TECHNICAL EXPLANATION OF H.R. 4019 FOR CONSIDERATION BY THE HOUSE COMMITTEE ON RULES ON JUNE 11, 2002

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 4019.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 4019 for Consideration by the House Committee on Rules on June 11, 2002,* (JCX-59-02), June 11, 2002.

A. Basic Standard Deduction Marriage Penalty Relief

Present Law

Marriage penalty

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

A “marriage penalty” exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[2] which is subtracted from adjusted gross income (“AGI”) in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2002, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

Present law provides that the basic standard deduction for a married couple filing a joint return will be increased to twice the basic standard deduction for an unmarried individual filing a single return. As provided in the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), this increase in the basic standard deduction is phased in over five years beginning in 2005 and will be fully phased in for 2009 and thereafter. Table 1, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals.

[2] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

Table 1.–Phase-In of the Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Taxable years beginning in calendar year	Standard deduction for joint returns as percentage of standard deduction for single returns
2002 - 2004	167%
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Sunset provision

EGTRRA made a number of changes to the Federal tax laws, including the increase of the basic standard deduction for married couples filing a joint return. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a "sunset" provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

Explanation of Provision

The bill repeals the sunset provision of EGTRRA for purposes of the increase in the basic standard deduction for married couples filing a joint return. Thus, under the bill, the increase in the basic standard deduction would remain in effect after December 31, 2010.

Effective Date

The provision is effective on the date of enactment.

B. Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[3] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15-percent rate bracket marriage penalty relief

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after

[3] The rate bracket breakpoint for the 39.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

December 31, 2007. Table 2, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 2.–Increase in Size of 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals
2005	180%
2006	187%
2007	193%
2008 and thereafter	200%

This provision of EGTRRA is effective for taxable years beginning after December 31, 2004.

Sunset provision

EGTRRA made a number of changes to the Federal tax laws, including the expansion of the 15-percent rate bracket for married couples filing a joint return. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a "sunset" provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

Explanation of Provision

The bill repeals the sunset provision of EGTRRA for purposes of the expansion of the 15-percent rate bracket for married couples filing a joint return. Thus, under the bill, the expansion of the 15-percent rate bracket would remain in effect for taxable years beginning after December 31, 2010.

Effective Date

The provision is effective on the date of enactment.

C. Marriage Penalty Relief and Simplification Relating to the Earned Income Credit

Prior and Present Law

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income, filing status, and whether the taxpayer has one, more than one, or no qualifying children.

The earned income credit is not available to married individuals who file separate returns. No earned income credit is allowed if the taxpayer has disqualified income in excess of $2,550 (for 2002) for the taxable year.[4] In addition, no earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.[5]

Definition of qualifying child and tie-breaker rules

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

Relationship test

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), an individual satisfied the relationship test under the earned income credit if the individual was the taxpayer's: (1) son or daughter or a descendant of either;[6] (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child was an individual (1) who was a brother, sister, stepbrother, or stepsister of the taxpayer (or a descendant of any such relative), or who is placed with the taxpayer by an authorized placement agency, and (2) whom the taxpayer cares for as her or his own child. Under EGTRRA, the relationship test for the earned income credit is met if the individual is the taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such

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[4] Sec. 32(i). Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income for the taxpayer year; and (5) net passive income for the taxable year. Sec. 32(i)(2).

[5] Repealed subsection 32(c)(1)(B).

[6] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

individuals.[7] A brother, sister, stepbrother, stepsister, or a descendant of such individuals, also qualifies if the taxpayer cares for such individual as his or her own child. A foster child satisfies the relationship test as well. A foster child is defined as an individual who is placed with the taxpayer by an authorized placement agency and whom the taxpayer cares for as his or her own child. In order to be a qualifying child, in all cases the child must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

Prior to EGTRRA, if a child otherwise qualified with respect to more than one person, the child was treated as a qualifying child only of the person with the highest modified adjusted gross income (the, "tie-breaking rule").

EGTRRA changed the prior-law tie-breaking rule. Under EGTRRA, if an individual would be a qualifying child with respect to more than one taxpayer, and more than one taxpayer claims the earned income credit with respect to that child, then the following tie-breaking rules apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return together, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest adjusted gross income. Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

Prior to EGTRRA, "modified adjusted gross income" was defined as adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income.[8] The losses disregarded were: (1) net capital losses (up to $3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income included: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).

EGTRRA simplified the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

Definition of earned income

To claim the earned income credit, the taxpayer must have earned income. Prior to EGTRRA, earned income consisted of wages, salaries, other employee compensation, and net earnings from self employment.[9] Employee compensation includes anything of value received

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[7] As under prior law, an adopted child is treated as a child of the taxpayer by blood.

[8] Sec. 32(c)(5).

[9] Sec. 32(c)(2)(A).

by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income include the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (sec. 106), dependent care (sec. 129), adoption assistance (sec. 137), educational assistance (sec. 127), and miscellaneous fringe benefits (sec. 132); (3) salary reduction contributions under a cafeteria plan (sec. 125); (4) meals and lodging provided for the convenience of the employer (sec. 119), and (5) housing allowance or rental value of a parsonage for the clergy (sec. 107). Under EGTRRA, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self employment. EGTRRA simplified the definition of earned income by excluding nontaxable employee compensation from the definition of earned income for earned income credit purposes.

Calculation of the credit

The maximum earned income credit is phased in as an individual's earned income increases. The credit phases out for individuals with earned income (or if greater, adjusted gross income) over certain levels. In the case of a married individual who files a joint return, the earned income credit both for the phase-in and phase-out is calculated based on the couples' combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

For taxpayers with adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount is reduced, falling to $0 at the "breakeven" income level, the point where a specified percentage of "excess" income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are adjusted annually for inflation. Table 3, below, shows the earned income credit parameters for taxable year 2002.[10]

For married taxpayers who file a joint return, EGTRRA increased the beginning and ending points of the earned income credit phase-out by $3,000. The increase is phased in as follows: by $1,000 in the case of taxable years beginning in 2002, 2003, and 2004; by $2,000 in the case of taxable years beginning in 2005, 2006, and 2007; and by $3,000 in the case of taxable years beginning after 2007. The $3,000 amount is to be adjusted annually for inflation after 2008.

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[10] The table is based on Rev. Proc. 2001-59.

Table 3.–Earned Income Credit Parameters (2002)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount	$10,350	$7,370	$4,910
Maximum credit	$4,140	$2,506	$364
Phase-out begins	$13,520	$13,520	$6,150
Phase-out begins (married filing jointly)	$14,520	$14,520	$7,150
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	$33,178	$29,201	$11,060
Phase-out ends (married filing jointly)	$34,178	$30,201	$12,060

Under prior law, an individual's alternative minimum tax liability reduced the amount of the refundable earned income credit.[11] This provision was repealed by EGTRRA.

EGTRRA authorized the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed.

Sunset provision

EGTRRA made a number of changes to the Federal tax laws, including the expansion of the earned income credit. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a "sunset" provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted. Likewise, all other provisions of the Code and ERISA will be applied as though the relevant provisions of EGTRRA had never been enacted.

Explanation of Provision

The bill repeals the sunset provision of EGTRRA for purposes of the expansion and simplification of the earned income credit. Thus, under the bill, the expansion and simplification

[11] Sec. 32(h).

of the earned income credit would remain in effect for taxable years beginning after December 31, 2010.

Effective Date

The provision is effective on the date of enactment.