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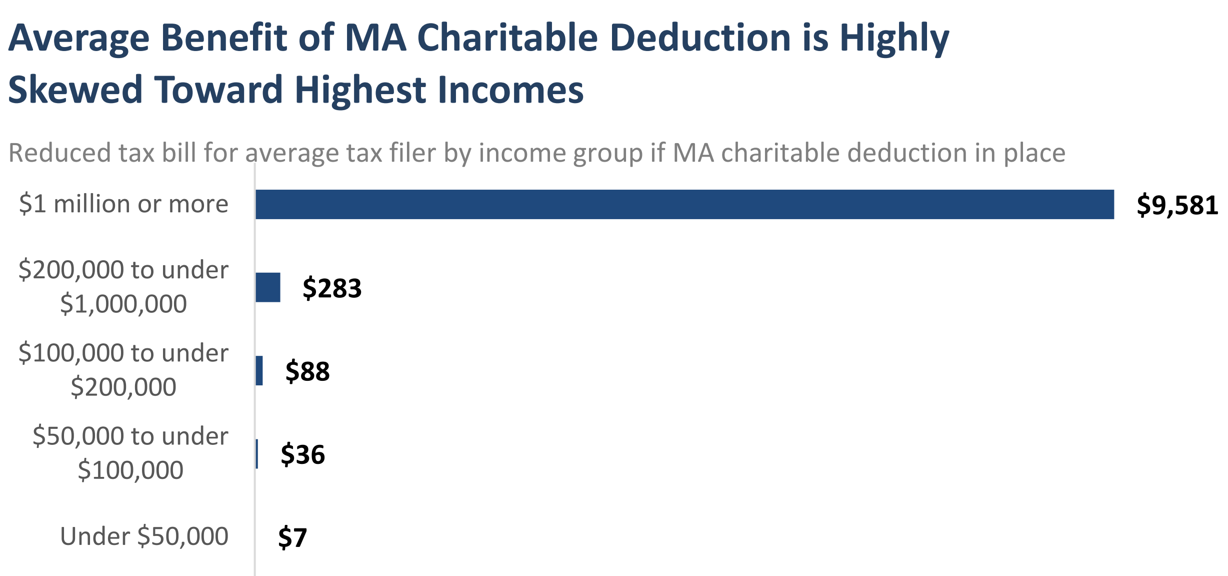
Wrong time for Massachusetts to introduce a charitable tax deduction?

Are there ways to stem revenue loss and limit subsidy to high incomes?

By *Phineas Baxandall*

The Covid-19 pandemic and the ensuing economic downturn have sharply reduced the revenue our Commonwealth collects to pay for schools, roads, public health, and other public functions. Meanwhile, the crisis requires the Commonwealth to spend more on unemployment, safety, social distancing and other investments. With less revenue available to meet rising needs, it will be a challenge to adequately fund the coming Fiscal Year 2021 budget and prevent budget cuts from holding back our economic recovery.[1]

A new tax subsidy initially approved two decades ago, the state charitable deduction, is set to automatically go into effect in January 2021. This deduction would further reduce state revenue by about $300 million annually. This ill-timed revenue loss will make it harder to avoid budget cuts to essential services, including public health, childcare, and many other supports we all rely on. The potential benefits from introducing a state counterpart to the federal charitable deduction are uncertain, but Internal Revenue Service (IRS) data indicate that a majority of the financial benefits will go to those with annual incomes over $1 million.



Based on IRS Stament of Income, 2017 federal tax filings by Massachusetts residents. Actual benefits are likely to be even more skewed because lower-income filers are less likely than higher-income filers to have remaining taxable income to offset. The average tax filer for each income group is calculated by dividing the group's total deductions by its total number of filers.

What is the State Charitable Deduction and Why is it Happening Now?

Presently, tax filers who contribute a gift to a tax-deductible organization can claim that amount as a deduction to reduce the amount of their income subject to federal taxes. Massachusetts residents claimed $6.8 billion in charitable contributions on their federal taxes in 2017, the most recent year for which the IRS has published data. High-income contributors can effectively recoup 37 cents on the dollar on their federal taxes by claiming a charitable deduction, which likely encourages some tax filers to make charitable gifts – at least among those who itemize and give to eligible organizations.

