Mind Your Pease

Understanding the Pease Amendment of the Tax Act

By Rex Macey, CIMA®, CFA®

The American Taxpayer Relief Act of 2012 reintroduced the Pease Amendment (named after the congressman who created it). This change created some confusion that this article will clear up.[1] When I Googled "Pease Amendment," the first item returned was titled "Limitations on Itemized Deductions." While tax accountant types might view the Pease Amendment (hereafter "Pease") as a limitation on deductions, most ordinary persons would not interpret it as such. Most people think of a limit on deductions as a ceiling or maximum allowable amount. Pease does not create such a limit. The bottom line is that for many of the wealthy who are impacted by Pease the marginal value of a deduction remains equal to their marginal tax rate, but the total value of the deduction is reduced thereby increasing the average tax rate. It also slightly increases the marginal tax rate for some people. First I will describe who is affected, then I will use an example to illustrate the effects. Finally, for those who can stand tax calculations, I provide the mechanics of the adjustment.

Who is Affected

Beginning with the 2013 tax year, Pease applies to married taxpayers with an adjusted gross income (AGI) of at least $300,000 ($275,000 for heads of households, $250,000 for single persons) that is called the threshold amount. For this article, these are the taxpayers with whom we are concerned. As an example, let's use a couple with a gross income of $500,000 and itemized deductions of $50,000 from a combination of state taxes, mortgage interest, and charitable donations. Deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses are not affected by this provision.

TABLE 1: CALCULATION FOR TAXPAYERS WHOSE INCOME EXCEEDS THRESHOLD AMOUNT

	Base	Deductions + $100
Gross Income	500,000	500,000
Deductions	50,000	50,100
Calculation of Pease Adjustment		
Excess over Threshold	200,000	200,000
3% of Excess	6,000	6,000
80% × Deductions	40,000	40,080
Pease Adjustment (lesser)	6,000	6,000
Adjustment Deductions	44,000	44,100
Taxable Income	456,000	455,900
Federal Tax @ 39.6%	180,576	180,536
Marginal Effect of + $100 Deduction		(39.60)

Illustrations of the Effects

The total amount of one's deductions is reduced. Under the rules that applied in 2012, the $50,000 would have been deducted from the income, leaving $450,000 of taxable income. The new rule means that only $44,000 is deductible, so the taxable amount is $456,000. At a marginal rate of 39.6 percent, this works out to an additional tax of $2,376. Both the taxes paid and the average tax rate are higher than they were before the Pease Amendment was applied.

The marginal benefit for most taxpayers will still be the marginal rate. If that couple made an additional dollar in charitable donations, bringing their deductions to $50,001, the couple would enjoy the full benefit of the extra $1 deduction at their marginal rate. For most taxpayers (especially those with mortgages and state income taxes), the marginal benefit will still be their marginal rate. They continue to have as much incentive to give the next dollar to charity. I'll describe when the marginal benefit of a deduction is affected later.

The marginal tax rate is increased. If this couple, who nominally is in a 39.6-percent bracket, earns an extra dollar while keeping deductions the same, the marginal tax paid will be 40.788 percent, so the marginal tax rate is increased. This affects the relative value of tax-exempt income.

The Calculations

Table 1 shows the calculation for taxpayers whose income exceeds the threshold amount. The deduction ($50,000 in our example) is reduced by the lesser of (a) 3 percent of the amount of income over the threshold or (b) 80 percent of the amount of deductions. In our example, 3 percent of $200,000 (= $500,000 income – $300,000 threshold) is $6,000. Eighty percent of the $50,000 is $40,000. Since $6,000 is less than $40,000, the $50,000

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of deductions is reduced by $6,000 resulting in the deduction of $44,000.

Note the critical value when 3 percent of the income over the threshold is equal to 80 percent of the deductions. This occurs when deductions equal (0.03 / 0.8) multiplied by the income in excess of the threshold. In our example, this would be $7,500 or 1.5 percent of the gross income. Below that level, the marginal value of a deduction is 20 percent. Above that level, the value is the marginal tax rate of 39.6 percent.

Taxpayers who pay state income tax or who have mortgage debt generally will have deductions in excess of this critical value. Taxpayers who live in states without income tax and who have no mortgage debt may not. If their charitable deductions are below this level then the marginal benefit is only 20 percent, considerably less than the 39.6-percent maximum rate.

For consultants with high-net-worth clients, understanding the Pease provision is useful for counseling on the value of charitable donations and the benefits of tax-exempt income.

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Endnote

1 This article is meant to provide general information and insight into one component of the recent tax law change. For simplicity and clarity I ignore some situations. Taxpayers should consult a tax professional for further information.