How Changes in Tax Rates Might Affect Itemized Charitable Deductions

The Center on Philanthropy at Indiana University
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Executive Summary

President Obama's budget proposal for 2010 and beyond includes provisions to reinstate tax rates for the highest income households to the rate in effect from 1993 through 2000 (39.6 percent) and to allow deductions from income to be itemized at a separate lower rate of 28 percent. The income generated for the U.S. Treasury under these provisions is intended, over 10 years, to fund a part of a $630 billion reserve, restricted to improving access to and delivery of health care.

Charitable organizations are concerned about a proposal that has the potential to decrease the amount of charitable giving in the U.S., which was $306 billion in 2007 (Giving USA 2008). This document draws on research findings about charitable giving to explore whose giving is likely to be affected and to present an idea of the possible impact.

Changes in income and tax benefits are two important drivers of the amount households give to charity – but they are not the only drivers. Changes in wealth and recent giving history also are important in individual and household giving. However, non-economic factors, such as volunteering, social connections with other people, and values and beliefs, also play a role in the decisions made by the 70 percent of American families that give to charity (Center on Philanthropy, 2009).

This summary looks at a one-year estimated dollar impact of each proposed rate change. These calculations rely on an approach developed at Indiana University-Purdue University Indianapolis by economists Partha Deb (now at Hunter College, New York) and Mark O. Wilhelm. The approach relies on national-level data only and does not take into account changes at the individual and household level. The method does not take into account the potential impact of other provisions in the budget proposal, including restoring the capital gains tax rate at 20 percent (which might increase gifts of appreciated securities, since it was set to 15 percent in 2003), or any proposed changes in the Alternative Minimum Tax, which limits itemized deductions for approximately 2.5 million tax filers with income of $200,000 and above.

This analysis also does not consider other factors that will affect giving, such as "pre-giving" that might occur in advance of tax rate changes if those changes were announced prior to the time when they would take effect. The method uses only the changes in the tax rates and does not take into account current economic circumstances, such as stock market prices, personal income, or concerns about personal financial stability that might influence giving more profoundly.

With the simplified model, the Center on Philanthropy estimates that had the proposed changes been in effect in 2006 (the latest year for which itemized giving data are available), the impact on itemized giving would have been a relatively small reduction when measured as a percentage of total itemized charitable giving by individuals (a decrease of 2.1 percent). It would have been a larger decline in estimated giving by the 4 million or so highest income households that would have been affected by the proposed changes in policy (an estimated drop of 4.8 percent). Again, this estimate uses only the changes in the tax rates and does not take into account current economic circumstances, such as stock market prices, personal income, or concern about financial stability that might influence giving more profoundly.

The larger economy plays a more important role in changes in giving than do tax rate changes. For example, research by the Center on Philanthropy has found that a 100-point change in the Standard & Poor's 500 Index is associated with a $1.85 billion change in giving, and a $200 billion change in personal income is associated with a change of $4.32 billion in charitable itemized deductions. To provide some context for these shifts, personal income in 2008 was approximately $12 trillion ($12,000 billion), and the Standard & Poor's 500 Index closed 2008 at 913.18 points.

Summary of the proposed changes in the federal budget considered in these calculations

- Reinstate top marginal tax rate to 39.6 percent, up from the current rate of 35 percent for those with income above $357,700 and up from the current rate of 33 percent for those with income of $250,000 to $357,699. Note that the 39.6 percent rate was in effect from 1993 to 2000.

- Set a rate of 28 percent that applies when itemizing deductions of all types, including charitable gifts, for tax filers with income of $250,000 or more ($200,000 for single filers or for married filing separately).

Who is affected?

In 2006, the most recent year for which data are available, 2.9 percent of tax returns (approximately 4 million returns) had adjusted gross income of $200,000 or more. In 2006, these 4 million returns had 31.3 percent of total income on all tax returns and accounted for 43.5 percent of all itemized charitable gift deductions claimed on individual tax returns.

High-income tax filers accounted for $81.26 billion out of a total of $186.65 billion that was claimed by all tax returns with itemized charitable deductions.

