BACKGROUND AND INFORMATION RELATING TO THREE TAX CUT PROPOSALS FOR MIDDLE-INCOME AMERICANS: A $500 PER-CHILD TAX CREDIT, A REDUCTION IN THE MARRIAGE PENALTY, AND A DEDUCTION FOR EDUCATION AND JOB TRAINING EXPENSES

Scheduled for a Public Hearing

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Prepared by the Staff

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 2, 1995, on three tax cut proposals for middle-income Americans: a $500 per-child tax credit, a reduction in the marriage penalty, and a deduction for education and job training expenses.

This document,* prepared by the staff of the Joint Committee on Taxation, provides background and information related to these three tax cut proposals. Part A provides a description of present law and the family tax credit contained in the American Dream Restoration Act (H.R. 6, part of the House Republicans' proposed "Contract with America" (Contract)). Part B provides a description of present law and the tax credit for families with young children contained in the Middle-Class Bill of Rights Tax Relief Act of 1995 (H.R. 980 and S. 452, part of the President's fiscal year 1996 budget proposal). Part C provides a description of present law and the education and job training tax deduction contained in that same bill. Part D provides a description of present law and the credit to reduce the marriage penalty contained in the American Dream Restoration Act. An appendix provides background information on the marriage penalty.

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A. Family Tax Credit (sec. 2 of H.R. 6)

Present Law

Present law does not provide tax credits based solely on the number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is $3,112 for taxpayers with more than one qualifying child, $2,093 for taxpayers with one qualifying child, and $314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the phaseout limit is $26,676 for taxpayers with more than one qualifying child, $24,388 for taxpayers with one qualifying child, and $9,234 for taxpayers with no qualifying children.

Description of Proposal

The bill would provide taxpayers with a maximum refundable tax credit of $500 for each qualifying child.

The credit would be phased out ratably for taxpayers with AGI over $200,000, and would be fully phased out at AGI of $250,000. In calendar years beginning after 1996, the maximum credit amounts and beginning point of the phaseout range would be indexed annually for inflation.

To be a qualifying child, an individual would have to satisfy a relationship test, a residency test, and an age test. The individual would satisfy the relationship test if the individual is a son, stepson, daughter, or stepdaughter of the taxpayer, a descendent of a son or daughter of the taxpayer, or a foster or adopted child of the taxpayer. A foster child would be defined as an individual whom the taxpayer cares for as the taxpayer's own child. An adopted child would include a child who is legally adopted or who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer. If the qualifying child is married at the close of the taxpayer's taxable year, the

taxpayer generally must be entitled to a dependency deduction for the taxable year with respect to such qualifying child in order to claim the credit.

An individual would satisfy the residency test if the individual has the same principal place of abode as the taxpayer for more than half the taxable year (the entire year for foster children). The determination of whether the residency requirement is met would be made under rules similar to those applicable with respect to whether an individual meets the requirements for head-of-household filing status. Thus, for example, certain temporary absences due to education or illness would be disregarded for purposes of determining whether the child had the same principal place of abode as the taxpayer for over half the year. Also, the residence would have to be in the United States.

An individual would satisfy the age test if the individual has not attained the age of 18 as of the close of the calendar year in which the taxable year of the taxpayer begins.

The maximum amount of credit, regardless of the number of qualifying children, could not exceed an amount equal to the sum of: (1) the taxpayer's income tax liability (net of applicable credits), and (2) the taxpayer's Railroad Retirement Tier 1 tax and Social Security tax (SECA and the employee and employer share of FICA), less the taxpayer's allowable EITC amount. For these purposes, Social Security tax would not include any amounts to the extent the taxpayer is entitled to a special refund under section 6413(c) (relating to overpayment of certain employment taxes). Also, any amounts paid pursuant to an agreement under section 3121(l) (relating to agreements entered into by American employers with respect to foreign affiliates) would be treated as Social Security tax for purposes of this credit.

