Tax Policy Center
Urban Institute and Brookings Institution

Options to Limit the Benefit of Tax Expenditures for High-Income Households

Daniel Baneman, Jim Nunns, Jeffrey Rohaly, Eric Toder, Roberton Williams
Urban-Brookings Tax Policy Center
August 2, 2011

ABSTRACT

This analysis measures the revenue and distributional impacts of three proposals to limit tax expenditures for higher-income households: the Obama Administration's plan to cap the value of itemized deductions at 28 percent; an effective minimum tax (EMT) to ensure that tax liability is at least a certain percentage of a taxpayer's income; and a modified version of a recent proposal to limit the value of specific tax expenditures to 2 percent of adjusted gross income (AGI). The first two options would raise roughly the same revenue, but the EMT would affect significantly fewer taxpayers and its effects would be more concentrated at the very top of the income distribution. The proposal to limit tax expenditures to 2 percent of AGI would raise much more revenue than the other options and affect just over half as many taxpayers as the limitation on itemized deductions.

We gratefully acknowledge financial support from the John D. and Catherine T. MacArthur Foundation.

This analysis considers three proposals that would limit tax expenditures for higher-income households: the Obama Administration's proposal to cap the value of itemized deductions at 28 percent; a minimum tax to ensure that tax liability is at least a certain percentage of a taxpayer's income; and a modified version of the Feldstein/Feenberg/MacGuineas (FFM) proposal to limit the value of specific tax expenditures to 2 percent of adjusted gross income (AGI).

To measure the revenue and distributional implications of these proposals, the analysis considers two baselines: current law and current policy. "Current law" is the standard baseline that official revenue estimators at the Joint Committee on Taxation use to score tax proposals. It assumes that tax law plays out as it is currently written. Most important, that means that the 2001–2010 income and estate tax cuts expire at the end of 2012 and that temporary relief from the alternative minimum tax (AMT) expires at the end of 2011. The "current policy" baseline assumes that Congress permanently extends all provisions in the 2011 tax code (except the 2 percent reduction in Social Security payroll tax) as well as AMT relief, indexed for inflation after 2011.

Option 1: 28 Percent Limitation on Itemized Deductions

The tax savings from itemized deductions depend on a taxpayer's marginal tax rate. For someone in the 35 percent top tax bracket, an additional $100 of itemized deductions reduces tax liability by 35 percent of that $100, or $35.[1] The first option is a proposal from the Obama Administration, which would limit the benefit of itemized deductions to 28 percent. This would effectively reduce the benefit of itemized deductions for taxpayers with a marginal tax rate above the 28 percent limit.[2] Thus, for example, an additional $100 of itemized deductions would save a taxpayer in the 35 percent bracket only $28 rather than $35.[3]

The 28 percent limitation on itemized deductions would raise an estimated $288 billion over the next ten years compared with current law (see Table 1).[4] Relative to current policy, the proposal would raise $164 billion. The smaller revenue gain versus current policy results in part from the lower top tax rates—33 and 35 percent versus 36 and 39.6 percent under current law. The smaller difference between the statutory rates and the 28 percent limitation would result in smaller tax increases and hence less additional revenue.

[1] This simplified example ignores the impact of phase-ins and phaseouts in the tax code that can cause a taxpayer's effective marginal tax rate to differ from her statutory rate.

[2] For a married couple claiming the standard deduction and personal exemptions only, and expressed in 2009 dollars, the 28 percent bracket would end at AGI of $227,500 under current policy in 2013, and at $153,800 under current law ($180,850 and $91,500 for singles, $205,800 and $133,050 for heads of household).

[3] Appendix A provides technical details of the modeling assumptions for all three options examined.

[4] Appendix Table A1 provides year-by-year revenue estimates against both current law and current policy. Revenue estimates include a microdynamic behavioral response but do not include any potential short-term timing shifts due to tax rate changes on realized capital gains.

