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INSIGHT

The Tax Treatment and Distribution of Taxable Interest Income

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For tax purposes, *interest* is the amount paid for the use of borrowed money. Interest received by individuals is generally included in taxable income, unless the interest is received for assets held in a tax-deferred or tax-exempt account (e.g., retirement account or education savings account) or a specific exclusion applies (e.g., qualifying state or local government bond interest). Legislation in the 117th Congress, the Middle-Class Savings and Investment Act (S. 4393), proposes excluding up to $300 of interest income per taxpayer ($600 in the case of married taxpayers filing a joint return). This Insight analyzes data on interest income reported on individual 2019 tax returns from the Internal Revenue Service's (IRS's) Statistics of Income (SOI) files, and highlights potential economic and policy considerations.

Taxable Interest: Individual Income Tax Return Data

Taxpayers reported $153.3 billion in taxable interest on 2019 individual income tax returns, which was about 1% of reported total income. Note that this figure reflects only interest reported on individual income tax returns, and does not include interest on assets held in tax-preferred accounts (as noted above) or interest earned by non-filers, including individuals with incomes below the filing threshold (e.g., low-income retirees). Additionally, ordinary (nonqualified) dividends may be in the nature of interest, but not included in this total.

Interest income tends to be reported on returns filed by taxpayers with higher income, older taxpayers, and married taxpayers.

Income: 8% of taxable interest income was reported by taxpayers with adjusted gross income (AGI) below $50,000, who represented about half (56%) of all taxpayers in 2019 and reported 17% of total income. In contrast, taxpayers with AGI of $5 million or more, who represented 0.1% of all taxpayers and reported 7% of total income, reported 23% of taxable interest income in 2019.

Age: The majority (51%) of taxable interest included on 2019 tax returns was reported by taxpayers age 65 and over; 20% of total income was reported by taxpayers in this age group, indicating taxable interest income is more concentrated among older taxpayers than income generally.

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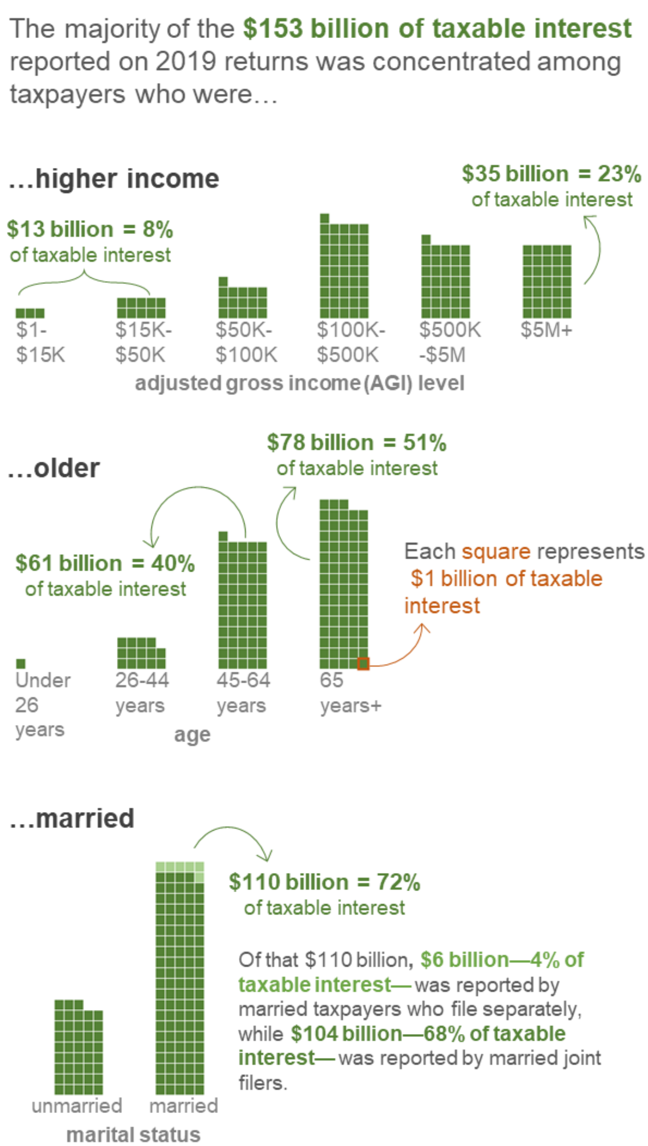
Marital Status: Married taxpayers reported 72% of taxable interest included on 2019 tax returns, while 66% of total income was reported by married taxpayers.

Distribution of Taxable Interest by Income, Age, and Marital Status, 2019



Source: IRS Statistics of Income Tables 1.3, 1.4, and 1.5.