The bill would provide that couples who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualifying child for more than one-half the taxable year and (2) furnished over one-half the cost of maintaining that household in that taxable year.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

B. Tax Credit for Families with Young Children

(Sec. 101 of H.R. 980 and S. 452 and sec. 101(c) of H.R. 981 and S. 453)

Present Law

In general

Taxpayers generally may claim a personal exemption for each dependent, including dependent children. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has more than one, one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is $3,110 for taxpayers with more than one qualifying child, $2,094 for taxpayers with one qualifying child, and $314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of a phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. In 1995 the phaseout threshold is $11,290 for both taxpayers with more than one qualifying child and taxpayers with one qualifying child, and $5,130 for taxpayers with no qualifying children. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the EITC is phased out at $26,673 for taxpayers with more than one qualifying child, $24,396 for taxpayers with one qualifying child, and $9,230 for taxpayers with no qualifying children.

Mathematical errors

The Internal Revenue Service (IRS) may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for

contesting an assessment arising out of a mathematical or clerical error.

Description of Proposal

The proposal would provide taxpayers with a maximum credit of $300 for each eligible child for taxable years 1996, 1997 and 1998. The maximum amount of the credit would be increased to $500 for each eligible child for taxable years beginning after December 31, 1998.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In the case of a taxable year beginning after calendar year 1999, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation. For each year in which the maximum amount of the credit exceeds $500, the size of the phaseout range would be increased from $15,000 (i.e., $75,000 minus $60,000) to 30 times the maximum amount of the credit in that year. For purposes of all these AGI tests, the taxpayer's AGI would be increased by any amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

To be an eligible child, an individual would have to satisfy a dependency test, a relationship test, an age test, and an identification test.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction.

An individual would satisfy the relationship test if the individual is a son, stepson, daughter or stepdaughter of the taxpayer, a descendant of a son or daughter, or a foster or adopted child of the taxpayer. A foster child would have to have as his principal place of abode the home of the taxpayer and be a member of the taxpayer's household. An adopted child would include a child who is legally adopted by the taxpayer or who is placed with the taxpayer by an authorized placement agency for legal adoption by the taxpayer.

An individual would satisfy the age test if the individual has not attained the age of 13 as of the close of the calendar year in which the taxable year of the taxpayer begins.

An individual would satisfy the identification test if the individual's taxpayer identification number is included on the taxpayer's return for such taxable year. Rules similar to those made applicable by the Administration proposals to the EITC would apply. If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

The maximum amount of the credit for each taxable year could not exceed an amount

equal to the sum of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability and earned income tax credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

C. Education and Job Training Tax Deduction

(Sec. 102 of H.R. 980 and S. 452)

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allowed an employee to exclude from gross income up to $5,250 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec. 127). This special rule for employer-provided educational assistance expired after 1994.

Another special rule, section 135, provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[1] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation (through issuance of bonds directly in the child's name), section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Section 117 excludes from gross income amounts received as a qualified scholarship by an

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[1] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI, and could be claimed regardless of whether the taxpayer itemizes deductions. In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000. In 1999 and thereafter, the maximum deduction would be increased to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phase-out range would be indexed for inflation.

Qualified educational expenses would be defined as tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an institution of higher education. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal expenses unrelated to a student's academic course of instruction would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is part of a degree program (or relates to the student's current profession).

An "eligible student" would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis or must be enrolled in a course which enables the student to improve current job skills or to acquire new job skills. In addition, the student cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien. Educational institutions would determine what constituted a half-time basis for individual programs.

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes

colleges and universities, and certain vocational and proprietary institutions.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. Similarly, qualified educational expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

Qualified educational expenses would be deductible in the year the expenses are paid, subject to the requirement that the education commences or continues during that year or during the first three months of the next year. Qualified educational expenses paid with the proceeds of a loan generally would be deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursements through insurance) of previously deducted tuition and fees.

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. A student would not be eligible to claim a deduction under this provision on his or her own tax return if that student could be claimed as a dependent of another taxpayer.

Effective Date

The proposal would be effective for qualified educational expenses paid after December 31, 1995.

D. Credit to Reduce the Marriage Penalty (sec. 3 of H.R. 6)

Present Law

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and to single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return (if they were to marry).

