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## **The Federal Income Tax and the Treatment of Married Couples: Background and Analysis**

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# The Federal Income Tax and the Treatment of Married Couples: Background and Analysis

## Summary

Defining the married couple as a single tax unit under the federal individual income tax means that some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus).

Eliminating marriage tax penalties and bonuses and creating a marriage neutral income tax is an elusive equity goal. Marriage neutrality conflicts with two other concepts of equity: progressivity and equal taxation of couples with equal incomes. Regardless of how these three concepts of equity are juggled, an income tax can achieve any two of these goals but cannot, under current definitions, simultaneously achieve all three.

Even measuring the extent and amount of marriage tax bonuses and penalties is difficult. Should marriage tax penalties and bonuses be computed on the basis of how the tax liabilities of two singles would change if they got married? Or should the basis of comparison be the change in tax liability that would occur if a married couple could file as two single individuals? The basic point of comparison used and the assumptions made about the allocation of taxpayer characteristics can significantly influence the calculations of marriage tax penalties and bonuses.

Over time, Congress has switched emphasis among these three equity goals of marriage neutrality, progressivity, and equal taxation of couples with equal incomes. Under consideration as possible legislative solutions to the current problems are, two-earner marital deductions, separate filing, and increases in the amount of the standard deduction and width of the tax rate brackets for joint returns. All of these approaches entail compromises and trade-offs between competing equity goals. No one approach is likely to satisfy everyone.

From an economic perspective one possible solution to the problem may be achieved by modifying the definition of what constitutes equal couples. Economics recognizes that two-earner married couples and one-earner couples with the same incomes are, in fact, not equal since the one-earner couple benefits from the extra time available to the non-working spouse, a benefit not available to the two-earner couple. Greater consideration of what constitutes equal couples might yield a federal income tax structure that is progressive, marriage neutral, and taxed couples with equal incomes and circumstances equally.

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# The Federal Income Tax and the Treatment of Married Couples: Background and Analysis

Defining the married couple as a single tax unit under the federal individual income tax tends to violate the principle of marriage neutrality. Marriage neutrality means that the tax system should not influence the choice of individuals with regard to their marital status. However, under the current federal income tax system, some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus).

A marriage neutral income tax, however, is an elusive goal. Marriage neutrality conflicts with two other concepts of equity: progressivity and equal taxation of couples with equal incomes. Regardless of how these three concepts of equity are juggled, an income tax can achieve any two of these goals but cannot simultaneously achieve all three.

Since its inception in 1913, Congress has repeatedly modified the federal income tax and has switched emphasis among these three goals. Originally, the federal income tax was marriage neutral but did not tax couples with equal incomes equally. Later it emphasized the equal taxation of couples with similar incomes but achieved this result at the expense of marriage neutrality. Other modifications have involved trade-offs between increased marriage neutrality and structural progressivity.

Given the possibility of tax legislation in the 107th Congress that might affect the marriage neutrality of the individual income tax, the remainder of this report provides background information and analysis of the issues associated with the federal individual income tax and marriage neutrality.<sup>1</sup> Issues addressed include a discussion of the conflicting goals of equity under an income tax, an explanation of the causes of structural marriage penalties and bonuses, an overview of the historical tax treatment of marital status, an analysis of the income splits that produce structural marriage penalties and bonuses, estimates of the magnitude of structural penalties and bonuses at various income levels, and a brief examination of possible legislative solutions.

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<sup>1</sup>Legislative proposals affecting the marriage neutrality of the income tax have the potential of causing unintended interactions with the alternative minimum tax for individuals. For more information on this issue see CRS Report RL30485, *The Individual Alternative Minimum Tax: Interaction with Marriage Penalty Relief and Other Tax Cuts*, by Jane G. Gravelle.

## Conflicting Goals of Equity Under an Income Tax

A widely accepted goal is that the individual income tax should be marriage neutral. Marriage neutrality means that the tax system should not influence the choice of individuals with regard to their marital status. That is, a couple's combined federal income tax liability should be the same if they are married or if they are single.

Marriage neutrality, however, tends to conflict with two other concepts of equity: that the tax system should be progressive (income tax payments should rise as a percentage of income as incomes increase) and that couples with the same total incomes should pay the same amount of income tax.

To appreciate the mutual exclusivity of these three goals of equity consider the following illustration (an algebraic representation of this example is contained in the appendix). Assume that there are four individuals: Andy, Betty, Cathy, and David. Andy and Betty each earn incomes of \$30,000 while David's income is \$60,000. Cathy has no income at all.