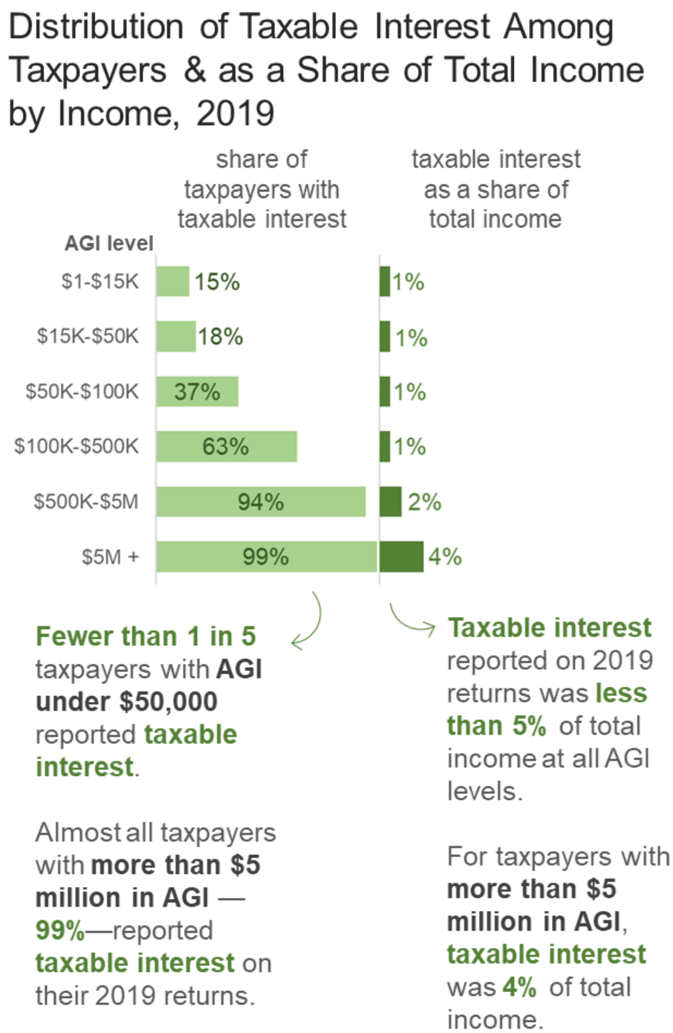
Notes: Amounts may not sum to total due to rounding. The distribution of taxable interest by AGI only includes tax returns with positive AGI and does not include about $8 billion of taxable interest income reported on tax returns that have no AGI. For married joint filers, the taxpayer's age is based on the primary taxpayer's age. Married taxpayers are those who file jointly and separately, as well as surviving spouses. Unmarried taxpayers include single and head of household filers.

The average amount of taxable interest income increases across the income distribution, as illustrated below. Taxpayers with AGI under $100,000 report less than $500 in interest income, on average.

Source: IRS Statistics of Income Table 1.4.

Notes: Only includes tax returns with positive AGI.

Lower- and middle-income taxpayers are less likely than higher-income taxpayers to report taxable interest income. Nearly all (99%) taxpayers with AGI of $5 million or more reported taxable interest income. At AGI levels below $50,000, fewer than one in five taxpayers reported taxable interest income. For all taxpayers, taxable interest is a small share of income. While taxable interest is a small share of total income for all taxpayers, it is a larger share of income for higher-income taxpayers than lower-income taxpayers, as illustrated below.



Source: IRS Statistics of Income Table 1.4.

Notes: Only includes tax returns with positive AGI.

Economic Considerations

Motivations for excluding a portion of taxable interest income might be to increase savings (and in the process, reduce inflation) or to provide relief from inflation-induced tax burdens.

Reduced taxes on interest—either from making some or all interest tax-free (e.g., an exclusion) or via a different form of tax cut (e.g., a reduced tax rate)—reduce the "price" of saving. In economic terms, this is the *substitution effect*. When it is less costly to save, individuals would tend to save more.

Reduced taxes on interest also increase current after-tax income (the *income effect*). Reduced taxes on interest result in a higher return to savings, so individuals can save less and still meet their overall savings targets, while increasing current consumption. Since the substitution effect would tend to increased savings, while the income effect could lead to decreased savings, the impact reduced taxes on interest have on individuals' saving versus spending is theoretically ambiguous.

For most higher-income taxpayers, a capped exclusion for interest income would not have a marginal effect (i.e., it would not reduce the price of savings). Instead, for these taxpayers, there would only be an income effect, meaning the policy would be less likely to lead to additional savings. As discussed in this survey, the empirical literature suggests that tax policies intended to promote savings are often ineffective.

There are additional economic considerations associated with savings tax incentives. If savings tax incentives reduce federal tax revenues (i.e., are deficit financed), then the policy might reduce public savings. National savings, or the sum of public and private savings, determines the level of investment in an economy, which in turn can affect economic growth. Other considerations relate to the tax treatment of debt versus equity. Debt financing is already tax preferred, since businesses can deduct their interest payments. Tax incentives that subsidize interest income could exacerbate any existing economic distortions stemming from the differences in effective tax rates for debt and equity financed investments.

Excluding interest income from taxation might also be viewed as a way to provide tax relief to households. Inflation tends to increase nominal interest rates returns (i.e., interest), and since interest is generally fully taxable, tax burdens can rise when purchasing power does not. The distributional analysis above indicates that most low- and moderate-income households would not benefit from an interest income exclusion, but for those who would, a substantial portion of their taxable interest income may be excluded and thus not taxed.

Past Policies

In 1980, Congress passed legislation to temporarily exclude up to $200 in interest income ($400 in the case of a jointly filed return). At that time, the provision was made temporary to allow Congress to further analyze the appropriate treatment of interest (and dividend) income. Of particular interest was whether the exclusion for interest income would efficiently increase individual savings. In 1981, Congress passed legislation repealing the exclusion for interest and dividend income, finding that the provision had been "inefficient in encouraging individual savings" and that "the exclusion provided no added incentive for individuals to save an amount sufficient to earn interest in excess of the excluded amount."

In a 1984 study, the Department of the Treasury recommended that a portion of interest income be excluded from tax to adjust for income that was not real income (i.e., an inflation premium). The 1984 Treasury recommendations would also have adjusted interest expense deductions, as part of broader policies that would have accounted for inflation in tax treatment of investment income. These recommendations were not enacted, and since the early 1980s interest has generally been taxed at ordinary income tax rates.

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