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, a general rule is that married couples whose earnings are split relatively evenly (between 50-50 and 70-30) suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Description of Proposal

Married couples who file a joint return and have a larger tax liability than if they were unmarried and filed individual returns would be eligible for a nonrefundable credit against their income tax liability. The amount of the credit would be determined by the Department of the Treasury so that the estimated reduction in revenues to the Treasury would not exceed $2 billion per fiscal year. In no event would the credit for a particular taxpayer be larger than the size of the marriage penalty the couple would face without the provision.

Effective Date

The provision would be effective for taxable years beginning after the date of enactment.

APPENDIX: BACKGROUND INFORMATION ON THE MARRIAGE PENALTY

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Prior to 1993 (and continuing under present law for the 15-, 28- and 31-percent brackets), the bracket breakpoints[1] and the standard deduction for single filers were roughly 60 percent of those for joint filers and those for head of household filers were about 83 percent of those for joint filers. The rate changes in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) exacerbated the existing marriage penalty because the new bracket breakpoints did not provide the customary ratios across filing statuses.[2] For the new 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket that results from the "surtax", the bracket breakpoint is $250,000 regardless of filing status.

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different ideas of tax equity. One principle is that the tax system should be "marriage neutral"; that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second principle of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax

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[1] A bracket breakpoint is the dividing point between two marginal rate brackets.

[2] Taxpayers who were not subject to the new rate brackets generally faced no change in their marriage penalty or bonus. Some taxpayers receiving the earned income tax credit (EITC) may have faced slightly larger or smaller marriage penalties or bonuses because of the OBRA '93 changes in the EITC, but the magnitude of these changes was generally small relative to the previously existing marriage penalties or bonuses for these taxpayers.

units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three.[3] The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: it specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral.[4] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity. It should be noted, however, that there is an exception to this rule if refundable credits are permissible. A system with a flat tax rate and a per taxpayer refundable credit would have marriage neutrality, equal taxation of couples with equal incomes and progressivity.[5]

There is disagreement among commentators as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality. (This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax system.) Those who hold marriage neutrality to be more important argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided

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[3] See the addendum for a derivation of this result.

[4] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Some married couples would still have marriage bonuses. As described below, the joint return allows married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple where one spouse has $60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

[5] Such a system could <u>not</u> have standard deductions. See footnote 12 for further explanation.

$10,000-$10,000 or $15,000-$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes.[6]

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, child care, other activities or leisure. It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary jobhunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.

Brief history of the marriage penalty

The marriage penalty in the rate structure dates from changes in the structure of individual income tax rates in 1969.[7] To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for joint filers and single returns were introduced. Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. With a progressive income tax, a married couple with only one spouse earning income could reduce its combined tax liability if it could split the income and assign half to each spouse. While the Supreme Court upheld the Commissioner's right to deny contractual attempts to split income,[8] it ruled that in States with community property laws, income splitting was required for community income.[9] As income tax rates and the number of individuals liable

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[6] For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, see Marjorie E. Kornhauser, "Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return", 45 *Hastings L. J.* 63 (1993); Edward J. McCaffery, "Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code", 40 *UCLA L. Rev.* 983 (1993); and Lawrence Zelenak, "Marriage and the Income Tax", 67 *S. Cal. L. Rev.* 399 (1994).

[7] In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household"status). Since the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

[8] *Lucas v. Earl*, 281 U.S. 111 (1930).

[9] *Poe v. Seaborn*, 282 U.S. 101 (1930).

for income taxes increased before and during World War II, some States adopted, or considered adopting, community property statutes to give their citizens the tax benefits of income splitting.

In the Revenue Act of 1948, income splitting was allowed to all married couples by establishing a separate tax schedule for joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income. (This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.) While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[10] In 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of those for married couples filing joint returns. This schedule created a marriage penalty.

Marriage penalty for low-income individuals under present law

There are three features of the current individual income tax system that create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status, the phaseout of the earned income tax credit (EITC) as income increases, and the variation of the size of the EITC by number of dependent children.

