

# Individual Income Tax Returns, Preliminary Data, 2007

By Michael Strudler and Michael Parisi \*

For Tax Year 2007, taxpayers filed 144.7 million U.S. individual income tax returns <sup>1</sup>, an increase of 4.5 percent from the 138.4 million returns filed for 2006. Adjusted Gross Income (AGI) increased from the previous year by 6.9 percent to \$8.5 trillion for 2007. Taxable income increased 6.8 percent to \$5.9 trillion; the alternative minimum tax rose 8.6 percent to \$20.9 billion; total income tax increased by 6.5 percent to \$1.1 trillion; and total tax liability rose by 6.4 percent to \$1.1 trillion.

Figure A shows that the largest component of AGI, salaries and wages, increased 6.4 percent to \$5,936.4 billion for Tax Year 2007, while the next largest component of AGI, net capital gains rose by 9.3 percent to \$749.1 billion. Other income items with notable percentage changes included capital gain distributions (part of net capital gains), which increased 38.6 percent from \$62.3 billion for 2006 to \$86.4 billion for 2007, taxable interest, which increased 20.1 percent to \$231.5 billion, and ordinary dividends, which increased 15.4 percent to \$214.6 billion. Of this dividend total, 66.6 percent were reported as qualified dividends. Qualified dividends, which receive preferential tax rates, were reported on 27.3 million returns and totaled \$143.0 billion, an increase of 9.9 percent from 2006. For 2007, taxable pensions and annuities, the third largest income item, increased 9.4 percent to \$504.1 billion. The other items related to retirement, taxable social security benefits and IRA distributions also rose for 2007, by 15.2 and 18.8 percent respectively. Increases in losses associated with business income were reported for Tax Year 2007 by partnership and S corporations (36.9 percent), business sole proprietorships (10.8 percent), and farms (7.1 percent). For the first two, this led to decreases in net income less losses compared to 2006 of 5.2 percent for partnerships and S corporations and 2.0 percent for business sole proprietorships. Further, for 2007, 7.7 million returns (a 3.7 percent increase from 2006) reported a total of \$29.8 billion in taxable unemployment compensation. This represents an 11.1 percent increase from 2006.

Statutory adjustments to total income increased 7.3 percent to \$118.2 billion for Tax Year 2007. The largest statutory adjustment was the deduction for one-half of self-employment tax, representing 19.5 percent of the total. This adjustment to income increased 2.4 percent to \$23.0 billion. The self-employment health insurance deduction increased 4.8 percent to \$19.4 billion. Payments to self-employed retirement (Keogh) plans fell 0.5 percent to \$20.1 billion, while deductible contributions to Individual Retirement Arrangements (IRAs) increased 3.3 percent to \$13.2 billion. The deduction for student loan interest increased 21.4 percent to \$7.5 billion, and the deduction for tuition and fees rose 10.5 percent to \$10.6 billion for Tax Year 2007. Over 581,000 taxpayers who made contributions to qualified health savings accounts took an adjustment totaling over \$1.4 billion (a 71.3 percent increase from 2006). With the law change in 2007 increasing the amount of qualified domestic production activities income that could have

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<sup>1</sup> The total number of returns count does not include individual income tax returns filed solely to receive the economic stimulus payment.

been deducted from 3% to 6% the domestic production activities deduction showed a substantial increase. For Tax Year 2007, over 448,000 taxpayers took the domestic production activities deduction for a total deduction of \$6.6 billion (a 102.6 percent increase from 2006). Altogether, the amount deducted for total exemptions increased by 6.6 percent from \$895.7 billion for 2006 to \$954.8 billion for 2007.

Total deductions, the sum of the standard deductions and total itemized deductions (after limitation) equaled \$1,941.3 billion, an increase of 8.2 percent from Tax Year 2006. The number of returns claiming the standard deductions increased 6.3 percent, accounting for 63.8 percent of all returns filed and 34.6 percent of the total deductions amount. Mostly due to inflation indexing, the average standard deduction (comprised of the basic and additional standard deductions for age and blindness) increased 3.3 percent from \$7,043 for 2006 to \$7,278 for 2007. Itemized deductions were claimed on 34.9 percent of all returns filed for 2007 and represented 65.4 percent of the total deductions amount.<sup>2</sup> The average total for itemized deductions (after limitation) was \$25,136, a 4.2 percent increase from the 2006 average of \$24,122. Due to the AGI limitation on itemized deductions, 7.1 million higher-income taxpayers were unable to deduct \$35.1 billion in itemized deductions, an increase of 4.7 percent from 2006. The interest paid deduction was the largest deduction, comprising 38.5 percent of total itemized deductions (before limitation). For 2007, it increased 11.5 percent to \$502.3 billion. The Tax Relief and Health Care Act of 2006 extended the election to deduct state and local general sales taxes instead of state and local income taxes. For 2007, an estimated 11.8 million taxpayers took advantage of this, deducting \$18.3 billion. Including taxpayers who deducted state and local sales taxes, 3.8 percent more taxpayers took a deduction for state and local income and sales taxes, and the total amount of this deduction increased 5.2 percent from 2006 levels. The total taxes paid deduction accounted for 35.2 percent of all itemized deductions and increased 5.5 percent to \$446.4 billion. The deduction for medical and dental expenses went up by 9.2 percent to \$75.4 billion, while the charitable contributions deduction increased slightly, 0.9 percent, to \$174.5 billion for 2007.

