High-Income Tax Returns for 1994

by John Latzy

The Tax Reform Act of 1976 required annual publication of data on individual income tax returns reporting income of $200,000 or more, including the number of such returns reporting no income tax liability and the importance of various tax provisions in making these returns nontaxable [1]. This article presents detailed data for the 1.1 million high-income returns for 1994, as well as summary data for the period 1977 to 1994. Detailed data for the years 1974 through 1993 have been published previously [2].

Two income concepts are used in this article to classify tax returns as high-income: the statutory concept of adjusted gross income (AGI) and the expanded income concept [3]. Expanded income uses items reported on tax returns to obtain a more comprehensive measure of income than AGI. Specifically, expanded income is AGI *plus* tax-exempt interest, nontaxable Social Security benefits, the foreign-earned income exclusion, and items of "tax preference" for "alternative minimum tax" purposes; *less* unreimbursed employee business expenses, moving expenses, investment interest to the extent it does not exceed investment income, and miscellaneous itemized deductions not subject to the 2-percent-of-AGI floor [4, 5]. Note that although expanded income is a more comprehensive measure of income than AGI, for some taxpayers, the subtractions from AGI to arrive at expanded income exceed the additions, with the result that expanded income is less than AGI.

Number of High-Income Returns

Table 1 shows that for 1994, there were 1,109,498 individual income tax returns reporting AGI of $200,000 or more, and 1,153,829 with expanded income of $200,000 or more. These returns represented, respectively, 0.957 percent and 0.995 percent of all returns for 1994.

Since 1977, the number of returns reporting income of $200,000 or more increased at a much more rapid rate than the total number of returns filed. This pattern is true under both income concepts. Between 1993 and 1994, while the total number of tax returns increased by slightly more than 1 percent, the number of high AGI returns increased by 11.7 percent, and the number of high expanded income returns rose by 10.6 percent. As a result, each year, returns with income of $200,000 or more have comprised a larger share of all returns than for the preceding year.

The difference in the number of high-income returns between the two income concepts significantly decreased beginning with 1987, when AGI began to include 100 percent of long-term capital gains. That change in the definition of AGI made the income concepts of AGI and expanded income more comparable. In addition, as a result of the inclusion of tax-exempt interest in expanded income starting with 1987, expanded income for years after 1986 is not strictly comparable to expanded income for years before 1987.

In the top panel of Figure A, the $200,000 threshold for high-income returns is measured in current-year (nominal) dollars. As a result of inflation, the real (constant) dollar level of the threshold fell over time, and some returns are classified as high-income that would not have been classified as high-income for earlier years. To maintain the comparability of the real threshold over time, the nominal $200,000 threshold has been adjusted for inflation to 1976 constant dollars for all years, and the number of high-income tax returns has been recomputed in the lower panel of Figure A [6].

When measured in 1976 constant dollars, under the expanded income concept, the total number of high-income returns was only 3.6 times the number for 1977. However, the number of high-income returns for 1994 measured in current-year dollars was 17.1 times as large as for 1977. Since 1977, the percentage of returns with expanded income of $200,000 or more in current dollars increased every year. However, the share of high expanded income returns in 1976 constant dollars fell for five of the most recent six years, from a high of 0.220 percent for 1988 to 0.185 percent for 1994. Figure B shows the difference between the constant and current dollar shares of high-income returns.

Based on AGI, the number of high-income returns for 1994 measured in current-year dollars was 20.8 times as large as for 1977. Measured in 1976 constant dollars, the number of returns for 1994 was only 4.5 times the number for 1977. Between 1988 and 1994, the share of such returns fell from 0.214 percent to 0.176 percent of all returns.

Nontaxable High-Income Returns

Two tax concepts are used in this article to classify tax returns as taxable or nontaxable. The first concept, "U.S. income tax," is total Federal income tax liability (including the "alternative minimum tax (AMT)," less all credits against income tax. Since the U.S. income tax applies to

This article was written by John Latzy, an economist with the Individual Operations Section, Individual Statistics Branch under the direction of Cathy Katz, Chief.

Figure A

All Returns and Returns with Income of $200,000 or More Measured In Current Dollars, and in 1976 Constant Dollars by Income Concept, Tax Years 1977 - 1994

Tax year	All returns	$200,000 income threshold measured in current dollars: Number of returns by income concept — Adjusted gross income	Expanded income	Percentage of all returns by income concept — Adjusted gross income	Expanded income
	(1)	(2)	(3)	(4)	(5)
1977	88,634,640	53,403	67,580	0.060	0.076
1978	89,771,551	68,506	85,137	0.076	0.095
1979	92,694,302	93,731	122,231	0.101	0.132
1980	93,902,459	117,250	149,826	0.125	0.160
1981	96,396,123	138,136	175,092	0.143	0.182
1982	95,337,432	169,367	207,291	0.178	0.217
1983	96,321,310	198,608	249,319	0.206	0.259
1984	99,438,708	243,760	310,042	0.245	0.312
1985	101,660,287	296,507	370,340	0.292	0.364
1986	103,045,170	374,363	529,460	0.363	0.514
1987	106,996,270	539,967	557,848	0.505	0.521
1988	109,708,280	725,345	737,659	0.661	0.672
1989	112,135,673	786,063	814,152	0.701	0.726
1990	113,717,138	834,957	860,940	0.734	0.757
1991	114,730,123	846,707	892,178	0.738	0.778
1992	113,604,503	954,747	989,522	0.840	0.871
1993	114,601,819	993,326	1,043,213	0.867	0.910
1994	115,943,131	1,109,498	1,153,829	0.867	0.995