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, as joint filers they may have some of their taxable income pushed into a higher marginal tax bracket than when they were unmarried.

As an example of the marriage penalty caused by the rate structure, consider two individuals, each with one dependent child and with wage income of $10,000 (and no income from other sources). Filing as heads of household in 1995, each would have had a standard deduction of $5,750 and two personal exemptions worth $2,500 each. The sum of the standard

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[10] Since income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

deduction and the $5,000 in personal exemptions would have exceeded each individual's adjusted gross income and thus would have reduced taxable income to zero. If they had married and filed a joint return with wage income of $20,000, they would have had a standard deduction of $6,550 and four personal exemptions ($10,000), leaving them with taxable income of $3,450, resulting in a $518 tax liability at a 15-percent rate.[11]

To eliminate the marriage penalty caused by the rate structure, the standard deduction and bracket breakpoints for all unmarried filers would have to be 50 percent of those for joint filers. This is the current ratio for individuals who are married, but file separate returns.[12]

Even if the marriage penalty caused by the rate structure could be eliminated, other features of the tax code conditioned on income can still cause marriage nonneutrality. For low-income individuals with dependent children, the EITC is one such feature. Because the EITC increases over some range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EITC for which they are eligible.[13] Consider again the two individuals in the previous example, each with one dependent child and with wage income of $10,000. In 1995, each would have qualified for the maximum one-child EITC credit of $2,094 (giving the pair a combined total credit of $4,188). If they had married and filed a joint return with wage income of $20,000, they would then be in the phaseout range of the EITC, so the two-child credit only would have been $1,350, a reduction of $2,838 from the combined amount they would have received as unmarried individuals. Therefore the combined effect of the higher tax liability and the reduced EITC would have been a marriage penalty of $3,356 ($2,838 + $518).

Marriage may reduce the size of a couple's EITC not only because their incomes are aggregated, but also because the number of dependent children is aggregated. Because the amount of EITC does not increase when a taxpayer has more than two dependent children, marriages that cause the resulting family to have more than two dependent children will result in a smaller number of children giving rise to the EITC than when their parents were unmarried. And even when each unmarried individual brings just one dependent child into the marriage

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[11] This calculation looks only at the tax liability and ignores any possible credits. The effect of the EITC is considered below.

[12] Note that even with such a rate structure, a marriage bonus would exist in the case of an individual with no taxable income marrying an individual with taxable income. The individual with no taxable income is, in essence, allowing some of his or her standard deduction to go "unused". By marrying an individual with taxable income, some of the taxable income of the couple can be reduced by the "unused" portion of the standard deduction.

[13] In the case of two individuals with very low wage income, marriage may *increase* the amount of their EITC available for a dependent child. If the individual with the dependent child is in the phase-in range of the EITC, the aggregation of incomes upon marriage could increase the amount of the EITC.

there is a reduction in the amount of EITC, since the maximum credit for two children is generally much less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EITC to face significant marriage penalties. For example,[14] in 1995, two individuals each with one dependent child, one with wage income of $14,000 and the other with wage income of $10,000, faced a marriage penalty of $3,841.

Eliminating the marriage penalty

The marriage penalty could be eliminated in two ways. One is through restructuring of rates (across different filing statuses) and phaseout ranges (for numerous provisions). The other is by giving married couples the option to calculate their tax liability as if they were unmarried. The revenue effects of the marriage penalty are sizable. A recent National Bureau of Economic Research paper by Daniel R. Feenberg and Harvey S. Rosen estimated that in 1994, 52 percent of married couples would face a marriage penalty, with an average penalty of about $1,244, while 38 percent would face a marriage bonus, with an average bonus of about $1,399.[15]

To eliminate the marriage penalty through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. This change could either gain or lose revenue — depending on whether unmarried individuals have their rate brackets shifted down or joint filers have theirs shifted up. Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same (they would differ only because of extra personal exemptions for the head of household's dependents and any EITC). Relying solely on extra personal exemptions to adjust for family size would result in unmarried individuals with dependents receiving smaller tax benefits than they now receive by filing as head of household. Such a change in rate structure would also bring back the "singles penalty" that led to the creation of an unmarried filing status (separate from married, filing separately) in 1969.

