Dream of repealing marriage tax shrinking

— Staying Ahead —

Jane Bryant Quinn

NEW YORK — During the election, the Republicans promised to repeal what they called the unfair and unconscionable "marriage tax." That's the extra tax that most married working couples pay, compared with two singles who earn the same income.

For example, take Sally and Joe, each with taxable incomes of $25,000. As singles, they pay $3,965 apiece in federal taxes. If they marry they pay a joint tax of $8,930. That's $1,000 more.

But the dream of repeal has shrunk to a symbol, in legislation working its way through the House of Representatives. A symbol worth just a few bucks a month to most working couples but $2 billion or more a year to the federal budget. Deficit hawks should say, no thanks.

What's more, this bill overlooks the marriage bonus that one-earner couples enjoy — which is equally unfair. Here are the rules that tell you whether you're helped or hurt by the way today's tax system deals with marriage:

- A penalty for working couples, like Sally and Joe above. Around 52 percent of all married couples pay some sort of penalty, according to Harvey Rosen of Princeton University and Daniel Feenberg of the National Bureau of Economic Research. (Their study used itemized deductions and made a bunch of other assumptions.)

- An even bigger penalty on low-earning workers who marry, especially if they have children. Take a single mother of two, earning $10,000. On her own, she gets the maximum credit of about $3,000 this year. But if she marries a man earning $15,000, her credit drops to $200 — because it's phased out as incomes rise.

- A bonus for one-earner families or where one spouse earns pin money. If Joe is at $50,000 and Sally earns nothing, his tax drops from $10,965 as a single to $8,930 as a married man — a saving of $2,035. Around 38 percent of taxpaying couples now collect this marriage bonus, Rosen and Feenberg believe. Middle-income families fall into this happy category if the major breadwinner earns at least 84

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To Pauline — Pls. find out what's happening — if anything — on marriage tax issue.
Thanks — HRC

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percent of the joint income, says Tom Ochsenschlager, a partner in the accounting firm, Grant Thornton.

• A big rap on most singles. Their taxes are higher than those of couples with exactly the same income. Singles with children or other dependents, who can file as "head of household," are taxed more lightly than singles without. Even so, they pay more per taxable dollar than a married couple does. It's fairer to say that the tax code sports a singles penalty than a penalty on the married.

Critics complain that the marriage tax is anti-family, encouraging people to live together instead of tying the knot. But people marry and unmarry for reasons having nothing to do with the IRS. No evidence exists that erasing the tax would set off a nationwide nuptial march.

But the marriage tax does appear to discourage a second earner from working, says Anne Alstott, associate professor at Columbia University Law School. One spouse may decide that a job isn't worth it, after totting up the cost of taxes, lunches, work clothes, commuting and child care.

There's no easy way of erasing the marriage tax because it's not an identifiable clause in the income-tax code. It's a mathematical byproduct of two basic principles of taxation.

The first principle is that people with higher incomes should pay a higher rate of tax. When one spouse's income is stacked on top of the other's, some of that money is often thrown into a higher bracket — resulting in a higher tax bill.

The second principle is that married couples with equal incomes should be taxed alike. If everyone were taxed without regard to marital status, a husband earning $50,000, with a wife at home, would pay more tax than a $50,000 working couple where each earns $25,000. Then you'd hear shrieks about a "homemaker" penalty.

The bill now in Congress proposes a working-couple tax credit, to offset the marriage penalty. But it could be a mess to claim. To discover the size of your credit, you'd have to do some special calculations — for yourself as single, your spouse as single and you both as a couple. Aaargh. The benefit would be capped at around $145.

Why bother, just to put $12 a month or less into working couples' pockets? Congress has a $203 billion deficit to break. Every little $2 billion helps.

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TO: Jen

FROM: Neera

RE: The Tax Code, Marriage Penalties and Stay-at-Home Parents

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I. The Tax Code Already Favors Stay-At-Home Parents

A. The Marriage Bonus

The tax code currently supplies marriage bonuses, as well as marriage penalties. However, where one spouse has most or all of the couple's income, the tax liability of the couple is lower than the combined liability of two single persons with the same levels of income. If one person who does not work marries someone who does work, their deductions increase, and therefore they are better off than if they remained single (the single non-worker would receive no deductions because they pay no tax.) Thus, single-earner couples receive a tax advantage from marriage, a marriage bonus."