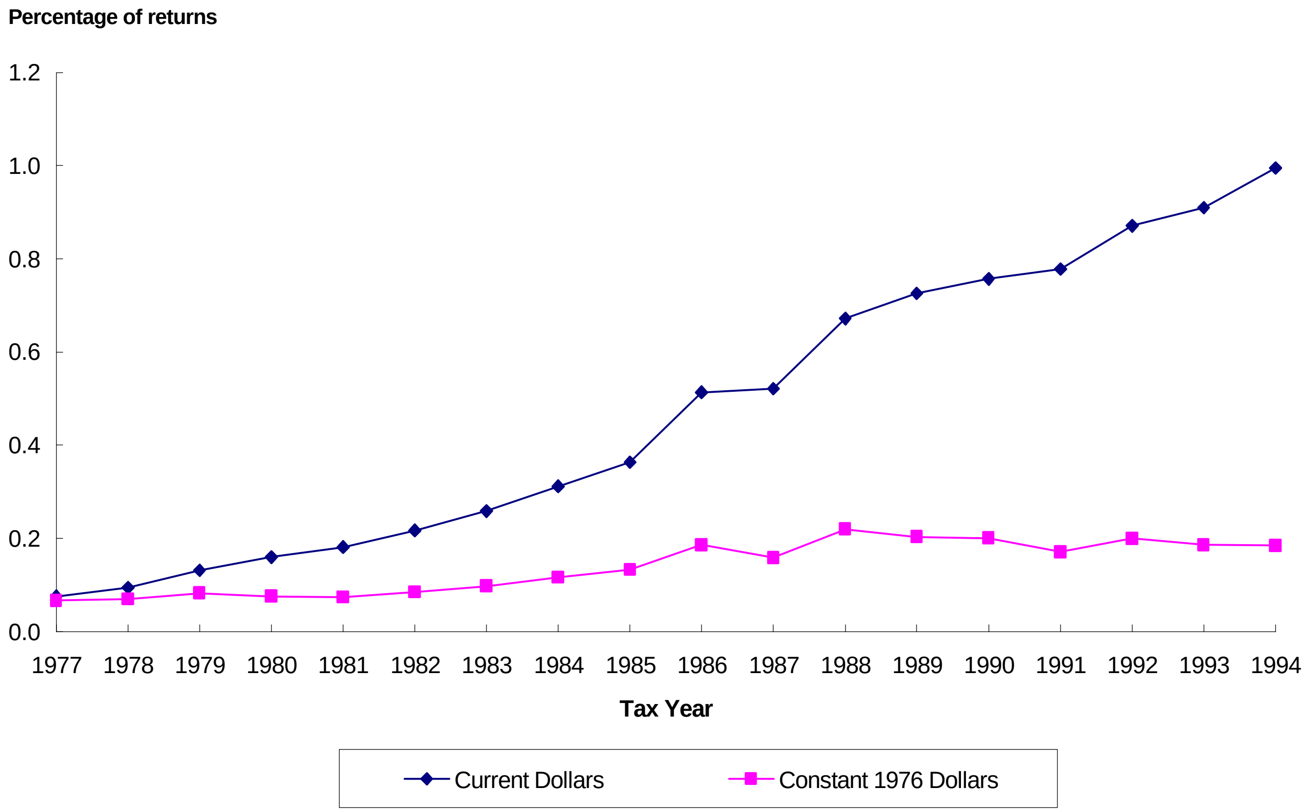
Tax year	All returns	$200,000 income threshold measured in current dollars: Number of returns by income concept — Adjusted gross income	Expanded income	Percentage of all returns by income concept — Adjusted gross income	Expanded income	Current dollar income threshold equal to $200,000 in 1976 constant dollars (whole dollars)
	(6)	(7)	(8)	(9)	(10)	(11)
1977	88,634,640	45,931	58,991	0.052	0.067	213,005
1978	89,771,551	49,388	62,556	0.055	0.070	229,174
1979	92,694,302	55,542	76,479	0.060	0.083	255,184
1980	93,902,459	52,512	71,704	0.056	0.076	289,631
1981	96,396,123	50,880	71,146	0.053	0.074	319,508
1982	95,337,432	59,411	81,297	0.062	0.085	339,192
1983	96,321,310	67,310	93,977	0.070	0.098	350,088
1984	99,438,708	80,800	116,389	0.081	0.117	365,202
1985	101,660,287	95,740	134,715	0.094	0.133	378,207
1986	103,045,170	119,550	191,596	0.116	0.186	385,237
1987	106,996,270	161,408	169,942	0.151	0.159	399,297
1988	109,708,280	235,051	241,201	0.214	0.220	415,817
1989	112,135,673	217,685	228,530	0.194	0.204	435,852
1990	113,717,138	216,716	228,659	0.191	0.201	459,400
1991	114,730,123	183,442	195,743	0.160	0.171	478,735
1992	113,604,503	213,783	227,354	0.188	0.200	493,146
1993	114,601,819	201,236	212,853	0.176	0.186	507,909
1994	115,943,131	204,532	214,673	0.176	0.185	520,914

worldwide income and since a credit (subject to certain limits) is allowed against U.S. income tax for income taxes paid to foreign governments, a return could be classified as nontaxable under this first concept, even though income taxes had been paid to a foreign government. The second tax concept, “worldwide income tax,” addresses this circumstance by adding to U.S. income tax the allowed foreign tax credit and foreign taxes paid on excluded foreign-earned income [7, 8].

For 1994, of the 1,109,498 income tax returns with AGI of $200,000 or more, 1,137, or 0.102 percent, showed no U.S. income tax liability; and 1,061, or 0.096

Figure B

Returns With Expanded Income of $200,000 or More: Percentage of All Returns Measured in Current and Constant (1976) Dollars, Tax Years 1977 - 1994



percent, showed no worldwide income tax liability (the top panel of Figure C) [9]. For 1993, there were 1,022 returns (0.103 percent) with AGI of $200,000 or more with no U.S. income tax liability; and 932 returns (0.094 percent) with no worldwide income tax liability. Even though the actual number of nontaxable returns with AGI of $200,000 or more increased, the percentage of those returns as a proportion of all returns with AGI of $200,000 or more did not change significantly.

Of the 1,153,829 tax returns with expanded income of $200,000 or more, 2,574, or 0.223 percent, had no U.S. income tax liability; and 2,161, or 0.187 percent, had no worldwide income tax liability. Of the 1,043,213 returns with expanded income of $200,000 or more for 1993, there were 2,392 (0.229 percent) with no U.S. income tax liability and 1,950 (0.187 percent) with no worldwide income tax liability. Thus, the proportion of nontaxable returns compared to all expanded high-income returns fell by one measure and was unchanged by the other measure between 1993 and 1994, even though the actual number of returns increased by 7.6 percent.

Although the number of nontaxable returns increased in all but three years since 1977, most of that increase was attributable to the growth in the overall number of all returns -- taxable and nontaxable -- with income of $200,000 or more. As mentioned previously, because of the inclusion of tax-exempt interest in expanded income starting with 1987, the concept of expanded income is no longer strictly comparable to expanded income calculated for years before 1987 [10].

Regardless of the income measure (AGI or expanded income) or the tax concept (U.S. income tax or worldwide income tax) used, the numbers of 1994 nontaxable high income returns in 1976 constant dollars were much lower than the numbers in current dollars. The percentages of nontaxable, high AGI returns are not substantially different

Figure C

Nontaxable Returns With Income of $200,000 or More Measured in Current Dollars and in 1976 Constant Dollars, by Tax and Income Concept

Tax year	$200,000 income threshold measured in current dollars							
	Number of nontaxable returns with income of $200,000 or more				Percentage of all returns with income of $200,000 or more			
	Returns with no U.S. income tax, by income concept		Returns with no worldwide income tax, by income concept		Returns with no U.S. income tax, by income concept		Returns with no worldwide income tax, by income concept	
	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1977	60	85	37	64	0.112	0.126	0.069	0.095
1978	98	105	60	67	0.143	0.123	0.088	0.079
1979	70	114	28	64	0.075	0.093	0.030	0.052
1980	143	198	56	114	0.122	0.132	0.048	0.076
1981	226	304	79	114	0.164	0.174	0.057	0.065
1982	262	299	109	153	0.155	0.144	0.064	0.074
1983	447	579	321	437	0.225	0.232	0.162	0.175
1984	532	325	471	271	0.218	0.105	0.193	0.087
1985	612	613	442	454	0.206	0.166	0.149	0.123
1986	659	595	437	379	0.176	0.112	0.117	0.072
1987	857	472	740	364	0.159	0.085	0.137	0.065
1988	822	397	731	309	0.113	0.054	0.101	0.042
1989	1,081	779	987	691	0.138	0.096	0.126	0.085
1990	1,219	1,183	1,114	1,087	0.146	0.137	0.133	0.126
1991	1,253	1,933	1,131	1,740	0.148	0.217	0.134	0.195
1992	909	1,896	823	1,799	0.095	0.192	0.086	0.182
1993	1,022	2,392	932	1,950	0.103	0.229	0.094	0.187
1994	1,137	2,574	1,061	2,161	0.102	0.223	0.096	0.187

