# Reduce the Value of Certain Tax Expenditures

## REDUCE THE VALUE OF CERTAIN TAX EXPENDITURES

### Current Law

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, claiming certain deductions in the computation of adjusted gross income (AGI), and claiming either itemized deductions or a standard deduction. The tax reduction from the last dollar excluded or deducted is $1.00 times the taxpayer's marginal income tax rate (e.g., if the marginal tax rate were 35 percent, tax value of the last dollar deducted would be 35 cents).

Certain types of income are excluded permanently or deferred temporarily from income subject to tax. These items include interest on State or local bonds, amounts paid by employers and employees for employer-sponsored health coverage, contributions to health savings accounts and Archer MSAs, amounts paid by employees and employers for defined contribution retirement plans, certain premiums for health insurance for self-employed individuals, certain income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, interest on education loans, and certain higher education expenses.

Individual taxpayers may elect to itemize their deductions instead of claiming a standard deduction. In general, itemized deductions include medical and dental expenses (in excess of 7.5 percent of AGI)[10], state and local property taxes and income taxes[11], interest paid, gifts to charities, casualty and theft losses (in excess of 10 percent of AGI), job expenses and certain miscellaneous expenses (some only in excess of 2 percent of AGI).

For upper-income taxpayers, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced prior to 2010 if AGI exceeded a statutory floor that was indexed annually for inflation. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) temporarily eliminated this provision and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA) extended the elimination of the limitation on itemized deductions for two years, through 2012. The baseline for this Budget assumes that relief from this limitation on itemized deductions as provided by EGTRRA and TRUIRJCA is made permanent. However, another proposal in this Budget would reinstate this limitation on itemized deductions beginning in 2013 for upper-income taxpayers only.

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[10] The AGI floor for medical and dental expenses rises to 10 percent in 2013 for taxpayers under 65 years of age and in 2017 for all other taxpayers.

[11] In 2011, taxpayers could elect to deduct state and local general sales taxes instead of state and local income taxes. This Budget includes a proposal to extend that election for two years through 2013.

## Reasons for Change

Increasing the income tax liability of higher-income taxpayers would reduce the deficit, make the income tax system more progressive, and distribute the cost of government more fairly among taxpayers of various income levels. In particular, limiting the value of tax expenditures including itemized deductions, certain exclusions in income subject to tax, and certain deductions in the computation of AGI, would reduce the benefit that high income taxpayers receive from those tax expenditures and help close the gap between the value of these tax expenditures for high-income Americans and the value for middle class Americans.

## Proposal

The proposal would limit the tax value of specified deductions or exclusions from AGI and all itemized deductions. This limitation would reduce the value to 28 percent of the specified exclusions and deductions that would otherwise reduce taxable income in the 36-percent or 39.6-percent tax brackets. A similar limitation also would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision would include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher education expenses.

This proposal would apply to itemized deductions after they have been reduced by the statutory limitation on certain itemized deductions for higher income taxpayers.

The proposal would be effective for taxable years beginning after December 31, 2012.