It is unclear whether the ability to claim an additional 5 percent (or 5 cents on the dollar of a gift) on Massachusetts state taxes would affect charitable contributions – especially among the large majority of tax filers who do not itemize on their federal taxes. It is also debatable whether minor inducements for contributing to charitable organizations are enough to justify the large reduction in revenues available for public investment.

Two decades ago, Massachusetts voters approved a ballot question to introduce a state charitable deduction along with cuts to the state income tax. Unfortunately, after voters approved these rate decreases and deductions, a steep recession occurred in 2001-2002. Facing severe tax revenue shortfalls and the prospect of crippling budget cuts, the Legislature delayed the subsequent tax rate reductions.

The 2002 law protected the public from cuts to programs they depended on by ensuring that each income tax rate cut would only occur at times when revenues were growing robustly.[2] Baseline annual revenue growth had to be certified as having grown at least 2.5 percent faster than inflation during the prior fiscal year and also to exceed inflation during the previous three-month period ending in December.

These safety valves were not included for the law's final tax cut, the introduction of a state charitable deduction. Despite being a larger revenue loss, the law automatically activated the deduction the year after the personal income tax rate was reduced to 5.00 percent – which happened last year. As a result, the charitable deduction will automatically be activated on January 1, 2021.

The Massachusetts Department of Revenue (DOR) estimates the charitable deduction would reduce tax revenue collections for the Commonwealth by about $300 million in Tax Year 2021.[3] Revenue losses would begin with lower estimated tax filings in January, which is the middle of Fiscal Year 2021. DOR forecasts that losses would increase each year, reaching $330 million by Tax Year 2024.

In deriving these estimates, the DOR adjusted for two ways that a state charitable deduction next year would work differently than the available IRS data on Massachusetts deductions. On the one hand, a new Massachusetts deduction could result in deeper revenue losses than the IRS data suggests because Massachusetts would allow filers who do not itemize on federal taxes to nonetheless claim the less valuable Massachusetts deduction. This might particularly encourage low- and middle-income filers who opted for the standard deduction to claim state deductions they didn't claim on their federal taxes. On the other hand, whether tax filers claim the relatively smaller state deduction may depend largely on whether they claim the federal deduction. Since 2018, a major increase to the federal standard deduction discourages low- and middle-income tax filers from itemizing deductions and therefore from claiming any charitable deduction. DOR anticipates that the impact of this further discouragement of low- and middle-income deductions will be about twice as strong as the state encouragement from allowing deductions from federal non-itemizers.[4]

Benefits Are Skewed Toward the Highest Incomes

Adding a state charitable deduction would impact Massachusetts residents of all incomes as fewer resources would be available for education, public health, transportation, affordable housing, and other programs funded through our state budget. Meanwhile, the tax benefits of a charitable deduction would be heavily skewed toward those with the highest incomes. The most recently published IRS data on Massachusetts tax filing in 2017 makes this clear:

- The average tax filer in Massachusetts with a taxable income under $50,000 deducted $140 in charitable giving on their federal taxes.[5] Given Massachusetts' 5 percent personal income tax rate, a tax filer who claimed this deduction on their state taxes could reduce their tax bill by a maximum of $7 dollars.