Tax year	$200,000 income threshold measured in 1976 constant dollars							
	Number of nontaxable returns with income of $200,000 or more				Percentage of all returns with income of $200,000 or more			
	Returns with no U.S. income tax, by income concept		Returns with no worldwide income tax, by income concept		Returns with no U.S. income tax, by income concept		Returns with no worldwide income tax, by income concept	
	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income	Adjusted gross income	Expanded income
	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
1977	54	75	32	56	0.118	0.127	0.070	0.095
1978	62	70	31	39	0.126	0.112	0.063	0.062
1979	38	71	15	39	0.068	0.093	0.027	0.051
1980	56	71	22	39	0.107	0.099	0.042	0.054
1981	53	87	21	55	0.104	0.122	0.041	0.077
1982	58	68	27	36	0.098	0.084	0.045	0.044
1983	138	135	113	108	0.205	0.144	0.168	0.115
1984	170	78	160	66	0.210	0.067	0.198	0.057
1985	190	155	137	99	0.198	0.115	0.143	0.073
1986	201	189	138	120	0.168	0.099	0.115	0.063
1987	312	126	271	85	0.193	0.074	0.168	0.050
1988	277	141	251	116	0.118	0.058	0.107	0.048
1989	293	128	269	106	0.135	0.056	0.124	0.046
1990	339	169	307	137	0.156	0.074	0.142	0.060
1991	301	305	273	277	0.164	0.156	0.149	0.142
1992	171	288	148	264	0.080	0.127	0.069	0.116
1993	180	323	160	300	0.089	0.152	0.080	0.141
1994	227	345	209	329	0.113	0.161	0.104	0.153

regardless of whether measured in constant or current dollars. For high expanded income returns, however, the percentage of nontaxable constant- dollar returns was greatly lower than for current-dollar returns. Of returns with AGI of $200,000 or more in current dollars, 0.102 percent reported no U.S. income tax for 1994, and 0.096 percent had no worldwide income tax. For returns in 1976 constant dollars, the percentage without U.S. income tax liability was 0.113; the percentage without worldwide income tax liability was 0.104 (see the lower panel of Figure C).

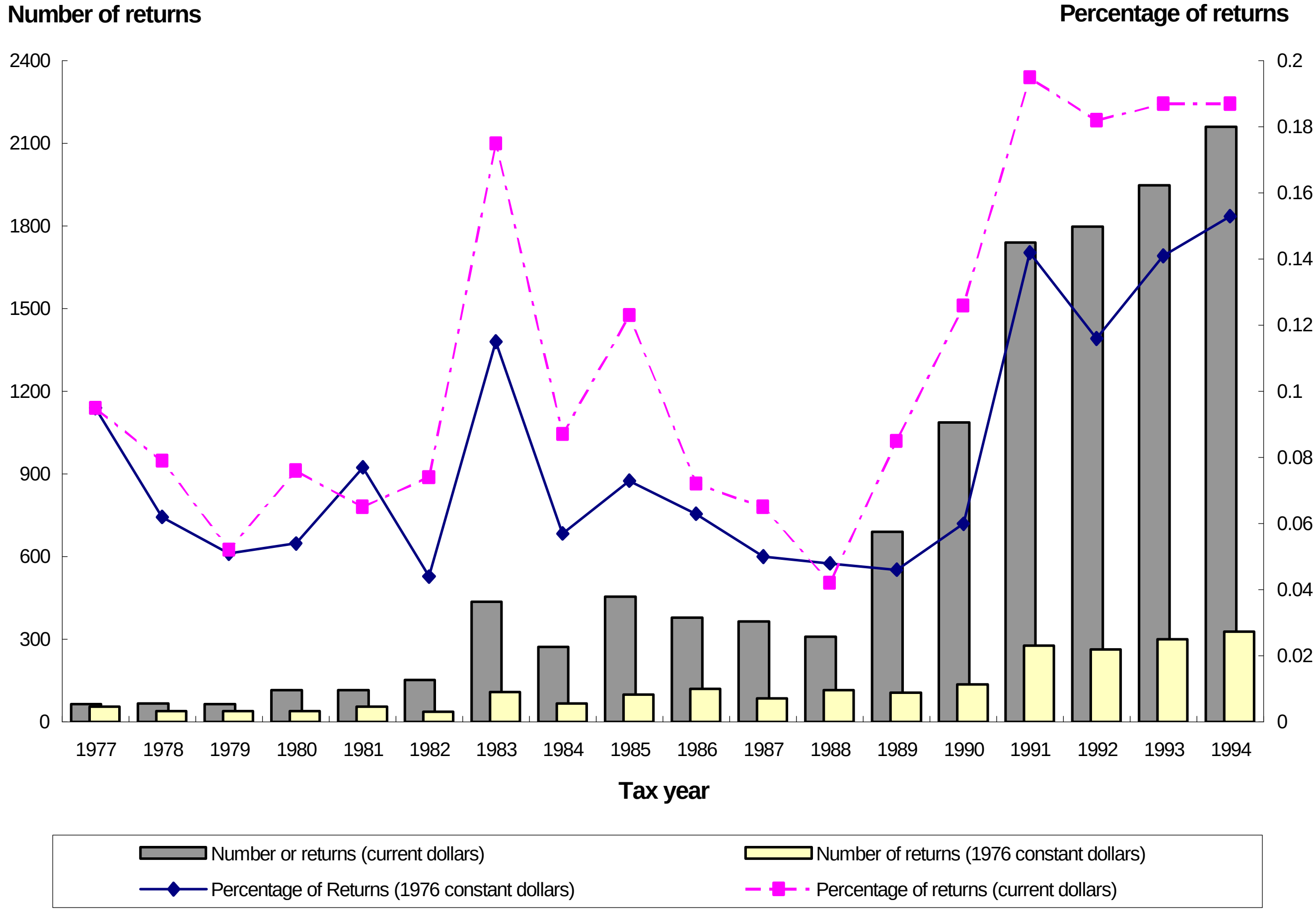
Of returns with expanded income of $200,000 or more in current dollars, 0.223 percent reported no U.S. income tax, and 0.187 percent reported no worldwide income tax. When looking at these same returns using 1976 constant dollars, the percentage without U.S. tax liability was 0.161; the percentage without worldwide income tax liability was 0.153.

Note that because the number of nontaxable returns with expanded income of $200,000 or more is based on samples, year-to-year differences in the numbers and percentages of nontaxable returns with expanded income of $200,000 or more may represent sampling variability, in addition to actual changes in the numbers of such returns. For example, beginning with Tax Year 1991, nontaxable returns with expanded income of $200,000 or more were sampled at higher rates for Statistics of Income, which reduced the sampling variability of these returns and therefore provided improved estimates. Thus, data for returns prior to 1991 are not entirely comparable with data for more recent years.

Figure D shows the number of returns with no worldwide income tax and with expanded income of $200,000 or more and their proportion of all high-income returns for 1977 through 1994. These data are shown in both current-year and 1976 constant dollars. In this figure, the spread between the two percentage lines was small for the late 1970's, showed an increase for the early 1980's, and then narrowed before widening again after 1988. The spread narrowed for 1994.

