Reducing the Tax Burden (March 16)

STATEMENT BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
Mr. Chairman and Members of the Committee:
This statement is presented on behalf of the American Bar Association and supplements earlier testimony presented by the Section of Taxation of the American Bar Association.

Under the U.S. income tax system, married couples with the same income pay the same tax, no matter what the source of their income. This result is the consequence of Congressional action in 1948 that permitted married couples to aggregate their incomes on one joint return and compute their tax liability as if each spouse had received one-half of their joint income.

Before the 1948 Act, married taxpayers living in community property states each reported one-half of community property income for tax purposes under the decision in Poe v. Seaborn. Under a progressive income tax, the effect of Poe v. Seaborn was to shift earned income in community property states from the higher marginal tax rate of the taxpayer who earned it to the lower rate of the spouse who did not, even when each files a separate return. The 1948 income-splitting legislation made the result in Poe v. Seaborn immaterial in determining tax liability, and eliminated the differences in the tax liabilities of married couples based on where they lived. After the 1948 change, however, income tax was still calculated according to one basic rate schedule. Consequently, the income levels at which marginal rates increased in a progressive tax ("rate-breaks") for an unmarried taxpayer were exactly 50% of the rate-breaks for married taxpayers filing joint returns. A taxpayer who married an individual with less taxable income would, as a result, pay less tax. Thus, the "marriage bonus" was created.

In 1969, Congress responded to concerns of single taxpayers that their tax burden was disproportionately large compared to the tax liability of a married couple with the same income by enacting an entirely new rate schedule for unmarried taxpayers. This schedule reduced the tax a single individual would pay by increasing the rate-breaks to levels which were 60% of those for married taxpayers filing joint returns. The result of this rate structure is that two taxpayers with approximately the same taxable income who marry will pay more income tax than the aggregate amount they paid as single individuals. Thus, the "marriage penalty" had been created.

Over the thirty years which followed enactment of the individual tax schedule in 1969, a great deal has been written about the marriage penalty. It has been studied by the GAO, the CBO, the Treasury Department and the Joint Committee and this Committee has received volumes of testimony relating to it. Somewhat lost in the current deluge of criticism of the "marriage penalty" is one essential fact. IT IS IMPOSSIBLE TO HAVE A MARRIAGE NEUTRAL TAX in a tax system that has a progressive rate structure and in which couples with equal family incomes pay the same tax. This proposition was demonstrated with elegant mathematical simplicity by Assistant Treasury Secretary Edwin S. Cohen in testimony before this Committee in 1972. As he concluded then, and as remains the case today, "no algebraic equation . . . can solve this dilemma . . . . All that we can hope for is a reasonable compromise."

Until now, Congress has chosen to tinker with the effect of marriage on tax liabilities, but has not changed the basic relationship between the rate schedules that produces the result. The revenue statistics reveal why the problem is difficult. The CBO has reported that, under a "basic measure" of the penalty and bonus, 25.3 million joint returns received a marriage bonus costing nearly $33 billion in revenue compared to 20.9 million joint returns which paid a marriage penalty increasing revenues by nearly $29 billion. Efforts to mitigate the penalty without reducing the bonus (causing a tax increase for some couples) are very expensive.
It is, of course, true that one way to solve the problem is to depart from the principle that all married couples with the same income should be taxed alike. Some proposals already do that by identifying characteristics which would justify a different tax liability, principally a deduction or credit based on the earnings of the lower earning spouse, but these proposals continue to rely on the underlying principle that married couples with similar incomes should bear the same tax burden.

Some have suggested a more radical solution -- that each individual taxpayer should be liable for tax on his or her own income. Individual filing would eliminate differences in the tax burden between married and unmarried couples having the same income. A single individual and a married couple, only one of whom had income, with the same income would, potentially at least, pay the same tax. Because there are many who advocate a return to filing as individuals, it is important to explore some of the difficulties that would have to be faced were this approach to be seriously considered.

**Issues Raised by Individual Filing**

Supporting families. It is said that the marriage penalty discourages two individuals with earned income from marrying. The marriage bonus might also be said to encourage marriage because of the tax advantage which a high earning individual could obtain after marriage with a low earning spouse. While there does not appear to be conclusive evidence for either proposition, adoption of an individual filing system would eliminate the marriage bonus. If Congress decided that there should be a tax advantage for marriage despite adoption of an individual filing system, it might consider whether to confer tax benefits on spouses who stay home, for example, to care for children. The child credit is one form of relief for families with children that might be expanded as the married filing rate schedule is eliminated. This would focus the effect of tax advantages on a different characteristic, such as minor children in the household, rather than the formal status of marriage.

Assigning income between spouses. One problem that is solved by a joint filing system is the assignment of income from one spouse to the other without any shift of economic benefit. The principal issue here is posed by Poe v. Seaborn, under which community property income is divided equally between spouses no matter which one earned or has control over it. Requiring individuals to pay tax on their own incomes will again raise the problem that the income-splitting joint return was enacted to solve.