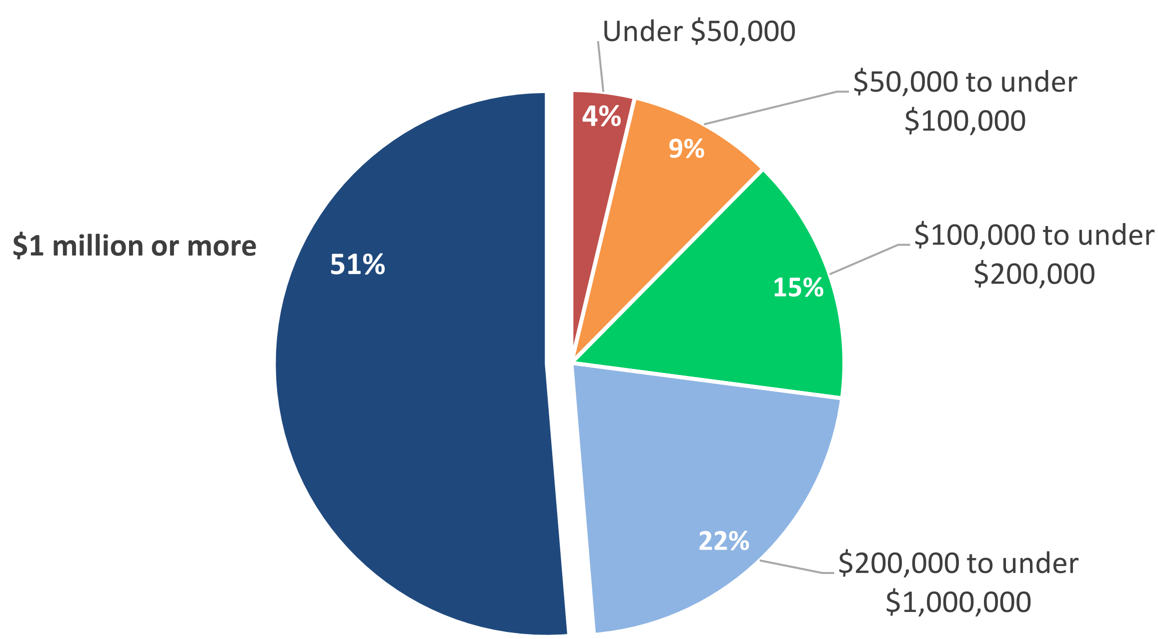
- Similarly, the average tax filer with a taxable income between $50,000 and $100,000 deducted $716 in charitable giving on their federal taxes. They could reduce their tax bill by a maximum of $36.

- Those two groups with taxable incomes below $100,000 together represent over three quarters of all Massachusetts tax filers.[6] Yet they claimed only one-eighth of the value of all charitable deductions. Likewise, 92 percent of tax filers earn taxable incomes of $200,000 or less; but this large majority of households together claimed only a bit over a quarter of charitable deductions.

- Tax filers with an income over $1 million represent only 0.5 percent of all filers; but they claimed a majority, 51.3 percent, of all charitable deductions in Massachusetts. On average, filers in this group claimed almost $200,000 in charitable deductions, an amount that would likely reduce their state tax bill by almost $10,000.

Most Charitable Deduction Dollars Go to Incomes Over $1 Miilion

Percent of benefits from MA charitable deducation, by income group (2017)



Higher-income households certainly have more money to give away and consequently tend to give larger dollar amounts than households with less income. However, even considering these differences in income, charitable tax deductions are heavily skewed toward the top. The average income for tax filers with incomes over $1 million is 68 times the average income of tax filers with incomes under $200,000. But the average charitable deduction claimed by the highest income group is 333 times larger.

Our state and local tax systems already require low- and middle-income households [to pay a larger share of their income] in taxes than the very highest-income households do. Those in the bottom 20 percent of Massachusetts incomes pay an average of 10.0 percent of their income in total state and local taxes; the middle 20 percent pay an average of 9.3 percent of their income, and those with the highest 1 percent pay an average of 6.8 percent of their income.[7] A state charitable deduction would add to this disparity.

In addition to deductions from charitable giving being highly concentrated among the highest-income households, the contributions themselves are heavily concentrated among the largest nonprofits. According to national IRS data, 56.3 percent of contributions go to organizations with assets over $50 million.[8] Organizations with less than $1 million in assets receive only 7.5 percent of contributions.

One reason the tax benefits for charitable giving are skewed so heavily toward high-income households is that federal tax filers only can deduct their charitable giving if they itemize their deductions.[9] For most moderate- and low-income people, it makes more sense to take the larger (and simpler) standard deduction. For very high-income people, the standard deduction represents only a small portion of their income and they pay a substantially higher marginal tax rate, prompting the vast majority to itemize deductions – including claims for charitable deductions.

