# ABA/AICPA/TEI Tax Simplification Recommendations
# September 13, 2002
# Attachment B: Simplification of Phase-Outs Based on Income Levels

## Present Law

The Internal Revenue Code is often used to distribute the benefits from a variety of social policy programs across selected groups of taxpayers. To accomplish these diverse goals, many Code sections phase-out the enumerated deductions and credits over various income ranges based on differing measures of taxpayer income. Currently, these phase-out ranges are not consistent either in defining income, the applicable levels of income, the range of income over which the phase-out applies, or the method of applying the phase-outs. The phase-out ranges even differ depending on filing status, and these differences are also inconsistent.

For example, the deduction for contributions to a traditional IRA phases out over a different range of income [defined as Adjusted Gross Income (AGI) modified for adoption assistance, tuition deductions, and student loan interest, foreign income and EE bond interest exclusions] for single filers than it does for married-joint filers. In contrast, the $25,000 allowance for passive losses from active participation rental activities phases out over the same range of income. In some cases, more than one phase-out must be addressed, involving multiple, and often interdependent, computations.

As a result, phase-outs cause inordinate complexity – particularly for taxpayers attempting to prepare their own returns without the assistance of tax preparation software.

The attached appendix lists the many tax provisions requiring phase-outs, and detail their respective income measurements, phase-out ranges, and phase-out methods. Note that many of the current phase-out ranges for married-filing-separately (MFS) taxpayers are 50 percent of the ranges for married-filing-jointly (MFJ), while many of the phase-out ranges for single and head-of-household (HOH) filers exceed 50 percent of the MFJ range. This creates a marriage penalty in the application of these programs when spouses' incomes are relatively equal.

## Reason for Change

Under current law, phase-outs complicate tax returns immensely and impose marriage penalties. Phase-out instructions are difficult to understand and the average taxpayer cannot manage the complex calculations. In addition, the differences in phase-out methods and definitions of income causes a compliance burden on many individuals and make it difficult for taxpayers to recognize when they are eligible for a benefit and when and how any phase out applies. Tremendous income-level differences exist across the various programs using phase-outs.

As it stands, some phase-outs are so complicated that neither the targeted taxpayers nor those charged with explaining and administering the rules are able to accurately understand and interpret them.

## Recommended Changes

Instead of the, approximately, 19 different phase-out ranges (see Appendix), we join the staff of the Joint Committee on Taxation in recommending that most phase-outs of tax provisions be eliminated. Congress has already taken an important step in this effort by providing that, beginning in 2006, two of these troubling phase-out provisions, dealing with personal exemptions and the overall limitation on itemized deductions, will begin to be eliminated. We applaud this legislative action, and recommend that the scheduled dates for eliminating these phase-out provisions be accelerated. If it is not possible under current revenue constraints to eliminate the remaining phase-outs of the various affected provisions immediately, we believe an important interim step would be to harmonize the provisions, through the application of consistent methodology in calculating phase out ranges and by using consistent measures of income to various affected income groups.

If the Treasury determines to pursue the approach of harmonizing these provisions, we recommend using only three phase-out ranges representing low-, middle- and high-income taxpayers. Each tax benefit provision would apply to taxpayers in one or more of these income levels. Where each provision should fall is a decision for policymakers. Moving programs between the income categories based on changing policy goals and needs would not impair the net simplification.

For example, benefits specifically targeted to low-income taxpayers – such as the dependent care, and elderly and disabled credits – would fall under the low-income phase-out range. Benefits targeted to low- and middle-income taxpayers [traditional IRA contribution, as well as the retirement savings credit] would fall under the middle-income phase-out range. Likewise, benefits specifically not available above designated income levels would fall under the high-income phase-out range. [See for example, the child and education credits; Coverdell Education Savings Accounts; Roth IRAs; pre-2009 itemized deductions and personal exemptions; adoption credit and exclusion; conversions to Roth IRAs; series EE bond exclusion; education loan interest expense, tuition deductions, and section 469 $25,000 rental exclusion and credit.]