Individual filing is not practical unless this problem is resolved. If Congress decides to return to individual filing as the basic principle in the income tax, it would probably be constrained to also provide that community property law will be disregarded in determining federal income tax liability. Such a decision would also require rules to allocate community property income and deductions between spouses. These issues are discussed below.

An alternative solution would permit voluntary assignments of income. In Lucas v. Earl, the Supreme Court refused to give effect for tax purposes to a binding contract under which husband and wife agreed to share the husband's earnings. This principle has been the bedrock of the income tax doctrine forbidding the assignment of personal earnings to another taxpayer for tax purposes, and any relaxation has been widely viewed as seriously undermining the U. S. income tax. Voluntary assignments of income between spouses should continue to be treated as ineffective for tax purposes. A rule permitting voluntary assignment, even when limited to interspousal transactions, ignores ownership principles under which the spouse who has the closest relationship to the income in question could retain control over it. This would be inconsistent with the principle underlying individual filing.

A return to individual filing will put pressure on assignment of income principles in any event as taxpayers seek to reduce tax burdens by shifting incomes within marriage. This will, in turn, cause potential compliance problems for the Internal Revenue Service in the exercise of its responsibility to assure that real transfers have occurred before income shifting is permitted.

Determining how income should be allocated between spouses. Allocation issues, as distinct from the filing burden discussed below, are difficult. Many allocation issues may turn out to be straightforward for
most taxpayers and where the supporting records for an allocation are lacking, arbitrary default rules can be adopted. Nonetheless, there are some problems.

Business income. Spouses may participate in the same business as owners, operators or employees. Business income may not be clearly the income of either, or may be arbitrarily allocated by them, potentially for tax effect. One possible approach would be to allocate business income to the spouse with control over the business.

Jointly owned property. The most administrable and reasonable rule for jointly owned property would be for title ownership to control how income from that property is allocated for tax purposes.

Deductions. An itemized deduction expense might be paid by one spouse, or from joint funds. In order to measure the taxable income of each spouse most accurately in an individual return system, the spouse who pays the expense should receive the deduction (e.g., the spouse makes the payments on a joint mortgage on the couple's jointly owned personal residence). Payments from a joint account, or made under circumstances where the identity of the payor cannot be shown from supporting records, could be divided equally.

Personal exemptions or credits. These are rate reduction devices for families with dependents. The spouse could allocate these as they decide; any alternative approach seems unduly burdensome and complex.

The filing burden. Both the Treasury Department (in its report on joint and several liability) and the Internal Revenue Service have asserted that separate filing for spouses would cause an enormous processing burden for the IRS. Some states now require married persons to pay tax individually and permit spouses to file a single return on which the income and deductions of the spouses are allocated between them. For most taxpayers, this is not difficult. But it is also true that state allocation requirements are probably simpler than those that would apply to a federal allocation regime. States' allocation systems begin with amounts reported on the federal return, and rely on the federal system for substantiation. Allocations for state purposes, moreover, carry less significance because marginal rates are lower and effective rates are lower still due to the deductibility of the state income tax for federal purposes. It is a different matter if allocation were permitted for federal purposes. Review of the allocation decisions also adds administrative burdens.

Rates. Eliminating the joint return rate schedule will change the allocation of the tax burden and the overall revenue yield of the individual income tax. The tax burden would increase on married couples in which one spouse earns most of the income, absent broader changes in rate schedules. A shift to an individual filing system would accordingly raise broader issues of the appropriate rate schedule.

Intermediate Proposals
As the foregoing demonstrates, the costs of moving to a system of individual filing are significant. The marriage penalty can be alleviated but not eliminated, with less comprehensive revisions.

Reducing the tax rate on earned income. The system of joint filing in place since 1948 has had an impact on married persons which is independent of marriage neutrality. When both spouses have earned income, the income of one spouse (the "secondary earner") is "stacked" on top of the income of the other (the "primary earner") for purposes of determining the marginal rate of tax applicable to the secondary income. The secondary income will then be perceived to have been taxed more heavily than will the income of the primary earner. While there is no obvious answer to which income is "primary," the rational choice is to treat the spouse with the larger income as the primary earner.

One way to address the disproportionate tax burden imposed on the second earner is to reduce the tax burden on the second income through a mechanism like an earned income deduction. From 1981 through 1986, a married couple filing a joint return was allowed to deduct 10% of the earned income of the lower earning spouse up to a maximum of $30,000. A similar provision, adjusted to meet revenue requirements, would reduce the tax burden on the income of the lesser earning spouse and could do so at moderate cost.
This proposal is more beneficial to higher income married taxpayers because this is where the incentive effect of the stacking problem is likely to be the greatest.