Total tax credits used to offset income tax liabilities increased 8.2 percent to \$62.2 billion. About 26.1 million taxpayers claimed \$31.8 billion in child tax credits, down 0.3 percent from 2006. However, the additional child tax credit (a refundable separate credit) increased by 2.9 percent to \$16.8 billion in 2007. The combined \$48.6 billion of the child tax credit and the additional child tax credit represented a slight, 0.8 percent, increase from 2006. Other notable percentage increases for major tax credits included a 48.4 percent rise in foreign credits to \$14.0 billion, and a 9.8 percent rise in the retirement savings contributions credit to \$1.0 billion. The adoption credit, which is a smaller credit, also had a significant increase from 2006 of 14.9 percent. The largest percentage decrease was in the general business credit, which decreased 35.5 percent from 2006 to \$0.7 billion. Tax Year 2007 introduced the refundable prior year minimum tax credit (see Changes in Law Section for details). Taxpayers on nearly 145,000 returns took advantage of the refundable prior year minimum tax credit for \$0.4 billion.

The total earned income credit (EIC) increased 9.6 percent to \$49.7 billion for Tax Year 2007. The portion of the EIC used to offset income tax before credits increased 17.3 percent to \$0.9 billion, and the portion of the EIC used to offset other taxes (such as the self-employment tax) rose 11.7 percent to \$5.2 billion. The largest part of the EIC, the refundable portion, was

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<sup>2</sup> The remaining 1.3 percent of the returns did not need to claim either a standard deduction or itemized deductions because no AGI was reported.

treated as a refund and paid directly to taxpayers who had no tax liability against which to apply the credit. The refundable portion of the EIC increased 9.1 percent to \$43.6 billion for 2007.

The comparisons of data for Tax Years 2006 and 2007 in this article are based on the preliminary estimates for both years. A few income and tax items tend to be understated in preliminary estimates; therefore, comparisons based on preliminary estimates for one year and final estimates for the previous year could be misleading. Comparisons based entirely on preliminary estimates reduce the likelihood of misinterpretation of the data and afford a more accurate representation of year-to-year changes. Final statistics for Tax Year 2006 are available in the Fall 2007 issue of the *Bulletin*.

## Changes in Law

In general, the definitions used in this article are the same as those in *Statistics of Income—2006, Individual Income Tax Returns*. The following is a partial list of tax law and Internal Revenue Service administrative changes that had a major bearing on the Tax Year 2007 preliminary data presented in this article.

*Additional Child Tax Credits* — Modifications were made to the additional child tax credit for 2007. In Tax Year 2006, the credit limit based on earned income was 15 percent of a taxpayer's earned income that exceeded \$11,300. For 2007, the limit was 15 percent of a taxpayer's earned income that exceeded \$11,750.

*Alternative Minimum Tax (AMT)* — For Tax Year 2007, the minimum exemption increased to \$66,250 for a married couple filing a joint return, up from \$62,550 in 2006, and to \$44,350 for singles and heads of household, up from \$42,500, and \$33,125 from \$31,275 for a married person filing separately.

*Domestic Production Activities Deduction* — For Tax Year 2007, the amount of qualified domestic production activities income that could have been deducted increased to 6% from 3% in 2006.

*Earned Income Credit* — The maximum amount of the earned income credit increased, as did the amounts of earned income and investment income an individual could have and still claim the credit. The maximum amount of investment income (interest, dividends and capital gain income) a taxpayer could have and still claim the credit increased to \$2,900 from \$2,800. The maximum credit for taxpayers with no qualifying children increased to \$428 from \$412. For these taxpayers, earned income and AGI had to be less than \$12,590 (\$14,590 if married filing jointly) to get any EIC. For taxpayers with one qualifying child, the maximum credit increased \$106 to \$2,853 and, for taxpayers with two or more qualifying children, the maximum credit increased to \$4,716 from \$4,536. To be eligible for the credit, a taxpayer's earned income and AGI had to be less than \$33,241 (\$35,241 for married filing jointly) for one qualifying child, or less than \$37,783 (\$39,783 for married filing jointly) for two or more qualifying children.

