

Taxing Adjusted Gross Income Instead of Taxable Income

By Eric Toder and Jacob Goldin

The House leadership recently proposed a new surtax on high income individuals to help pay for healthcare reform. The surtax rates on couples would be 1 percent on modified adjusted gross income¹ between \$350,000 and \$500,000, 1.5 percent on AGI between \$500,000 and \$1 million, and 5.4 percent on AGI in excess of \$1 million (singles would face the same rates with brackets 80 percent as high). The president's budget also raises rates for the top two income tax brackets from 33 and 35 percent to 36 and 39.6 percent.

To compute taxable income, taxpayers subtract from AGI personal exemptions plus the higher of the standard deduction or itemized deductions. Capital gains and

qualified dividends are included in taxable income, but are taxed using a separate rate schedule with a maximum rate of 15 percent in 2009. Unlike a surtax imposed on AGI, increases in marginal income tax rates do not apply to gains and dividends.

Table 1 shows the ratio to AGI of income taxed at ordinary rates, taxable income, capital gains and dividends, and exemptions and deductions for different income groups. On average, income taxed at ordinary rates in 2006 equaled 58 percent of AGI, with exemptions and deductions accounting for most of the shortfall. But for the highest income taxpayers, capital gains and dividends accounted for most of the difference between income taxed at ordinary rates and AGI. This discrepancy reflects the importance of gains and dividends in the income of those at the very top of the distribution, as well as the smaller share AGI reduced by exemptions and deductions. For taxpayers with income greater than \$1 million, most of the difference between raising rates on taxable income and imposing a new surtax on AGI occurs because the latter raises taxes on capital gains and dividends.

¹Modified AGI is AGI less investment interest.

Table 1. Income Taxed at Ordinary Rates as Share of AGI, 2006

Adjusted Gross Income Range in \$thousands	Income taxed at ordinary rates	Capital gains and qualified dividends*	Taxable Income	Exemptions and Deductions**
0-200	59%	3%	62%	38%
200-500	69%	13%	82%	18%
500-1,000	66%	21%	87%	13%
1,000 +	46%	43%	89%	11%
All	58%	11%	69%	31%

*Capital gains subject to the lower rates are equal to net long-term gains in excess of net short term losses plus capital gains distributions not reported on Form 1040.
**By definition, taxable income is equal to AGI less exemptions and deductions. Reported IRS data show all reported exemptions and deductions, even if claiming them all would reduce taxable income below zero.



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