A Massachusetts charitable deduction would have different rules because it could be claimed even by those who don't itemize on their federal taxes; but decisions about whether people claim a state charitable deduction are apparently driven more by whether they claim the larger federal deduction. On the one hand, the Massachusetts DOR anticipates the that claims by those who take the federal standard deduction will increase use of the state charitable deduction. On the other hand, the much larger federal standard deduction, instituted in 2018, will have a strong impact in discouraging charitable deduction claims, especially for low- and middle-income people.

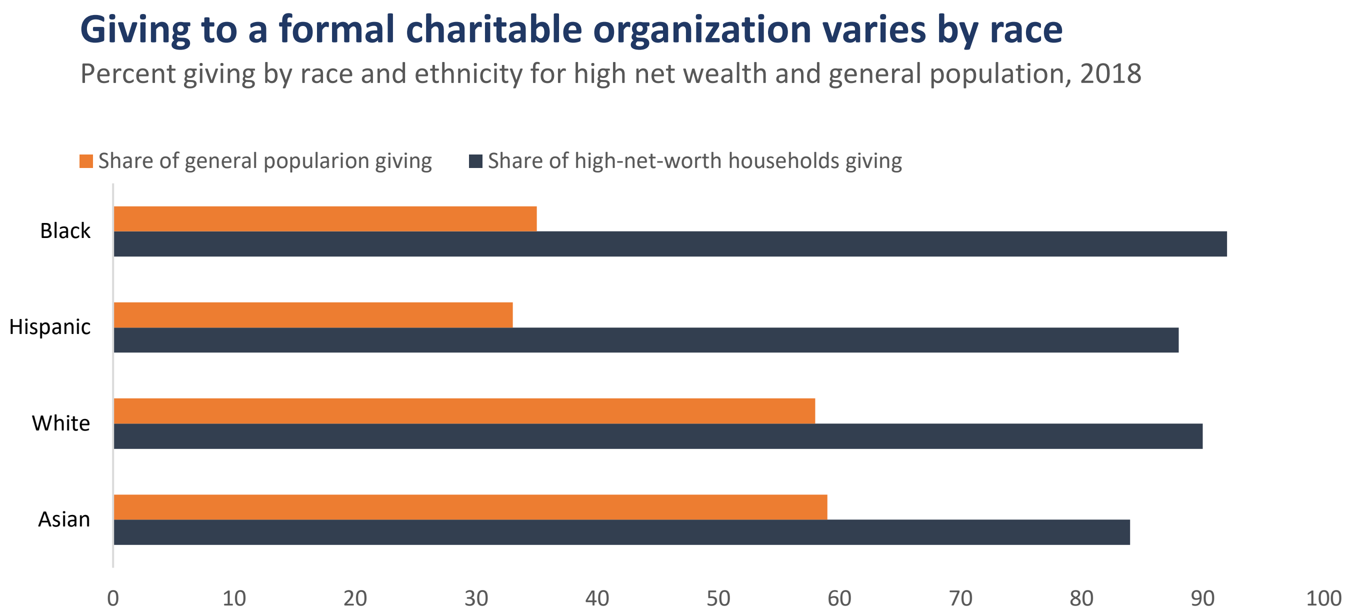
Higher-income people may also claim a larger share of the charitable tax deduction because they may be more likely than lower-income people to give to organizations that are formally registered as tax deductible, as opposed to less formal donations to friends, a church, or other needy individuals.

The tax benefits of a charitable deduction also fall starkly along racial lines. This is in part because people of color tend to have lower incomes as a result of systematic barriers and a long legacy of racism. Whites may also direct a greater portion of their giving to registered tax-deductible organizations. According to the Tax Policy Center, "Almost 60 percent of White and Asian households gave to formal charitable

Itemized deductions vs. standard deduction

Deductions reduce the amount of income that is subject to tax. For instance, Massachusetts allows people to reduce how much income is subject to tax by listing on their taxes ("itemizing") certain expenditures, such as for childcare or commuting to work. For calculating *federal* income taxes there is another set of deductions that can be listed (itemized) *or* taxpayers can forgo these federal deductions and instead simply take a preset (*"standard"*) deduction amount based on their family type (single, married filing jointly, or head of household).

organizations in 2015 compared with a third of Black and Hispanic households."[10] But Blacks and Hispanics with high net worth, contribute to formal organizations at similar rates as Whites – Black rates are even slightly higher.



