



Limitations on Income Tax Charitable Deductions – Simple and Complex Aspects

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The income tax charitable deduction reduces a taxpayer's reportable income. It does not reduce the income tax due on a dollar-for-dollar basis. For example, consider a taxpayer with a marginal income tax rate of 24%. If the taxpayer makes a charitable gift of \$10,000 that is fully deductible, the income tax savings is not \$10,000. Instead, the donor's reportable income is reduced by \$10,000, with tax savings in this case being 24% of \$10,000, or \$2,400.

The ability to use the income tax charitable deduction has limitations, however. It is a basic tax principle that a taxpayer cannot reduce her reportable income to zero using the income tax charitable deduction. Some limitations on the ability to use the charitable deduction are tied to the amount of the donor's income. Other limitations relate to the type of charity or type of property donated.

Limitations Related to the Donor's Income

The deduction that a donor can claim in one tax year for gifts to a public charity is limited by the donor's adjusted gross income (AGI). AGI is defined as gross income that is not considered tax-exempt and adjusted for specific deductions. Some of these adjustments to income were modified by the Tax Cuts and Jobs Act of 2017 that became effective January 1, 2018. Miscellaneous itemized expenses such as employee business expenses, heretofore a reduction of gross income subject to IRS limitations, are no longer deductible. However, contributions to certain retirement arrangements, such as 401(k)s and IRAs, still reduce AGI and were not affected by the new tax law.

Limitations Related to the Type of Charity

Income tax charitable deductions are also limited depending on the type of organization to which the gifts are made. Public charities as described in IRC § 170(b)(1)(A) are deemed 50% limit organizations. Organizations described in IRC § 170(c), of which a private nonoperating foundation is the most common example, are deemed 30% limit organizations. These

percentages refer to limitations based on the donor's AGI for the amount of the charitable deduction in any one tax year that a donor can use for gifts to these organizations.

Limitations Related to the Type of Property Donated

Once a taxpayer determines her AGI for a given tax year, her income tax charitable deductions for gifts to public charities are limited based on the type of property donated.

Gifts of Cash

The Tax Cuts and Jobs Act of 2017 introduced a new 60% limitation for gifts of cash to public charities. Under the new tax law for gifts of cash, the donor can use the charitable deduction for up to 60% of AGI, an increase from the old law that limited the use of the deduction for gifts of cash to 50% of AGI.

Gifts of Long-Term Gain Property

The use of the charitable deduction for gifts of appreciated property qualifying for long-term capital gain tax treatment (i.e. owned for at least one year), such as real estate and publicly traded securities, remains unchanged in the new tax law. These gifts may be deducted only to the extent of 30% of the donor's AGI in any one tax year. This 30% limit operates within a larger 50% overall limit: if a donor takes cash deductions equal to 30% of AGI, then the donor can take deductions for contributions of long-term gain property up to another 20% of AGI ($50\% - 30\% = 20\%$). It is unclear whether the 2017 Tax Act increased the 50% overall limit to 60%. See below for more discussion of this question.

Gifts of Short-Term Gain Property

Gifts of short-term gain property (i.e. owned for one year or less) have a different limitation. For these gifts, the allowable charitable deduction requires that the market value be reduced by the amount of the gain such that effectively the deduction is limited to the cost basis. The use of the deduction in this case is 50% of AGI. The 50% of AGI rule also applies to gifts of inventory and property subject to depreciation.

Deduction Carry Forward

The donor may carry forward unused deductions of each type for up to an additional five tax years. Keep in mind that the carryforward doesn't count in the year of the gift. Therefore, the deduction may be taken on six tax returns, one in the year of the gift and on up to five more returns in the future.

The 30%/50%/60% deduction limitations described above apply to gifts made to public charities. The relevant limitations for gifts to 30% charities (primarily private non-operating foundations) are 30% of AGI for gifts of cash and 20% of AGI for gifts of long-term capital gain property.

Order of Priority for Percentage Limitation

The percentage limitation rules above are straightforward if a donor only makes gifts of cash,

or only securities, or only gifts to public charities. In fact, donors may make gifts of cash and appreciated property in the same year. They may also make gifts to public charities and private non-operating foundations in the same year. They may also have carryforward for any of these types of deductions from gifts made in past years. The sequencing of the use of the charitable deductions in each category works as follows: (1) first, all current-year contributions are deducted; and (2) like deductions carried over from preceding tax years are used on a first-in, first-out basis (i.e. the carryforward deductions from the earliest previous tax years get used first).

Under prior law, gifts subject to the 50% limitation were deductible first. These are gifts of cash and noncapital gain property such as ordinary income property and short-term capital gain property to public charities, not to exceed 50% of AGI. Second, contributions of cash to 30%-limit charities were deductible and limited to 30% of the donor's AGI. Third, contributions of capital gain property to public charities were deductible up to 30% of AGI.

The Impact of the new 60% Limit and the 30% Limit

The interplay of the 30%/50%/60% deduction limitations under the Tax Cuts and Jobs Act is subject to differing interpretation. The IRS is expected to issue technical corrections to clarify. A reasonable interpretation of the rules suggests that cash contributions reduce, dollar for dollar, the limit on 50% deductions taken in the same tax year, whether current gifts or carryforward. They also reduce this 50% limit when considering the 30% limit on gifts of long term appreciated property. The result is that the only way a donor can deduct contributions equal to 60% of AGI is if the donor makes these contributions entirely with cash.

The IRS is expected to issue technical corrections to clarify the interplay of the 30%/50%/60% deduction limitations. Until the IRS issues further guidance, donors should consult their tax advisers as to how the ordering rules for 2018 will work.

The Pease Limitation

The Tax Cuts and Jobs Act of 2017 eliminated the Pease limitation. The Pease limitation reduced deductions for certain high-income taxpayers. It is no longer in effect.

Conclusion

The income tax charitable deduction is an important incentive to make charitable gifts. Although it is the passion and commitment of donors to your mission that motivates them to give, the availability of a charitable deduction is subject to a potentially complex web of limitations that may affect the timing and size of their gifts.