If the tax system is progressive, then David who has \$60,000 of income, should pay a higher tax than the combined tax of Andy and Betty, who only have incomes of \$30,000 each. On the other hand, if the tax system were proportional, then the combined income tax of Andy and Betty would equal the income tax on David. (Alternatively, if the tax system were regressive, then the combined tax of Andy and Betty would be greater than David's tax.)

Now consider what would happen if Andy and Betty got married and David and Cathy got married. If the tax system is marriage neutral, then the tax on Andy and Betty as a married couple should be the same as their combined income tax as two single individuals. Likewise, as a married couple, David and Cathy should pay the same amount of income tax as combined income tax they paid while they were single.

The third concept of equity requires that couples with the same incomes pay the same amount of income tax. In this case, Andy and Betty who have a \$60,000 income and Cathy and David, who also have \$60,000 of income should pay the same amount of income tax.

However, it is obvious that if these two couples pay the same amount of income tax, then the tax system cannot be progressive, since the combined tax of Andy and Betty is now the same as income tax paid solely by David on his \$60,000 income. In this case the tax system is proportional (David pays the same amount of tax as the combined tax of Andy and Betty) rather than progressive (David would pay a larger amount of tax than the combined tax of Andy and Betty).

Regardless of how these three concepts of equity are juggled, under current definitions an income tax can be designed to achieve any two of these goals, but it cannot simultaneously achieve all three. The system might be marriage neutral and tax couples with equal incomes equally but it could not be progressive. As an alternative, the tax system might be progressive and tax couples with equal incomes equally but then it would not be marriage neutral. Finally, the tax system could be

progressive and marriage neutral but not tax couples with equal incomes equally. The current federal income tax system has chosen progressivity and equal taxation of couples with equal incomes at the expense of marriage neutrality.

These three goals of equity are not mutually exclusive if the definition of what constitutes equal couples is modified. For instance, the equity argument for equal taxation of couples with the same total income is weaker when the comparison is between two-earner married couples and one-earner married couples. Economics recognizes that in this case the couples are, in fact, not equal since the one-earner couple benefits from the extra time available to the non-working spouse, a benefit not available to the two-earner couple.

If the economic distinction between one-earner and two-earner couples as it relates to the principle of equal taxation of couples with equal incomes is accepted, then the three concepts of equity are not necessarily in conflict. Hence, by redefining what constitutes equal couples, the income tax system can be progressive, marriage neutral, and tax couples with equal incomes and circumstances equally.

However, the practical difficulties of including both incomes and circumstances in the definition of equality between couples would be significant. For instance, while the case of a two-earner versus one-earner couple is fairly straightforward, the case is not so clear for couples under other circumstances. How would the tax system account for circumstances when a two-earner couple has the same income as a couple with one full-time and one part-time worker? Using measures other than income to define equality between couples might invite more dissatisfaction than the current system.

### **Causes of Structural Penalties and Bonuses**

The three most important structural features affecting the marriage neutrality of the income tax are the earned income tax credit (EITC), the standard deduction, and the tax rate schedules. Under the current income tax system, single individuals, heads of households, and married couples are subject to different standard deductions and tax rate schedules. The EITC amounts and phaseout ranges also vary according to filing status. These differences give rise to structural marriage tax penalties and bonuses.

For example, consider the standard deductions for joint and single returns in 2000. The standard deduction is \$7,350 for joint returns and \$4,400 for single returns. Hence, two singles get a combined standard deduction of \$8,400 compared to \$7,350 as a joint return. To be completely marriage neutral, the joint standard deduction should be twice the amount of the single standard deduction. The structural asymmetry also appears in the marginal tax rate brackets where the joint return marginal tax rate brackets are not exactly twice the width of the marginal tax rate brackets for single returns. (A table containing the tax rate brackets and standard deductions for tax year 2000 is contained in appendix B.)

Because of these asymmetries, when the income of one spouse is added to the income of the other spouse, a married couple might find themselves paying either more federal income tax (a marriage penalty) or less tax (a marriage bonus) than they

would by filing as two singles. Conversely, two singles (or some combination of singles and heads of households) contemplating marriage might find that their federal income tax liability increases (a marriage tax penalty) or decreases (a marriage tax bonus) by filing a joint return.

