

## What Does the Fiscal Cliff Deal Mean for Nonprofits?

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The following fact sheet examines the effects of the American Taxpayer Relief Act of 2012 on charitable giving. The major individual income tax provisions are estimated to increase giving by **\$3.3 billion or 1.3 percent**, relative to 2012 law, mainly due to the increase in the top marginal tax rate. Numerous other smaller provisions, detailed below, will also affect charitable giving.

### Summary of Relevant Provisions

The American Taxpayer Relief Act of 2012 makes a number of changes to the tax code that may affect nonprofits, including:

- The top tax rate increases from 35 percent to 39.6 percent on taxable income above \$400,000 (\$450,000 for couples). Taxpayers who elect to itemize their deductions can continue to deduct charitable contributions at their full marginal income tax rate.<sup>1</sup>
- The top marginal tax rate on capital gains increases from 15 to 20 percent for taxpayers in the top income tax bracket, increasing the tax benefit for taxpayers that donate appreciated property to charity.
- The overall limitation on itemized deductions (Pease) is reinstated for individuals with adjusted gross income (AGI) above \$250,000 (\$300,000 for couples). The Pease limitation reduces itemized deductions by 3 percent of amount by which AGI exceeds the above thresholds, but not more than 80 percent of the total.
- The estate tax is maintained for estates in excess of \$5 million (\$10 million for couples), indexed since 2010, while the top tax rate increases from 35 percent (in 2012) to 40 percent. This retains some of the Bush-era estate tax cuts, but not the eventual elimination that was temporarily in place in 2010.

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<sup>1</sup> Roger Colinvaux, Brian Galle, C. Eugene Steuerle. "Evaluating the Charitable Deduction and Proposed Reforms." Washington, DC: The Urban Institute, 2012. <http://www.urban.org/publications/412586.html>.

- The charitable IRA rollover provision,<sup>2</sup> which allows up to \$100,000 in tax-free distributions to certain public charities from an Individual Retirement Account (IRA) held by individuals age 70½ or older, was extended until December 31, 2013, with special transition rules for certain distributions made in December 2012 and January 2013.<sup>3</sup> The Joint Committee on Taxation (JCT) estimates the revenue loss from this provision to be \$1.2 billion.<sup>4</sup>
- The enhanced charitable deduction for contributions of food inventory is extended until December 31, 2013. The JCT estimates the revenue loss from this provision to be \$314 million.
- The basis adjustment to stock of S corporations making charitable contributions of property is extended until December 31, 2013. The JCT estimates the revenue loss from this provision to be \$225 million.

## Estimated Impact on Charitable Giving

Overall, the American Taxpayer Relief Act of 2012 (ATRA) is expected to increase giving very modestly relative to 2012, mainly due to the increase in the top marginal tax rate. The following summarizes these effects provision by provision.

### *Impact of Income Tax Changes on Charitable Giving*

Higher Marginal Tax Rate: The tax value of the charitable deduction is equal to a taxpayer's marginal tax rate. For example, an individual in the 35 percent tax bracket will reduce their tax liability by 35 cents for every 1 dollar of contributions, for a net cost of 65 cents. Increasing the top marginal rate from 35 percent to 39.6 percent represents a 7 percent decrease in the after-tax cost of giving for taxpayers in that tax bracket.

Higher Capital Gains Tax Rate: Gifts of appreciated property (e.g., corporate stock, investments, real estate, etc.) receive an additional tax benefit, in that taxpayers do not have to pay capital gains tax on the unrealized gain while recognizing the full market value for purposes of the charitable deduction. A higher capital gains tax rate increases the incentive to donate appreciated

<sup>2</sup> Joseph Rosenberg and Katherine Toran. "IRA Charitable Rollover." Washington, DC: The Urban Institute, 2012. <http://www.urban.org/publications/412634.html>.

<sup>3</sup> Distributions made in January 2013 can be counted towards 2012, a year in which the IRA rollover had expired.

