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“Pease” Provision in Fiscal Cliff Deal Doesn’t Discourage Charitable Giving and Leaves Room for More Tax Expenditure Reform

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The recent “fiscal cliff” deal reinstated a limit on itemized deductions for high-income taxpayers known as the “Pease” provision,¹ which policymakers created as part of the 1990 bipartisan deficit-reduction package but which the Bush tax cuts phased out between 2006 and 2010. In recent days, some pundits and leaders of some charitable organizations have suggested² that because Pease limits the total amount of itemized deductions that high-income filers can claim, it will reduce the incentive for taxpayers to donate to charity. That suggestion is incorrect, however, as a close look at Pease makes clear.

As an important new paper from the Urban Institute and Tax Policy Center (TPC) shows, the fiscal cliff law’s tax provisions will *increase* charitable giving, not reduce it. The analysis — whose authors include C. Eugene Steuerle, a leading expert on these issues — estimates that the new law will boost charitable giving by \$3.3 billion a year, or 1.3 percent, compared to what it would have been if policymakers had extended the tax laws that were in place in 2012. The increase results mainly from the rise in the top marginal income tax rate to 39.6 percent, which raises the value of the charitable deduction.

The Urban Institute-TPC analysis also explains that “the Pease limitation has *negligible effects* on the tax incentive for charitable giving” (emphasis added). It shows that for people in the top income tax bracket, the tax benefit of making charitable donations will rise from 35 cents in less tax liability for each additional dollar in charitable giving to 39.6 cents per dollar — an increase in the tax incentive that Pease does *not* affect.³

¹ The provision is named after the late Congressman Donald Pease, who authored the original version of it.

² See Stephen Ohlemacher, “Charities worry that new tax law will reduce donations,” Washington Times, January 16, 2013, <http://www.washingtontimes.com/news/2013/jan/16/charities-worry-new-tax-law-will-reduce-donations/?page=all#pagebreak>.

³ Joseph Rosenberg, C. Eugene Steuerle, and Katherine Toran, “What Does the Fiscal Cliff Deal Mean for Nonprofits?,” Urban Institute and Tax Policy Center, January 2013.

How Pease Works — And Why Various Assumptions About It Are Mistaken

“[T]he impact of the Pease limitation on charitable contributions,” the Urban Institute-TPC analysis aptly notes, “is the subject of much confusion.” Many people who aren’t tax policy experts understandably assume that because Pease limits the total amount of itemized deductions that a high-income taxpayer can claim, this limit is based on the amount of a taxpayer’s deductions and reduces the marginal incentive to donate. That’s not correct, however.

In its reinstated form, Pease will reduce the total amount of a taxpayer’s allowable itemized deductions by *3 percent of the amount by which the taxpayer’s adjusted gross income (AGI) exceeds certain thresholds* — \$300,000 for married couples filing jointly and \$250,000 for single filers.⁴ (For this reason, Pease affects fewer than the top 2 percent of households and doesn’t touch anyone else.) Let’s say that a married couple has AGI of \$350,000, or \$50,000 above the threshold; Pease would shave the total amount of the couple’s allowable itemized deductions by 3 percent of this \$50,000, or \$1,500.

This structure of Pease has important implications. It means that Pease doesn’t reduce a taxpayer’s incentive to give more to charity because (except in extremely rare cases, as the appendix explains), its impact depends on the taxpayer’s income — not on how much the taxpayer donates.

Tax incentives such as itemized deductions are typically intended to subsidize certain activities and encourage taxpayers to do more of them. That’s true for the deduction for charitable giving; it lowers the “price” of giving, making it more attractive. When taxpayers in the 39.6 percent top income bracket deduct a \$100 gift to charity from their adjusted gross income, that deduction reduces their taxable income by \$100 and their tax bill by \$39.60. In effect, the \$100 donation costs them only a little over \$60.