Others features of the federal individual income tax system that have the potential of affecting the marriage neutrality of the system include, among others, the tax treatment of Social Security benefits, the child care tax credit, the additional standard deductions for the elderly and the blind, the net capital loss offset, limits on the tax-free gain from the sale of a principal residence by a taxpayer aged 55 years or older, and limits on deferred compensation plans.<sup>2</sup>

In general, the division of income, or income split, of the two individuals determines whether they will have a marriage tax bonus or penalty. The largest marriage tax bonuses occur when one spouse earns 100% of the income. In this case, the married couple can take full advantage of the higher standard deduction and the lower marginal tax rate brackets for joint returns. Had they filed as two singles, since only one had income, the entire tax burden would have been borne by the one individual filing a single return.

The more evenly divided the income the more likely a married couple will experience a marriage tax penalty. The largest tax penalties occur where the income is evenly divided between the two spouses, a 50/50 income split. In this instance the stacking of income and the resultant taxation at higher marginal tax rates produces a larger income tax liability for a joint return than would have been the case for two single returns. At the lower end of the income scale, the joining of incomes may produce a reduced EITC for joint returns compared to what they would have had if the couple had filed as two singles (or heads of households).

### **Historical Tax Treatment of Marital Status**

The fact that the federal individual income tax system can produce marriage tax penalties and bonuses has long been recognized. When the individual income tax was originally enacted in 1913, married couples were required to file separate returns if each spouse had income. In fact, married couples could minimize their total federal income tax burden by evenly splitting their income when they filed their separate returns.

This system gave married couples in community property states an advantage over married couples in common law states. Regardless of which spouse earned the income, couples in community property states were able to split their income 50/50 for federal income tax purposes. Married couples in common law states, however, were required to divide their income according to which spouse actually earned the income. Married couples in community property states continued to enjoy the advantage of income splitting through 1947. Hence, the federal income tax system

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<sup>2</sup>A comprehensive list of the income tax provisions that affect the marriage neutrality of the federal income tax can be found in: U.S. Congress. General Accounting Office. *Income Tax Treatment of Married and Single Individuals*. GAO/GDD 96-175. September 1996.

was progressive and marriage neutral but it did not tax couples with equal incomes equally. (Couples who lived in community property states had lower federal income tax liabilities than couples with the same incomes who lived in common property law states.)

The Revenue Act of 1948 effectively extended the benefits of income splitting to all married couples, including those who lived in common law states. The 1948 Act changed the federal income tax rate brackets so that, in effect, married couples were taxed as two singles. There were now two tax rate schedules: one for married couples filing joint returns and one for individuals filing single returns. The change in tax rate structures, while alleviating the dichotomy in the taxation of married couples living in community and common law property states, significantly increased the tax burden of single individuals relative to married couples. Single individuals paid considerably more in federal income taxes than did married couples at the same income level. Thus, the Revenue Act of 1948 emphasized more equal taxation of couples with equal incomes at the expense of marital neutrality. (Singles could reduce their income tax liability by getting married; hence, the reciprocal of a single's tax penalty is a marriage tax bonus).

The Tax Reform Act of 1969 addressed this problem of the single's tax penalty by reducing the tax rate schedule of single returns relative to the tax rate schedule for joint returns. In general, the tax rate reductions for single returns were designed so that over the middle income ranges the tax liability of a single return would be no more than 20% higher than the tax liability of a married couple with the same income filing a joint return. Although reducing the single's tax penalty, the Tax Reform Act of 1969 meant that some two-earner married couples paid more in federal income tax (a marriage tax penalty) filing a joint return than they would have if they filed as two singles, while others paid less (a marriage bonus). Hence, the 1969 Act merely rearranged the lack of marriage neutrality under the federal income tax.

The Economic Recovery Tax Act of 1981 contained provisions which were designed to reduce the problem of marriage tax penalties. Under this Act, two-earner married couples were allowed to reduce their taxable income by an amount equal to 10% of the lower-earning spouse's earned income (the maximum reduction in taxable income was \$2,000). This two-earner marital deduction helped to reduce the marriage tax penalties faced by some two-earner married couples, but it did not eliminate the penalties for all couples. Moreover, for some two-earner married couples, the provision actually increased their marriage tax bonuses. In the attempt to make the income tax system more marriage neutral, the two-earner deduction introduced a violation of the principle of equal taxation of couples with equal incomes (two-earner couples would pay less income tax than one-earner couples with the same income).

The Tax Reform Act of 1986 changed the tax rate brackets and the standard deductions for both single and joint returns. Tax rates were substantially lowered and the number of statutory marginal tax rates were reduced from 14 to two. In addition, the standard deduction for joint returns was increased proportionally more than the standard deduction for single returns.



