American Bar Association

Section of Taxation

Report to the ABA House of Delegates

RECOMMENDATION

RESOLVED that the American Bar Association recommends to the Congress that it repeal Section 68 and subsection 151(d)(3) of the Internal Revenue Code of 1986, which phase-out itemized deductions and personal exemptions if an individual taxpayer has adjusted gross income over a given threshold, and it is

FURTHER RESOLVED that Congress replace the revenue currently raised by subsection 151(d)(3) and Section 68 with adjustments to the explicit tax rates in the tax brackets of section 1(a)-(d) to raise the same amount of revenue, distributed in substantially the same way among tax brackets, and it is

FURTHER RESOLVED that all necessary conforming changes, including the elimination of all cross references to Section 68 and subsection 151(d)(3), be made.

REPORT

Current Law. Under current law, section 68 of the Code increases taxable income by 3% per dollar of adjusted gross income in excess of a threshold, currently set at $121,200. The reduction operates across the 31%, 36%, and 39.6% brackets. The product of the 3% increase in taxable income and the tax bracket rates yields a tax of approximately 1% of adjusted gross income. Tax rates are usually stated and understood as a percentage of taxable income, however, and taxable income is a smaller base than adjusted gross income. For a typical taxpayer in the top bracket, for instance, the section 68 tax on adjusted gross income might be restated as a tax of 1.41% of taxable income.

In form, section 68 tax is contingent, not just on extra adjusted gross income, but also on 80% of certain targeted itemized deductions. The selected itemized deductions reduced by section 68 are itemized deductions that have been criticized as providing some element of self-service or consumption to the taxpayer. In practice, however, the selected deductions are so plentiful that the itemized deduction ceiling only rarely comes into play. Analysis of the IRS Statistics of Income seems to imply that section 68 is substantially equivalent in impact to a tax imposed without regard to the targeted itemized deductions.

Subsection 151(d)(3) of the Code phases out personal exemptions as adjusted gross income increases over a range of adjusted gross income now set at between $181,800 and $304,300. The range is adjusted annually for inflation. Subsection 151(d)(3) yields a surtax between seven-tenths and eight-tenths of a percent of adjusted gross income per personal exemption. Taxes are usually understood and usually stated as a percentage of taxable income and, within the range of section 151(d)(3), taxable income is, on average, 76% of adjusted gross income. Restating the section 151(d)(3) surtax as a tax on taxable income, using that average, means that the amount of the surtax becomes a tax of nine-tenths of a percent to 1.1% of taxable income per personal exemption.

The structure of subsection 151(d)(3) means that larger families face a higher surtax than smaller households. A couple in the 36% tax bracket with three children, that is, five exemptions for the household, faces a subsection 151(d)(3) surtax of 5% of taxable income. At least in theory, subsection
151(d)(3) can yield quite high marginal tax rates: a taxpayer in the top 39.6% tax bracket with 10 exemptions can face a marginal tax rate of 52% of taxable income from a combination of explicit bracket tax rates plus the two phaseout taxes. Subsection 151(d)(3) creates a tax rate "bubble" because the surtax disappears once a taxpayer's adjusted gross income reaches the top of the range at which all exemptions have disappeared.

Reasons for Change. According to reports contemporaneous with enactment, the phaseouts of section 151(d)(3) and section 68 were adopted to raise revenue from high income taxpayers, without giving the appearance of raising explicit tax rates. The impact of the phaseouts is to create extra tax for extra income within the range of the phaseouts, which is equivalent to an increase in marginal tax rates for the income within the range.

Disguising the increased tax rate has serious costs. Section 68 and subsection 151(d)(3) together add 19 lines of worksheets to individual tax returns. The adjustments are difficult for taxpayers to comprehend and complexity increases the potential for errors in the computation of taxes due.

Subsection 151(d)(3), moreover, operates as surtax on dependent exemptions. The larger the family, the higher the surtax. In other contexts, however, Congress has adopted a structure of lower taxes for larger families. The extra tax due to extra dependents thus seems to have been caught up in the phaseouts only by accident and the important justifying factor appears to be that the taxpayer has extra income. Extra tax for more income could be accomplished more simply and without the side-effects of a higher tax of families by adjusting section 1 rates.

The combination of bubble tax and brackets also raises the marginal tax rates within the range of the phaseout bubble in a manner that could produce unnecessary economic losses because of taxpayer behavior seeking to avoid high marginal tax rates. There is no justification offered for the bubble structure under which taxpayers with a higher standard of living pay a lower tax rate, while taxpayers with a lower standard of living pay higher tax rates within the bubble.

The Committee believes that the current marginal tax rate structure would be considerably simplified and rationalized by repealing subsection 151(d)(3) and section 68 and, to the extent revenue neutrality is deemed appropriate, by replacing the revenue with adjustments to the highest tax brackets of section 1.

Revenue Neutrality. To achieve revenue neutrality, subsection 151(d)(3) and section 68 might be replaced with tax rates that do not substantially change the distribution of tax among tax brackets.

In restating the impact of subsections 151(d)(3) and section 68 in terms of section 1 tax brackets, the Committee has assumed that tax rates need to be rationalized into tax brackets in which the tax rate is uniform within the bracket and rates increase from bracket to bracket as taxable income increases. Currently, for example, for many taxpayers, the subsection 151(d)(3) surtax disappears before the top 39.6% bracket starts and that creates a dip in the tax rates, which should not be preserved in replacing the phase out taxes. Currently for some taxpayers, subsection 151(d)(3) overlaps with the top 39.6% tax bracket and that recreates a high spike in the tax rates, which should not be preserved. Rationalizing the brackets means that the current distribution of tax can not be exactly duplicated. Published statistics, moreover, do not allow precise computation of revenue yield of either the phase out taxes or their replacement, so it is impossible to calculate a revenue and distributionally neutral replacement with any precision.
The Committee presents an illustrative projection to show what explicit tax rates would be equivalent to the current phase out taxes for an average or typical taxpayer within each tax bracket. The illustrative projection by the Committee is that, with the repeal of the phaseout taxes, the 39.6% bracket might be replaced with a 41% tax bracket, the 36% bracket might be replaced with a 40.3% tax bracket, and the 31% bracket might be replaced with a 32.2% bracket.

