

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE
PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL**

**PART ONE: INDIVIDUAL INCOME TAX AND
ESTATE AND GIFT TAX PROVISIONS**

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B. Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability

Present Law

General structure of the individual income tax

Under the Code, gross income means “income from whatever source derived” except for certain items specifically exempt or excluded by statute. An individual’s adjusted gross income (“AGI”) is determined by subtracting certain “above-the-line” deductions from gross income. These deductions include, among other things, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to certain IRAs, one-half of self-employment taxes, certain moving expenses, and alimony payments.

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2009, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds, which are indexed annually for inflation. The applicable thresholds for 2009 are \$166,800 for single individuals, \$250,200 for married individuals filing a joint return and surviving spouses, \$199,950 for heads of households, and \$125,100 for married individuals filing separate returns. For 2010, the deduction for personal exemptions is not reduced or eliminated based on income.

Standard and itemized deductions

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer’s filing status. For 2009, the amount of the standard deduction is \$5,700 for single individuals and married individuals filing separate returns, \$8,350 for heads of households, and \$11,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.¹⁸⁰ The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation. Finally, a taxpayer may reduce AGI by an additional standard deduction for State and local property taxes paid of \$500 (\$1,000 for joint filers) and for qualified motor vehicle taxes.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5

¹⁸⁰ For 2009, the additional amount is \$1,100 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,400. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2009) of \$2,200 or \$2,800, as applicable.

percent of AGI), casualty and theft losses (in excess of \$500 per loss and in excess of 10 percent of AGI), and certain miscellaneous expenses (in excess of two percent of AGI).

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's 2009 AGI in excess of \$166,800 (\$83,400 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present law limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under present law, the otherwise allowable itemized deductions may not be reduced by more than 80 percent. The overall reduction in itemized deductions is phased down to 1/3 of the full reduction amount in 2009 and terminates in 2010. However, the limitation is fully effective again in 2011 and thereafter as a result of the EGTRRA sunset provision.

Individual income tax rates

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2009, the regular individual income tax rate schedules are listed earlier in section III.B of this document.

Alternative minimum tax liability

An alternative minimum tax ("AMT") is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2009 are: (1) \$70,950 in the case of married individuals filing a joint return and surviving spouses; (2) \$46,700 in the case of other unmarried

individuals; (3) \$35,475 in the case of married individuals filing separate returns; and (4) \$22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions items, are not allowed to reduce AMTI.

Description of Proposal

The proposal limits the rate at which taxpayers with taxable income in excess of a threshold amount benefit from itemized deductions. In general, the proposal limits the benefit of itemized deductions for individuals to 28 percent of the amount of the deductions. The proposal applies to itemized deductions after they have been reduced under a separate fiscal year 2010 budget proposal that would reinstate the pre-EGTRRA limitation on certain itemized deductions, but with adjusted AGI thresholds in 2011 of \$250,000 (indexed for inflation from 2009) for married taxpayers filing jointly and \$200,000 (indexed for inflation from 2009) for other taxpayers. After 2011, these thresholds will be indexed for inflation.

Example 1: Taxpayer subject to regular income tax

For example, assume that a taxpayer in the 36-percent income tax bracket in 2011 makes a \$10,000 charitable contribution. Under present law, the \$10,000 contribution will result in a \$3,600 tax savings, or 36 percent of \$10,000 (disregarding any other limitations that may apply to reduce the taxpayer's itemized deductions). Under the proposal, the same \$10,000 contribution by the same 36-percent bracket taxpayer will result in a tax savings of only \$2,800 (28 percent of \$10,000), thus raising his tax liability by \$800 (or eight percent (36 percent minus 28 percent) of his \$10,000 contribution).

Example 2: Taxpayer subject to alternative minimum tax

The proposal has two effects on taxpayers subject to the AMT. However, these effects apply only if the taxpayer is first subject to any reduction in his regular tax liability—that is, if his marginal statutory regular tax rate is in excess of 28 percent.

Under the first effect, the proposal increases the taxpayer's tentative minimum tax liability by a fraction of the increase in regular tax liability caused by the limitation. The fraction is equal to the proportion of non-preference item itemized deductions to total itemized deductions. For example, in the example above, assume the taxpayer had \$20,000 in State and local taxes, an itemized deduction that is a preference item for purposes of the AMT, in addition

to his \$10,000 charitable deduction (a non-preference item), for a total of \$30,000 of itemized deductions. Under the regular tax, the taxpayer will have his tax liability increased by eight percent (36 percent minus 28 percent) of \$30,000, or \$2,400. The taxpayer's tentative minimum tax liability is increased by \$2,400 times the fraction of non-preference to total itemized deductions ($\$10,000/\$30,000$, or $1/3$), or \$800.