In 2002, a year that more closely resembles the current economy, 1.9 percent of tax filers had income of $200,000 or more, which was 2.5 million tax returns. In 2002, these 2.5 million returns claimed 30.3 percent of all itemized charitable deductions.

Separating the estimated impact of changes in deduction rates and in disposable (after-tax) income

In looking at charitable giving at a national level, changes in personal income and changes in wealth play a larger role overall in shaping charitable giving than do changes in tax rates. Changes in tax rates matter in the short-term, the year before they take effect and the year they are implemented.

The Center on Philanthropy has calculated the one-year impact of the proposed changes, taken singly, using a model developed by Partha Deb (now at Hunter College) and Mark O. Wilhelm (at Indiana University-Purdue University Indianapolis). Using this method, if the proposed changes had been in effect in 2006, the Center calculates that itemized charitable deductions in 2006 could have been lower by:

- $1.63 billion (a decrease of less than 1 percent) in total itemized charitable deductions for 2006 (most recent year available), when looking only at the change in the deductibility rate for gifts (28 percent instead of 35 percent)

- $2.24 billion (1.2 percent less) in total itemized charitable deductions for 2006 (most recent year available), when looking only at the change in the amount of disposable income because of higher taxes (39.6 percent instead of the current 35 percent)

- $3.87 billion less (2.1 percent less) in total individual itemized giving for 2006 when adding the two potential changes together.

The Center calculates that the two changes combined would have resulted in a $3.87 billion reduction in total itemized giving in 2006. While not a direct estimate of the change in giving in the year that any approved tax rate changes take effect , this calculation does suggest that the reduction would be in the range of 2 percent of total itemized charitable giving. Expressed as a percentage of giving done by taxpayers with income above $200,000, the reduction would be 4.8 percent. Taxpayers in 2006 who had income of $200,000 or more claimed itemized charitable gift deductions of $81.26 billion.

The estimate is for a change in one year; over time, the impact would be different

This estimate is for 2006 only. After any change in tax rates, households adjust their giving to the new tax circumstances. In addition, changes at other levels of government and in the economy also occur, which also impact giving in complex ways (Bakija and Heim, 2008).

Distinguishing between the long run and short run impact of a change in tax rates is important for planning and policy-formulation. It can be challenging to estimate beyond a few years, because long-term estimates require a giving history for households covering a long period of time. At the household level, individuals may act differently if they view a tax change as a temporary measure or as a permanent shift, which adds to the difficulty of forecasting in the long run.

An additional complication in estimating the impact of a tax rate change is that people can change their behavior in the very near-term (this year) in anticipation of changes in tax benefits in the future (Barrett, McGuirk, and Steinberg, 1997). For example, people may “pre-give” in advance of an announced tax rate change that would lower the deductibility of some contributions. The early donations would not be a change in total giving but a reallocation from one year to another so that the donor can maximize the tax benefits he or she receives.

Are all gifts by high-income households itemized?

Several studies have shown that high-income households give more than appears in the tax system.

The Bank of America Study of High Net-Worth Philanthropy (Center on Philanthropy 2008) found that among nearly 700 high net-worth households giving averaged $56,602 ($189,397, when outliers are included) in 2007 from their own personal income or assets. This greatly exceeds the average amount claimed on tax returns for 2006 of $22,224 per return with itemized charitable deductions for returns with $200,000 or more in income.

Moreover, David Joulfaian (2001), an economist at the U.S. Department of the Treasury, found that among high net-worth households, most donated two times as much to charities as they could legally deduct in any given year. Paul Schervish, a scholar of wealth and philanthropy, has reported that among high net-worth households he interviewed, many do not track or report their donations. They are subject to income limitations on claiming deductions or are subject to the Alternative Minimum Tax, so their tax position does not change because of their giving. In a Center analysis of data from the 2004 Survey of Consumer Finances, which reaches a large sample of high-net worth households, average giving among high net-worth households (income of $200,000 or more and wealth of $1 million or more) was $182,607 (not excluding any outliers).

Do taxes, income, or wealth drive giving?