Figure D

Number and Percentage of Returns with No Worldwide Income Tax and with Expanded Income of $200,000 or More, Tax Years 1977 - 1994



Detailed Data for 1994

Tables 1 through 12 present data based on income tax returns for 1994, mainly those with income of $200,000 or more (measured in current-year dollars) of AGI or expanded income. Most of the data are shown for taxable and nontaxable returns, both separately and combined. In summary, the tables show:

- The numbers of returns under the two tax concepts, cross-classified by broad AGI and expanded income size classes (Tables 1 and 2);
- The distributions of taxable income as a percentage of AGI and expanded income (Tables 3 and 4);
- The frequencies and amounts of various sources of income, exclusions, deductions, taxes, and tax credits, as well as the relationship between the two income concepts (Tables 5 and 6);
- The frequencies with which various deductions and tax credits are the most important and second most important items in reducing (or eliminating) income tax (Tables 7 and 8);
- The frequencies with which various itemized deductions, tax credits, and tax preference items occur as certain percentages of income (Tables 9 and 10); and
- The distributions of effective tax rates, i.e., income tax under each definition as a percentage of income, by broad income-size classes (Tables 11 and 12).

Tables 1,3,5,7,9, and 11 use the U.S. income tax concept to classify returns as taxable or nontaxable, whereas Tables 2, 4, 6, 8, 10, and 12 use the worldwide income tax concept.

Size of Income

Tables 1 and 2 show the number of all returns, taxable returns, and nontaxable returns, cross-classified by broad AGI and expanded income-size classes. The tables show that most returns fall in the same broad income-size class under both income concepts, but that expanded income tends to be a broader measure of income and therefore classifies more total and taxable returns in each of the $50,000-and-over income-size classes. Table 1 shows that 1,137 returns with no U.S. income tax had an AGI of $200,000 or more, and 2,574 returns with no U.S. income tax had an expanded income of $200,000 or more.

Distribution of Tax Levels

Tables 3 and 4 show the distributions of high-income returns by the ratios of "adjusted" taxable income to AGI or expanded income. Taxable income has been "adjusted" for these tables by subtracting from taxable income the deduction equivalents of tax credits and other items [11].

The tables illustrate three important facts about high-income tax returns. (The examples in the paragraphs below are drawn from the "expanded income" columns in Table 4.)

- As already described, only a small portion of high-income taxpayers were able to escape all income taxes (0.187 percent, which is rounded to 0.2 percent in Table 4).
- Another group of high-income taxpayers--small, but larger than the nontaxable group--was able to offset a very substantial fraction of its income before being subject to tax. This type of high-income taxpayer pays income tax equal to only a small share of his or her income. Such taxpayers may be called "nearly nontaxables." (About 0.9 percent of high expanded-income taxpayers reported some tax liability, but were able to reduce their taxable income to less than 25 percent of their expanded income.)
- Overall, a large portion of high-income taxpayers were subject to tax on a large share of their income and, consequently, reported very substantial amounts of tax. (Almost 68 percent had taxable income equal to 80 percent or more of expanded income. Over 96 percent had taxable income equal to 50 percent or more of expanded income.)

Tables 11 and 12 show the distributions of tax returns in another way: by tax burden. These two tables classify all tax returns by both size of income and effective tax rate, i.e., income tax as a percentage of either adjusted gross income or expanded income. These tables show that, on average, high-income taxpayers did have higher effective tax rates. The tables also illustrate the wide dispersion of effective tax rates for high-income returns. For example, Table 12 shows that while 2.2 percent of returns with expanded income of $200,000 or more had either no worldwide income tax or worldwide income tax of less than 10 percent of expanded income, 57 percent had effective tax rates of 25 percent or more. Over 84 percent of high-income taxpayers had average tax rates ranging from 20 percent to 35 percent, while almost 38 percent had effective tax rates between 25 percent and 30 percent.

Characteristics of Tax Returns

Tables 5 and 6 show, in the aggregate, the frequencies and amounts of the types of income, the items of tax preference, and the various deductions, credits, and income taxes shown on high-income returns. By comparing the columns for nontaxable returns with those for taxable returns, some of the different characteristics of nontaxable returns can be deduced. For example, nontaxable returns, under the expanded-income concept, were much more likely to have tax-exempt interest than were taxable returns, and when they do have it, the average amount is much higher. Similarly, they were much less likely to have any income from wages and salaries.

Reasons for Nontaxability

It is possible for certain itemized deductions and certain exclusions from income to cause nontaxability by themselves, but high-income returns are more often nontaxable as a result of a combination of reasons, none of which, by itself, would result in nontaxability. Moreover, some items, which singly or in combination may eliminate "regular tax" liability, i.e., income tax excluding the alternative minimum tax (AMT), cannot eliminate an AMT liability, since these items give rise to adjustments or preferences for AMT purposes.

Because they do not generate AMT adjustments or preferences, tax-exempt bond interest, itemized deductions for interest expense, miscellaneous itemized deductions not subject to the 2-percent-of-AGI floor, casualty or theft losses, and medical expenses (exceeding 10 percent of AGI) could, by themselves, produce nontaxability [12].

Due to the AMT exclusion of $45,000 on joint returns ($33,750 on single and head-of-household returns and $22,500 on returns of married taxpayers filing separately), a return could have been nontaxable, even though it included some items that produced AMT adjustments or preferences [13]. Further, since the starting point for "alternative minimum taxable income" was taxable income for regular tax purposes, a taxpayer could have adjustments and preferences exceeding the AMT exclusion without incurring AMT liability. This situation could occur if taxable income for regular tax purposes was sufficiently negative, due to itemized deductions and personal exemptions exceeding AGI, so that the taxpayer's AMT adjustments and preferences are less than the sum of the AMT exclusion and the amount by which regular taxable income is below zero. Note that because of the AMT, taxpayers may have found it beneficial to report additional deduction items on their tax returns, even if the items did not produce a benefit for regular tax purposes.

Tables 7 and 8 classify tax returns by the items that had the largest and second largest effects in reducing or eliminating income tax. For returns on which each of the largest effects was identified, the tables show each of the second largest effects [14]. For example, on taxable returns with some U.S. income tax and expanded income of $200,000 or more, the taxes paid deduction was the most important item 35.9 percent of the time. Where this was the primary item, the interest paid deduction was the second most important item 50.6 percent of the time, and the contributions deduction was the second most important item 31.2 percent of the time (Table 7).

On taxable returns with some worldwide tax and expanded income of $200,000 or more, the most important item in reducing the tax reported on 36 percent of the returns was the itemized deduction for taxes (State and local) paid; for these returns, the itemized deduction for interest paid was the second most important item 51 percent of the time, and the deduction for charitable contributions was the second most important reason 32 percent of the time (Table 8).