Allowing joint filers the option of calculating a combined tax liability as if they were not married would fix the problem at the cost of complicating the tax return. To take advantage of the provision, taxpayers would have to calculate their tax liability under two alternatives and then choose the smaller liability. Either rules would have to prescribe how taxpayers would allocate deductions and dependent exemptions (if any) between the two spouses or the spouses could be allowed to allocate them in the most favorable manner. In many cases, it would be

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[14] The amount of the marriage penalty would have been even larger if each individual had two or more children.

[15] Daniel R. Feenberg and Harvey S. Rosen, "Recent Developments in the Marriage Tax", NBER Working Paper No. 4705, April 1994.

difficult for the Internal Revenue Service to enforce detailed rules short of upon audit; in practice, taxpayers could have wide latitude to allocate deductions and unearned income in the most favorable way.

A second issue for the optional unmarried filing is what filing status to allow taxpayers with dependents to use. Should married filers be allowed to file as heads of household on the grounds that they could get divorced and do so? Or should they be constrained to file using the single rate schedules? The answer would depend upon the frame of reference. If one measures the marriage penalty relative to what tax treatment the spouses would get if they divorced, then head of household filing is appropriate. If one measures the marriage penalty relative to the tax treatment before the time of marriage, then the answer hinges upon whether the dependents arose before or after the marriage.

An alternative approach to reducing the marriage penalty is to return to the 1982-1986 second-earner deduction, which allowed joint filers a deduction for ten percent of the lesser of the earned income of the lower-earning spouse or $30,000. This approach reduces the marginal tax rate on the lower-earning spouse, but does not eliminate the marriage penalty, especially if the size of the deduction is capped, as was the 1982-1986 deduction. What this approach lacks in tailoring the remedy to the particular situation of a married couple, it makes up for in simplicity of administration. Because it is a deduction, its value rises as the couple's marginal tax rate rises. This feature does not necessarily track the size of the marriage penalty, which is much larger for individuals in the bottom (in relative terms) and top (in dollar amounts) marginal tax brackets. Also, a second-earner deduction allows a tax break even if the couple suffers no marriage penalty (because the second-earner earns such a small amount of the combined income).

Description of attached charts

In the addendum are "contour maps" showing the size of marriage penalties and bonuses for individuals of different filing statuses under projected tax schedules for 1996. For all of these calculations, all of the income of the individuals is assumed to be earned income. The separate income of one spouse is shown on the horizontal axis, the separate income of the other spouse is shown on the vertical axis. The point at the intersection of two income levels indicates the marriage penalty or bonus for the couple. Marriage penalties are shown as positive numbers in the map, marriage bonuses are shown as negative numbers.

ADDENDUM

The inconsistency of progressivity, equal taxation of couples with equal income and marriage neutrality can be shown mathematically as follows: Consider four individuals, A, B, C and D. Assume that A and B have equal incomes, C has an income equal to the combined incomes of A and B, and D has no income. Let T(A), T(B), and T(C) be the tax burdens of the three individuals with income. If the tax system is not proportional,

$$T(C) \neq T(A) + T(B). \qquad \textbf{(1)}$$

Now assume A and B marry each other, as do C and D, and let T(AB) and T(CD) be the tax burdens of the married couples. The principle that families with the same income should pay the same tax requires that