Table 1

Impact on Individual Income Tax Revenue (billions of current dollars)

2012-21 Fiscal Years

	Current Law	Current Policy
Option 1: Limit Value of Itemized Deductions to 28 Percent	287.9	164.2
Option 2: Effective Minimum Tax [a]	258.4	169.0
Option 3: Limit Tax Expenditures to 2 Percent of AGI	592.3	519.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).
Notes: Proposals are effective 01/01/12. Estimates include a microdynamic behavioral response.
a. The effective minimum tax rate would be 27 percent under current law and 21 percent under current policy.

In 2013 against current policy, the proposal would increase taxes for about 5.4 million tax units, or 3.3 percent of all tax units, by an average of about $2,850 (see Table 2).[5] The proposal would affect no households in the bottom two income quintiles and just 0.2 percent of those in the third and fourth quintiles. The 5.3 million affected households in the top quintile would see their taxes go up by an average of about $2,900.[6] The average tax increase for the 697,000 affected households in the top 1 percent would be about $13,300.[7]

Almost all of the tax increase—99.8 percent—would fall on households in the top quintile of the income distribution—those with cash incomes greater than $111,000 (see Table 3). The top 1 percent would bear 61 percent and the top 0.1 percent would pay a little more than one-third. The higher tax would reduce after-tax income of households in the top quintile by 0.3 percent and that of households in the top 1 percent by 0.6 percent.

[5] Appendix Tables A2 and A3 provide estimates against 2013 current law. The TPC website contains complete distribution tables at http://www.taxpolicycenter.org/numbers/displayatab.cfm?SimID=403.
[6] We use the terms "tax units" and "households" interchangeably although the two concepts differ. See http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=1535#q6.
[7] The cash income percentile classes in the tables contain an equal number of people, not tax units. The percentile breaks in 2011 dollars are 20% $17,910; 40% $37,091; 60% $64,533; 80% $111,349; 90% $160,384; 95% $227,324; 99% $593,011; 99.9% $2,682,257.

Table 2
Tax Units With a Tax Increase Under Current Policy, 2013 Calendar Year

Cash Income Percentile	All Tax Units ('000s)	28 Percent Limit on Itemized Deductions		21 Percent Effective Minimum Tax		Limit Tax Expenditures to 2 Percent of AGI	
		Number ('000s)	Avg Tax Increase ($)	Number ('000s)	Avg Tax Increase ($)	Number ('000s)	Avg Tax Increase ($)
Lowest Quintile	43,362	0	0	0	0	0	0
Second Quintile	37,681	0	0	0	0	0	0
Middle Quintile	32,699	26	156	0	0	0	0
Fourth Quintile	27,208	93	301	0	0	0	0
Top Quintile	24,067	5,268	2,917	394	80,473	2,851	16,521
All	166,272	5,387	2,857	394	80,472	2,851	16,521
Addendum							
80-90	12,130	283	447	0	0	13	396
90-95	5,919	985	678	0	0	42	1,262
95-99	4,805	3,207	1,570	113	19,313	1,883	3,762
Top 1 Percent	1,213	697	13,283	243	109,056	828	46,575
Top 0.1 Percent	124	96	53,632	38	401,513	84	240,673

Source : Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).
Notes: Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals.

Option 2: Effective Minimum Tax (EMT)

The second option would ensure that high-income taxpayers pay at least a certain percentage of their income in tax. The specific option examined here would require that taxpayers with income above specified thresholds pay tax of at least 27 percent of their modified adjusted gross income (MAGI), defined as AGI plus interest from currently tax-exempt municipal bonds.[8] Taxpayers would calculate their tax under current rules, compare that to their tentative effective minimum tax of 27 percent of their MAGI, and pay the higher of the two amounts.[9]

[8] The 27 percent rate would apply under current law. The minimum tax rate would be 21 percent when assessed against current policy. These rates would raise approximately the same revenue as the 28 percent limitation on itemized deductions.

