**A New Tax Bracket for Millionaires?**

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The debate over extending the 2001–2003 tax cuts beyond 2010 has revolved around two options: extend all provisions for all taxpayers, and the president's proposal to extend all provisions except those that apply only to high-income taxpayers. A third option has drawn attention: extend the 2001–2003 tax cuts fully for all taxpayers except those with income over $1 million. This paper explores alternate ways to structure an additional tax rate on millionaires (as defined by annual income, not wealth), but does not consider other alternatives, such as eliminating or reducing tax preferences, that would increase tax liabilities of millionaires without raising marginal tax rates.

One alternative would add a new tax bracket for taxable income over $1 million. Extending the 2001–2003 tax cuts would continue the current 35 percent top tax rate on taxable income over $379,150 in 2011. This approach would maintain the 35 percent top rate for most taxpayers subject to it, but would create a new, higher rate bracket starting at $1 million of taxable income. The higher rate would apply only to ordinary income and not to capital gains or qualified dividends; extending the 2001 and 2003 tax cuts would retain the current top rate of 15 percent on income from those sources. The new tax bracket would thus not affect millionaires with income solely or primarily from capital gains and dividends.

Raising taxes for all taxpayers with $1 million or more of taxable income, regardless of source, requires a different structure. The simplest approach would impose a new flat rate tax (a surcharge) on taxable income in excess of $1 million. The surcharge would apply to all taxable income, including capital gains and qualified dividends. The impact of the surcharge would depend on how it would apply in calculating a taxpayer's liability for the alternative minimum tax (AMT). Adding the surcharge to regular tax liability in determining AMT liability would exclude taxpayers who remained on the AMT; they would continue to pay the same total tax they would have paid without the surcharge. To ensure that all taxpayers with $1 million or more of taxable income pay additional tax, a third alternative would add the new surcharge to a person's tax liability only after calculating AMT.

These three alternatives would raise tax liability for taxpayers with *taxable* income over $1 million. But taxable income is the result of subtracting personal exemptions and itemized deductions (or the standard deduction) from the broader income measure, adjusted gross income (AGI). With enough deductions, a taxpayer with AGI well above $1 million could avoid any of the three tax increases. A fourth alternative— a surcharge on AGI (or an even broader income

measure) in excess of $1 million—would raise taxes for all high-income taxpayers. This surcharge would apply only after computing AMT liability.

The rates for each alternative depend on how much revenue they are intended to raise. The following estimates of the rate increases required for 2011 use as a target the revenue that the president's proposal raises, relative to full extension of the 2001–2003 tax cuts, by not extending certain provisions to high-income taxpayers. Under the president's proposal, the top rates of 33 and 35 percent would increase to 36 and 39.6 percent, the top rate on capital gains and qualified dividends would increase from 15 to 20 percent, and the personal exemption phaseout (PEP) and the limitation on itemized deductions (Pease) would be reinstated. All of these provisions would apply under current law for 2011, except that under the president's proposal, they would apply only to joint filers with incomes over $250,000 and single filers with incomes over $200,000. The estimates take into account only long-run behavioral responses and assume that the AMT "fix" proposed in the president's budget is in place.

The resulting tax rates on items of income, on deductions, and under the AMT in 2011 under extension of the 2001–2003 tax cuts and under each of the four alternatives would be as follows:

| | Tax rates (%) under: | | | | |
|---|---|---|---|---|---|
| | Tax cuts extended | Alternative | | | |
| | | 1 | 2[a] | 3[a] | 4[a] |
| Wages and other ordinary income | 35 | 50 | 44.2 | 43.1 | 41.3 |
| Capital gains and qualified dividends | 15 | 15 | 24.2 | 23.1 | 21.3 |
| Deductions | 35 | 50 | 44.2 | 43.1 | 35.0 |
| Top alternative minimum tax rate | 28 | 28 | 28.0 | 36.1 | 34.3 |
| ADDENDUM | | | | | |
| Taxpayers affected (thousands) | | 134 | 194 | 226 | 289 |

a. Rates shown are for a taxpayer subject to the top statutory tax rate on each source.

*Notes:*

Alternative 1 adds a new tax bracket of 50 percent at $1 million of taxable income.

Alternative 2 adds a surcharge of 9.2 percent on taxable income over $1 million and adds the surcharge to regular tax liability in determining AMT liability.

Alternative 3 adds a surcharge of 8.1 percent on taxable income over $1 million and does not add the surcharge to regular tax liability in determining AMT liability.

Alternative 4 adds a surcharge of 6.3 percent on AGI over $1 million and does not add the surcharge to regular tax liability in determining AMT liability.

The 50 percent rate on wages (and other ordinary income) under alternative 1 represents a 15 percentage point increase over the top rate of 35 percent that would apply if all of the 2001–2003 tax cuts were extended. Smaller rate increases would apply under the other alternatives because they apply to a broader base and hence to more income and more taxpayers. Alternatives 2, 3, and 4 would all increase the top rate on capital gains and qualified dividends, but—by design—preserve the 20 percent rate differential established by the 2001–2003 tax cuts.

A further consideration in the design of any alternative is whether the same $1 million threshold should apply to all taxpayers, regardless of filing status. If it does, marriage penalties on joint

taxpayers with similar incomes would increase. Setting a lower threshold for single and head of household filers would limit the increase in marriage penalties; reducing their threshold to half the joint amount, or $500,000, would eliminate any increase in penalties. The lower threshold for single and head of household filers would also reduce the required rates under each alternative by imposing the additional tax on more unmarried taxpayers. (For example, the required rate for alternative 1 would drop 1 percentage point to 49 percent.) Eliminating the increase in marriage penalties, however, would also increase current marriage bonuses for couples with highly disparate incomes.