Under the second effect, if the taxpayer's AMTI is in the range that makes him subject to the phaseout of the AMT exemption amount, the taxpayer is subject to an additional increase in his tentative minimum tax liability. The additional increase is equal to the amount by which the value of the non-preference itemized deductions exceeds 28 percent of the deduction. For example, if the taxpayer is in the 28 percent marginal rate bracket of the AMT, but is also subject to the phaseout of the AMT exemption amount, a non-preference itemized deduction reduces his AMT liability in two ways under present law. First, the direct effect is that the deduction lowers AMTI by the amount of the deduction, reducing the tax liability by 28 percent of the deduction amount. Second, in reducing AMTI directly, the deduction reduces the phaseout of the AMT exemption amount by 25 percent of the deduction amount. Thus the joint effect of the deduction under present law is to reduce AMTI by 125 percent of the deduction, which, for the 28 percent ratepayer, reduces AMT liability by 125 percent of 28 percent, or 35 percent of the deduction amount. Under the proposal, the value of the deduction is limited to 28 percent of the deduction amount, and thus a taxpayer subject to the AMT exemption amount phaseout will face a further increase in his AMT liability, in this case equaling seven percent of the deduction amount.¹⁸¹ For the taxpayer described above with \$10,000 of non-preference deductions, the taxpayer's tentative minimum tax liability is increased a further \$700 (seven percent of \$10,000).

Effective date.—The proposal is effective for tax years beginning after December 31, 2010.

Analysis

In general

The proposal has been the subject of considerable debate, much of which centers on the likely effect of the proposal on charitable giving and housing (discussed below), although the proposal applies broadly to all itemized deductions. Some proponents have argued that limiting the benefit of itemized deductions in this manner will reduce the incentive to undertake certain activities. Some opponents have argued that such a limitation is inappropriate to the extent that the deductions, such as those for medical expenses, casualty or theft losses, or local taxes, are designed to more accurately reflect a taxpayer's ability to pay. If this is the case, then no adjustment should be made to the deductions, and any concern about fairness or progressivity should be addressed through the marginal tax rate structure.

¹⁸¹ In the case of a taxpayer subject to the AMT exemption phaseout but in the statutory 26 percent AMT rate bracket, the value of a non-preference item is 125 percent of 26 percent, or 32.5 percent. Such taxpayer will face an increase in their AMT liability of 4.5 percent (32.5-28) of the amount of the deduction by this second effect of the proposal.

Alternative minimum tax

The proposal impacts taxpayers subject to the AMT more substantially than taxpayers not subject to the AMT. Specifically, the proposal reduces the value of the taxpayer's itemized deductions to an amount less than 28 percent, as a result of the two effects described in example 2 above. Under present law, because the taxpayer's aggregate liability is determined by the AMT (since that yields a higher tax than the regular tax), the taxpayer's regular tax liability is not relevant, so long as it is below his AMT liability. Under the proposal, notwithstanding that the taxpayer is subject to the AMT, an additional increase in AMT liability is imposed based on a regular tax computation that ordinarily would have no bearing on AMT liability. In the example, under present law the taxpayer will receive a \$3,500 tax benefit from his \$10,000 charitable contribution, composed of the deduction against the 28 percent marginal AMT rate (yielding \$2,800) and the reduction in the amount of the phaseout of the exemption amount (25 percent of 10,000 = \$2,500), whose value at the 28 percent rate is 28 percent of \$2,500, or \$700. Under the proposal, the taxpayer loses this \$700 benefit related to the phaseout of the exemption amount, and is also subject to the \$800 increase in tax based on the first of the AMT effects described above, related to the reduction in the value of the itemized deductions as calculated for the regular tax. On net, the taxpayer thus receives only a \$2,000 benefit for the \$10,000 deduction; i.e., the value of his charitable deduction is held to 20 percent, not 28 percent.¹⁸²

It is not clear on what grounds the proposal imposes the first of these effects on AMT taxpayers, as the second effect is sufficient to limit the value of the deductions to 28 cents on the dollar. Furthermore, imposing an additional tax liability on taxpayers based on an increase in their regular tax that still leaves their regular tax liability below their AMT liability is a departure from the normal relationship between the regular tax and the AMT. Any tax rule or proposal that increases a taxpayer's regular tax liability could, in a manner parallel to the current proposal, be added to a taxpayer's AMT liability. For example, the limitation in the value of personal exemptions raises a taxpayer's regular tax liability, and the amount by which this limitation raises regular tax liability could be added to AMT liability in like fashion, notwithstanding the normal relationship between the AMT and the regular tax, which is that an increase in one's regular tax liability will increase one's tax liability only if regular tax liability exceeded AMT liability.

