The Effects of the 2017 Tax Reform on Itemization Status and the Charitable Deduction

James Andreoni*
University California, San Diego

Jon Durnford†
Datalake Nonprofit Research

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Abstract

This note summarizes recent IRS data showing steep declines in itemization status from 30% of taxpayers to barely 10% as a result of the 2017 tax reform. Charitable deductions also declined in magnitudes mirroring the loss of the charitable deduction. Perhaps surprisingly, all income groups saw significant reductions in charitable deductions. Low- and middle-income households effectively eliminated from any tax benefits. Even the very wealthy saw their charitable deductions down 20% over 2017. Given that we know donors tend to respond more the existence of a charitable subsidy than to the actual size of the subsidy, this could indicate fall off in donors in the years to come.

*Andreoni is a Distinguished Professor of Economics at the University of California, San Diego, andreoni@ucsd.edu;

†Durnford is President of DataLake Nonprofit Research (datalake.net), a consulting firm based in San Diego, CA, jon@datalake.net.

1 Introduction

The Tax Cuts and Jobs Act of 2017 that took effect in 2018 had two features that could have adverse impacts the charitable sector of the economy. First, it lowered marginal tax rates for most Americans. For those itemizing deductions, this means the subsidy to charitable giving will go down, creating a higher cost to giving and a weakened incentive to give.

Second, and perhaps more consequentially, the new tax law raised the standard deduction for a married couple from $12,700 in 2017 to $24,000 in 2018. This means that those with itemized deductions above $12,700 but below $24,000 will lose their itemization status and, as a result, they lose their charitable deduction. For these taxpayers, the cost of giving rises all the way to 100% of their gift. For the lowest income group, losing the itemized deduction means increasing in the cost of giving by about 11% (from 0.9 to 1), while for the highest income group losing the deduction will raise the cost of giving by nearly 58% (from 0.60 to 1). For those who maintain their charitable deduction, the price increase is rather small, ranging from an increase of less than 1% for low incomes to 5% for large incomes.[1]

There may be reason to believe that many people did not fully understand or anticipate the effect of the tax changes on their itemization status or marginal tax rates during the tax year 2018 itself. The bill was enacted relatively quickly, being introduced on November 2, 2017 and signed into law on December 22, 2017, allowing little time for the public at large to understand the consequences for their charitable activity before the new tax year began. Moreover, the federal law interacted with state tax laws, adding to the complexity of understanding the law's effects. We expect that many households may have only learned of consequences of the new law after filing their 2018 tax returns, which will make 2019 a more informative time to measure the law's effects on behavior. The purpose of this note presage some of these anticipated behaviors so that charities can react to the new giving landscape.

Evidence of or claims from this data have already begun to be seen by the Fundraising Effectiveness Project (FEP). Through analysis of individual donations to more than 20,000 charitable organizations, the FEP has forecast a steep decline in the number of givers and in dollars collected in 2019. For the first quarter, the FEP indicated number of donors dropped 5.7% relative to 2018, while dollars collected fell 2.2%. The report also documented a clear shift of fundraising efforts to pursue "major donors" who are capable of giving over $1,000 per year.

2 The Data

In mid-July,2019, The Internal Revenue Service revealed the first report on 2018 tax filings. Although there will be another report in the fall including filers who requested extensions, the comparison between the 2017 and 2018 returns from the same time period show negligible differences in areas unrelated to the tax reform, thus we expect the fall report to have a similarly negligible effect on what we find here.

[1] For a full discussion of how tax price and AGI affect giving in empirical studies, see Andreoni (2006) and Andreoni and Payne (2013)