Revenue concerns could be addressed by adjusting the ranges and percentages, as long as the phase-outs for each income-level stayed consistent across all relevant provisions.

Recent legislative changes have been eliminating the marriage penalty caused by phase-outs by having single and HOH ranges to be half of the MFJ ranges. We suggest that Treasury consider whether it would be appropriate to continue to lessen the marriage penalty caused by phase-outs.

Instead of applying phase-outs using different methodologies, benefits subject to phase-outs should be reduced evenly over the phase-out range. Finally, to address inconsistent income measures, AGI with or without modifications could be determined to be appropriate, but a consistent income measure should be applied across the board.

# APPENDIX – Selected AGI Phase-Out Amounts (as of August 2002)

## PHASE-OUT LEVELS FOR LOW-INCOME TAXPAYERS

| IRC Section | Provision | Footnotes (FN) | Current - Joint (MFJ) | Current -Single (S) & HOH (H) | Current – Married/Sep(MFS) (7) |
|---|---|---|---|---|---|
| 21 | 30 Percent Dependent Care Credit | (3, 11) | $10,000-28,000 | $10,000-28,000 | No credit |
| 22 | Elderly & Disabled Credit | (4,10,11) | $10,000-20,000 | $7,500-17,500 | No credit |

## PHASE-OUT LEVELS FOR MIDDLE-INCOME TAXPAYERS

| IRC | Provision | FN | Curr - MFJ | Curr - S & H | Curr--MFS(7) |
|---|---|---|---|---|---|
| 25B | Retirement Contribution Credit | (1) | | | |
| | 50% credit | | Up to $30,000 | (S) up to $15,000<br>(H) up to $22,500 | Up to $15,000 |
| | 20% credit | | $30,001-32,500 | (S) $15,001-16,250<br>(H) $22,501-24,375 | $15,001-16,250 |
| | 10% credit | | $32,501-50,000 | (S) $16,251-25,000<br>(H) $24,376-37,500 | $16,251-25,000 |
| 86 | Social Security Benefits 50% Taxed | (1, 11) | $32,000-44,000 (base amount) | $25,000-34,000 (base amount) | $0 (base amount) |
| 86 | Social Security Benefits 85% Taxed | (1, 11) | $44,001- (base amount) | $34,001- (base amount) | $0 (base amount) |
| 219 | IRA Deduction with retirement plan | (1,9,11) | $54,000-64,000 | $34,000-44,000 | $0-$10,000 |

## PHASE-OUT LEVELS FOR HIGH-INCOME TAXPAYERS

| IRC | Provision | FN | Curr - MFJ | Curr - S & H | Curr--MFS(7) |
|---|---|---|---|---|---|
| 24 | Child Credit | (1,5, 11) | $110,000-130,000 | $75,000-95,000 | $55,000-75,000 |
| 25A | Hope Credit & Lifetime Learning Credit | (1,2, 11) | $82,000-102,000 | $41,000-51,000 | No credit |
| 23 & 137 | Adoption Credit/ Exclusion | (1,2, 11) | $150,000-190,000 | $150,000-190,000 | No benefit |
| 55(d) | AMT Exemption | (1,8, 11) | $150,000-346,000 | $112,500-255,500 | $75,000-173,000 |
| 135 | EE Bond Interest Exclusion | (1,2, 11) | $86,400-116,400 | $57,600-72,600 | No exclusion |
| 219 (g)(7) | IRA – spouse w/retirement plan | (1, 11) | $150,000-160,000 | Not applicable | No deduction |
| 221 | Education Loan Interest Expense | (1,2, 11) | $100,000-130,000 | $50,000-65,000 | No deduction |
| 222 | Tuition Deduction | (1, 11) | $130,000 | $65,000 | No deduction |
| 408A | Roth IRA Deduction | (1, 11) | $150,000-160,000 | $95,000-110,000 | $0-10,000 |
| 408A | IRA to Roth IRA Rollover | (1, 11) | $100,000 | $100,000 | No rollover |
| 469(i) | $25,000 Rent Passive Loss | (1, 11) | $100,000-150,000 | $100,000-150,000 | No deduction |
| 469(i) | Passive Rehabilitation Credit | (1, 11) | $200,000-250,000 | $200,000-250,000 | No credit |
| 530 | Coverdell Education Savings Account | (1) | $190,000-220,000 | $95,000-110,000 | $95,000-110,000 |