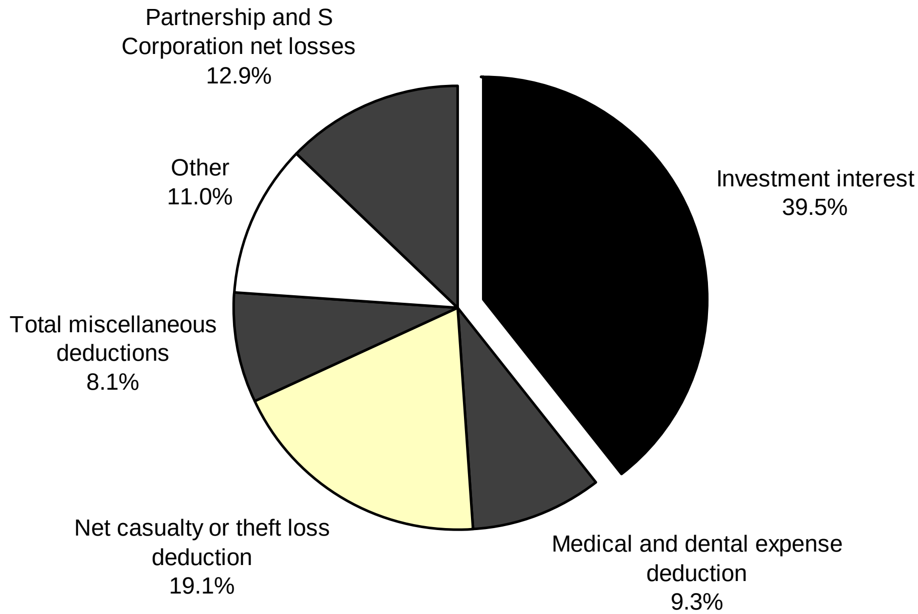
The four categories with the largest effect in reducing taxes on high adjusted gross income returns with no worldwide income tax were the investment interest deduction (419 returns, or 39.5 percent of the 1,061 tabulated returns with AGI of $200,000 or more and with no worldwide tax liability); net casualty or theft loss deduction (203 returns, or 19.1 percent); partnership and S Corporation net losses (137 returns, or 12.9 percent); and medical and dental deductions (99 returns, or 9.3 percent). These effects are also shown in Figure E.

The four categories that most frequently had the largest effect in reducing taxes for high expanded-income returns with no worldwide income tax were tax-exempt interest (1,479 returns, or 68.4 percent of the 2,161 tabulated returns with expanded income of $200,000 or more and with no worldwide tax liability); medical and dental expense deductions (213 returns, or 9.9 percent); net casualty or theft loss deduction (201 returns, or 9.3 percent); and partnership and S corporations net losses (135 returns, or 6.3 percent). These effects are also shown in Figure F**.** Table 8 also shows the two items that most frequently had the second largest effect in reducing regular tax liability for high expanded-income returns with no worldwide tax. These were the deduction for taxes paid and the deduction for medical and dental expenses.

Tables 9 and 10 present another way of illustrating the importance of various tax provisions in reducing or eliminating income tax. Unlike Tables 7 and 8, these tables cover only nontaxable returns, i.e., returns showing no income tax liability, including AMT. Tables 9 and 10 show the number of times that various items reduced income by different fractions of income. The items shown are the various categories of itemized deductions, the deduction equivalents of two different types of tax credits, and total tax preferences excluded from income. For example, for high expanded-income returns with no worldwide income tax (Table 10), the itemized deduction for casualty or theft losses exceeded 100 percent of ex-

Figure E

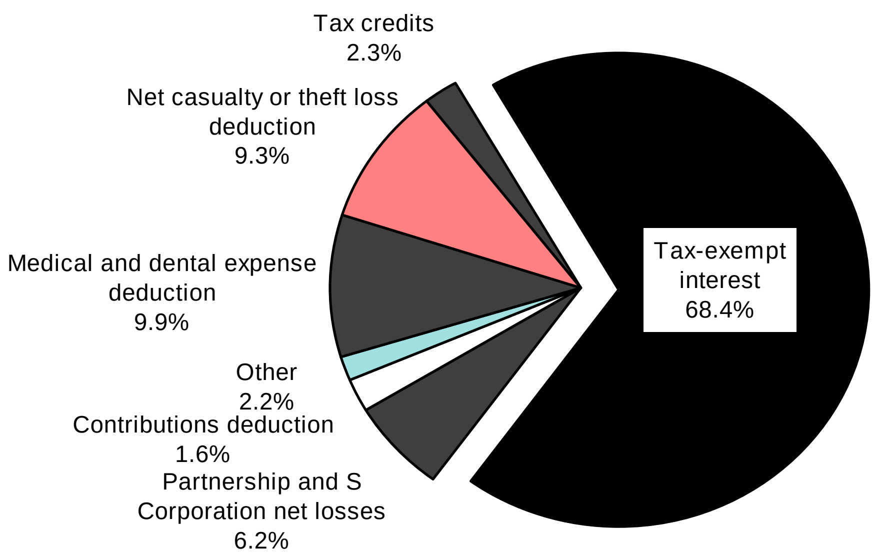
Returns With No Worldwide Income Tax and With Adjusted Gross Income of $200,000 or More: Primary Reasons for Reduced Income Tax Liabilities, Tax Year 1994



NOTE: Detail may not add to total because of rounding.

Figure F

Returns With No Worldwide Income Tax and With Expanded Income of $200,000 or More: Primary Reasons for Reduced Income Tax Liabilities, Tax Year 1994



NOTE: Detail may not add to total because of rounding.

panded income on 109 of the 2,161 returns, but there was no casualty or theft loss deduction on 1,924 returns. The medical expense deduction exceeded total expanded income on 34 returns and amounted to between 50 percent and 100 percent of expanded income on an additional 176 returns.

Notes and References

[1] The statutory requirement is contained in section 2123 of the Tax Reform Act of 1976 (90 Stat. at 1915).

[2] Lerman, Allen H., "High-Income Tax Returns: 1974 and 1975, A Report on High-Income Taxpayers Emphasizing Tax Returns with Little or No Tax Liability," U.S. Department of Treasury, Office of Tax Analysis, March 1977, and "High-Income Tax Returns: 1975 and 1976, A Report Emphasizing Nontaxable and Nearly Nontaxable Income Tax Returns," U.S. Department of Treasury, Office of Tax Analysis, August 1978.

U.S. Department of Treasury, Internal Revenue Service, Statistics of Income--Individual Income Tax Returns for 1977 through 1982 and 1985 through 1988. (For 1977 and 1978, only the number of nontaxable, high-AGI returns was published.)

Lerman, Allen H., "High-Income Tax Returns, 1983," *Statistics of Income Bulletin*, Spring 1986, Volume 5, Number 4, pp. 31-61, and "High-Income Tax Returns, 1984," *Statistics of Income Bulletin*, Spring 1987, Volume 6, Number 4, pp. 1-29; "High-Income Tax Returns for 1989," *Statistics of Income Bulletin*, Spring 1993, Volume 12, Number 4, pp. 23-50; "High-Income Tax Returns for 1990," *Statistics of Income Bulletin,* Winter 1993-1994, Volume 13, Number 3, pp. 104-132; "High-Income Tax Returns for 1991," *Statistics of Income Bulletin*, Winter 1994-1995, Volume 14, Number 3, pp. 96-130; "High-Income Tax Returns for 1992," *Statistics of Income Bulletin,* Winter 1995-1996, Volume 15, Number 3, pp. 46-82. Latzy, John, "High-Income Tax Returns for 1993," *Statistics of Income Bulletin,* Winter 1996-1997, Volume 16, Number 3, pp. 64-101.

[3] The 1976 Act specified four income concepts for classifying tax returns: adjusted gross income (AGI), expanded income, AGI plus excluded tax preference items, and AGI less investment interest not in excess of investment income. Section 441 of the Deficit Reduction Act of 1984 (90 Stat. at 815) eliminated the requirement to use the last two income concepts.