Targeting benefits and limiting revenue loss from a charitable deduction

Well before the COVID-19 pandemic, when revenues were projected to grow steadily, Governor Baker already signaled doubt about automatically introducing a state charitable deduction. In January 2020, the Governor's budget proposal called for DOR to examine revenue estimates, "for alternative options including, but not limited to, reducing the charitable deduction percentage and capping the deductible amount per taxpayer." If there was a case for limiting and deferring the deduction, it has certainly become stronger as the COVID-19 pandemic will force lawmakers to offset billions of dollars in lost revenues in order to avert budget cuts that would stifle economic recovery.

Lawmakers could explore ways to reform the charitable deduction that would stem revenue loss and make benefits less skewed toward tax filers with the highest incomes. A decision whether to introduce a reformed deduction could wait until policymakers better understand the alternatives and how different paths would impact revenues and taxpayers of different incomes.

There is no shortage of alternatives that could be explored and combined.[11]

- Vermont, in 2018 changed, their charitable deduction to a non-refundable credit capped at 5 percent of the first $20,000 contributed – thus limiting the subsidy for charitable deductions to $1,000 per filer and making it less regressive.[12] Massachusetts could cap the amount at a lower level to limit revenue losses.

- The deduction itself could also be made partial, so that only a portion of a charitable contribution could be deducted. For instance, 2 percent of a contribution could be deducted from taxable income rather than the full 5 percent. To make the deduction more progressive, the first few hundred dollars could be fully deductible with subsequent contributions made partially deductible. This would limit the extent to which the biggest contributions would receive the biggest subsidies.

- The opposite approach would be to allow deductibility only for exceptionally high contributions that exceed a particular floor. This might aim to incentivize contributions beyond the levels that people would ordinarily give. It would, however, focus subsidies even more among those with the highest incomes, unless the floor was set relative to income. For instance, charitable deductions might be applied only to the portion of a filer's contributions that exceed 7 percent of their income. Thus, it would reward high- and low-income filers, but only if they contributed an exceptionally high portion of their income to charity.

- The state deduction could be made available only to those who do *not* itemize on their federal income taxes. The highest-income contributors generally would continue to itemize federally because of the significantly higher federal tax rate. This approach would focus resources on prompting low- and middle-income tax filers, who might not claim deductions, to do so.

- There might be a way to restrict charitable deductions to contributions given to smaller nonprofits. Doing so, however, would likely create significant administrative challenges.

If lawmakers stop the automatic introduction of the new tax deduction, it would both create fiscal breathing room during the current recession and buy time to best consider the alternatives.

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[1] Federal Reserve Bank of Boston, "Economic Fallout of the COVID-19 Pandemic in New England" April 2020 at https://www.bostonfed.org/news-and-events/news/2020/04/neppc-covid-analysis.aspx

[2] MassBudget, "Automatic Income Tax Rate Cuts: Frequently Asked Questions," (Dec. 2014) at https://www.massbudget.org/report_window.php?loc=Facts_Automatic_Income_Tax_Rate_Cuts.html

[3] Department of Revenue, "Revenue Impact of Reinstatement of the Charitable Deduction in 2021," April 29, 2020 memo to the Senate Working Group on the Future of Taxation. DOR's analysis begins by using IRS published data for the 2016 tax year for its initial estimates. These findings, including those on the top 1 percent of income filers' share of the deductions, match earlier analysis by MassBudget published in a February 2019 report, "Why Highest Incomes in Massachusetts Receive Most Benefits from Charitable Deduction." MassBudget's analysis on the distribution of benefits in the present report differs slightly because it uses more current 2017 tax year data from the IRS. Compared to analysis based on the 2016 data, the more current data suggest that revenue losses will be about 10 percent higher and benefits slightly more skewed toward the highest-income filers. After subsequent adjustments based on changes to the standard deduction and different state rules allowing deductions, DOR estimates a midpoint revenue reduction of $298 million for Tax Year 2021. Reduced income tax payments will reduce Fiscal Year 2021 revenues by a midpoint estimate of $64 million.