B. The Secondary-Earner Bias

The income tax works through a system of marginal rates. This means that successive amounts of income are taxed at higher rates. The rate structure works like a ladder: as income moves up through the rate "brackets," it is subjected to higher rates at the margin. In a rate structures with joint filing, the secondary earner's wages, which we can think of as the lesser-earning spouse, come on "on top of" the primary earner': The second earner's first dollar of salary is taxed at the bracket where the primary earner's salary has left him or her. (This second-earner bias has no necessary connection to marriage penalties.)

This bias has two components. First, the rate structure encourages families to think in terms of a primary and secondary worker, because there is one rate structure applied to couples. Under separate filing, actions that a spouse who makes less money is considering, like accepting a promotion, take place at her marginal rate. However, under joint filing, the spouse faces a new and different question: Where does her salary come into play? That is, whose salary comes first? The spouse's secondary earnings are taxed after the primary earnings are taxed. The first dollar earned by the secondary earner is at the highest rate. Therefore, the secondary earner's work is taxed more heavily than the primary earner's work. Indeed, this question of where to place a spouse's income was created by the fact of joint filing. Therefore, joint filing creates strong disincentives against second earners working in the paid workforce at all, because they enter it at high marginal tax rates.[EDWARD MCCAFFERY, TAXING WOMEN, 14-21]

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C. Social Security

The Social Security system provides that the spouses of wage earners receive benefits regardless of whether they have worked outside the home, in paid labor markets. In gendered terms, while the husband is alive, the wife receives credit for the greater of her own or 50 percent of her husband's "potential insurance amount." This means that the wife is treated as if she earned one-half as much as her husband. Since the husband is receiving 200 percent credit for his own work, the couple gets to pool at least 150 percent of his benefits. On the husband's death, the widow receives credit for the greater of her own earnings or 100 percent of her husbands. That is, on the benefits side, the Social Security system rewards single-earner families - wives get benefits without ever paying Social Security tax.

The rationale behind this system is that stay-at-home spouses, especially when they become widowed, need Social Security too. The problem is that there is no marginal return of the taxes paid on the first dollars earned by a secondary-earning spouse. Since such a spouse would get benefits anyway as a presumed dependent on her husband, she does not receive her own benefits until she has established herself as a persistent and large earner, relative to her husband: until the "greater of her own or 50 percent of her husband's profile" comes to mean "her own." She must be persistent as well as a higher earner because the Social Security system looks to earnings weighted over time, so that workers who have stretches of being absent from the paid workforce are penalized. In this manner, the Social Security system encourages women not to work at all because part-time or intermittent work is not rewarded by the system.[EDWARD MCCAFFERY, TAXING WOMEN, 95-96]

D. Child Care Deductions - or The Lack Thereof

Child care and other work-related or "mixed business-personal" expenses, as they are often called, have long been a troubling area of the income tax laws. Tax logic allows a deduction from "gross" or total income for legitimate business expenses in order to arrive at "net" or taxable income. A knotty question for tax legislators has been how to separate out personal items, which should not be deductible. The question of child-care costs is whether they are personal consumption, and hence appropriately taxed, or business expenses, and hence appropriately left untaxed. Because only working parents have child care costs and more specifically, only working single parents or two earner households, many have argued that they should be deductible. This problem is partially ameliorated by the child care credit, but because the child care credit is currently limited, it does not eliminate the current incentive within the tax system to have one parent stay at home because of the large expense of child care.

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II. The Different Solutions to the Marriage Penalty Create Different Incentives For Parents to Stay At Home

A. The Penalty

The marriage penalty is triggered when two people get married and their joint income pushes them into a higher tax bracket than they were in before. As a result, the couple pays more in taxes than the two of them together would have paid if they had remained single. Families in which both spouses have similar levels of income generally have a higher tax liability than the combined tax liability of two single persons with the same levels of income. Thus, they encounter a "marriage penalty." The extent of the marriage penalty or bonus depends on the division of income (and deductions) between the spouses. The tax bracket thresholds and standard deductions for couples are set at less than twice the dollar amount for singles, leaving dual-income married people with more income taxed at higher rates. The Congressional Budget Office found that couples with spouses at similar income levels generally receive smaller deductions, face higher tax rates and get less of the earned-income tax credit than do individual taxpayers with similar income.[Newsday, 11/9/97]