The 2008 Bank of America survey asked people how they thought their giving would change if they received no charitable deduction at all: 52 percent said it would stay the same, and just over 1 percent said it would increase. Nearly 4 in 10 (37 percent) said it would decrease somewhat and only 10 percent said it would dramatically decrease.

In the 2008 Bank of America report, respondents with high net-worth (high wealth) gave by far the most, on average. Those with $50 million or more in net-worth contributed an average of $885,387 from their own personal assets and from their private foundations, donor advised funds and charitable trusts; those with net-worth from $1 million to $3 million gave an average of $13,939, again from both personal assets and from their private foundations, donor advised funds and charitable trusts. People with wealth between those two extremes gave average amounts that rose steadily with wealth level.

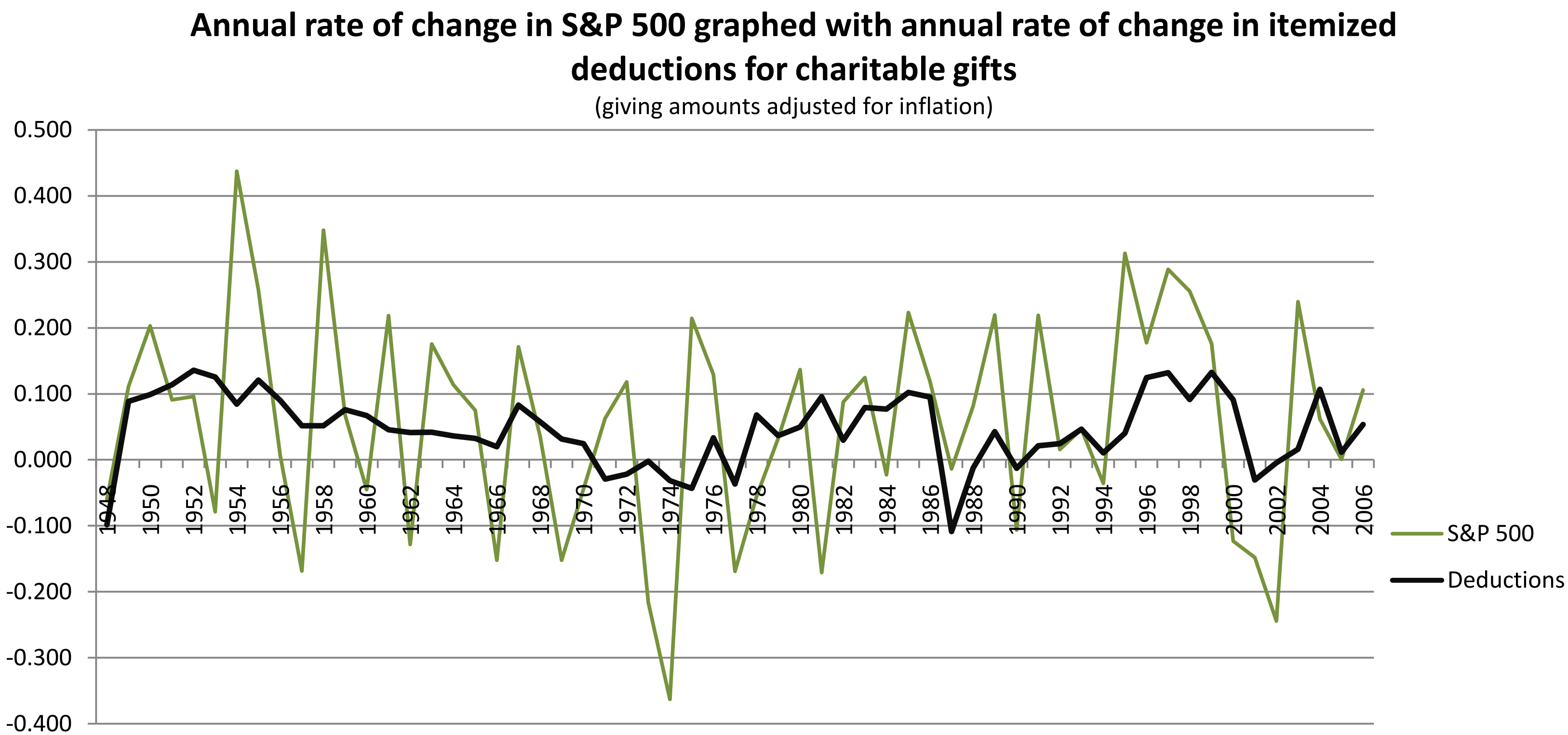
John Havens et al. (2006) summarized results from many studies that showed that wealth and a sense of financial security are very important in how much a high-income or high net-worth household gives. Using data from the Survey of Consumer Finances and other sources, Schervish and Havens (2001) have shown that high-income families with low wealth give comparatively little; and high-wealth households, even those with relatively low income, tend to give a higher than average share of their income. The 2006 Bank of America Study of High Net-Worth Philanthropy also found that high net-worth households that reported feeling personally financially secure donated more to charity, on average, than did households that did not feel personally financially secure.