Charitable deduction

Some argue that the proposed limitation on itemized deductions diminishes a taxpayer's incentive to make charitable contributions by increasing the cost (price) of charitable giving.¹⁸³

¹⁸² In the event that the taxpayer were in the 39.6 percent regular tax bracket but subject to the AMT as well as the phaseout of the AMT exemption amount, the \$10,000 charitable deduction will trigger an increase in the AMT of \$1,160 by the first effect (39.6 percent - 28 percent times \$10,000), and a further \$700 by the second effect as described above, yielding a deduction value of only \$1,640 (\$3,500 - \$1,160 - \$700). Such taxpayer's charitable contribution deductions are thus limited to 16.4 cents on the dollar, rather than the asserted 28 cents on the dollar.

¹⁸³ For a recent literature review of the responsiveness of charitable giving to its price, see John Pelozo and Piers Steele, "The Price Elasticities of Charitable Contributions: A Meta Analysis," *Journal of Public Policy & Marketing* 24: 260-272, 2005. See also Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985; and Jon Bakija and Bradley Heim "How Does Charitable Giving Respond To

Additionally, the reduction in after-tax income resulting from the proposal will mean that taxpayers have less disposable income to spend on all goods, including charity. Such commentators argue that the proposal therefore will result in a decrease in charitable giving as a result of both the increased price of charitable giving and the reduction in after-tax income.¹⁸⁴ With respect to the altered price of giving, for example, under present law a 39.6-percent bracket taxpayer who makes a \$1,000 charitable contribution (disregarding any other limitations that may apply to limit itemized deductions) will save \$396 (39.6 percent of \$1,000). In other words, the after-tax cost to the taxpayer is only \$604 to give \$1,000 to charity (\$1,000 - \$396 savings). Under the proposal, the same \$1,000 charitable contribution will cost the same taxpayer \$720 (\$1,000 - (28 percent of \$1,000)). This represents a cost increase of more than 19 percent.

Others, however, argue that the proposed limit will result in little if any reduction in overall charitable giving.¹⁸⁵ Some argue, for example, that charitable giving is motivated in significant part by factors other than tax rules, such as altruism and the overall state of the economy;¹⁸⁶ most taxpayers, therefore will not eliminate or significantly reduce charitable giving under the proposal. Indeed, under the proposal, each additional dollar given to charity by a taxpayer subject to the proposal will continue to result in a tax savings, although at a rate of 28 percent rather than the higher 36- or 39.6-percent rates.

Furthermore, some argue that the proposal improves fairness and equity to the tax treatment of itemized deductions by partially leveling the tax benefit to higher- and lower-income taxpayers resulting from identical gifts. For example, assume that a taxpayer in the 36-percent bracket and a taxpayer in the 25-percent bracket each make identical \$1,000 contributions to charity. As a result of the \$1,000 contribution, the higher-income taxpayer will have a tax savings of \$360 (36 percent of \$1,000), such that his cost of making the \$1,000 contribution is \$640 (\$1,000 - \$360). The taxpayer in the 25-percent bracket, however, will achieve a tax savings of only \$250 (25 percent of \$1,000), such that his cost of making the

Incentives And Income? Dynamic Panel Estimates Accounting For Predictable Changes In Taxation,” National Bureau of Economic Research Working Paper 14237, August 2008.

¹⁸⁴ See Independent Sector, Statement on Changes to Tax Incentives for Charitable Giving and Health Care Reform, http://www.independentsector.org/media/20090326_giving_healthcare_statement.html (March 26, 2009) (arguing that changes in tax benefits affect charitable giving levels and that the President’s budget proposal will result in a decrease in charitable giving).

¹⁸⁵ For example, the Center on Philanthropy at Indiana University performed a study to determine how the President’s proposal would affect charitable giving. See The Center on Philanthropy at Indiana University, white paper, “How Changes in Tax Rates Might Affect Itemized Charitable Deductions,” available at http://www.philanthropy.iupui.edu/docs/2009/2009_TaxChangeProposal_WhitePaper.pdf (March 2009) (hereafter “Indiana University White Paper”). Using a simplified model and 2006 itemized deduction data, the Center estimated that, if the budget proposal had been in effect in 2006, “the impact on itemized giving would have been a relatively small reduction when measured as a percentage of total itemized charitable giving by individuals (a decrease of 2.1 percent).” Looking only at the highest income households, the Center estimated a slightly larger drop (approximately 4.8 percent). The Center concluded that “[t]he larger economy plays a more important role in changes in giving than do tax rate changes.”