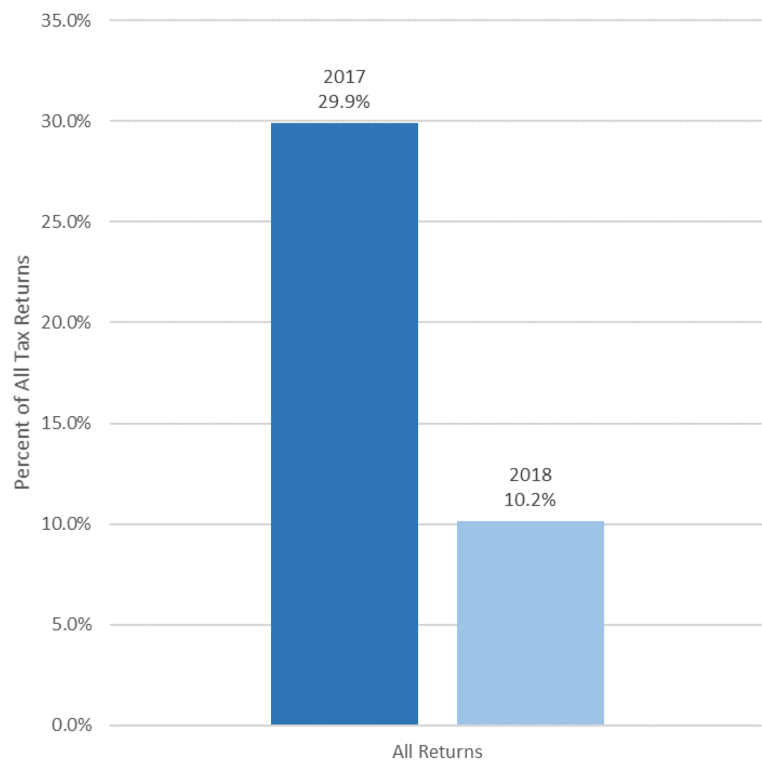

Figure 1: Change in Itemization Status 2017 to 2018

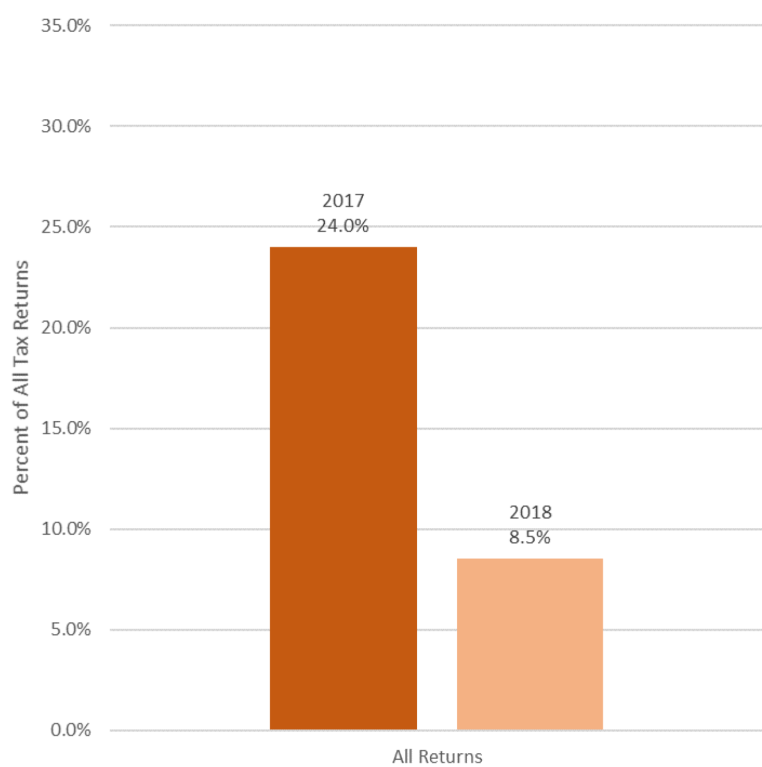

Figure 2: Change in Percent of Filers Claiming a Charitable Deduction

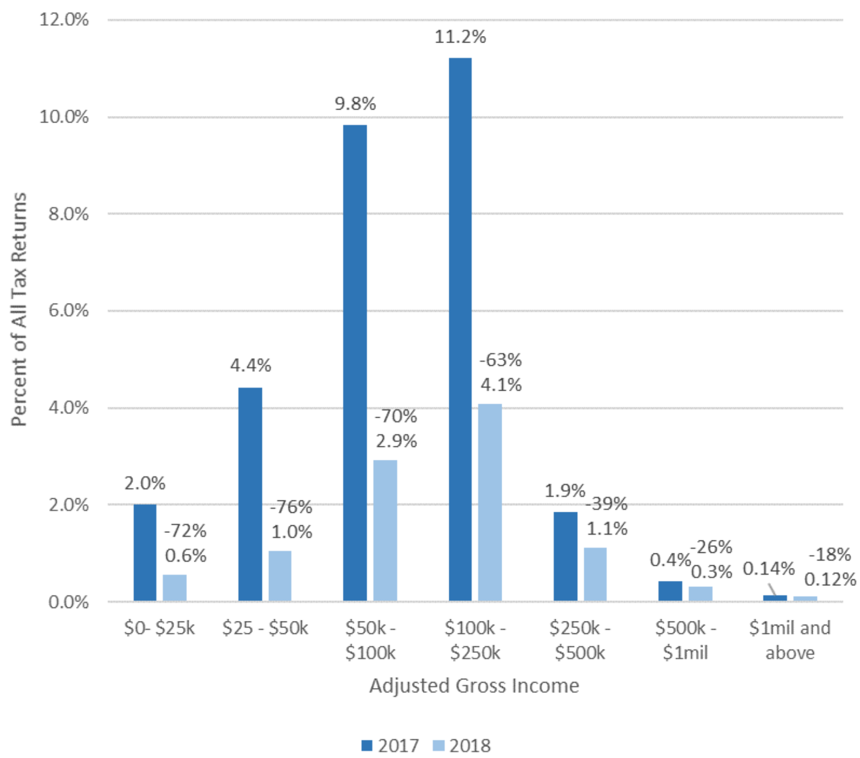

Figure 3: Itemization Status as a Percent of All Returns by AGI Category

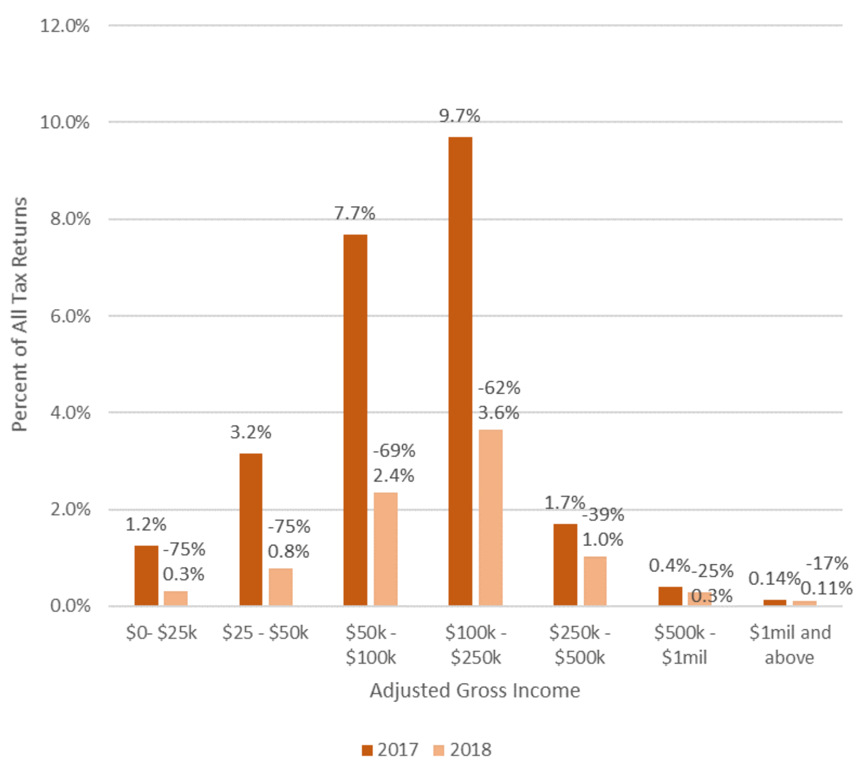

Figure 4: Charitable Deductions as a Percent of All Returns by AGI Category

Figures 1 and 2 illustrate the aggregate findings.[2] We see in Figure 1 that in 2017 nearly 30% of tax filing households could itemize their taxes and thus qualify for a charitable deduction, and we see in Figure 2 that 24% of filers did take a charitable deduction. In 2018 the number qualifying for itemization status fell to 10.2% , and 8.5% actually took a charitable deduction. This means that the number of people who can benefit from giving to tax-exempt organizations in 2018 was *one third of what it was in 2017*, and comprised only *one tenth of the population* of taxpayers.

Figure 3 gives a disaggregated view of the change in itemization status. As expected, the 2018 tax law had a disproportionate impact on households with AGI below $250,000, but especially for those with AGI below $100,000. The number of itemizers among those with incomes from $1 to $100,000 fell by over 70%. Those with AGI below $50,000 who also itemize has been reduced to just 1% of all tax filers. The largest group of itemizers has AGI between $100,000 and$250,000. Their number of itemizers has been slashed from 11.2% of all tax filers to just 4.1%, a decline of 64%. For higher income group, the loss of itemization was, as expected, relatively smaller. Still the numbers are not trivial, going from 39% losing itemization at incomes from $250,000-$500,000, and 18% among millionaires and above.

Figure 4 disaggregates the data in Figure 2 and on the charitable deduction. Again, groups with incomes groups below $50,000 are now largely excluded from the benefits of giving to the nonprofit sector. The largest group, those with AGI of $100,000-$250,000, comprises 15% of the population of taxpayers, yet only a quarter of them (3.6% of taxpayers) are claiming a charitable deduction. Comparing Figures 3 and 4, the percent reductions in charitable deductions appears to track very closely to the percent reduction in itemization status, indicating that the changes in the law governing itemization is the primary driver in reduced deductions. This is not surprising given both the small change in tax rates for itemizers and the anticipation that the behavioral effects will be seen more fully in 2019.