[4] The definition of adjustments to AGI to obtain the expanded income given in the text is for 1994. Moving expense deductions are for prior-year moves only. Beginning with 1994, current-year moving expenses were no longer an itemized deduction on Schedule A. Instead, taxpayers deducted current-year qualified moving expenses in the calculation of adjusted gross income as a statutory adjustment. See Appendix A for a discussion of AGI and expanded income, and a list of adjustments covering all years since 1977.

[5] See Notes to Appendix A, A4.

[6] Inflation-adjusted constant dollars are based on the Consumer Price Index (CPI-U) computed and reported by the U.S. Department of Labor, Bureau of Labor Statistics, *Monthly Labor Review.* This is also reported in Table B-58, page 365 of the 1997 *Economic Report of the President.*

[7] See Appendix B for a discussion of the tax concepts. In data published for years prior to 1989, either in articles presented in the Statistics of Income Bulletin or in chapters in Statistics of Income--Individual Income Tax Returns (see footnote 2), the "U.S. income tax" concept was described as "total income tax," and the "worldwide income tax" concept was described as "modified total income tax."

[8] The inclusion of foreign taxes paid on excluded foreign-earned income, beginning with Tax Year 1990, represents an improvement in the worldwide income tax concept. It does, however, represent a slight break in the year-to-year comparability of data for worldwide income tax. However, the number of returns with foreign taxes paid on excluded foreign-earned income is extremely small compared to the number of returns with the foreign tax credit.

[9] Includes returns on which income tax was entirely offset by the earned income credit.

[10] Tax-exempt interest had to be reported on the individual income tax return starting with Tax Year 1987 and is included in expanded income starting with that year. Beginning with Tax Year 1991, tax-

exempt interest was incorporated into the criteria used for sampling returns for Statistics of Income, thus increasing the reliability of the estimates of expanded income.

[11] See Appendix B for a description of how the deduction equivalent of credits was computed.

[12] The deduction for charitable contributions could also fall into this class if it were not limited to 50 percent of AGI.

[13] The AMT exclusion phases out above certain levels of "alternative minimum taxable income," based on filing status, but since taxpayers will have some AMT liability in the phaseout range, the phaseout income is not relevant for nontaxable returns.

[14] Tax year 1994 was the first time tax-exempt interest and the foreign-earned income exclusion were included in Tables 7 and 8 as possible tax effects. Therefore, caution should be exercised in making comparisons between data for 1994 and for previous years.

Appendix A: Income Concepts

Congress wanted data on high-income taxpayers classified by an income concept that was more comprehensive than adjusted gross income (AGI), but that was based entirely on items already reported on income tax returns. In order to derive such an income concept, it was necessary to begin with a broad, inclusive concept of income. AGI must then be compared to this broad income concept, and the differences (both additions and subtractions) that can be determined from items reported on tax returns identified.

This appendix begins by defining "Haig-Simons income," a very broad concept of income used by economists and others as a standard. AGI is then compared to Haig-Simons income, and the major differences between the two income concepts *are* listed. The final section defines "expanded income," a more comprehensive income measure than AGI, based entirely on tax return data.

Haig-Simons Income

The broadest measure of annual income generally used by economists and others is defined as the value of a household's consumption plus the change, if any, in its net worth. This income concept is referred to as Haig-Simons income, or H-S income, after the two economists who wrote extensively about it [A1]. The H-S income of a household that consumed $25,000 and saved $2,000 in a year would be $27,000. Alternatively, the H-S income of a household that consumed $25,000 and had no additions to savings, but had assets that declined in value by $1,000 in a year, would be $24,000.

H-S income consists of three broad components: labor income, capital income (income from assets), and income from transfer payments. The major elements of each of these three components are as follows:

Labor income. -- This includes all forms of employee compensation (including wages and salaries), employee fringe benefits (such as employer-provided health insurance and accrued pension benefits or contributions), and the employer share of payroll taxes (such as Social Security taxes). Labor income also includes the labor share of self-employment income. Expenses of earning labor income would be deducted in arriving at H-S income. Deferred labor income (such as pension benefits) would be counted in the year it was earned, rather than in the year it was received.

Capital income.-- This includes all income from assets, including interest, dividends, rents, royalties, accrued capital gains (whether or not realized), the capital income share of self-employment income, and the rental value of consumer durables (most importantly, the rental value of owner-occupied housing). Capital income is measured in real (inflation-adjusted) terms, and is net of real, economic depreciation and all other expenses (which could exceed capital income).

Transfer payments.-- These include payments in cash (such as Social Security benefits, workers' compensation, unemployment benefits, Aid for Dependent Children, or AFDC, and noncash benefits (such as Medicare, Medicaid, and food stamps).

For purposes of tax analysis, H-S income should be measured on a pre-tax basis, the amount that would be earned if there were no Federal income tax in place. Most items of income are unaffected, or little affected, by the income tax and so are reported on a pre-tax basis. However, certain income items from tax-preferred sources may be reduced because of their preferential treatment. An example is interest from tax-exempt State and local Government bonds. The interest rate on tax-exempt bonds is generally lower than the interest rate on taxable bonds of the same maturity and risk, with the difference approximately equal to the tax rate of the typical investor in tax-exempt bonds. Thus, investors in tax-exempt bonds are effectively paying a tax, referred to as an "implicit tax," and tax-exempt interest as reported is measured on an after-tax, rather than a pre-tax, basis. Income from all tax-preferred sources should be "grossed up" by implicit taxes to properly measure H-S income.

Adjusted Gross Income

AGI is the statutory definition of income for Federal income tax purposes. AGI differs from H-S income by excluding some components of H-S income and by allowing accelerated business deductions and deductions unrelated to income, but also by disallowing or limiting certain expenses of earning income and certain losses. In addition, AGI is not “grossed up” for implicit taxes.

The components of H-S income excluded from AGI include most employee fringe benefits, the employer share of payroll taxes, accrued but deferred employee compensation, accrued but unrealized real capital gains, the rental value of consumer durables, most Social Security benefits, most other cash transfers, all noncash transfers, and the real income of borrowers due to inflation [A2].

Depreciation and certain other expenses allowed in determining AGI may be accelerated (relative to economic depreciation and other costs) in the early years of an investment, thus understating investment income. In later years, however, investment income in AGI will be overstated because depreciation and other accelerated expenses will then be understated. AGI also excludes contributions to Individual Retirement Arrangements (IRA’s) and self-employed retirement (Keogh) plans, which are not expenses related to earning income.

AGI generally *exceeds* H-S income to the extent expenses of earning income and losses are limited or disallowed. Most of the expenses of earning income are deductible *from* AGI in calculating taxable income, but only if the taxpayer “itemizes” deductions and then in some cases only to the extent that the sum of all such items exceeds 2 percent of AGI. Expenses incurred in the production of income that are itemized deductions include certain expenses of employees (such as union dues; expenditures for items used on the job but not reimbursed by the employer; and the employees’ travel, meal, and entertainment expenses); tax year 1994 job-related moving expenses (for prior year moves only); and expenses attributable to a taxpayer’s (passive) investments (as opposed to active participation in a trade or business, for example), including, but not limited to, interest expense incurred in connection with investments in securities [A3]. Note that there are limits on certain types of deductible expenses. In particular, deductible meal and entertainment expenses are limited to 50 percent of total meal and entertainment expenses. Although some job-related moving expenses have been deducted in calculating AGI, the deductions for some related expenses, such as expenses for temporary quarters and expenses for selling a former residence, are limited.