It was argued that the change in the relationship between the standard deductions for joint and single returns along with the flattening out of the tax rate structure reduced the need for the two-earner marital deduction. As a consequence, the two-earner marital deduction was repealed.

At the same time, however, the 1986 Act also introduced new marital-specific provisions governing contributions to individual retirement accounts (IRAs) for workers covered by employee-sponsored pension plans. The Act also contained provisions establishing additions to the standard deductions of the elderly and blind, the size of which were a function of marital status.

Thus, on the one hand, the 1986 Act increased the marriage neutrality of the federal income tax by reducing its structural progressivity (through a flattening of the rate structure) while it simultaneously made the system less marriage neutral by introducing new marital specific tax provisions.

The Omnibus Budget Reconciliation Act of 1990 (OBRA90) also affected the marriage neutrality of the federal income tax. It did so primarily through a change in the marginal income tax rate schedule. OBRA90 legislated a new 31% marginal tax rate and thus created a 3-tiered statutory marginal tax rate structure as opposed to the 2-tiered statutory rate structure under prior law.

More significant changes affecting the marriage neutrality of the federal income tax occurred with the passage of the Omnibus Budget Reconciliation Act of 1993 (OBRA93). OBRA93 made two major structural changes that had ramifications for marriage neutrality. It increased and expanded the EITC, and it added two new marginal tax rates, 36% and 39.6%, at the upper end of the income scale.

The EITC was changed in several ways. OBRA93 repealed the supplemental tax credit for children under one year of age and the supplemental tax credit for health insurance premiums for children. At the same time, OBRA93 increased the maximum EITC for families with qualifying children; extended the income ranges over which the EITC is phased out; and extended EITC coverage to childless taxpayers ages 25 to 64 who are not claimed as dependents on another taxpayer's return.

By increasing the EITC and adding two new tax brackets at the upper-end of the income scale, OBRA93 increased the structural progressivity of the individual income tax. The cost of the increased structural progressivity, however, was a decrease in the marriage neutrality of the federal income tax over these two income ranges.

The 104th Congress addressed the issue of the marriage neutrality of the federal income tax as part of the Balanced Budget Act of 1995. The House version of the Act included a provision which would have provided a nonrefundable credit of up to \$145 as a means of relieving the marriage tax penalties of certain two-earner married couples. The Senate opted for a different approach and included a provision which would have increased the standard deduction for joint returns relative to the standard deduction for single returns. The Conference agreement followed the Senate approach and modified the standard deduction for joint returns such that, by the year 2005 and there after, it would be twice the size of the standard deduction for single

returns. The Balanced Budget Act of 1995, however, was ultimately vetoed by President Clinton.

Several marriage tax penalty relief bills were also introduced during the 105<sup>th</sup> Congress. These bills took multiple forms including proposals for two-earner marital deductions, proposals to increase the standard deduction for joint returns, and proposals to widen the tax brackets for joint returns to twice the width of the tax brackets for single returns. However, marriage penalty tax relief did not end up in the final tax cut package, the Taxpayer Relief Act of 1997 (P.L. 105-34), which was signed into law on August 5, 1997.

Marriage penalty tax relief was a major legislative issue in the 106<sup>th</sup> Congress. The Marriage Penalty Tax Relief Reconciliation Act of 2000 (H.R. 4810) was passed by the House on July 20, 2000 and by the Senate on July 21, 2000. It would have increased the standard deduction for joint returns to twice the size of the standard deduction for single returns, increased the width of the 15% tax bracket for joint returns to twice the width of the 15% tax bracket for single returns, and would have increased the phaseout point for the EITC by \$2,000 for married couples. President Clinton citing revenue and distributional concerns vetoed H.R. 4810 in August 2000.<sup>3</sup>

Marriage penalty tax relief is a subject of legislative activity in the 107<sup>th</sup> Congress. President George W. Bush included a proposal for a two-earner marital deduction as part of his across-the-board tax cut plan. In late March 2001, the House passed H.R. 6 which contained marriage penalty tax relief provisions.

## **Measuring the Extent and Amount of Marriage Tax Penalties and Bonuses**

Significant practical problems are associated with actually defining and measuring the extent of marriage tax bonuses and penalties. The first issue involves deciding on the appropriate basis of comparison. Should marriage tax penalties and bonuses be computed on the basis of how the tax liabilities of two singles would change if they got married? Or should the basis of comparison be the change in tax liability that would occur if a married couple could file as two single individuals?