$$T(AB) = T(CD), \qquad \textbf{(2)}$$

and marriage neutrality requires both that

$$T(A) + T(B) = T(AB) \qquad \textbf{(3)}$$

and that

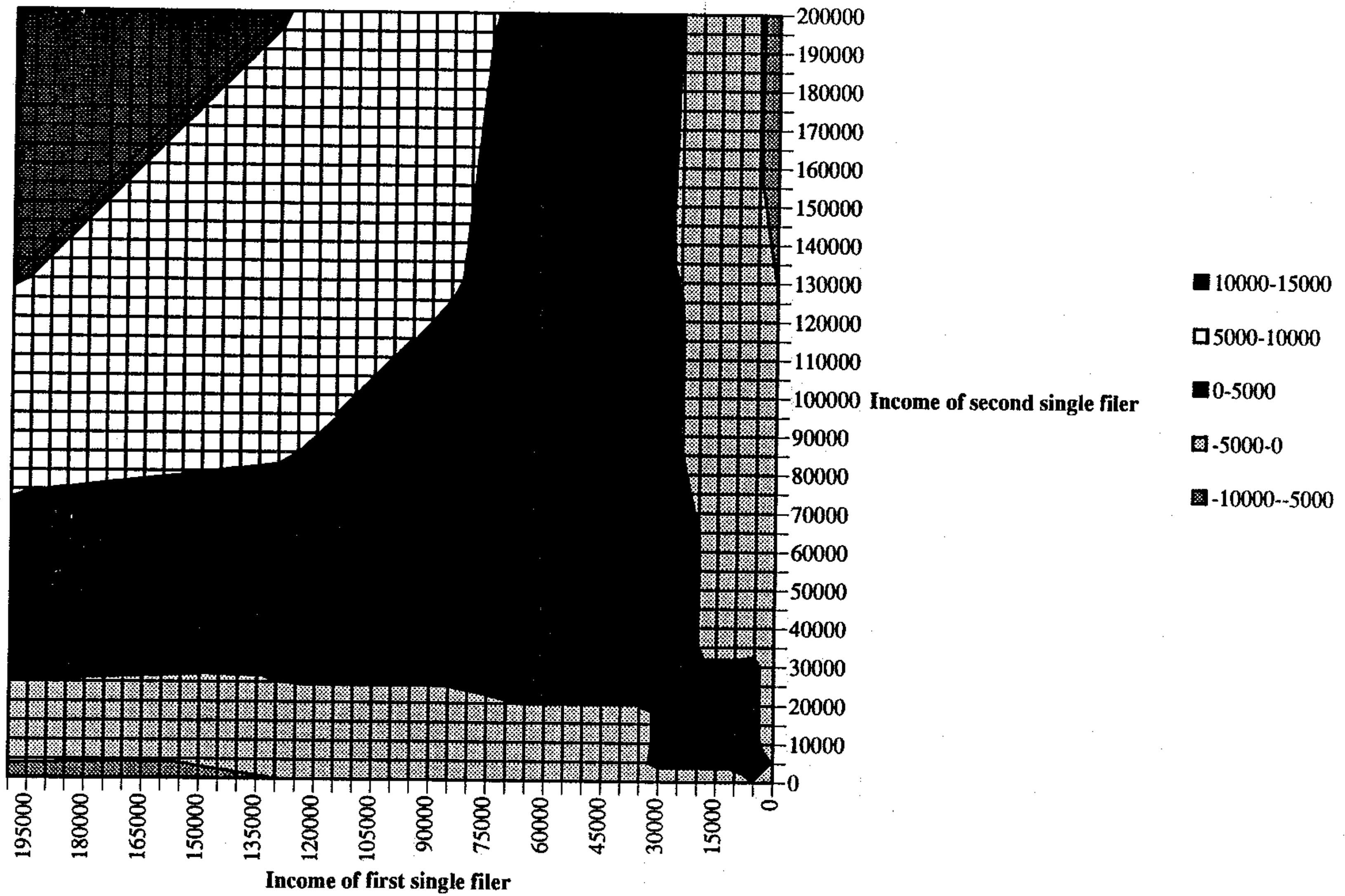
$$T(CD) = T(C). \qquad \textbf{(4)}$$