**Footnotes**:

(1) Modifications to AGI apply
(2) Inflation indexed
(3) Not used
(4) Not used
(5) Phase-out range depends on number of children
(6) Lower credit percentage available if AGI above the specified level
(7) Living together during the year
(8) Phase-out applies to alternative minimum taxable income rather than AGI
(9) Increases for future years are specifically provided in the statute
(10) Larger phase-out if both spouses eligible
(11) Special rules apply if spouses lived apart during entire tax year or for the last six months of the year and certain other conditions are met.

## APPENDIX CONTINUED - Current Method of Phase-Out

| Code Section(s) | Tax Provision | Current Methodology for Phase-out Application |
|---|---|---|
| 21 | Dependent Care Credit | Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income. After 2002, credit percentage increases to 35 percent then reduced to 20 percent by 1 percent credit for each $2,000 in AGI exceeding $15,000. |
| 22 | Elderly & Disabled Credit | Credit amount reduced by amount of excess over AGI range. |
| 23 & 137 | Adoption Credit & Exclusion | Benefit reduced by excess of modified AGI over lowest amount noted divided by $40,000. |
| 24 | Child Credit | Credit reduced by $50 for each $1,000 in modified AGI over lowest amount noted. |
| 25A | Education Credits (Hope/Lifetime Lrng) | Credits reduced by excess of modified AGI over lowest amount divided by $10,000 (single) and $20,000 (joint). |
| 25B | Retirement Contribution Credit | Reduced credit is available at the levels specified. No credit is available once AGI exceeds the highest level indicated. |
| 32 | Earned Income Credit | Credit determined by earned income and AGI levels. |
| 55 | AMT Exemption | Exemption reduced by 1/4 of AGI in excess of lowest amount noted. |
| 86 | Social Security Benefits | Benefits taxed when modified AGI plus half social security benefits exceeds the base amount. |
| 135 | Series EE Bonds | Excess of modified AGI over lowest amount divided by $15,000 (single), $30,000 (joint) reduces excludable amount. |
| 219 | Traditional IRA w/ Retirement Plan | Individual retirement account (IRA) limitation ($3,000/$6,000) reduced by excess of AGI over lowest amount noted divided by $10,000. IRA limitation is higher for taxpayers over the age of 50. |
| 219(g)(7) | IRA w/Spouse w/ Retirement Plan | Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by $10,000. |
| 221 | Education Loan Interest Expense Deduction | Deduction reduced by excess of modified AGI over lowest amount noted divided by $15,000 ($30,000 for joint returns). |
| 222 | Tuition deduction | Deduction is completely eliminated when AGI exceeds the levels indicated. |

| | | |
|---|---|---|
| 408A | Roth IRA | Contribution reduced by excess of modified AGI over lowest amount noted divided by $15,000 (single) and $10,000 (joint and married filing separately). |
| 408A | IRA Rollover-Roth IRA | Rollover not permitted if AGI exceeds $100,000 or if MFS (unless considered unmarried). |
| 469(i) | Passive Rental Loss $25,000 Rule | Benefit reduced by 50 percent of AGI over lowest amount noted. |
| 530 | Coverdell Education Savings Account | Contribution reduced by excess of modified AGI over lowest amount noted divided by $15,000 (single) and $10,000 (joint). |