[9] In order to avoid double taxation of income earned abroad, the proposal would allow taxpayers to subtract the foreign tax credit from their tentative effective minimum tax. In addition, as with the other two options, this proposal would retain the current alternative minimum tax. Thus, taxpayers would first compare their regular tax to their tentative AMT in order to determine their tax liability under current rules. They would then compare that amount to their tentative EMT and pay the higher amount. The AMT could be repealed simultaneously with the imposition of the effective minimum tax, but that would require a higher minimum tax rate or a lower income threshold in order to raise the same amount of revenue.

Table 3
Distributional Impact Under Current Policy, 2013 Calendar Year

Cash Income Percentile	All Tax Units ('000s)	28 Percent Limit on Itemized Deductions		21 Percent Effective Minimum Tax		Limit Tax Expenditures to 2 Percent of AGI	
		Share of Total Tax Change	Percent Change in After-Tax Income	Share of Total Tax Change	Percent Change in After-Tax Income	Share of Total Tax Change	Percent Change in After-Tax Income
Lowest Quintile	43,362	0.0	0.0	0.0	0.0	0.0	0.0
Second Quintile	37,681	0.0	0.0	0.0	0.0	0.0	0.0
Middle Quintile	32,699	0.0	0.0	0.0	0.0	0.0	0.0
Fourth Quintile	27,208	0.2	0.0	0.0	0.0	0.0	0.0
Top Quintile	24,067	99.8	-0.3	100.0	-0.6	100.0	-0.9
All	166,272	100.0	-0.2	100.0	-0.3	100.0	-0.5
Addendum							
80-90	12,130	0.8	0.0	0.0	0.0	0.0	0.0
90-95	5,919	4.4	-0.1	0.0	0.0	0.1	0.0
95-99	4,805	33.3	-0.4	7.6	-0.2	15.5	-0.6
Top 1 Percent	1,213	61.2	-0.6	92.4	-1.8	84.4	-2.6
Top 0.1 Percent	124	34.3	-0.8	53.0	-2.4	44.5	-3.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).
Notes: Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals.

In order to limit the effective minimum tax to higher-income taxpayers, the rate would phase in proportionately between MAGI of $250,000 and $500,000 for married couples filing a joint return and between $200,000 and $400,000 for singles and heads of household.[10] Thus, for example, a married couple with MAGI of $300,000 would face a minimum tax equal to 5 percent of their MAGI—one-fifth of the full 25 percent rate because their $300,000 MAGI is one-fifth of the way into the $250,000–$500,000 phase-in range. The minimum tax would not apply to households with MAGI below the $250,000/$200,000 thresholds.

Compared against current law, the EMT rate of 27 percent would generate $258 billion of additional revenue over the 2012–2021 period, roughly the same as the first option (see Table 1). Against current policy, a lower rate of 21 percent would generate about the same revenue as the 28 percent limitation, or $169 billion.

[10] The phase-in range would be $125,000 to $250,000 for married individuals filing a separate return. All thresholds in this paper would be indexed for inflation after 2009.

Although it would raise roughly the same revenue as the 28 percent limitation on itemized deductions, the EMT would affect significantly fewer taxpayers, would raise the tax burden on those affected by much more, and would be more concentrated on those at the very top of the income distribution. In 2013 against current policy, the proposal would increase taxes for just 394,000 tax units, about 0.2 percent of all tax units (see Table 2). The 2 percent of households in the top quintile affected by the tax would see their taxes go up by an average of $80,500. The 243,000 affected households in the top 1 percent would incur an average tax rise of $109,000. The tax increase would average $401,500 for the 38,000 affected households in the top 0.1 percent—those with cash income of at least $2.7 million.

About 92 percent of the overall tax increase would fall on the top 1 percent and half on the top 0.1 percent (see Table 3). After-tax income would fall an average of 0.6 percent for households in the top quintile, by 1.8 percent for those in the top 1 percent, and by 2.4 percent for those in the top 0.1 percent.

