

SUMMARY
OF A
STAFF REPORT

"THE INCOME TAX TREATMENT OF MARRIED
COUPLES AND SINGLE PERSONS"

PREPARED FOR THE
HOUSE COMMITTEE ON WAYS AND MEANS
AND THE
SENATE COMMITTEE ON FINANCE

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SUMMARY OF STAFF REPORT:

"THE INCOME TAX TREATMENT OF MARRIED COUPLES AND SINGLE PERSONS"

PRESENT LAW

The income tax law generally treats a married couple as one tax unit, which must pay tax on its total taxable income. While couples may elect to file separate returns, the tax law is carefully structured so that separate returns lead to a tax increase for almost all couples compared to a joint return. Different tax rate schedules apply to single persons and to single heads of households (persons who maintain households for certain relatives). Along with other provisions of the law, these rate schedules give rise to a "marriage penalty" or a "divorce bonus" when persons with relatively equal incomes marry or divorce each other.

Except for the policy of discouraging separate filing by married couples, there is little consistency in the way the tax law treats married couples relative to single persons. In some provisions, such as the social security payroll tax and some pension provisions of the income tax, a married couple is treated as two distinct individuals. In some provisions, such as the personal exemption, a couple is given exactly twice the benefit given to a single person. However, in other provisions, such as the \$3,000 limit on the deductibility of capital losses against ordinary income, a married couple is given the same benefit as a single person. Still other provisions, such as the zero bracket amount (formerly the standard deduction), give the married couple more than a single person but less than twice as much.

The overall relationship between the tax burdens of married couples and single persons with the same income, and the actual marriage and divorce bonuses or penalties in particular cases, are the result of the combined effect of these varying approaches.

HISTORY

Under the initial version of the modern individual income tax, enacted in 1913, married couples were taxed as separate individuals. In 1930, the Supreme Court ruled that State community property laws were to be given effect for income tax purposes, which meant that, in the States with such laws, married couples could split income considered community property 50-50, the split which minimizes a couple's combined tax burden in a progressive tax system. After the large increase in tax rates enacted to finance World War II, many States enacted community property laws in order to give their citizens the benefit of this income splitting.

To stop this community property trend, in 1948 Congress provided that all married couples could enjoy the benefits of income splitting by filing joint returns. Separate filing by married persons was allowed, but the loss of income splitting meant that this almost always led to a tax increase. Single persons were required to use the same rate schedules as married couples and received no special treatment to offset the married couples' benefit from income splitting; therefore, marriage almost always resulted in a tax reduction for married couples and divorce in a tax increase.

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In 1951, Congress enacted the head-of-household rate schedule for single persons who maintain households for certain relatives. This provided a "divorce bonus" to married couples with children if they had relatively equal incomes.

In 1969, Congress enacted a special rate schedule for single persons to give them about one-half the benefit of income splitting and adjusted the head-of-household rate schedule to give these taxpayers about three-fourths of the benefit of income splitting. These changes increased the divorce bonus provided by the head-of-household rate schedule and created a "marriage penalty" when single persons with relatively equal incomes married each other.

ISSUES

The proper tax treatment of married couples and single persons involves judgments about equity, economic efficiency and complexity.

Equity

The first question is what should be the tax unit, the group whose income and deductions are pooled in determining tax liability. Many people believe that the tax system should be "marriage neutral"; that is, a married couple should have the same tax burden as two single persons, each of whom has the same income as one of the spouses. Many people, however, also believe that, because most married couples pool their income and spend as a unit, fairness requires that the tax burden of a married couple not depend on how their combined income is distributed between them. A third widely held proposition is that the tax system should be progressive; that is, as income rises, tax burdens should increase as a percentage of income. Many Americans, if asked, would express agreement with all three of these principles of tax equity: marriage neutrality, equal taxation of couples with equal incomes, and progressivity.

One problem with devising a satisfactory method of taxing married couples is that these three principles of tax equity are logically inconsistent. A tax system generally can have any two of them, but not all three. A progressive tax system that treats the individual, not the couple, as a tax unit preserves marriage neutrality but sacrifices equal taxation of couples with equal incomes because couples with unequal incomes would pay a larger combined tax than couples with relatively equal incomes. The present income tax sacrifices marriage neutrality, but maintains equal taxation of couples with equal incomes and progressivity. A proportional income tax could have both marriage neutrality and equal taxation of couples with equal incomes, but it would sacrifice progressivity (although some limited progressivity could be introduced through refundable per capita tax credits without violating the other two principles). Which of these three principles ought to be sacrificed is a subjective question.

A second equity issue is how the overall tax burden should be distributed between single persons, single heads of households, one-earner married couples and two-earner married couples. This too is essentially a subjective judgment. The enactment of income splitting

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in 1948 shifted the tax burden away from one-earner married couples and other couples with relatively unequal incomes. The special rate schedules for heads of households and for single persons shifted the burden away from these classes of taxpayers. Recent proposals to reduce the marriage penalty involve shifting the burden away from two-earner couples. Any proposal that shifts the tax burden away from one of these groups means increasing the relative burden on the others.

Efficiency

Considerations of economic efficiency dictate that tax rates be lowest on persons whose work effort would be most responsive to lower taxes. Virtually all statistical studies of the issue conclude that a wife's work effort is more responsive to reduced taxes than her husband's. Therefore, the present system of taxing both spouses' earnings at the same marginal tax rate is economically inefficient compared to a system with lower tax rates on the wife's earnings. (The marginal tax rate is the rate applicable to the next dollar of income.) However, the present system may have countervailing benefits to the extent society gains from uncompensated work performed by wives.