Pease does not change that. For taxpayers in the 39.6 percent bracket, an additional dollar in charitable deductions will lower their income tax by 39.6 cents *with or without* the Pease provision. Hence, Pease doesn’t affect their marginal incentive to donate. As the Urban Institute-Tax Policy Center analysis explains, Pease really operates by slightly increasing the top marginal tax rates, not by reducing incentives to engage in deductible activities.⁵

Economists agree that the most important question about how a tax provision such as Pease affects total charitable giving is how it influences a taxpayer’s decision to make an additional dollar of donations. Because the dollar reduction in itemized deductions under Pease depends on a taxpayer’s income rather than on the amount he or she donates, Pease doesn’t affect decisions on whether to give more to charity. As the non-partisan Congressional Joint Committee on Taxation wrote in 2001, when President Bush proposed eliminating Pease:

⁴ Under the laws that were in place prior to the “fiscal cliff” deal that policymakers enacted through the American Taxpayer Relief Act of 2013, the Pease threshold would have been \$178,150 in 2013 for both single and joint filers.

⁵ The Urban Institute-TPC analysis explains that Pease essentially operates as a surtax that’s equal to 3 percent of a taxpayer’s marginal income tax rate. If you are in the 39.6 percent tax bracket, Pease effectively raises your marginal tax rate to 39.6 percent x 1.03 so that your true marginal rate becomes 40.8 percent. Its effect is on marginal tax rates, not on incentives to donate or to engage in other deductible activities.

[T]here generally is little or no difference in the tax-motivated economic incentive to give to charity for a taxpayer subject to the [Pease] limitation compared to a taxpayer not subject to the limitation. . . . Economists would say that the “tax price” of giving is not altered by the limitation.⁶

A Telling Example

Consider a couple with \$350,000 of AGI in 2013. Let’s assume that the household claims \$40,000 in itemizable expenses (which is typical for a household in this income range⁷).

- Pease reduces the household’s total itemized deductions by \$1,500 — 3 percent of the \$50,000 by which its AGI exceeds the \$300,000 Pease threshold — or from \$40,000 to \$38,500.
- But, the household would still receive the *full tax benefit* from any additional donation it makes. If the household gave \$10,000 more to charity, Pease would still reduce its total itemized deductions by the same \$1,500 (3 percent of \$50,000).

The household’s total allowable itemized deductions would rise by the full \$10,000 as a result of its new \$10,000 donation — from \$38,500 (\$40,000 minus the \$1,500 Pease limitation) to \$48,500 (\$50,000 minus the \$1,500 limitation). The household’s taxable income — its AGI minus its deductions — would still fall by *the full \$10,000* that it donated to charity.

- Because the household would be in the 33 percent bracket, its tax liability would fall by 33 percent of \$10,000, or \$3,300, as a result of its \$10,000 donation — the same amount as its taxes would fall in the absence of Pease. The household would get a tax subsidy worth 33 cents on the dollar for every dollar of its \$10,000 donation — just as it would if policymakers had not reinstated Pease.⁸

⁶ Joint Committee on Taxation, “Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President’s Individual Income Tax Rate Proposals,” March 6, 2001, JCX-6-01, p.14.

⁷ We have chosen a round number for the sake of simplifying the example, and \$40,000 in itemized deductions is a reasonable illustrative amount for a household with \$350,000 in AGI. On average, households that claimed itemized deductions and had AGI between \$200,000 and \$500,000 in 2009 claimed itemized deductions equal to \$51,000. See Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns Publication 1304*, “Table 2.1 Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009,” http://www.irs.gov/file_source/pub/irs-soi/09in21id.xls.

⁸ The household’s taxes would go up if, instead of claiming more deductions, it earned more income. Assume the household kept its itemized expenses at \$40,000 but earned \$10,000 more in income. Its adjusted gross income would now be \$360,000. That would increase, from \$50,000 to \$60,000, the amount by which the household’s income is above the Pease threshold of \$300,000 for a married couple. The Pease reduction in the household’s itemized deductions would now be 3 percent of \$60,000, or \$1,800 — \$300 more than the \$1,500 reduction when the household’s AGI was \$350,000. As a result of the extra \$10,000 in income earned, Pease would reduce the household’s total itemized deductions claimed by \$300 — from \$38,500 to \$38,200 — for a \$99 (33 percent of \$300) increase in its tax bill.