Option 3: Limit Benefit of Tax Expenditures to 2 Percent of AGI

In a recent National Bureau of Economic Research paper, Martin Feldstein, Daniel Feenberg, and Maya MacGuineas evaluated a proposal to cap the tax savings from specified tax expenditures at 2 percent of a taxpayer's AGI.[11] We examine a modified version of this proposal that would apply the cap only for high-income households.

The modified FFM proposal examined here would limit the value of itemized deductions, the exclusion for employer-sponsored health insurance (ESI) premiums, and the child and dependent care and general business tax credits to 2 percent of a taxpayer's adjusted gross income.[12] The cap would phase in for married couples with AGI between $250,000 and $500,000 and for singles and heads of household with AGI between $200,000 and $400,000.[13]

A 2 percent limitation on tax expenditures would raise $592 billion relative to current law over the 2012–21 budget window, significantly more revenue than either of the other two options (see Table 1). The plan would raise less revenue against current policy—$520 billion—because of that baseline's lower marginal rates, which reduce the value of itemized deductions and exclusions.

Although this proposal would raise much more revenue, it would affect only about half as many households as the 28 percent limitation on itemized deductions. The $16,500 average tax increase in 2013 for the 2.9 million affected households would be nearly six times that for the 28 percent limitation (see Table 2). The 828,000 affected households in the top 1 percent of the income distribution would pay an average of $46,600 more in

[11] See "Capping Individual Tax Expenditure Benefits" at http://www.nber.org/papers/w16921.pdf. Feldstein summarized the proposal in a New York Times opinion piece, available at http://www.nytimes.com/2011/05/05/opinion/05feldstein.html?_r=2&hp.

[12] In addition to ESI premiums paid by the employer, the limitation would also apply to premiums paid by the employee with pre-tax dollars and contributions to a medical flexible savings arrangement (FSA) or a health savings account (HSA).

[13] The phase-in range for married individuals filing separate returns would be $125,000 to $250,000.

taxes. Within the top 0.1 percent, about 84,000 households would see their taxes rise by an average of about $240,000. Compared with the limitation on itemized deductions, that represents about 12 percent fewer affected households in that top income range, but an average tax increase that is more than four times as much.

The distribution of the increased tax burden across income groups closely resembles that of the effective minimum tax and is therefore more concentrated toward the top of the distribution than is the limitation on itemized deductions. Approximately 84 percent is borne by the top 1 percent and 45 percent by the top 0.1 percent (see Table 3). The tax increase would reduce after-tax income by 0.9 percent for households in the top quintile, by 2.6 percent for those in the top 1 percent, and by 3.2 percent for those in the top 0.1 percent.

Appendix A: Technical Modeling Assumptions

Option 1: 28 Percent Limitation on Itemized Deductions

The Obama Administration has proposed the 28 percent limitation on itemized deductions in each of its budgets but has not provided specific details for how the plan would be implemented. This analysis assumes taxpayers would first calculate their tax liability under the regular tax law—that is, ignoring the alternative minimum tax (AMT). They would then recompute tax liability on a tax base equal to taxable income plus itemized deductions and subtract an "itemized deduction credit" equal to 28 percent of their itemized deductions. Tax liability under regular tax rules would equal the larger of the two calculated tax amounts.

Taxpayers would then calculate their tentative AMT in two ways, first under the rules in place in the baseline and then on a tax base equal to AMT taxable income plus all itemized deductions allowed for AMT purposes and subtracting 28 percent of itemized deductions allowed for AMT purposes. The larger of the two amounts would then be tentative AMT.

Finally, taxpayers would compare tentative AMT to regular tax liability and pay the larger amount. The difference, if positive, would be the taxpayer's AMT liability.

Under current law, the limitation on itemized deductions or "Pease" would still be in place. Thus, "itemized deductions" in the current law calculations for the regular tax refer to itemized deductions after the Pease limitation has been applied.[14] In contrast, Pease does not apply under the current policy baseline.