Complexity

Joint returns for married couples are simpler than separate returns. With separate returns, it is necessary to apportion unearned income and deductions between spouses, and there is no entirely satisfactory way of doing this. Attempting to allocate deductions and unearned income in a way that corresponds to how the couple would be taxed as two single persons would be complex and would invite manipulation of unearned income and deductions to achieve de facto income splitting and marriage bonuses. However, any arbitrary method of making these allocations could be considered unfair and would create its own marriage bonuses or penalties.

ALTERNATIVE PROPOSALS

Three basic proposals to change the current system have received most attention in recent years: mandatory separate filing by married couples using the same rate schedule as single persons; optional separate filing by married couples using the same rate schedule as single persons; and retention of the present system with ad hoc changes to reduce the marriage penalty, such as a deduction or credit for married couples based on the earnings of the spouse with the lower amount of earnings. Other suggestions, such as letting single persons use the joint return rate schedule, were popular in previous years but have not been prominently mentioned recently.

Mandatory separate filing

Under this proposal, separate filing by married couples would be mandatory or there would be no tax advantage to a joint return. This concept is embodied in H.R. 2553 (sponsored by Rep. McDonald) and H.R. 108 (sponsored by Rep. Annunzio). If married persons were required to file separately and use the current single person's rate

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schedule, there would be tax increases for about 60 percent of married couples and tax cuts for the other 40 percent. Because there would be a large overall tax increase of between \$12 and \$18 billion, the rate schedule could be reduced below the current single person's rate schedule.

Any system in which separate filing was either mandatory or advantageous for many married couples would raise questions of how income (both earned income and investment income) and itemized deductions should be allocated between spouses. While these issues exist under present law, they are relevant only to the small number of married persons who file separately and are often resolved by penalizing the separate filers. There is no entirely satisfactory way of making these allocations in a system that encourages or mandates separate filing. Whatever method is adopted, however, will greatly affect the revenue impact. Some vestiges of joint filing would probably have to be maintained in provisions with phaseouts based on income; otherwise, low-income taxpayers with high-income spouses would receive tax benefits, such as the earned income credit, which were originally intended only for low-income families.

Mandatory separate filing would firmly resolve the equity question on the side of marriage neutrality, except to the extent that allocation rules for income and deductions created marriage bonuses or penalties or that vestiges of joint filing were retained. There would be a reduction in marginal tax rates on second earners. Also, there would be a shift in the tax burden away from two-earner couples and towards one-earner couples.

Optional separate filing

Under this proposal, separate filing by married couples using the single person's rate schedule would be optional. This concept is embodied in H.R. 3609 (sponsored by Rep. Fenwick), H.R. 5012 (sponsored by Rep. Moore) and S. 336 (sponsored by Sen. Mathias). The same technical issues raised by mandatory separate filing would also apply to optional separate filing, and an additional complexity would result from any tendency of married persons to compute their tax both separately and jointly to make sure they were minimizing their total tax burden.

Optional separate filing using the present single person's rate schedule would involve a tax cut of \$7 to \$9 billion, depending on how investment income and deductions were allocated between spouses. It would reduce marginal tax rates for second earners for those couples who elected separate filing, but not for others. It would shift the tax burden away from two-earner couples.

This proposal does not conclusively resolve the equity question. Optional separate filing would be characterized neither by marriage neutrality nor by equal taxation of couples with equal incomes. It would, however, eliminate marriage penalties.

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Relief for second earners

Another group of proposals involves ad hoc relief for two-earner married couples, designed to reduce the marriage penalty and marginal tax rates on second earners while retaining the basic system of joint filing. Such relief could take the form of a deduction or credit equal to a percentage of the earnings of the spouse with the lower amount of earnings. A deduction of 10 percent of the first \$10,000 of earnings is contained in H.R. 6203 (sponsored by Rep. Fisher), a deduction of 10 percent of the first \$20,000 of earnings in S. 1247 (sponsored by Sen. Gravel) and H.R. 6822 (sponsored by Rep. Conable), and a deduction of 20 percent of the first \$20,000 of earnings in S. 1877 (sponsored by Sen. Sasser). In H.R. 6822, the deduction is limited to couples where each spouse contributes at least 20 percent of the combined earned income. A credit of 10 percent of earnings, with a maximum credit of \$500, is contained in H.R. 6798 (sponsored by Rep. Patten).

A deduction or credit for second earners is the simplest way to reduce the marriage penalty and the marginal tax rates on second earners. Per dollar of revenue loss, a deduction would be more effective in these respects; however, a credit gives more benefit to lower income couples than a deduction. If either a deduction or credit were adopted, the system would be characterized neither by marriage neutrality nor by equal taxation of couples with equal incomes.

Other proposals

Other proposals for resolving the married-single tax issue have been discussed in previous years, but have not been mentioned as prominently in the current debate. One suggestion is to return to the pre-1969 system by repealing the single person's rate schedule and requiring single persons to use the same rate schedule as married persons filing separate returns. This would eliminate the marriage penalty inherent in the rate schedules. However, it would shift the tax burden from both one- and two-earner married couples to single persons. The opposite proposal also has been discussed; that is, allowing single persons and heads of households to use the joint return rate schedule to reduce alleged discrimination against single persons. This is contained in H.R. 872 (sponsored by Rep. Yates). This proposal often is accompanied by suggestions for larger dependency exemptions and a deduction or credit for second earners.

Another possibility, which has received little attention, would be to reduce the marriage penalty by flattening out the tax rate schedule for joint returns. By itself, this would reduce progressivity, but there could be a per capita tax credit to restore much of the progressivity lost by changing the rate schedule.

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