, then, the 25% tax credit proposal would probably dampen charitable contributions somewhat more than the 28% deduction cap proposal, but the affect would still be modest.

Conclusion

Although charities have every right to be concerned about the proposals for curtailing the tax incentives for making charitable gifts, only one of the proposals strikes us as having the potential to dampen charitable gifts, and especially planned gifts, significantly: limiting the deductibility of gifts of appreciated property to cost basis. This change could substantially reduce gifts, especially planned gifts, funded from a very important source of current donations. The 2% threshold proposal would affect the largest group of donors – all who itemize – but would affect least those who give most, including planned gift donors. The 28% deduction ceiling and 25% tax credit proposals would affect only a small minority of donors, but an especially critical one for many charities, especially those involved in health, education, or the arts. Nevertheless, it seems unlikely that a modest reduction in income tax savings for these high income donors would lead them to give significantly less to the causes they support.

Two more things to keep in mind. All of these proposed changes relate to income taxes only. They will have no affect on bequests, the source of roughly 80% of all planned gift dollars. More importantly, most of your organization's donors give first and foremost out of a desire to support its mission, not to accrue tax benefits. Focus your message in promotional materials, group settings, donor visits, and all other donor interactions, on the great work your organization is doing and your fundraising will be successful no matter what twists and turns the tax law may take.

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