[4] The Department of Revenue's April 29, 2020 memo to the Senate Working Group on the Future of Taxation suggest that higher federal standard deduction amounts that reduce itemization, will reduce revenue losses by about 22 percent. Partly counteracting this effect, DOR estimates the ability for federal non-itemizers to deduct charitable contributions at the state level would increase revenue losses on the order of 12 percent. Both of these impacts are overwhelmingly for middle- and low-income filers because high-income filers almost always itemize and continue to have a strong incentive to do so. (See Tax Policy Center "Reforming Charitable Tax Incentives: Assessing Evidence and Policy Actions," (November 2018), p 3, at https://www.taxpolicycenter.org/sites/default/files/publication/156165/reforming_charitable_tax_incentives_assessing_evidence_and_policy_options.pdf#page=3). DOR estimates the revenue impact from federal changes discouraging middle- and low-income filers from the large federal deduction is significantly greater than the impact of allowing state deductions by federal non-itemizers suggests that the net effect of these changes will therefore skew the benefits of a charitable deduction even *more* heavily toward the highest-income filers. The DOR's conclusions are consistent with those of the Penn-Wharton Budget Project, which analyzes the likely impacts of a temporary 2020 federal tax filing change that allows non-itemizers to claim up to $300 in Covid-19

related deductions. They conclude that, "the new deduction would likely do little to spur giving." See Penn-Wharton Budget Project, "New charitable deduction in the CARES Act: Budgetary and Distributional Analysis (March 2020) at https://budgetmodel.wharton.upenn.edu/issues/2020/3/27/charitable-deduction-the-cares-act

[5] Analysis based on IRS, Statistics of Income Division, Individual Master File (2017), Table 2.

[6] Tax filers with taxable incomes up to $100,000 represents a larger portion of the middle- and upper-middle class than it might seem because this represents income after deductions, exemptions, and credits have been applied.

[7] "Who Pays? Low and Middle Earners in Massachusetts Pay Larger Share of their Income in Taxes" (MassBudget 2018), http://www.massbudget.org/report_window.php?loc=Who-Pays-Low-and-Middle-Earners-in-Massachusetts-Pay-Larger-Share-of-their-Incomes-in-Taxes.html

[8] IRS Statistics of Income, Charities & Other Tax-Exempt Organization Statistics, Table 1. Form 990 Returns of 501(c)(3) Organizations: Balance Sheet and Income Statement Items, by Asset Size, Tax Year 2016, at https://www.irs.gov/statistics/soi-tax-stats-charities-and-other-tax-exempt-organizations-statistics. Calculations of contributions exclude government grants, membership dues, campaign from a federation, events, and contributions from other organizations. Data published September 2019; does not include private foundations, most organizations with receipts less than $50,000, most churches, and certain other types of religious organizations.

[9]According to national estimates by the Urban-Brookings Tax Policy Center, in 2017 almost all charitable contributions by those with the highest 1 percent of incomes received a tax deduction. Among middle-income earners, just over half of contributions receive a deduction. And among low-income earners, only 15 percent of charitable gifts receive the benefits of a tax deduction. These disparities are expected to have grown substantially starting in 2018. See Urban Brookings Tax Policy Center, "Reforming Charitable Tax Incentives: Assessing Evidence and Policy Actions," Tax Policy Center (November 2018), p 3, at https://www.taxpolicycenter.org/sites/default/files/publication/156165/reforming_charitable_tax_incentives_assessing_evidence_and_policy_options.pdf#page=3

[10] Tax Policy Center, "Charitable Giving" in "Racial Disparities and the Income Tax" (January 2019). https://apps.urban.org/features/race-and-taxes/#charitable-giving

[11] See, for example, Congressional Research Service, R45922, "Tax Issues Relating to Charitable Contributions and Organizations," (Sept. 2019) at https://crsreports.congress.gov/product/pdf/R/R45922

[12] State of Vermont, "Vermont Charitable Reduction Cap," at https://tax.vermont.gov/individuals/income-tax/charitable-contribution-credit