Comparison with other tax changes

Many studies have shown that changes in tax rates have an impact on itemized charitable deductions claimed on tax returns. Giving also changes with changes in income. Auten et al. (2002), in particular, examine the long-term (persistent) effects of changes in tax rates and suggest that if there were no deduction at all for charitable gifts, itemized giving would eventually drop between 25 and 36 percent. Bakija and Heim (2008) show that households make changes in giving based on permanent (long-term) changes in income and taxation and are less likely to shift their contributions in response to temporary changes. They also find that high-income tax payers, in particular, respond to changes in tax incentives for giving that are put in place and intended to stay in place for a relatively long term. One such incentive is a comparatively high rate applied to tax deductions, so that donors receive a deduction for their contributions and lower their tax liability.

Some short-term tax incentives to encourage households to give more have also been successful in the United States and in other countries. Two examples in recent history are the Katrina Emergency Tax Relief Act (KETRA) and the IRA roll-over provisions. KETRA lifted caps on giving cash to public charities in the last four months of 2005. Under the provisions of KETRA, more than $11 billion was claimed on tax returns for 2005. Additional funding has been raised by charities through provisions of tax acts that allow tax-free roll-overs of Individual Retirement Accounts (IRAs) for people above 70 ½ years of age. *Giving USA 2008* estimates that the IRA provision has resulted in at least $1 billion in additional charitable giving.

The graphs on the following pages illustrate the percentage change in itemized giving along with changes in the Standard and Poor's 500 Index, changes personal income, and changes in tax rates.