In other words, Pease does not raise this household’s (or other filers’) taxes if they take more deductions; it raises their taxes if they earn more income. As the Congressional Research Service notes, “the Pease limitation does not depend on the amount of itemized deductions, only AGI.” That’s why Pease is often described by tax policy experts as an implicit increase in the marginal tax rate for high-income filers, and why the Urban Institute-TPC paper refers to it as essentially a surtax. For those facing Pease, it raises their effective marginal tax rate by 3 percent of the statutory marginal rate. See

This example illustrates why the UI-TPC analysis calls Pease’s effect on charitable giving “negligible.”

Pease affects the incentive to increase charitable giving for those very few high-income taxpayers who claim so little in itemized deductions — typically, less than 3 percent of their AGI for *all* of their deductions combined — that they hit what is known as Pease’s “80-percent limit.” (Pease cannot reduce a taxpayer’s total deductions by more than 80 percent;⁹ for more on that point, see the Appendix.)

But hardly any high-income taxpayers have deductions that small; in fact, it’s nearly impossible for high-income taxpayers to wind up in these situations in the overwhelming majority of states that have state income taxes (which are allowable deductions). Moreover, when one also takes into account other deductions, such as those for mortgage interest, property taxes, and other deductible expenses, the number of high-income taxpayers with deductions that low dwindles even further. As tax policy expert Leonard Burman, TPC’s former head, explained, “almost nobody hits [the 80 percent] limit because deductions tend to increase with income. Think state and local taxes and charitable donations, which are much more than 3% of income for almost everyone with higher income.”¹⁰

JCT at p.14. See also Thomas L. Hungerford, “Deficit Reduction: The Economic and Tax Revenue Effects of Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease),” Congressional Research Service, April 29, 2011, p.3.

⁹ In theory, Pease could also reduce a filer’s total itemized deductions to less than the standard deduction, causing the filer to switch to the standard deduction, but in reality, such a situation would be extremely rare, as the Appendix explains.

¹⁰ Leonard Burman, “No, Ari, The Cliff Deal Will Raise The Economic Incentive To Give To Charity,” Tax Policy Center *TaxVox* blog, January 8, 2013, <http://taxvox.taxpolicycenter.org/2013/01/08/no-ari-the-cliff-deal-will-raise-the-economic-incentive-to-give-to-charity/>.

Pease Leaves Much More to Do in Revenue-Raising Tax Expenditure Reform

Pease is an important first step to limiting tax expenditures, which now total \$1.1 trillion a year in lost federal revenue — far more than the cost of Social Security or the cost of Medicare and Medicaid combined, and nearly double the amount that the budget allocates for all non-defense discretionary (i.e., non-entitlement) programs combined. But any misperception that Pease makes further tax-expenditure reform unnecessary don't withstand scrutiny. Indeed, Pease leaves in place a vast array of costly and inefficient tax expenditures that policymakers should reform, both to help reduce budget deficits and to clean up and improve the efficiency of the tax code.

For example, many tax expenditures have a flawed “upside-down” design: they give the largest subsidies for particular activities to high-income people, even though those often are the people who least need a financial incentive to take the action that the tax incentive is designed to promote, such as buying a home, sending a child to college, or saving for retirement. Nearly all high-income households would do these things anyway. Moreover, tax experts have long noted that high-income individuals do not need tax subsidies that are *bigger* than those that other households get in order to induce them to buy a house, send a child to college, or save for retirement. Yet, that's precisely what the current tax code provides them.

Pease leaves in place such tax expenditures with this flawed upside-down design. Despite Pease, a millionaire banker will still receive a subsidy of 39.6 cents for every dollar of additional mortgage interest payments he or she deducts, while a welder earning \$38,000 will get an interest subsidy worth only 15 cents on the dollar.

In addition, Pease doesn't touch the numerous tax expenditures that have nothing to do with deductions and come in the form of exclusions, exemptions, or preferential rates, such as a loophole (known as “carried interest”) that allows various financial-fund managers to pay tax on their compensation at lower capital gains tax rates rather than at higher ordinary income tax rates.

Accordingly, policymakers should complement Pease with further well-designed tax-expenditure reforms or limits. The tax code remains full of tax breaks that are ripe for reforms that could generate revenues for deficit reduction while improving the equity and efficiency of the tax code.*

* See Chye-Ching Huang and Chuck Marr, “Raising Today's Low Capital Gains Tax Rates Could Promote Economic Efficiency and Fairness, While Helping Reduce Deficits,” Center on Budget and Policy Priorities, September 19, 2012, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3837>.