Although net capital losses reduce economic income, only the first $3,000 of net realized capital losses may be deducted in computing AGI. Any additional realized losses must be carried forward to future years. In a somewhat similar manner, “passive” losses (from investments in a trade or business in which the taxpayer does not materially participate) can also reduce economic income, but in computing AGI, they can only be deducted from “passive” income from other, similar investments (although a larger amount may be deducted when the losses are from rental real estate activities).

AGI can also exceed H-S income because of differences in the timing of income between the two concepts. For example, a taxpayer may realize more capital gains in a year than he or she accrues in capital gains. Since AGI includes only realizations of capital gains, whereas H-S income includes only accruals, AGI in this circumstance would exceed H-S income.

Finally, just as AGI understates the income of borrowers due to inflation, it overstates the income of lenders, who include bond owners and owners of bank deposits.

Expanded Income

Expanded income is meant to be a measure of income that is conceptually closer to H-S income than AGI, but that is derived entirely from items already reported on income tax returns. Figure G shows the adjustments made to AGI to arrive at expanded income. Since the definition of AGI

Figure G

Derivation of Expanded Income from Adjusted Gross Income, Tax Years 1977 - 1994

Adjusted gross income (AGI)

PLUS:
- o Excluded capital gains (tax years prior to 1987)
- o Tax-exempt interest (1987 and later tax years)
- o Nontaxable Social Security benefits (1987 and later tax years)
- o Tax preferences for alternative minimum tax purposes [A5]
- o Foreign-earned income exclusion (Tax Year 1990 and later tax years)

MINUS:
- o Unreimbursed employee business expenses [A6]
- o Nondeductible rental losses (Tax Year 1987)
- o Moving expense deduction (Tax Years 1987 through 1993) [A7]
- o Investment interest expense to the extent it does not exceed investment income
- o Miscellaneous itemized deductions not subject to the 2-percent-of-AGI floor (1989 and later tax years)

EQUALS: o Expanded income

NOTE: Footnotes to Figure G are included with the footnotes to Appendix A.

was changed by legislation several times since 1977, and certain reporting requirements also changed, the adjustments differ over the years, as indicated for each item [A4]. Most of these adjustments are relatively straightforward, but the adjustment for investment requires some explanation.

Investment Interest

In measuring H-S income, it generally would be appropriate to deduct all expenses incurred in the production of income, including those related to any income-producing investments, without limit. Investment expenses in excess of investment income would then represent net economic losses. However, such a liberal deduction for investment-related expenses is not necessarily correct when not all income items have been included currently. (Investment income includes interest, dividends, and capital gains.)

If all income has not been included currently, full deduction of investment expenses might represent a mismatching of receipts and expenses and might result in *understating* income. For example, if a taxpayer borrowed funds to purchase securities, net income would be understated if the taxpayer deducted all interest payments on the loan, but did not include as income any accrued gains on the securities. A similar mismatching of income and expenses would occur if investment expenses that should properly be capitalized were deducted when paid. In these instances, a more accurate measure of income might be obtained by postponing the deduction of the expense until such time as the income were recognized for tax purposes.

Additional problems are created when a person with a loan has both income-producing assets, such as securities, and non-income-producing assets, such as a vacation home or yacht. It is not possible to determine what portion of the interest expense should be attributed to taxable income-producing assets and, therefore, ought to be deductible against the gross receipts from such taxable assets. As a result of these problems, it has been necessary to set arbitrary limits on the amount of investment expenses that are deductible in calculating expanded income.

Investment expenses that have not been deducted in determining AGI generally can appear on a Federal individual income tax return in two places. Investment interest is taken into account in the calculation of the itemized deduction for interest paid. Deductible investment interest is a separate part of the total interest deduction. Other investment expenses, such as management fees, are included in the miscellaneous category of itemized deductions [A8]. Beginning with 1987, most types of income-producing expenses included as miscellaneous itemized deductions are only deductible to the extent that their total exceeds 2 percent of AGI. To determine expenses that should be deductible in calculating an approximation of H-S income, investment expenses have been defined as deductible investment interest. Other investment expenses could not be separated from the remainder of miscellaneous deductions. Hence, they have not been used in the adjustment for investment expenses.

To the extent that interest expenses do *not* exceed investment income, they are generally allowed as a deduction in the computation of deductible investment interest and thus expanded income. Investment interest expenses that do *exceed* investment income are *not* deductible in calculating expanded income. One consequence of this definition is that investment expenses can never turn positive investment income into investment losses. Generally, allowing investment expenses to offset all investment income is generous and tends to understate broadly-measured income. However, in some instances, limiting investment expenses to investment income may *overstate* income by disallowing genuine investment losses.

Notes to Appendix A

[A1] Haig, Robert M. (ed.), *The Federal Income Tax*, Columbia University Press, 1921, and Simons, Henry C., *Personal Income Taxation*, University of Chicago Press, 1938.

[A2] Borrowers receive income due to inflation because the real value of debt is reduced by inflation. Even though inflation may be anticipated and reflected in interest rates, tax deductions for nominal interest payments overstate interest costs because part of these payments represent a return of principal to the lender, rather than interest.

[A3] See Notes and References, footnote 4.

[A4] For 1977, 50 percent of net long-term capital gains were included in AGI. During 1978, the inclusion ratio was changed to 40 percent. This inclusion ratio remained unchanged through 1986. Beginning with 1987, there was no exclusion allowed for capital gains in computing AGI, and thus, this adjustment was not made in computing expanded income for returns for years after 1986.

From this time forward, taxpayers were required to report on their Federal income tax returns the amount of their tax-exempt interest income from State and local Government bonds. Since 1987, tax-exempt interest has been included in expanded income.

Taxpayers are also required to report Social Security benefits. Since 1988, nontaxable Social Security benefits have been included in expanded income. However, if none of a particular taxpayer's Social Security benefits are taxable, then gross Social Security benefits are not required to be shown on the income tax return. In such instances, which generally only affect lower and middle income taxpayers, Social Security benefits are not included in expanded income.

The subtraction of unreimbursed employee business expense and the moving expense deduction is to make the concept of expanded income comparable to years prior to 1987. Note that only prior-year moving expenses were subtracted for 1994. All current-year 1994 moving expenses were deducted in the calculation of AGI as a statutory adjustment.

Due to subtracting non-limited miscellaneous deductions and not subtracting the nondeductible rental loss for 1989, the expanded income concept for 1989 is not strictly comparable to expanded income for 1988. Nor is the expanded income concept for 1990 strictly comparable to expanded income for 1989 because of the addition of the foreign-earned income exclusion. Specific details on the definition of expanded income for any given year are available in the reports and publications enumerated in footnote 2, under Notes and References.

[A5] The "tax preferences" (obtained from Form 6251, *Alternative Minimum Tax Computation*) excluded from adjusted gross income and tabulated in Tables 5 and 6 include the following items: the excess of accelerated depreciation over straight-line depreciation on certain real property and property subject to a lease (for property placed in service before 1987); the appreciated portion of the value of certain property contributed to charitable organizations; the excess of percentage depletion over the "adjusted basis" of the property; certain intangible drilling costs to the extent that they exceed otherwise allowable amortization deductions; and related adjustments, refigured for AMT purposes, such as section 179 expense deductions, expenses for business or rental use of the home, taxable IRA distributions, etc.