Figure 5 graphs the charitable deduction as a percent of AGI for each of the income categories. While this is an incomplete picture of the behavioral changes as we don't have data on giving by non-itemizers. Figure 5 nonetheless helps us understand the differential effects of the tax cut by AGI. The overall effect is to lower giving from 1.7% of AGI from in 2017 to 1% in 2018, a decline of 40%. The negative effects of the tax changes are most severe in those most affected by reduction in itemization status—giving as a percent of AGI fell by nearly a full percentage point for those with AGI between $50,000 and $250,000. Those with AGI over $1 million were affected the least, with deduction falling by only 0.3% of AGI.

3 The Full Effects

Will the tax cuts put enough money in people's pockets that this can ignite enough additional generosity to offset the loss in the charitable deduction?

The bars in Figure 6 show the difference in average real tax liabilities between 2017 and 2018, per household. These numbers should give us some indication of the increase in disposable income in each AGI bracket due to the tax cuts. The maximum decrease in

[2] All figures are authors' calculations from IRS data, available at https://www.irs.gov/statistics/filing-season-statistics.

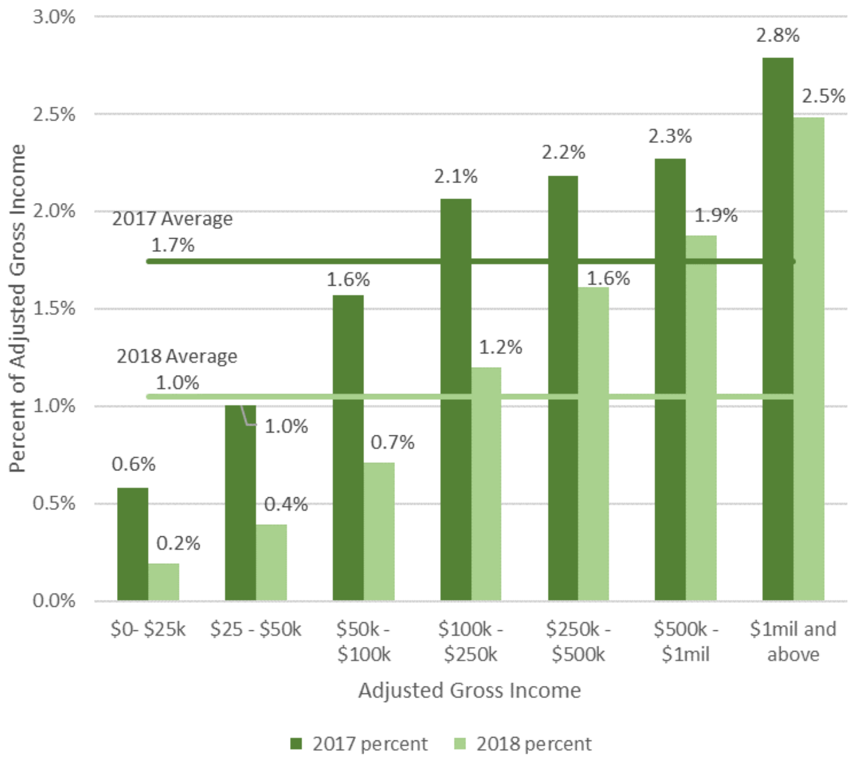

Figure 5: Charitable Deductions as a Percent of AGI

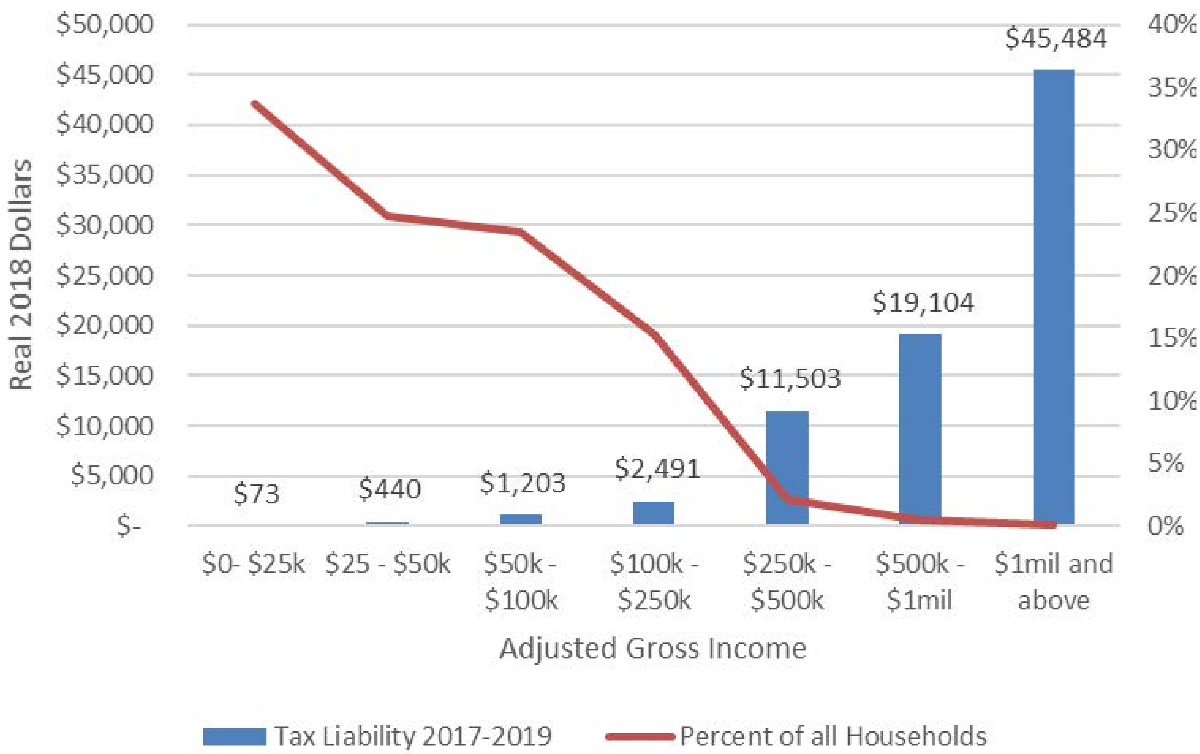

Figure 6: Tax Liability Per Household in 2017 less Tax Liability in 2018

tax liabilities went to the very top AGI group, at over $45,000 per tax paying household. The lowest AGI group netted just $73 by comparison. The middle AGI groups received from $1200 to $2,500.

In contrast, these lower income groups are far more numerous than the extremely wealthy. The red line in Figure 6 shows the fraction of the entire sample in the AGI group. As can be seen, the households who we anticipate received the most significant tax cuts are also the in the least populous AGI categories. This data puts charities in a quandary; do they devote resources to gaining big donations from a very small group of people or do they focus on middle income donors what may not give large sums, but could give in large numbers?

4 Implications for 501(c)(3) organizations.