*Exemption Amount* — For Tax Year 2007, the exemption amount increased by \$100 to \$3,400. Taxpayers could have lost a portion of their exemption benefits if their adjusted gross income was above certain amounts (\$117,300 married persons filing separately, \$156,400 single individuals, \$195,500 for heads of household, and \$234,600 for married persons filing jointly or qualifying widow(er)s). For 2007 and 2006, a taxpayer could lose no more than 2/3 of the dollar

amount of their exemption, so the amount of each exemption could not be reduced to less than \$1,133. For 2005 and previous years, exemption amounts could be limited to zero. The exemption for housing a person displaced by Hurricane Katrina did not apply for Tax Year 2007.

*Health Savings Account Deduction-* For tax year 2007, contributions were not limited to the taxpayers annual health plan deductible. The maximum HSA deduction increased by \$150 to \$2,850 (\$5,650, if family coverage, up from \$5,450). These limits were \$800 higher if the taxpayer was age 55 or older. There were also changes that allowed qualified HSA distributions for Tax Year 2007 from flexible spending accounts and individual retirement accounts.

*Indexing.* — The following items increased due to indexing for inflation: personal exemption amounts, basic standard deduction amounts, tax bracket boundaries, beginning income amounts for limiting certain itemized deductions, and for the reduction of personal exemption deductions. The maximum amount of earnings subject to self-employment tax increased based on the percentage change in average covered earnings.

*Individual Retirement Arrangement Deduction—* The phase-out range for IRA deductions for those covered by a retirement plan began at income of \$83,000 if married filing jointly or a qualifying widow(er), up from \$75,000 in 2006. The phaseout was \$52,000 for single person or head of household up from \$50,000 in 2006 and at \$0 for a married person filing a separate return. A taxpayer may have been able to deduct an additional \$3,000 if they were a participant in a 401(k) plan and their employer was in bankruptcy in an earlier year.

*Limit on Itemized Deductions Increased—* Taxpayers who had adjusted gross income above \$156,400 (\$78,200 if married filing separately) could have lost part of their deduction for itemized deductions. This was an increase from 2006 amounts of \$150,500 (\$75,250 if married filing separately). For Tax Year 2007 and 2006, the amount by which the deduction was reduced was only 2/3 of the amount of the reduction that would have otherwise applied (for 2005 and previous years).

*Refundable prior-year minimum tax credit—* New for 2007, a refundable credit was available to a taxpayer who had any unused minimum tax credit carryforward from 2004 or earlier years. The taxpayer could have qualified for the refundable credit for part or the entire unused amount, even if the total amount of the 2007 credit exceeds the tax liability amount. This credit was only available for individual taxpayers.

*Standard Deduction Amount Increased--* The standard deduction for people who did not itemize deductions on Schedule A of Form 1040 was, in most cases, higher for 2007 than it was in 2006. The amount depended on filing status, being 65 or older or blind, and whether an exemption could be claimed for a taxpayer by another person. For 2007, the standard deduction increased to \$10,700 for joint filers, up from \$10,300 in 2006. For single filers and married filing separately the deduction amount increased to \$5,350. For heads of households the deduction was \$7,850. In addition, the additional standard deduction for being 65 or older or blind was increased by \$50 per taxpayer.

## Data Sources and Limitations

The preliminary statistics in this data release are based on a sample of individual income tax returns (Forms 1040, 1040A, and 1040EZ including electronically-filed returns) filed during Calendar Year 2008. Returns in the sample were stratified based on: (1) the larger of positive income or negative income; (2) the size of business and farm receipts; (3) the presence or absence

of specific forms or schedules; and (4) the usefulness of returns for Treasury Department tax modeling purposes.<sup>3</sup> Returns were then selected at rates ranging from 0.1 percent to 100 percent. The preliminary Tax Year 2007 data are based on a sample of 262,319 returns and an estimated final population of 153,673,511 returns. The corresponding sample and population for the preliminary 2006 data were 243,548 and 138,503,310 returns, respectively.

Since the data presented here are estimates based on a sample of returns filed, they are subject to sampling error. To properly use the statistical data provided, the magnitude of the potential sampling error must be known; coefficients of variation (CV's) are used to measure that magnitude. The reliability of estimates based on samples, and the use of coefficients of variation for evaluating the precision of estimates based on samples, are discussed in the appendix to this issue of the *Bulletin*.

While the preliminary estimates are intended to represent a full year of taxpayer reporting, they are actually based on returns processed for tax administration purposes, in the case of 2007 returns, between January and late September of 2008. In general, returns processed during the remainder of each year tend to have somewhat different characteristics compared to returns processed earlier. These characteristics include, for example, disproportionately large amounts of investment income, passive losses, and alternative minimum tax.

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<sup>3</sup> Returns in the sample were stratified based on the presence or absence of one or more of the following forms or schedules: Form 2555, *Foreign Earned Income*; Form 1116, *Foreign Tax Credit (Individual)*