Another way to address the issue is through a tax credit. The Tax Section adopted a Legislative Recommendation in 1978, subsequently passed by the ABA House of Delegates, that would permit a credit for married individuals equal to the taxes paid on the earned income of the spouses in excess of the sum of the taxes each spouse would pay on the separate income of each if unmarried. The effect of the proposal is to assure that no married individual will pay a greater tax on earned income due to marital status.

Adjusting rate breaks for higher income taxpayers. The marriage penalty was exacerbated by the 1993 tax changes, particularly at upper income levels where the rate breaks for the higher marginal rates for single individuals were placed at a higher percentage of the similar rate breaks for joint returns. This effect could be reduced by raising the rate breaks for the joint return rate schedule. For example, the rate breaks for the basic marginal rates (15, 28 and 31%) for singles are approximately 60% of those for joint returns; thus, the 28% marginal rate for 1997 for single returns begins at $59,750, which is 60% of $99,600, the 28% rate break for joint returns. On the other hand, the rate break for the 36% rate is $124,650 for singles, which is 82% of the comparable rate break for joint returns ($151,750); and the 10% surcharge begins at the same income level for both singles and joint returns. The effect is to produce a very large marriage penalty at the highest incomes. That marriage penalty could be reduced by reducing the income level at which singles begin to pay the higher marginal rates, by raising the income level at which joint filers begin to pay at the comparable marginal rate, or by some combination of the two. This simple measure would address the most striking examples of marriage penalties.

In 1969, the Congress decided to calibrate the brackets for single taxpayers as 60% of the brackets for married taxpayers filing jointly. A reduction in this relationship, which could be accomplished by reducing the tax on married couples without increasing the tax currently imposed on unmarried individuals, would reduce the "penalty" on two earner couples who marry but would, in the long run, cause a redistribution of a portion of the income tax burden from married couples to single individuals. Although related to the "marriage penalty" issue, the relative tax burden of single and married individuals is a different issue, which ought to be considered on its own merits.

The earned income tax credit. For taxpayers at the opposite end of the income scale, there are also marriage penalty effects. The most serious involves the earned income tax credit and results from the application of the earned income tax phase-out rule. When the phase-out amount for an individual taxpayer is more than half of the amount allowed for a married couple, married taxpayers will have a smaller exemption (the phaseout will begin earlier) than would be true for two individual unmarried taxpayers. More generally, however, a married taxpayer is required to aggregate his or her income with the income of a spouse in order to apply the phase-out rule. This is accomplished by requiring married couples to file a joint return in order to obtain the benefit. The earned income tax credit, for example, is phased out as the taxpayer's adjusted gross income (or earned income if greater) rises above a phaseout level ($11,930 for 1997). This level is the same whether the taxpayer files as an individual or jointly with his or her spouse, but she is required to file jointly if married.

In these cases, as with other means-tested welfare benefits, the apparent purpose is to limit a benefit based upon household resources, where marriage is used to define the household. The difficulty with the definition is that many households include individuals who are not married, and in some instances, households do not include both spouses. Because of the definition, however, and the relative importance of the EITC to taxpayers in that income level, there is a strong incentive not to marry. There may be sound programmatic reasons for aggregating household incomes, but an adjustment in phase-out levels for two income producing taxpayers in the same household could significantly affect the impact of this provision on marriage decisions.
Other phaseouts. Differential taxation of married couples results also from other provisions in the Internal Revenue Code which provide different levels of benefits depending on whether the taxpayers are married or single. Some of these effects are artifacts of the rate schedule, such as the amounts allowed as standard deductions. In 1998, after indexation, an unmarried taxpayer is allowed a standard deduction of $4,250, which is more than half the $7,100 amount allowed to married taxpayers filing a joint return. Taxpayers who marry are limited to a standard deduction which is $1,400 less than the amounts they could otherwise claim by not marrying and filing separately.

Phase out provisions for personal exemptions and itemized deductions. Personal exemptions are subject to a phase out beginning at specified adjusted gross income levels for which the ratio between single and married filers is 67%. Itemized deductions are subject to a limitation imposed after the specified adjusted gross income level for both joint returns and returns of an unmarried individual. These provisions are revenue raising devices at high income levels and thus contribute to the marriage penalty at the top end of the scale. Shifting the bracket levels to diminish the marriage penalty could be effective to reduce the marriage penalty effect of these phase-out provisions.

**Conclusion**

Individual filing is the only way to eliminate the marriage penalty but it would require abandoning the fifty year old objective of tax neutrality among married couples. A case can be made in favor of that approach. However, it would entail significant compliance, filing and administrative costs. On balance, these costs appear to outweigh the potential benefits of individual filing.

This statement has suggested other ways to reduce the increased tax burden imposed on two income families in the context of the present system. These alternative approaches seek to minimize the impact of changes on the distribution of the tax burden on all types of filers, a matter which will have to be considered more fully as the Committee debates this issue.