Substituting (3) and (4) into (2) yields

$$T(A) + T(B) = T(C) \qquad \textbf{(5)}$$

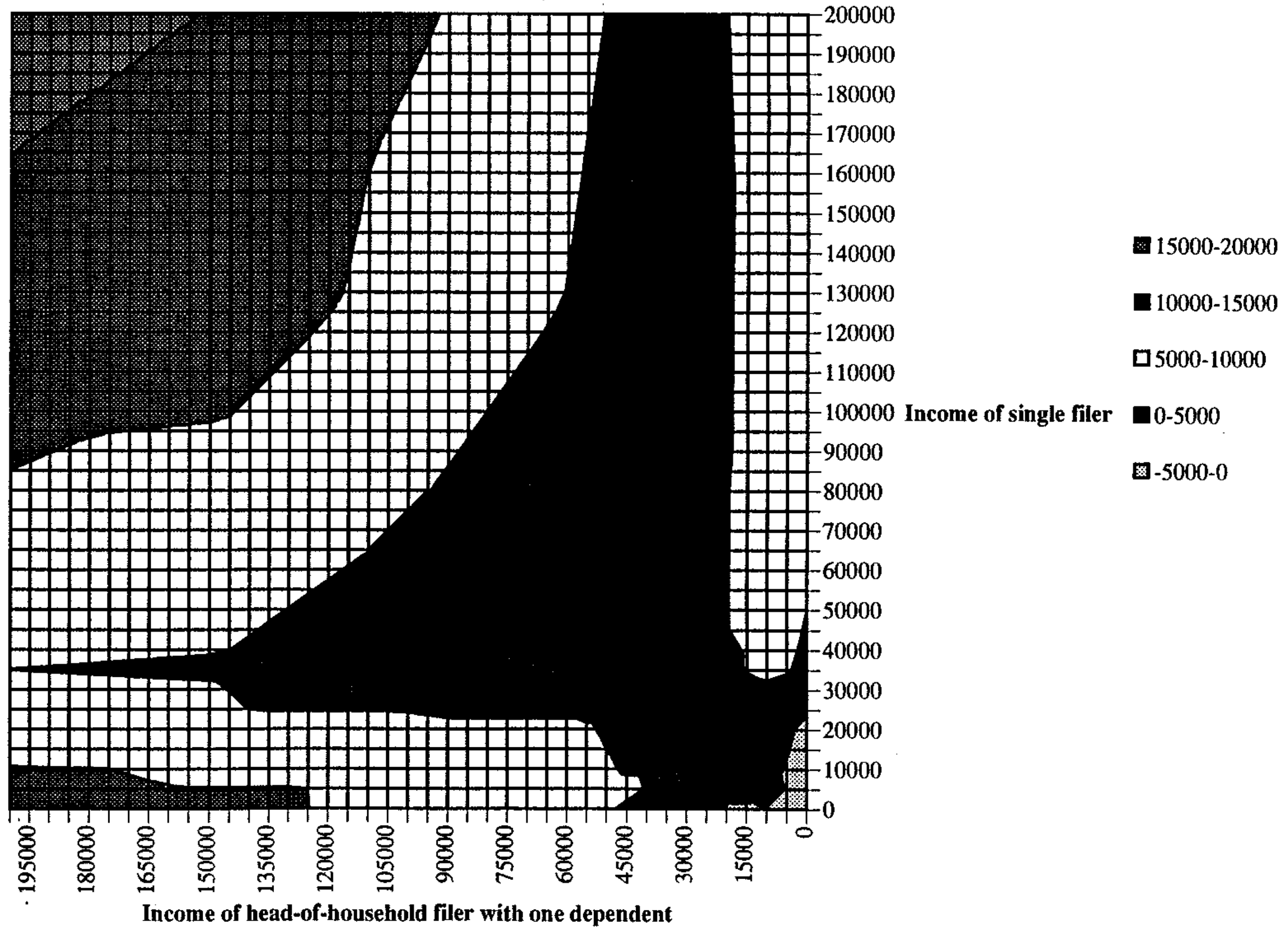
This, however, contradicts equation (1), indicating that equations (2) and (3) can only both be true in a proportional tax system.