Respectfully Submitted,

Stefan F. Tucker, Chair

February, 1999

EXECUTIVE SUMMARY

Replace Phase Out Taxes of Subsection 151(d)(3) and Section 68

1. Summary of Recommendation

Replace section 68 and subsection 151(d)(3) of the Code, which phase out itemized deductions and personal exemptions, with adjustments to the tax brackets of section.

2. Summary of the Issue which the Recommendation addresses

Under current law, section 68 of the Code increases taxable income by 3% per dollar of adjusted gross income in excess of a threshold, currently set at $121,200. In form, section 68 tax is contingent, not just on adjusted gross income, but also on certain targeted itemized deductions, but the targeted deductions are so plentiful that, in practice, the targeted deductions do not materially affect section 68. Section 68 can be restated typically as a tax of 1.4% of taxable income.

Under current law, subsection 151(d)(3) of the Code phases out personal exemptions over a range of adjusted gross income, now set for joint returns as between $181,800 and $304,300. For a typical family with five exemptions, subsection 151(d)(3) is like a 5% surtax. A large, top-tax-bracket family can face marginal tax rates of 52%. The surtax creates a tax rate Abubble@ because the surtax disappears once a taxpayer=s income is over the ceiling.

Section 68 and subsection 151(d)(3) were adopted to allow revenue to be raised from high income taxpayers, without giving the appearance of raising explicit tax rates. The disguise, however, is not without cost. The phase out taxes add 19 lines to the worksheets for individual tax returns. The surtaxes create high tax rate bubbles in which the marginal tax rate is unnecessarily high. Phase out of dependents= exemptions creates a tax on families, whereas in other contexts Congress has adopted lower taxes for larger families in recognition of the significant cost of raising children.

3. Please explain how the proposed policy position will address the issue
The recommendation would simplify and rationalize the current rate structure by replacing subsection 151(d)(3) and section 68 with adjustments to tax brackets of section 1. The Committee recommends maintaining revenue and distributional neutrality in the replacement, so that simplification and rationalization is not defeated by conflicts over who should bear the burden of tax. The Committee presents an illustrative projection of what the new tax brackets might look like, without the dips and spikes in the tax rates present under current law.

4. Summary of any minority views or oppositions which have been identified

Members of the Committee preferred to replace the revenue from the phase out taxes with general broadening of the tax base. Comments suggested that the Committee now recommend distributional neutrality in replacement of the phase out taxes. Some comments opposed projections of what tax rates would be needed to replace the phase out taxes, even on a pro forma basis, because the projections might carry the Section outside of its professional expertise. Some comments were opposed in principle to any increase in a section 1 tax rate. The recommendations were presented for Committee vote twice, with differing estimates of what replacement tax rates would be needed, and both times passed by overwhelming proportions.

GENERAL INFORMATION FORM

Submitting entity: Section of Taxation

Submitted by: Stefan F. Tucker, Chair, Section of Taxation

1. Summary of Recommendation

To repeal sections 68 and 151(d)(3) of the Internal Revenue Code of 1986 to eliminate the phase outs of itemized deductions and the personal and dependency exemption deduction and replace the revenue with increases in the highest brackets of section 1(a)-(d) that raise the same revenue as does section 68 distributed in the same way.

2. Approval by Submitting Entity

Approved by the Section of Taxation at its 1998 Annual Meeting in Toronto Canada

3. Has this or a similar recommendation been submitted to the House or Board previously?

No

4. What existing association policies are relevant to this recommendation and how would they be affected by its adoption?

None

5. What urgency exists which requires action at this meeting of the House?
The House Ways and Means Committee has announced its intention to examine a group of tax law revision proposals into which the current recommendation is a logical fit. This may be the only time at which the current recommendation would receive the close Congressional attention that it deserves.

6. Status of Legislation
None

7. Cost to the Association
None

8. Disclosure of Interest
No member of the originating Committee or the Council of the Section of Taxation is known to have a material interest in the Resolution by virtue of specific employment or engagement to obtain the results of the Resolution.

9. Referrals
All Sections and Divisions

10. Contact Persons
James P. Holden
Steptoe & Johnson LLP
1330 Connecticut Avenue, NW
Washington, DC 20036
202/429-6407

Jere D. McGaffey
Foley & Lardner
777 East Wisconsin Avenue, Suite 3600
Milwaukee, WI 53202
414/297-5729

Christine A. Brunswick
Director, Section of Taxation
11. Contact persons (who will present the report to the House)

James P. Holden
Steptoe & Johnson LLP
1330 Connecticut Avenue, NW
Washington, DC 20036
202/429-6407

Jere D. McGaffey
Foley & Lardner
777 East Wisconsin Avenue, Suite 3600
Milwaukee, WI 53202
414/297-5729

12. Contact person regarding amendments to this recommendation

James P. Holden
Steptoe & Johnson LLP
1330 Connecticut Avenue, NW
Washington, DC 20036
202/429-6407

Jere D. McGaffey
Foley & Lardner
777 East Wisconsin Avenue, Suite 3600
Milwaukee, WI 53202

414/297-5729