¹⁸⁶ See, e.g., Indiana University White Paper, *supra*.

\$1,000 contribution is \$750 (\$1,000 - \$250). In other words, under present law, an identical charitable contribution results in a greater tax benefit (in this example, \$110) to the higher-bracket taxpayer, even though the lower-bracket taxpayer arguably has been more generous by contributing a higher percentage of his taxable income to charity. The proposal limits (but does not eliminate) this disparate treatment by limiting the rate at which the higher-bracket taxpayer may benefit from itemized deductions to 28 percent.¹⁸⁷

On the other hand, such a fairness argument rests on an implicit assumption that, when a taxpayer makes a charitable contribution, he or she is buying something. If, however, one's initial view is that a gift to charity reduces a taxpayer's resources available for private consumption, then the proposed modification to the marginal rates at which taxpayers may benefit from deductions should not be undertaken, lest taxpayers similarly situated with respect to resources available for private consumption would face differential tax burdens.

Mortgage interest and property tax deductions

The deductions for home mortgage interest and property taxes reduce the after-tax cost of financing and maintaining a home. The benefit generally rises as the marginal tax rate of the taxpayer rises. However, research suggests that the benefits of the home mortgage interest deduction, and thus the costs of any limitation, are distributed heterogeneously among taxpayers, even among those with more than \$250,000 in income.¹⁸⁸ Within this group, the largest benefits accrue to younger homeowners, who tend to have higher loan-to-value ratios, and to those taxpayers purchasing more expensive homes.

Limiting itemized deductions will raise the after-tax cost of financing and maintaining a home for affected taxpayers. One study estimates that completely repealing the mortgage interest deduction will raise the cost of capital for owner-occupied housing by seven percent.¹⁸⁹ Smaller cost increases are associated with limiting the deduction. However, if taxpayers adjusted their portfolios to reduce their loan-to-value ratios, changing the tax treatment of mortgage interest might have little impact on the user cost.¹⁹⁰ As with the benefits of the

¹⁸⁷ Note that this disparate treatment would not exist if all taxpayers faced the same marginal tax rate. In other words, the disparate treatment is the joint effect of the deduction and a progressive rate (or any non single rate) structure.

¹⁸⁸ James Poterba and Todd Sinai, "Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income," *American Economic Review Papers and Proceedings*, vol. 96, May 2008.

¹⁸⁹ *Ibid.*

¹⁹⁰ See Martin Gervais and Manish Pandey, "Who Cares about Mortgage Interest Deductibility?" *Canadian Public Policy*, vol. 34, March 2008. Wealthier households are more likely to alter their balance sheets to reduce their loan-to-value ratios. To the extent that non-housing assets generate income derived subject to tax, such portfolio shifting will reduce taxable income for these households, partially offsetting the increase in tax due to limitation of the deduction. Indeed, the benefits of deductibility do not increase with income as fast as taxes paid. Accordingly, Gervais and Pandey (2008) find "mortgage interest deductibility makes the tax code less progressive at relatively low levels of income and more progressive for relatively high levels of income."

deduction, the largest increases in the cost of housing will occur for younger, high-income homeowners with relatively higher loan-to-value ratios and relatively fewer non-housing assets with which to reduce those ratios. Demand for housing by affected taxpayers is expected to decline in response to the increased cost.

Some argue that the proposal will have a detrimental effect on the U.S. economy, because it will lead to a decline in home prices at a time when many homeowners have seen the value of their residences decline to an amount below their mortgage balances. Areas with relatively large numbers of affected taxpayers and relatively inelastic housing supply will be expected to face the greatest price declines. This, they argue, could lead to deterioration in bank balance sheets as the value of their mortgage loans and mortgage-backed securities also decline.

Others argue that limiting the home mortgage interest deduction is unlikely to have a detrimental effect on the U.S. economy. They argue that the limitation will affect too few taxpayers to reduce incentives for the marginal homebuyer. Still others question whether the mortgage interest deduction does much to encourage homeownership and thus the positive spillover benefits that might entail.¹⁹¹ On the contrary, to the extent that the mortgage interest deduction creates economic distortions—increasing the size and cost of housing, increasing the allocation of capital to owner-occupied housing away from potentially higher pre-tax return investments in other sectors, increasing the amount of leverage used to purchase homes—limiting the deduction could be beneficial to the economy as a whole.

Prior Action

No prior action.

¹⁹¹ Edward L. Glaeser and Jesse M. Shapiro, “The Benefits of the Home Mortgage Interest Deduction” in James M. Poterba (ed.), *Tax Policy and the Economy* 17, (Cambridge, Mass.: The MIT Press), 2003.