In the aggregate, marriage penalties are approximately $30 billion per year. But, marriage bonuses are equally large, so that the net marriage bonus or penalty is very small. Indeed, according to a recent CBO study, in the aggregate there is a net marriage bonus of $4 billion a year. Marriage bonuses predominate for low income families, while marriage penalties predominate for very high income families, especially when there are two high earners. In terms of number of taxpayers, there tend to be more with bonuses than penalties, although the relative numbers differ by income level.[Treasury Memo, 10/97]

B. Background

A tax system cannot simultaneously achieve all three of the following equity objectives: 1) Imposing the same amount of tax on married couples and single individuals with the same combined income; 2) imposing the same amount of tax on married couples with the same combined income regardless of how the income divided between the spouses; and 3) maintaining progressivity. Advancing any one of these objectives necessarily requires making a sacrifice with respect to one or both of the other two objectives, and produces marriage penalties, bonuses or both.

Originally, the income tax did not take account of marriage at all: husbands and wives simply filed separate individual tax returns. As a result, the tax code neither rewarded nor penalized marriage, which seemed fair enough on the surface. However, this policy caused some anomalies. First, different couples with the same total income paid different taxes. For example, one couple, in which one spouse earned $20,000 and the other earned $80,000 would pay more taxes because of progressive rates than another couple in which both spouses earned $50,000. This system produced complaints because it was felt that couples who earn the same amount jointly should not pay different amounts of tax simply because their family income is divided up differently.

In addition, this system created an additional inequity of its own: couples had an incentive to shift income from the higher-earning spouse to the lower-earning spouse. This was easier to accomplish for those with investment income than with earned income (e.g., transferring title to stock funds and real estate holding to the lower-paid spouse). This meant that families with investment income, who tend to be wealthier, received bigger tax advantages than families who lived off their paychecks. It also meant that a family's income tax burden largely depended on its capacity to partake in relatively expensive tax planning.

Underneath these inequities lay a common premise in the tax code: an assumption that spouses do not share income. In 1948, Congress decided to rectify this assumption - it changed the law so that every family would pay twice the income tax on half its total income through joint filing. In other words, a family earning $100,000 would pay twice the income tax of a single person earning $50,000, which works out to be less than the tax burden on a single person earning $100,000. (Since the income tax is progressive, with higher rates for higher income, the tax on $100,000 is more than twice the tax on $50,000.) Therefore, how the couple's earnings were divided did not matter for tax purposes.

However, this created an inequity between married couples and singles. The law allowed two income earners who married to move into a lower tax bracket, and thus lessen their tax burden, while singles were left at the higher rates. Congress' solution to this problem was to enact a compromise between married couples and singles. As part of the broader tax overhaul in 1969, Congress reduced the tax disadvantages of living single and, for the first time, introduced some negative tax consequences for certain married couples. That system is the one in place today where married couples in which one spouse makes much more than the other actually receive a marriage bonus, and spouses who make about the same as each other receive a penalty. This was less of a problem when few women worked. However, marriage penalties have increased as women have entered the workforce and their wages have increased.[Jonathan Chait, *The Penalty Box*, THE NEW REPUBLIC, Oct. 20, 1997]

C. Solutions

At least four different options for marriage penalty reduction have been discussed: a single filer option; a two-earner deduction; a targeted two-earner deduction or credit; and income splitting.

1. Single Filer Option

A single filer option permits a married couple to continue to file a joint tax return or to elect to file two separate returns, as if each were an unmarried individual or a head of household,

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depending on their circumstances. A variant, introduced as H.R. 2456 by 218 members of the House, would permit the separate calculation of tax but continue the use of the joint return concept. Essentially, it would combine separate filing on one tax return form. H.R. 2456 would lessen some of the costs and the inherent complexity of separate filing by arbitrarily prorating deductions and by retaining a joint EITC computation.

Optional single filing option can completely eliminate marriage penalties without increasing marriage bonuses. As a result, it would be very expensive, approximately $30 billion a year. By eliminating the higher EITCs stemming from separate filing, H.R. 2456 would not address marriage penalties from the EITC but would reduce the cost of optional single filing.