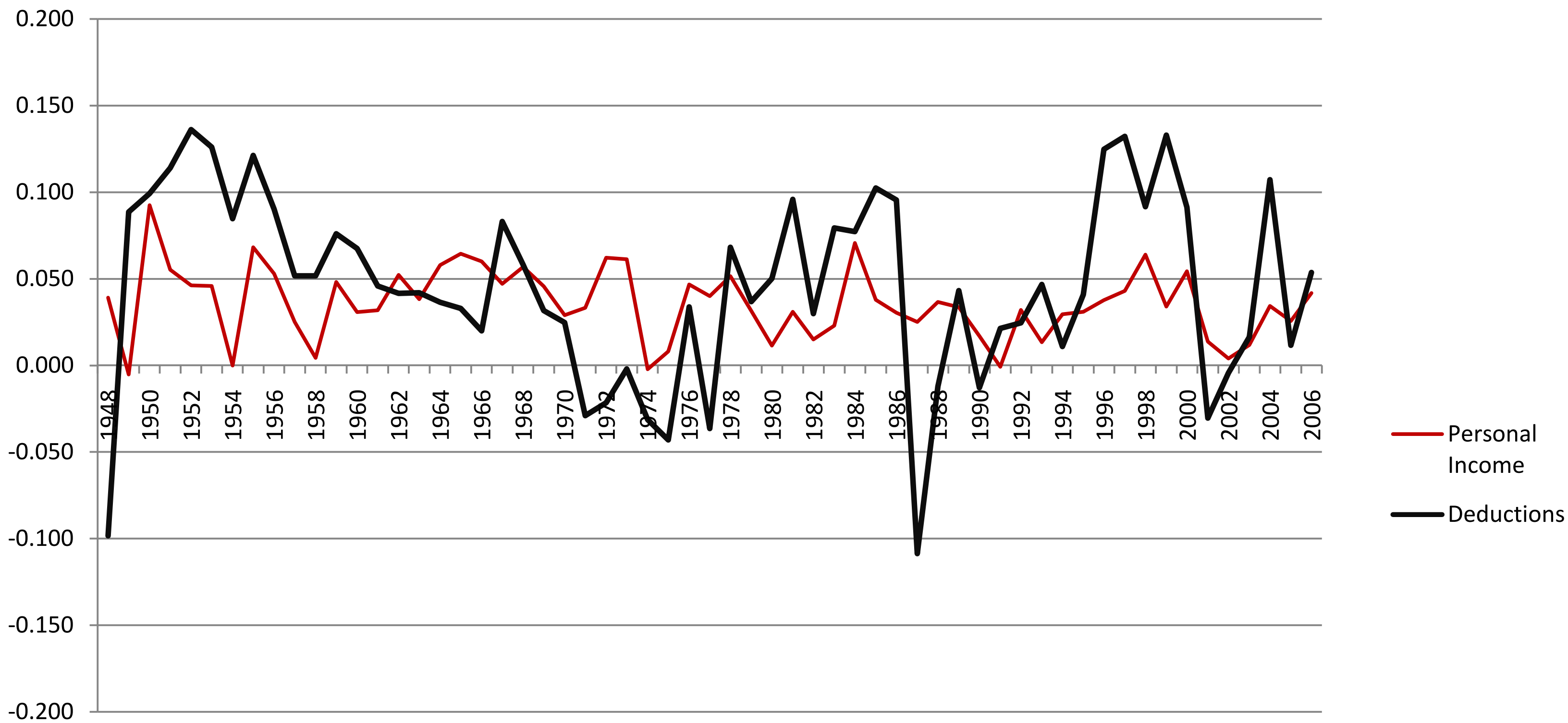


Data: Itemized deduction information is total itemized deductions from the IRS records. They are adjusted for inflation using the Personal Consumption Expenditures index from the Bureau of Economic Analysis. 2000 = 100 in that method. Standard & Poor's 500 values were downloaded initially from www.economagic.com and have been updated since 2002 using the Standard & Poor's 500 Index page. All values are the close on the last trading day of the year. Adjusted for inflation using the PCE index. The relationships graphed are meant to show how itemized deductions change over time with economic indicators but do not suggest causality.
Analysis: Center on Philanthropy at Indiana University

This graph illustrates the changes in the S&P 500 in relation to changes in itemized deductions. Since the mid-1980s changes in the S&P 500 have more closely aligned with changes in itemized deductions than it did in previous years. More recently, as the S&P 500 increased so did itemized deductions and as the S&P 500 decreased so did deductions.

Annual rate of change in personal income graphed with annual rate of change in itemized deductions for charitable gifts