Marriage penalty / (bonus) for two single filers



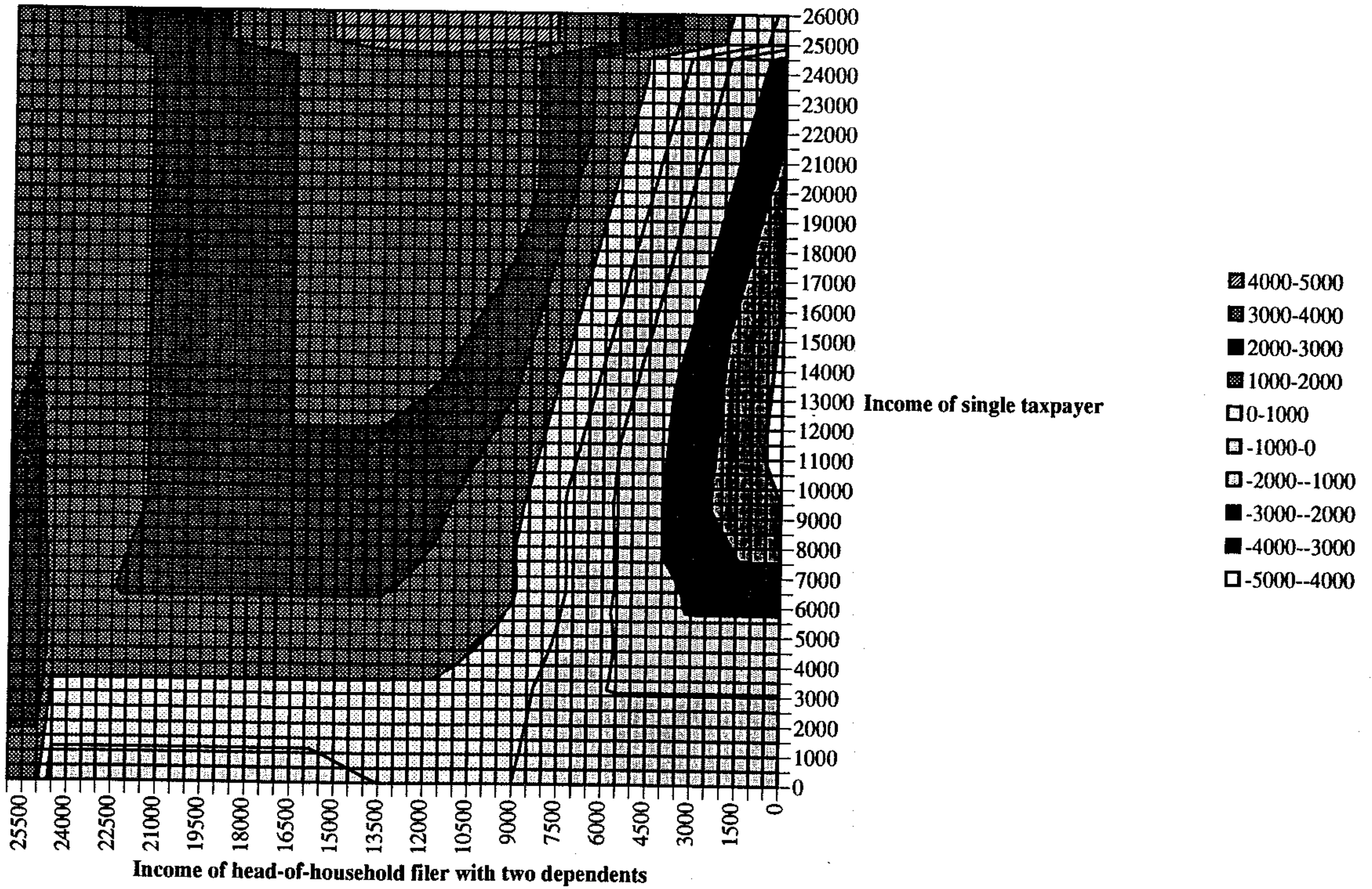
1996 Projection
Both filers are assumed to take the standard deduction.
All income is assumed to be earned income.

Marriage penalty / (bonus) for single filer and head of household filer with one dependent



1996 Projection
Both filers are assumed to take the standard deduction.
All income is assumed to be earned income.

Marriage penalty / (bonus) for single filer and head of household filer with two dependents



1996 Projections
Both individuals are assumed to take the standard deduction.
All income is assumed to be earned income.