A problem with optional single filing is that it would substantially increase the burdens of the income tax system. Many, if not most, married couples would have to make three, rather than one, tax computation (joint, his, and hers) in order to determine the filing method that results in the least tax liability. Currently, families who pool their resources need not keep separate records by family member. Under optional separate filing, separate income and deduction records would be necessary, even for many who would not ultimately opt for single filing. There would be conceptual complexities as well, such as how to allocate a deductible expenditure made by one spouse but partially for the benefit of the other spouses and children which the other spouses may be claiming as dependents.

In addition, optional separate filing would put an undue premium on careful tax planning and the ability to "divide" income and deductions optimally between spouses. For example, taxpayers with small businesses would have an undue ability (compared to employees) to "share" earnings on paper in order to reduce tax liability. Also those with investment income, which tend to be wealthier families, would have greater ability to shift income.

Finally, the single filing option would eliminate the second-filer bias, which would in turn eliminate an incentive in the current tax code to have one parent stay at home.

2. Two-Earner Deduction

Twenty-two Ways and Means Committee members (mostly Republicans) have introduced H.R. 2593, which would resurrect the 1982-1986 second earner deduction of 10 percent of the first $30,000 of the earnings of the spouse with lesser amount of earnings

A substantial portion of the benefits of any second earner deduction are "wasted" by increasing the marriage bonuses of those already receiving marriage bonuses or by changing the current marriage penalties into marriage bonuses. The more generous the second earner deduction, the more difficult it is to target it to those with current marriage penalties.

A second earner deduction grants to families that may have net marriage bonuses as the result of the "income splitting" of passive income that joint filing allows. In addition, this type of proposal adds some complexity to the tax computation process for virtually all two-earner couples.

3. A Targeted Two-Earner Deduction or Credit

Two-earner deductions of the type permitted between 1982 and 1986 "waste" a considerable portion of their cost by increasing marriage bonuses rather than by targeting marriage penalties. Better targeting can be achieved by setting a floor of some percentage, say, 20 percent, of combined total income (not only earnings) on the second earner deduction. A deduction or tax credit could then be provided for some percentage of the amount by which the earnings of the lower-earnings spouse exceed 20 percent of the family unit's total income. The size of the deduction or credit can be capped, if there is a resource constraint.

Compared with a simple second earner deduction, very little of the benefits of a targeted deduction or credit are "wasted" on those already receiving marriage bonuses. However, even a targeted second earner deduction grants benefits to two-earner families that may have net marriage bonuses as the result of the "income splitting" of passive income that joint filing allows.

This type of proposal adds a little additional complexity to the tax computation compared with the simple second earner deduction. However, that complexity is more than offset by the reduction in taxpayers who will need to make the computation.

Deductions with low caps address the problem by providing limited, and perhaps not very important, relief to the many taxpayers with small marriage penalties without providing meaningful relief to those who with very large penalties. If some marriage penalty relief is deemed to be required, a targeted second earner deduction or credit provides that relief most efficiently.

Both the two-earner deduction and its more targeted form reduce an incentive in the current tax system for one spouse to stay at home by reducing the tax code's current penalty on many dual-income couples.

4. Income Splitting

Under income splitting, a married couple at tax time would add up their income and divide by two, so that effectively each spouse would be taxed on half of their joint income. This would apply to both two-earner and single-earner couples. Thus, if one spouse earned $ 20,000 and the other $ 30,000, each would report a taxable income of $ 50,000 "split" in two, or $ 25,000, to be taxed at the basic rate. And if one spouse earned $ 50,000 and the other nothing, the tax result would be the same. Income splitting legislation has been proposed in the Senate by Republican

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Connie Mack of Florida and others.

In contrast to the single filing option, straight income splitting would incorporate joint filing and its premise that in the economic sphere, married people cooperate, trade off, and give freely to each other. [Legal notions like community property and the equal division of assets following divorce recognize this fact.]

By rewarding couples for sharing their income for tax purposes, and by treating both partners as equal taxpayers, income splitting would recognize the contribution of married people who are not in the labor force. <u>Indeed, it would give greater advantages to those couples where one person stays at home because it would increase their deductions.</u>

In addition, income splitting would return to the pre-1969 system of penalizing singles. Finally, it would be expensive: one estimate is that it would cost roughly $30-35 billion a year in lost tax revenues.[Allan C. Carlson and David Blankenhorn, *The Wages of Wedlock*, THE WEEKLY STANDARD, Nov. 17, 1997]