<sup>4</sup> "Estimated Revenue Effects of the Revenue Provisions Contained in an Amendment in the Nature of a Substitute to H.R.8., the 'American Taxpayer Relief Act of 2012,' as Passed by the Senate on January 1, 2013." Washington, DC: Joint Committee on Taxation, 2013. <https://www.jct.gov/publications.html?func=startdown&id=4497>.

property to charity, rather than realize the gain and face capital gains tax. ATRA increased the highest tax rate on long-term capital gains from 15 percent to 21.2 percent.<sup>5</sup>

Impact of the Pease Limitation on Itemized Deductions: The impact of the Pease limitation on charitable contributions is the subject of much confusion. Other than the effect of reduced income, the Pease limitation has negligible effects on the tax incentive for charitable giving. Since the amount of the limitation is based on income and not the amount of deductions, it operates as an effective surtax equal to 3 percent of the taxpayer's marginal tax rate.<sup>6</sup> For example, someone in the new 39.6 percent bracket would often face an effective marginal income tax rate of 40.8 percent ( $39.6\% \times 1.03 = 39.6\% + 1.2\% = 40.8\%$ ). However, contributions would be deducted at the 39.6 percent rate. Pease therefore does create a differential between the tax rate that applies to ordinary income and the tax rate at which charitable contributions can be deducted. To the extent that Congress relies more and more on such types of phaseouts as indirect ways of increasing rates, it does weaken the incentives that would apply with a more transparent tax code.

**Table 1. Impact of ATRA on Charitable Giving, 2013**

Income Percentile	Tax Units		Change in Contributions Under ATRA	
	Number (thousands)	Percent of Total	Amount (\$ billions)	Percent Change
Lowest Quintile	40,520	25.6	0.0	0.0
Second Quintile	36,208	22.9	0.0	0.0
Middle Quintile	31,370	19.8	0.0	0.0
Fourth Quintile	26,062	16.5	0.0	0.0
Top Quintile	23,189	14.7	3.3	2.5
All	158,260	100.0	3.3	1.3
<b>Addendum</b>				
80-90	11,692	7.4	0.0	0.0
90-95	5,736	3.6	0.0	0.0
95-99	4,615	2.9	-0.1	-0.3
Top 1 Percent	1,147	0.7	3.4	6.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0412-8). Changes are estimated relative to TPC's current policy baseline, which assumes that 2012 tax law is extended (except for the payroll tax cut and health care legislation).

<sup>5</sup> Since capital gains are included in AGI, realizing capital gains also generates additional tax liability via Pease. For taxpayers affected by Pease, the top rate would be 21.2 percent ( $20\% + 39.6\% \times .03$ ). Although not a result of ATRA, the new 3.8 percent investment surcharge associated with the health reform legislation takes effect in 2013, increasing the highest marginal rate on capital gains to 25 percent.

<sup>6</sup> Pease could affect the marginal incentive for taxpayers whose disallowed deductions exceed the 80 percent maximum limit. Very, very few taxpayers would fall into this category.

Table 1 shows the estimated changes in individual giving as a result of ATRA by income group. Overall giving is expected to increase by \$3.3 billion or 1.3 percent, relative to 2012 law. The overall gain is almost entirely driven by an estimated 6.2 percent increase by taxpayers in the top 1 percent of the income distribution.

### *Impact of Estate Tax Changes on Charitable Giving*

In general, the estate tax encourages charitable bequests by allowing a deduction against the gross value of the estate. The estate tax rate has fluctuated widely over the past decade. The 2001 tax act gradually lowered the top estate tax rate from 55 percent to 45 percent in 2009, before eliminating the estate tax altogether in 2010. The 2010 tax act extended the estate tax at a 35 percent rate for 2011 and 2012, before it was scheduled to return to its pre-2001 level of 55 percent in 2013.

ATRA retains the \$5 million exemption level for individuals and \$10 million for couples (indexed for inflation from 2010) implemented as part of the 2010 act, but sets the top tax rate at 40 percent. The level of bequests expected under ATRA is likely to fall in between the levels that would have prevailed if the tax rate had been maintained at 35 percent or increased to 55 percent. In a November 2012 publication, the Joint Committee on Taxation reported that decreasing the top estate tax rate from the previously scheduled 55 to 45 percent would lead to a drop in charitable bequests by approximately five percent, from \$32.3 billion to \$30.6 billion in 2013, with similar decreases in future years.<sup>7</sup>

### *Other Provisions*

The combined revenue effect of the remaining provisions, all temporary, is about \$1.7 billion. Assuming a tax rate of about 35% (the highest statutory rates for individuals and corporations in 2012), this implies maximum additional deductions of about \$5 billion. However, some of those contributions would have occurred anyway. For instance, businesses might still have contributed food inventory, and some contributions out of IRA accounts might have been accelerated or been subject to a 50 percent limitation. Thus, the Joint Committee implicitly is assuming a somewhat modest impact on charitable giving.

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<sup>7</sup> “Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation.” Washington, DC: The Joint Committee on Taxation, 2012. <https://www.jct.gov/publications.html?func=startdown&id=4492>.

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