



the impact on the charitable deduction of the new phaseout of itemized deductions

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As has been widely reported, a concerted effort by a coalition of charitable organizations in the middle of the "fiscal cliff" negotiations successfully preserved the charitable contribution income tax deduction against proposals from both the Administration and members of Congress to cap or otherwise limit the charitable deduction. The celebration over this legislative victory was muted, however, as a result of the return to the Internal Revenue Code of the phaseout of itemized deductions. Many in the charitable sector view this phaseout as somehow taking back some of the hard-earned victory to preserve the charitable deduction. Charitable gift planners are concerned that the phaseout will reduce tax incentives for charitable gifts and therefore result in reduced giving. However, for most donors this is simply not the case.

The phaseout of itemized deductions under the American Taxpayer Relief Act of 2012 will not reduce the value of charitable contribution deductions for most taxpayers. It is critically important for gift planners to educate donors on this point, and to demonstrate that charitable contribution deductions will in most cases be unaffected by the new tax act.

Mechanics

Starting in 2013, itemized deductions are phased out for taxpayers with adjusted gross incomes above a threshold, which is \$300,000 for married taxpayers filing jointly, \$250,000 for single taxpayers, \$275,000 for heads of households, and \$150,000 for married taxpayers filing separately. These thresholds will be adjusted for inflation. The reduction resulting from this phaseout is the lesser of (a) 3% of the excess of adjusted gross income over the threshold or (b) 80% of otherwise allowable itemized deductions.

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Example 1

Assume that a married couple with an adjusted gross income of \$1 million resides in a high-tax state like California or New York. We know that the potential reduction in their itemized deductions will be \$21,000, that is, 3% of \$700,000, the amount by which their AGI (\$1 million) exceeds the threshold (\$300,000). The couple plans to make a charitable contribution of \$100,000. Their other itemized deductions are state and local taxes, including property taxes, of \$150,000, and home mortgage interest of \$50,000. Thus, their total itemized deductions of \$300,000 will be reduced by \$21,000 to \$279,000. Assume for a moment that no charitable contribution is made. In this case, the other deductions of \$200,000 will be reduced by the same \$21,000, with \$179,000 after the reduction. In other words, *the full amount of the charitable contribution deduction of \$100,000 is unaffected by the new phaseout rule.*

The key point of Example 1 is that high-income donors living in states with a state income tax will be unaffected by the new phaseout rules.

Example 2

But what if the donors reside in a state like Florida or Wyoming with no state income tax, and own their home(s) free and clear, so they have no mortgage income tax deduction. Assume the same couple with AGI of \$1 million whose only other itemized deduction is property taxes of \$50,000. Their itemized deductions will be reduced by the same amount as in Example 1, \$21,000. If they make a charitable contribution of \$100,000, their total itemized deductions of \$150,000 will be reduced to \$129,000. However, had they not made the gift, their property taxes of \$50,000 would have been reduced by the same \$21,000 to \$29,000. Again, even for donors residing in a state with no income taxes and who have no mortgage interest expense, the offset applies to the nondiscretionary itemized deduction for property tax, meaning that *the charitable deduction is not affected by the phaseout.*

So who would be affected? Can we conjure a situation in which the phaseout from the new tax act would reduce a donor's tax incentive to make a charitable gift?

Example 3

Assume the same couple with an AGI of \$1 million lives in a state with no income tax and pays neither home mortgage interest nor property taxes because they rent the dwelling they occupy in a retirement community. Their only itemized deduction is a charitable gift of \$100,000. In this situation, the reduction of \$21,000 would offset the charitable deduction of \$100,000, meaning that only \$79,000 of the \$100,000 gift will actually be deductible.

The takeaway is that, as is often the case, it is important not to overreact to the headlines. Gift planners will perform a service to the charitable sector by familiarizing themselves with the mechanics of the phaseout of itemized deductions to enable them to demonstrate to prospective donors when these rules will – and will not – reduce the tax benefits of making a charitable gift.