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If You Like Complicated Hidden Taxes, You'll Love Phase-outs

By Michael Schuyler

The Tax Code is littered with rules that phase out various deductions, exemptions and credits as taxpayers' incomes rise. These rules create hidden increases in marginal tax rates for unsuspecting citizens and greatly complicate tax calculations. Some of the items that taxpayers lose with higher incomes are deductible individual retirement accounts, Roth IRAs, the earned income tax credit (EITC), the exclusion of Social Security benefits from taxable income, the child credit, education credits and deductions, a portion of itemized deductions, even the personal exemption.

How do phase-outs increase marginal tax rates? The marginal tax rate is the rate a person must pay on an additional dollar of income. It is the relevant tax rate when people decide whether to work, save or invest a bit more or a bit less, or otherwise alter their production and consumption behavior. Normally, added income is taxed at the statutory tax rate. But the added income can push a taxpayer into a higher tax rate if it results in the reduction or loss of a credit, deduction or exemption. (Once a phase-out has been completed, it does not continue to increase the marginal tax rate, but it leaves the total tax burden higher than if the credit or deduction had not been withdrawn.)

Illustrations of Phase-outs for Couples. The figure shows, for married couples filing jointly, the income ranges over which the income tax's phase-out provisions occur and the increases in marginal tax rates they can produce. All numbers are for 2001:

- Parents with two or more children lose 21.06 cents of the EITC for every additional dollar of income between $13,090 and $32,120. This creates a marginal tax rate spike of 21.06 percentage points. If the parents are in the 15 percent rate bracket, the EITC phase-out boosts their effective marginal federal income tax rate to 36.06 percent. Their overall effective marginal tax rate can approach 50 percent with the inclusion of payroll taxes and state and local income taxes.
- The Hope scholarship tax credit for students in the first two years of college phases out for a couple at a rate of up to 7.5 cents per student for every additional dollar of income between $80,000 and $100,000. For a couple in the 28 percent rate bracket and with two children starting college, it can push their effective marginal income tax rate to 43 percent.
- If a couple has four dependent children, earns between $199,450 and $324,450, and is in the 36 percent rate bracket, the phase-out of their personal exemptions adds 5.01 percentage points to their marginal tax rate. With the limitation on itemized deductions contributing another 1.08 percentage points, the couple faces an effective marginal income tax rate of 42.09 percent.

Complexity of Phase-outs. The figure actually understates the complexity of phase-outs because it does not show the many tedious and confusing steps required to calculate them. Adding yet more complexity, phase-out ranges are usually specified in terms of "modified" adjusted gross income, and the modifications differ across phase-outs.

Families earning less than $30,000 can face 50 percent tax rates.

Which, if any, phase-outs a specific taxpayer encounters depends on the taxpayer's income and other tax-related factors. Many taxpayers will experience no phase-outs; others will experience one or more over different parts of their incomes; some will be hit by multiple phase-outs on the same dollars of earnings, with one rate spike piled on top of another.

More Taxpayers Face Phase-outs. Two of the fastest-growing phase-outs are the limitation on total itemized deductions, which according to recently released IRS data snared 9.5 percent more taxpayers in 1998 than in the prior year, and the disallowance of personal exemptions. The annual report of the Internal Revenue Service's own National Taxpayer Advocate recommends repealing both these phase-outs, citing

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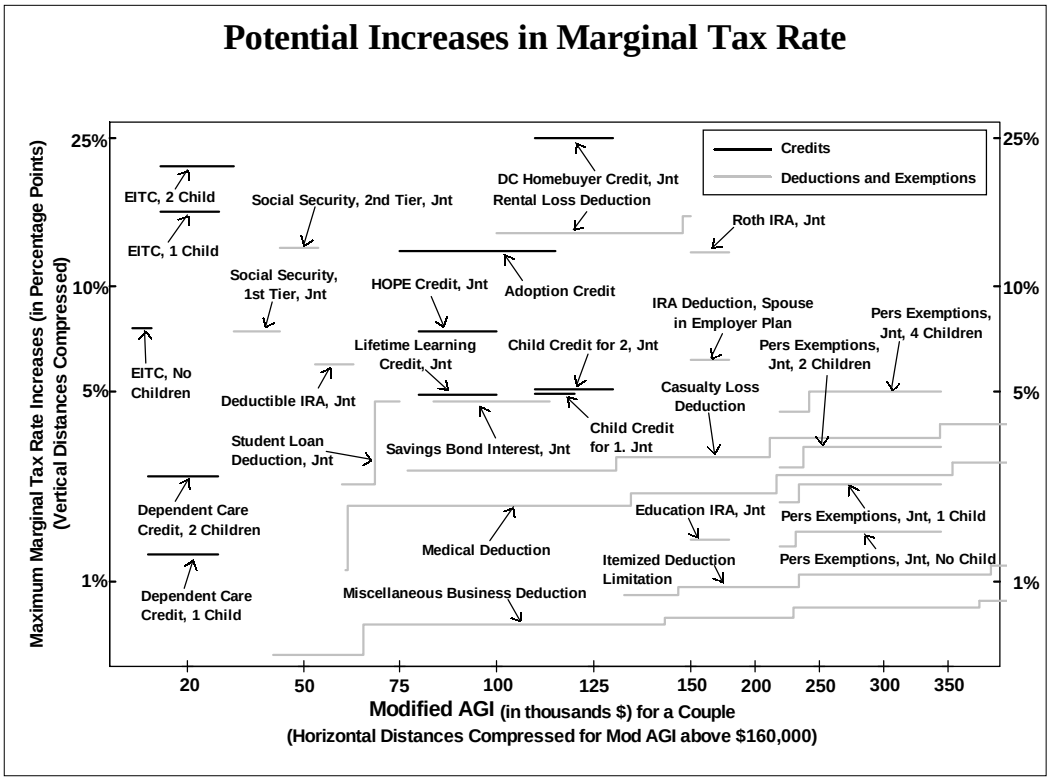
their "confusing and complex calculations" and the "significant tax and economic burden" they place on "a growing number of middle-income taxpayers."



Real vs. Nominal Tax Rates. Because of phase-outs, the top nominal income tax rates are a fiction for most upper-income taxpayers. For instance, instead of supposed rates of 31 percent, 36 percent and 39.6 percent, a couple with four dependent children will probably find that the itemized deduction limitation and the phase-out of personal exemptions bump them into a bizarre succession of elevated, stealth rate brackets: 31.93 percent, 36.25 percent, 42.09 percent, 37.08 percent and finally 40.79 percent.

Unfairness of Phase-outs. Besides harmful effects on the economy, phase-outs are unfair. If the government wants to make the tax code more "progressive," it should do so openly, honestly and simply by steepening the statutory rate schedule or by increasing items like the personal exemption and standard deduction that have the biggest percentage impact on lower-income taxpayers. If greater tax progressivity cannot pass when done openly, it should not be sneaked in via phase-outs.

The Bush Plan. President Bush's tax plan would soften the impact of two phase-outs. By creating a 10 percent tax bracket on the first few thousand dollars of income and doubling the child credit, it would zero out the regular income tax liabilities of most low-income people experiencing the EITC phase-out, thereby cutting their now very high effective marginal income tax rates by roughly a third. It also would roughly double the income threshold at which the child credit begins phasing out, greatly reducing the number of families it hits.

Making the Bush Plan Better. President Bush and the Congress should work to remove most current-law phase-outs, or at least raise their thresholds. They should refuse to add new phase-outs, remembering that thresholds create serious problems. Ideally, they should begin a fundamental overhaul of the tax system in which all phase-outs are swept aside.

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