Preferences obtained through itemized deductions do not represent omitted income. Hence, they have not been counted as preference items in calculating a broader measure of income. The preference from tax-exempt interest on certain private activity bonds was not included, since the interest for *all* tax-exempt State and local Government bonds is considered to be omitted income. Specific details on the tax preference items obtained from Form 6251 for earlier years are available in the reports and publications enumerated in footnote 2, under Notes and References.

[A6] Includes deductible meal and entertainment expenses. Deductible expenses are limited to 50 percent of total meal and entertainment expenses, beginning with Tax Year 1994.

[A7] Certain moving expenses, such as expenses for temporary quarters and expenses of selling the former residence, are limited.

[A8] Some income deferrals and accelerated expense deductions may also be involved in income or losses from rental property, from royalties, from partnerships, and from S Corporations, only the net amounts of which are included in adjusted gross income.

Appendix B: Tax Concepts

This appendix provides a brief summary of the U.S. taxation of worldwide income and the foreign tax credit. The two tax concepts used in this article are then defined. The following section explains the computation of the deduction equivalent of credits and other items. A final section discusses the possible implications of the use of unaudited tax return data for this article.

U.S. Taxation of Worldwide Income and the Foreign Tax Credit

Citizens and residents of the United States, regardless of where they physically reside, must generally include in income for Federal income tax purposes income from all geographic sources. Thus, for example, dividends and interest received from a foreign corporation or income earned working abroad is subject to Federal income tax in the same manner as income received from sources inside the United States [B1]. Income from sources outside the United States may also be subject to tax by foreign governments.

To reduce, if not eliminate, the possibility of double taxation of the foreign-source income of U.S. citizens and residents, the Federal income tax allows a credit for income taxes paid to foreign governments. This foreign tax credit is generally limited to the amount of (pre-credit) U.S. tax liability attributable to foreign-source income. This limit prevents the foreign tax credit from offsetting the U.S. tax on U.S.-source income.

As a result of taxing citizens and residents on a worldwide basis but allowing a foreign tax credit, some Federal income tax returns may report substantial income but little or no U.S. tax liability after credits. This may occur, for example, if a taxpayer has income only from foreign sources (the taxpayer may live abroad the entire year and have no income-producing assets in the United States), or if a taxpayer has foreign-source income that exceeds a net loss from U.S. sources, and pays income taxes to a foreign government that are comparable to the U.S. tax [B2].

For taxpayers with income from foreign sources, these procedures understate the taxpayers' true worldwide income tax liabilities and effective income tax rates. For such taxpayers, it does not seem appropriate to classify U.S. income tax credits for foreign tax payments as reducing tax liabilities. This is particularly true for tax filers who appear to be nontaxable because they do not have any U.S. tax liability, but who have paid foreign income taxes. A more accurate measure of overall income tax burden, as well as the numbers of nontaxable returns, can be obtained by considering all income taxes -- U.S. as well as foreign. Thus, a second tax concept, worldwide income tax, has been used in addition to the traditional U.S. income tax.

Two Tax Concepts

Two tax concepts are used in this article to classify tax returns as taxable (i.e., returns showing an income tax liability) or nontaxable (i.e., returns showing no income tax liability) and to measure the tax burdens on taxable returns: U.S. income tax and worldwide income tax. Worldwide income tax is defined for purposes of this article as U.S. income tax plus the foreign tax credits reported on the U.S. income tax return and foreign taxes paid on excluded foreign-earned income (obtained from Form 1116, *Foreign Tax Credit*). The amount of the foreign tax credits and foreign taxes paid on excluded foreign-earned income is used as a proxy for foreign tax liabilities [B3]. The relationship of U.S. income tax to tax items reported on individual income tax returns, and to worldwide income tax, is shown in Figure H.

Comparing Exclusions, Deductions, Tax Credits, and Special Tax Computations

In order to compare the importance of various exclusions, deductions, tax credits, and special tax computations (such as the alternative minimum tax on tax preferences), the different types of items must be placed on the same basis. One way of doing so is to calculate the size of the deduction that would reduce (or increase) income tax by the same amount as a tax credit or special computation. This amount is called the "deduction equivalent" of the tax credit or special computation.

The deduction equivalent of a tax credit or a special tax computation is the difference between the taxable income that, using the ordinary tax rate schedules, would yield the actual tax before the provision in question is considered and the actual tax after the provision. For example, the "deduction equivalent of all tax credits" is equal to the difference between "taxable income which would yield income tax before credits" and "taxable income which would yield income tax after credits."

Using this method of equating the value of deductions, exclusions, credits, and special tax computations, the order in which the various credits and special tax computations are calculated may affect the value of their deduction equivalents. Because the tax rate schedules are progressive, with successive increments to income taxed at successively higher tax rates, the deduction equivalent

Figure H

Derivation of "U.S. Income Tax" and "Worldwide Income Tax," Tax Year 1994

Tax at regular rates (tax generated)	
PLUS:	Additional taxes (such as tax on accumulation distributions from qualified retirement plans, Form 4972)
EQUALS:	Income tax before credits
PLUS:	Alternative minimum tax (Form 6251)
MINUS:	Tax credits
EQUALS:	U.S. income tax
PLUS:	Foreign tax credit
PLUS:	Foreign taxes paid on excluded foreign-earned income (Form 1116)
EQUALS:	Worldwide income tax

of the credit converted last to a deduction equivalent will be larger (for the same amount of a credit) than the item converted first, unless all relevant taxable income amounts are within a single tax rate bracket.

The deduction equivalents of tax credits shown in Tables 9 and 10 were computed by assuming that deductions and exclusions reduce taxes before credits. As a result, the deduction equivalent of tax credits may be overstated.

Unaudited Data

Tax return data used for *Statistics of Income* have been tabulated as they were reported on tax returns filed with the Internal Revenue Service (IRS). Certain obvious arithmetic errors have been corrected, and certain adjustments have been made to achieve consistent statistical definitions. Otherwise, the data have not been altered. In particular, the data do not reflect any changes that may have been or may be made in the future as a result of IRS audits. While this is true of data throughout the entire Statistics of Income program, it is of particular relevance for high-income tax returns. Because of the greater complexity of these returns, there is a higher probability of error and more scope for disagreement about the proper interpretation of tax laws.

The fact that the data have been drawn from unaudited returns is of even greater importance for those high-income returns that are nontaxable. Almost any audit changes would make such returns taxable. Even where the tax consequences are minor, such returns would be reclassified from nontaxable to taxable, thereby changing the counts of nontaxable returns.

Notes to Appendix B

[B1] An exception is that certain income earned abroad may be excluded from AGI. Any foreign taxes paid on such income are not creditable against U.S. income tax. The tables in this article include such excluded income in expanded income. Foreign taxes paid on such income are reflected in worldwide income tax, as discussed later.

[B2] Although the foreign tax credit is an item of tax preference for AMT purposes, taxpayers below the AMT exclusion thresholds, or with preferences or deductions not subject to AMT, could completely offset pre-credit U.S. income tax liability with foreign tax credit.

[B3] Where foreign tax rates exceed U.S. rates, foreign tax credits will be less than foreign tax liabilities. In such cases, using foreign tax credits as a proxy for foreign tax liabilities understates worldwide income tax liability. In other cases, when foreign tax credits are for taxes paid on income from previous years, use of foreign tax credits as a proxy may overstate *or* understate worldwide taxes on current-year income.