Option 2: The Effective Minimum Tax

For taxpayers with modified AGI above specified thresholds—$250,000 for married couples filing a joint return and $200,000 for others—the EMT would equal the applicable minimum tax rate times modified AGI, minus foreign tax credits, where modified AGI is AGI plus tax-exempt interest income. Taxpayers would then pay the larger of tax liability calculated under the tax law in place in the baseline and the minimum tax amount. Taxpayers with modified AGI of $500,000 for married couples filing a joint return ($400,000 for singles and heads of household) would pay the full minimum tax rate.

To avoid a "cliff" at which an additional dollar of income could impose a very large increase in tax liability, the minimum tax would phase in proportionately for married couples with modified AGI between $250,000 and $500,000 and for singles and heads of household with modified AGI between $200,000 and $400,000.[15]

For example, consider a married couple with modified AGI of $350,000. Their income would put them $100,000 into the $250,000 wide phase-in range, so their minimum tax

[14] Pease does not apply for AMT purposes.

[15] The phase-in range for married individuals filing separate returns would be $125,000 to $250,000. All amounts would be indexed for inflation after 2009.

rate would be $100,000/$250,000, or 40 percent of the fully phased-in rate. If the fully phased-in rate were 27 percent, they would face a minimum tax rate of 10.8 percent and their minimum tax would equal 10.8 percent of their modified AGI of $350,000, or $37,800. The couple would then pay the larger of $37,800 or their tax liability calculated under regular tax rules, including any applicable AMT liability.

Option 3: Limit Value of Tax Expenditures to 2 Percent of AGI

Taxpayers with adjusted gross incomes greater than specified thresholds—$250,000 for married couples and $200,000 for others—would calculate their tax liability two ways. They would first calculate their individual income tax under regular rules, including any applicable AMT liability. They would then recalculate their tax liability assuming no itemized deductions and no child and dependent care and general business tax credits and counting as income any health insurance premiums paid by themselves using pre-tax dollars or by their employers.[16] They would subtract 2 percent of their AGI from the latter amount to get their "expenditure-limited" tax and pay the larger of that amount and their regular tax.

For example, consider a taxpayer with AGI of $3,000,000 whose tax liability would equal $600,000 under regular income tax rules and for whom disallowing the specified tax expenditures would result in tax liability of $800,000. The taxpayer's benefit from the specified tax expenditures equals the difference—$200,000. Because that benefit exceeds 2 percent of AGI, or $60,000, the limitation would apply, boosting final tax liability to $740,000—the difference between the $800,000 tax and the $60,000 limit on the value of tax expenditures.

To avoid creating a cliff at the threshold values of $250,000/$200,000, the limitation would phase in proportionately over the AGI range of $250,000 to $500,000 for married couples filing a joint return and $200,000 to $400,000 for singles and heads of household.[17] Consider, for example, a married couple with AGI of $300,000 who would owe $40,000 under regular income tax rules and for whom disallowing tax expenditures would raise their tax to $70,000. If the proposal were fully phased in, they would pay $64,000, which is the larger of $40,000 and $70,000 less 2 percent of AGI. That amount would represent $24,000 more than they would pay under regular tax rules. Since the couple is $50,000 into the $250,000 wide phase-in range, the additional amount they would owe would be limited to 50/250 or 20 percent of that extra amount—$4,800—yielding a final tax liability of $40,000 + $4,800 = $44,800.

[16] Taxpayers would also have to include in income any contributions to medical FSAs or HSAs.

[17] The phase-in range for married individuals filing separate returns would be $125,000 to $250,000. All amounts would be indexed for inflation after 2009.