The main reasons for forming an organization as a 501(c)(3) public charity are, first, to prevent managers from profiteering off of the activities of the organization. The second reason is allow donors to deduct their gifts from taxable income. If organizations find they rely on the tax deduction to motivate donors, this could impede their annual fundraising.[3] This new tax law now would appear to potentially put the 501(c)(3) organizational form in some peril by undermining the primary benefits of public charity status, while putting onerous constraints on the managers.

Alternative organizational forms to 501(c) status are also available in some states, known as *benefit corporations*. "B-corp" organizations are for-profit corporations with the distinction that they are not required to maximize the profits of their owners. At the same time, the investors in the B-corp can withdraw some of the gains made by the organization, as any for-profit organization can, although the investors typically expect a below-market return. They view this lower return as their charitable contribution. Since the lower return represents income not received, it is also not taxed and thus the B-corp structure can effectively restore tax detectability to donors/investors with the means to invest in a B-corp.

5 Conclusion

The immediate impact of the Tax Cuts and Jobs Act of 2017 is to limit the charitable tax deduction to about 10% of the tax-paying population, over half of whom have incomes over $100,000. The financial impact on the nonprofit landscape may take several more years to measure, but the outcome of this legislation is fairly clear. Federal incentives first enacted more than a century ago—in 1917—to promote participation by all individuals in supporting a diverse and vibrant charitable sector have been significantly altered. Both the privilege and responsibility of supporting the charitable sector—and choosing which organizations to support—has now fallen even more heavily on those with the highest incomes and wealth.

[3]There is evidence to suggest that givers respond to the existence of a subsidy to giving, but less so to the size of the subsidy, and the difference is mainly on whether to give or not rather than the decision of how much to give. See Karlan and List(2007), and Huck and Rasul (2011). In addition, sudden changes in funds raised can have existential consequences of both kinds for small charities, as discovered by Andreoni, Payne, and Smith (2014).

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