Appendix: Pease Reduces Marginal Incentives Only in Very Unusual Cases

Pease can reduce a filer's itemized deductions by a maximum of 80 percent. It affects the marginal incentive for charitable giving only for the very few high-income families who claim so little in itemized deductions — typically, less than 3 percent of their AGI — that they hit this 80-percent limit. Such households are rare: IRS data show that households with AGI over \$500,000 that itemize claim itemized deductions worth nearly 15 percent of AGI, on average.¹¹

To see how Pease can affect marginal incentives in these quite rare cases, consider a household with \$3.5 million in AGI and just \$65,000 in itemizable expenses. (Itemized deductions of \$65,000 would be far below the typical amount for a household with this much income; the average amount of itemized deductions for filers with income between \$2 million and \$5 million is \$400,000.¹² Pease reduces this household's itemized deductions by the *lesser* of:

- 80 percent of its \$65,000 in itemized expenses, or \$52,000; or
- 3 percent of \$3.2 million (the amount by which the household's income exceeds the \$300,000 Pease threshold for married filers), or \$96,000.

Hence, the household faces the 80-percent Pease limit: Pease can reduce its itemized deductions by a maximum of \$52,000, with the result that its itemized deductions are \$13,000 under Pease. Now consider what happens if the household incurs an additional \$10,000 in itemizable expenses. Its total itemized deductions are now \$75,000. Since Pease can reduce this amount by the lesser of: a) 80 percent of the household's \$75,000 in itemized expenses, which equals \$60,000; or b) 3 percent of \$3.2 million (or \$96,000), the household will still face the 80-percent Pease limit. Its itemized deductions will total \$15,000 (\$75,000 minus the \$60,000 Pease reduction), or \$2,000 more than its deductions would be without the additional \$10,000 in deductible expenses. Because of Pease, the household can deduct only \$2,000 of the \$10,000 in additional expenses, as Pease eliminates the other 80 percent.

But the only households that hit this Pease 80-percent limit are those whose total itemized deductions for *everything* — mortgage interest *plus* state and local taxes *plus* charitable donations *plus* all other itemized deductions — are less than 3.75 percent of the amount by which their AGI exceeds the Pease thresholds of \$300,000 for married couples and \$250,000 for single filers. For these households, their itemized deductions would generally be less than 3 percent of their overall income. This is a virtual impossibility for nearly all high-income households due to deductions for state and local income, sales, and property taxes alone, even before taking into account the mortgage interest deduction, the charitable deduction, and other deductions.

Even rarer would be a situation in which Pease would cause the value of itemized deductions after the Pease limitation to fall below the value of the standard deduction, leading the filer to switch to

¹¹ Internal Revenue Service, Statistics of Income Division, Individual Income Tax Returns Publication 1304, "Table 2.1 Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2009," http://www.irs.gov/file_source/pub/irs-soi/09in21id.xls.

¹² See IRS Table 2.1. Such a household would have to give much less to charity or otherwise have much smaller itemized deductions than the typical household in this income range.

the standard deduction. This would almost never happen. (As with the 80 percent limitation case, this generally could only happen if a filer's itemized deductions are less than 3 percent of their AGI.)¹³

Households at these income levels that claim so little in itemized deductions are extremely rare. Moreover, they are very unlikely to make significant charitable donations in the first place — if they did, their total deductions would be higher, and Pease would be very unlikely to cause the household to be subject to the 80-percent rule (or to gain by switching to the standard deduction). As a result, the fact that Pease reduces the incentive to make additional donations for households in such a situation should have little impact on those households' charitable giving (since they give little in the first place), and it should have *no* discernible effect on overall charitable giving. In fact, large charitable contributions can actually help such taxpayers *avoid* facing the 80 percent limitation (or the standard-deduction situation) in the first place, by raising their itemized deductions as a share of their AGI.

¹³ Specifically, Pease could cause a household to switch to the standard deduction only if both of the following conditions are met: (1) Their itemized deductions are less than the standard deduction plus 3 percent of the amount by which their AGI exceeds the Pease threshold; and (2) their itemized deductions are less than five times the standard deduction.