Each of these approaches present problems. Both the Congressional Budget Office (CBO) and the Treasury Department have opted for computing marriage tax penalties and bonuses by taking married couples and computing their tax liabilities as if they were single. However, this approach necessitates making difficult assumptions about how children, income, and deductions should be allocated between two spouses.

For instance, when a married couple has children how do you allocate the children when calculating marriage tax penalties and bonuses? If there is only one

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<sup>3</sup>For more information on legislation in the 106<sup>th</sup> Congress see CRS Report RL30420, *Marriage Tax Penalties: Legislative Proposals in the 106<sup>th</sup> Congress*, by Gregg A. Eisenwein.

child, who should get to claim the child as a dependent? For purposes of calculating marriage tax penalties and bonuses should the spouse claiming the child be allowed to file as a head of household? If there are two or more children should each parent be allocated children and thus both be eligible for filing as head of household?

Also problematic is the inclusion and allocation of unearned income. How do you divide unearned income between spouses, do you give the unearned income to the lower earning spouse or to the higher earning spouse? Should you allocate the unearned income based on the ratio of the spouses' earned income? The treatment of itemized deductions presents a similar quandary. How should the deductions be allocated between the two spouses?

In its most recent estimates, CBO offers two alternative measures of marriage tax bonuses and penalties. In its basic measure CBO assumes that all unearned income is allocated to each spouse in proportion to their earned income. Itemized deductions are allocated on the same basis. If there is one child, then the higher-earning spouse claims the dependent and files as a head of household. If there are two or more children, then the lower-earning spouse claims one dependent and files as a head of household while the higher-earning spouse claims the other children as dependents and also files as a head of household.<sup>4</sup>

Under this approach, which could be considered a tax minimization approach, in 1999, 43% of all married couples were estimated to have marriage tax penalties with aggregate penalties amounting to \$32 billion. Some 52% of married couples were estimated to have marriage tax bonuses with aggregate bonuses totaling \$42 billion. The remaining 5% of married couples were unaffected. Under this measure, there was a net marriage tax bonus of \$10 billion.

CBO's alternative measure assigned all children to the lower-earning spouse, a measure which they refer to as a "divorce model". Under this measure in 1999, 37% of married couples had a marriage tax penalty with penalties amounting to \$24 billion. An estimated 60% of couples had a marriage tax bonus with total bonuses of \$73 billion. The remaining 3% of couples were unaffected. Under this divorce model there was a net marriage tax bonus of \$49 billion.

The Office of Tax Analysis (OTA) at the Treasury Department uses a resource pooling approach to estimate marriage tax penalties and bonuses. This approach is based on the assumption that married couples could maintain the same living and financial arrangements that occurs within the marriage without actually being married. Under this approach, the higher-earning spouse is assumed to claim head of household status and take all personal exemptions for dependents. All deductions associated with dependents and maintenance of the household are also claimed by the higher-earning spouse. Unearned income is allocated in proportion to earned income.<sup>5</sup>

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<sup>4</sup>U.S. Congress. Congressional Budget Office. *Updated Estimates of Marriage Penalties and Bonuses*. Memorandum dated September 18, 1998.

<sup>5</sup>U.S. Department of the Treasury. *Defining and Measuring Marriage Penalties and Bonuses*. By Nicholas Bull, Janet Holtzblatt, and James R. Nunns. November 1999.

Using this resource pooling methodology OTA estimated that in 1999, 48% of married couples incurred a marriage tax penalty, 41% had a marriage tax bonus, and the remaining 11% were unaffected. Aggregate marriage tax penalties are estimated at \$28.3 billion, aggregate marriage tax bonuses were estimated at \$26.7 billion for a net marriage tax penalty in 1999 of \$1.6 billion.

The CBO and OTA estimates of marriage tax penalties and bonuses for 1999 are summarized in the following table.