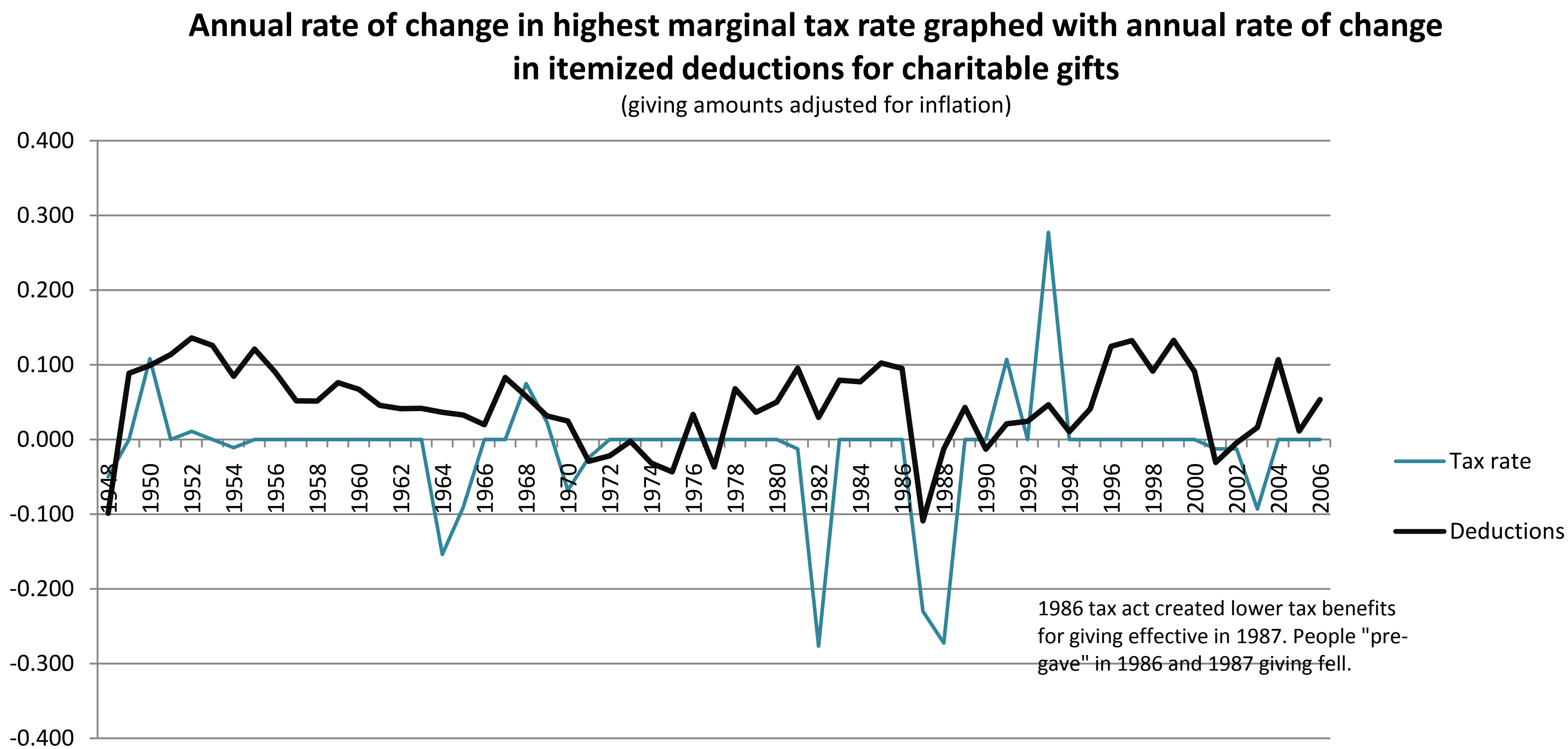
(dollar amounts adjusted for inflation)



Data: Itemized deduction information is total itemized deductions from the IRS records. They are adjusted for inflation using the Personal Consumption Expenditures index from the Bureau of Economic Analysis. 2000 = 100 in that method. Income information is total personal income from the Bureau of Economic Analysis, downloaded. Also adjusted for inflation using PCE index. The relationships graphed are meant to show how itemized deductions change over time with economic indicators but do not suggest causality.

Analysis: Center on Philanthropy at Indiana University.

For nearly 60 years, changes in personal income track closely with changes in itemized deductions. In general when personal income rose, itemized deductions rose and often rose further than income and when personal income fell, deductions tended to fall and often fell further.



Data: The itemized deduction information is total itemized deductions from the IRS records. They are adjusted for inflation using the Personal Consumption Expenditures index from the Bureau of Economic Analysis. 2000 = 100 in that method. Tax rate information is the highest marginal tax rate reported and compiled at http://www.taxplanet.com/library/oldtaxrates/oldtaxrates.html, with annual updates from Bankrate.com. The relationships graphed are meant to show how itemized deductions change over time with economic indicators but do not indicate causality.

Analysis: Center on Philanthropy at Indiana University.

Changes in the tax rates have less closely aligned with changes in itemized deductions than have changes in personal income or changes in the S&P 500. More recently, for example, when there were no changes in the tax rate from 1994 to 2000 itemized deductions increased. Further when the tax rate decreased in 2006, deductions began to rise, indicating less of a relationship between changes in tax rates (when examined by themselves) and changes in itemized deductions.

Research papers available for more information

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