Appendix Table A1

Impact on Individual Income Tax Revenue (billions of current dollars), 2012-21

	Fiscal Year										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2012-21**
Baseline: Current Law											
Option 1: Limit Value of Itemized Deductions to 28 Percent	8.8	20.9	25.3	27.2	29.2	31.1	33.0	35.0	37.3	40.1	287.9
Option 2: 27-Percent Effective Minimum Tax	20.6	14.2	19.8	24.6	26.4	27.7	29.1	30.7	32.3	33.0	258.4
Option 3: Limit Tax Expenditures to 2 Percent of AGI	25.6	46.9	52.8	55.9	59.5	63.1	66.6	70.1	73.9	78.0	592.3
Baseline: Current Policy											
Option 1: Limit Value of Itemized Deductions to 28 Percent	7.4	12.2	13.7	14.8	16.0	17.3	18.7	20.0	21.3	22.8	164.2
Option 2: 21-Percent Effective Minimum Tax	9.5	10.1	5.3	14.7	19.1	20.1	21.1	22.2	23.3	23.6	169.0
Option 3: Limit Tax Expenditures to 2 Percent of AGI	27.0	41.0	44.5	47.6	50.7	54.3	58.0	61.6	65.4	69.6	519.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

Notes: Proposals are effective 01/01/12. Estimates include a microdynamic behavioral response.

Appendix Table A2
Tax Units With a Tax Increase Under Current Law, 2013 Calendar Year

Cash Income Percentile	All Tax Units ('000s)	28 Percent Limit on Itemized Deductions		27 Percent Effective Minimum Tax		Limit Tax Expenditures to 2 Percent of AGI	
		Number ('000s)	Avg Tax Increase ($)	Number ('000s)	Avg Tax Increase ($)	Number ('000s)	Avg Tax Increase ($)
Lowest Quintile	43,362	0	0	0	0	0	0
Second Quintile	37,681	0	0	0	0	0	0
Middle Quintile	32,699	0	0	0	0	0	0
Fourth Quintile	27,208	784	203	0	0	0	0
Top Quintile	24,067	10,400	2,788	489	68,046	2,932	18,864
All	166,272	11,183	2,605	489	68,046	2,932	18,864
Addendum							
80-90	12,130	1,579	529	0	0	13	435
90-95	5,919	3,919	660	0	0	44	1,477
95-99	4,805	3,874	2,173	129	17,784	1,993	5,490
Top 1 Percent	1,213	924	18,252	324	88,096	807	53,167
Top 0.1 Percent	124	103	75,640	36	419,250	74	277,578

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).
Notes: Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals.

Appendix Table A3
Distributional Impact Under Current Law, 2013 Calendar Year

Cash Income Percentile	All Tax Units ('000s)	28 Percent Limit on Itemized Deductions		27 Percent Effective Minimum Tax		Limit Tax Expenditures to 2 Percent of AGI	
		Share of Total Tax Change	Percent Change in After-Tax Income	Share of Total Tax Change	Percent Change in After-Tax Income	Share of Total Tax Change	Percent Change in After-Tax Income
Lowest Quintile	43,362	0.0	0.0	0.0	0.0	0.0	0.0
Second Quintile	37,681	0.0	0.0	0.0	0.0	0.0	0.0
Middle Quintile	32,699	0.0	0.0	0.0	0.0	0.0	0.0
Fourth Quintile	27,208	0.6	0.0	0.0	0.0	0.0	0.0
Top Quintile	24,067	99.4	-0.6	100.0	-0.7	100.0	-1.2
All	166,272	100.0	-0.3	100.0	-0.3	100.0	-0.6
Addendum							
80-90	12,130	2.9	-0.1	0.0	0.0	0.0	0.0
90-95	5,919	9.0	-0.3	0.0	0.0	0.1	0.0
95-99	4,805	29.2	-0.7	7.4	-0.2	20.3	-0.9
Top 1 Percent	1,213	58.4	-1.2	92.6	-2.1	79.6	-3.1
Top 0.1 Percent	124	27.1	-1.3	49.7	-2.6	38.4	-3.5

Source : Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).
Notes: Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative cash income are excluded from the lowest quintile but are included in the totals.