Adjusted gross income

Susan C. Nelson
Department of the Treasury

A measure of an individual taxpayer's net income used in calculating personal income taxes.

Adjusted gross income (AGI) is defined by section 62 of the Internal Revenue Code as gross income from all sources not specifically excluded, minus certain deductions. Because AGI is a creature of the tax code, its components have changed over the years with tax law changes.

AGI can be understood in part by comparison with other measures of income. Compared with a measure of comprehensive income, AGI is primarily a measure of money income, but one that does not include many forms of money income that would be part of comprehensive income. From the perspective of the economy as a whole, AGI is similar to personal income in the National Income and Product Accounts (NIPA) but differs from it primarily in the same ways it differs from comprehensive income. In terms of the income tax system, AGI is the broadest measure of income but, compared with taxable income (the income measure to which tax rates are actually applied), it does not reflect personal differences that affect individuals' ability to pay taxes.

Components of AGI

The major sources of income in AGI in 1994 included wages and salaries; taxable interest and dividends; business income from partnerships, Subchapter S corporations, sole proprietorships, and farms; capital gains; taxable pension and Individual Retirement Account (IRA) distributions; unemployment compensation; and some Social Security benefits. The deductions taken in reaching AGI included trade and business expenses, expenses attributable to rents and royalties, and certain losses from the sale or exchange of property. The Form 1040, on which individuals calculate their income tax, refers to other deductions allowable in reaching AGI as "Adjustments to income" or as "Statutory adjustments." For 1994, these adjustments included primarily alimony payments, moving expenses, certain savings for retirement (such as contributions to Keogh plans for the self-employed and to IRAs for employees and their spouses), one-half of the self-employment tax, and a health insurance deduction for the self-employed.

Recent changes in the definition of AGI

Tax law amendments had changed this definition of AGI somewhat in the previous 15 years, generally expanding it. The most significant revisions came in the Tax Reform Act of 1986 (TRA86). Among these were the full inclusion of long-term capital gains (previously, 40% was included in the AGI, and before 1979, 50% had been included). TRA86 also imposed limits on "passive losses" that would be allowed in calculating AGI. It changed moving expenses and unreimbursed employee business expenses from income "adjustments" to itemized deductions. (Starting in 1994, moving expenses were again allowed as an adjustment to income instead of as an itemized deduction.) It eliminated the adjustment to income for a married couple with a second earner and the exemption for the first $400 of dividends received. Working to narrow the definition of AGI, it allowed self-employed individuals a deduction for up to 25 percent of their health insurance premiums.

Other legislation has made more modest changes in the definition of AGI. Legislation in 1991 added the adjustment to income for one-half of an individual's self-employment tax. In 1984, half of Social Security benefits were for the first time included in the AGI for taxpayers with other income of $25,000 ($32,000 for married couples), and in 1994 the share was increased to 85 percent for individuals with other income of $34,000 ($44,000 if married). Similarly, in 1979 unemployment compensation was initially added to AGI for persons with other income of $20,000 ($25,000 for couples), and in 1987 for all taxpayers regardless of other income. The Economic Recovery Tax Act of 1981 (ERTA) and TRA86 both substantially revised the depreciation schedules, with ERTA liberalizing the deductions and TRA86 tightening them. Consequently, a given amount of business profits (as measured for the company's books and records) would contribute less to AGI in the early 1980s than it would after 1986. Recent tax revisions have added deductions for self-employed individuals' health insurance and education deductions, as well as restoring some of the deduction for IRAs that had been curtailed in 1986.

Comparison with comprehensive income, personal income, and taxable income

AGI can be compared conceptually and quantitatively to other frequently used measures of income.

Comprehensive income, or the Haig-Simons definition of income as consumption plus changes in net worth, is a broader concept of income than AGI.

Haig-Simons is a comprehensive measure of income ("economic income") defined as the increase in an individual's power to consume (sum of consumption plus net wealth).

AGI excludes most forms of nonmoney income as well as some types of money income. Components of comprehensive income not in AGI include imputed rent on owner-occupied housing, unrealized capital gains, and in-kind fringe benefits of employees. Including any of these in income for tax purposes would entail substantial valuation problems. Sources of money income that are missing from AGI include welfare payments, interest on state and local government bonds, employer-provided contributions for health and pension plans, and income on savings through life insurance. These forms of income are excluded more for policy than for administrability reasons.

Personal income in the NIPA is also broader, on balance, than AGI (it amounted to $6.2 trillion in 1992, compared with $4.2 trillion of AGI), but AGI includes $0.8 trillion in sources of income that are missing from personal income. The largest of these is personal contributions to Social Security and related programs ($293 billion), followed by taxable private pensions ($160 billion) and net capital gains ($130 billion). Personal income includes the following major items that are not in AGI: transfer payments ($771 billion), employer-provided fringe benefits ($402 billion), investment income of life insurance or private pension funds ($228 billion), and differences in accounting treatment between NIPA and tax regulations ($54 billion). In addition, there is a $630 billion discrepancy, or gap, between AGI as reported to the Internal Revenue Service and AGI as the NIPA would calculate it. Much of the gap represents noncompliance with the tax code (Park 1994).

For tax purposes, AGI represents a broad measure of net income; however, in most respects it does not reflect differences in personal circumstances that the public wants to take into account before levying taxes. Such differences include family size, marital circumstances, or particularly large expenditures for purposes that the public either wants to encourage (such as charitable contributions or home ownership) or views as appropriate adjustments to a measure of ability to pay (such as state and local income taxes, extraordinary medical expenses, or extraordinary casualty losses). More specifically, in 1994 AGI ($3.96 trillion) exceeded taxable income ($2.6 trillion) by the amount of personal exemptions ($563 billion) plus the amount of either itemized deductions ($493 billion) or the standard deduction ($397 billion) (Internal Revenue Service 1997: 38, 48).

Additional readings

Internal Revenue Service. *Statistics of Income Bulletin* (various years). Washington, D.C.

Park, Thae S. "Relationship between Personal Income and Adjusted Gross Income, 1991–1992." *Survey of Current Business* (August 1994): 51–53.

Pechman, Joseph A. *Federal Tax Policy.* Washington, D.C.: The Brookings Institution, 1987.

Cross references: charitable deductions; family, tax treatment of; health expenditures, tax treatment; income tax, federal; individual retirement accounts; interest deductibility; itemized deductions; Social Security benefits, federal taxation.