**Table 1. Estimates of Aggregate Tax Penalties and Bonuses for 1999**

	CBO Estimates		OTA Estimates
	Basic Model	Divorce Model	Resource Pooling Model
<b>Married Couples with Marriage Tax Penalties:</b>			
Percent of total	43%	37%	48%
Aggregate \$ amount (billions)	\$32	\$24	\$28.3
<b>Married Couples with Marriage Tax Bonuses:</b>			
Percent of total	52%	60%	41%
Aggregate \$ amount (billions)	\$42	\$73	\$26.7
<b>Married Couples Unaffected:</b>			
Percent of total	5%	3%	11%
Net Aggregate Penalty or (Bonuses)	(\$10)	(\$49)	\$1.6

The difficulties of accurately defining and measuring marriage tax penalties and bonuses cannot be over stressed.<sup>6</sup> From a theoretical perspective it is not even clear what the appropriate base line comparison should be: should it be the tax consequences if two single individuals decide to marry or, should it be the tax consequences if a married couple were allowed to file as two separate individuals? Furthermore, the basic economic characteristics of married couples, heads of households and single individuals are different. As a result, including children,

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<sup>6</sup>For more information on the problems of measuring marriage tax penalties and bonuses see CRS Report RL30419, *The Marriage Tax Penalty: An Overview of the Issues*, by Jane G. Gravelle.

unearned income, and itemized deductions into the calculations can introduce measurement errors that reflect these basic differences in the economic characteristics of the filing units rather than the marriage tax penalties and bonuses that arise because of the structural components of the tax system.

To avoid these measurement problems the remainder of this report will concentrate on the “structural” marriage tax bonuses and penalties in the federal income tax system. Comparisons will be based on earned income only and will exclude head of household status, unearned income, dependents, and itemized deductions.

## **Income Splits That Produce Structural Penalties and Bonuses**

As mentioned earlier, it is principally the EITC, differences in the standard deductions, and differences between the tax rate schedules for joint and single returns that gives rise to structural marriage tax penalties and bonuses. When the income of one spouse is added to the income of the other spouse, married couples may find that they pay more in income tax (marriage tax penalty) or less in income tax (marriage tax bonus) than they would if they had filed as two singles. The division of income, or income split, of the two spouses determines whether they have a bonus or penalty.

The largest marriage bonuses occur when one spouse earns 100% of the total income. In this case, the married couple can take full advantage of the larger standard deduction and lower marginal tax rate brackets for joint returns. Had they filed as two singles, since one spouse had no income, the entire tax would have been borne by one individual filing a single return. Under these circumstances, because of the differences in EITCs, standard deductions, and tax rate brackets, the couple would pay far less income tax by filing a joint return than they would have by filing a single return.

Conversely, the more evenly divided the income, the more likely a married couple will experience a marriage tax penalty. Indeed, the largest marriage tax penalties occur where the income is evenly divided between the two spouses, a 50/50 income split. In this instance, the asymmetry between standard deductions for joint and single returns and the stacking of income which results in taxation at higher marginal income tax rates produces higher income tax liabilities for the couple filing a joint return than would be the case had they filed as two singles.

Between these two points, there is a specific income split that would produce no marriage tax penalty or bonus. In other words, at this break-even income split, the tax code would be essentially marriage neutral since a married couple would pay the same in income taxes by filing a joint return or by filing two single returns. These break-even income splits are shown in table 2.

This table shows for each specific income level the income division between the two spouse that would produce neither marriage tax penalties nor marriage tax bonuses. For example, at the \$40,000 income level, a married couple with one spouse earning 88% of the income and the other earning 12% of the income would pay the same income tax whether they file a joint return or two single returns. If they file a joint return, then their federal income tax would be \$4,058. If they file two single

returns, then the federal income tax on the spouse with the higher income (\$35,140) would be \$4,411 while the lower earning spouse (\$5,774) would receive an EITC of \$353, for a total tax of \$4,058.

If the couple's income is more evenly divided than the break-even income splits shown in the table, then they will experience a marriage tax penalty. If their income is less evenly divided than that shown in the table, then they will experience a marriage tax bonus. For instance, a couple earning \$40,000 with an income split of 70/30 would experience a marriage tax penalty. If the couple's income were split 90/10, then they would experience a marriage tax bonus.

**Table 2. Break-Even Income Splits Income Splits That Produce Neither Marriage Tax Penalties Nor Bonuses Tax Year 2000**

Total Income (1)	Income Earned by each Spouse		Percentage of Total Earned by each Spouse	
	(2)	(3)	(4)	(5)
\$20,000	\$16,194	\$3,806	81%	19%
\$30,000	\$26,194	\$3,806	87%	13%
\$40,000	\$35,140	\$4,860	88%	12%
\$50,000	\$35,123	\$14,877	70%	30%
\$70,000	\$48,323	\$21,677	69%	31%
\$100,000	\$76,900	\$23,100	77%	23%
\$150,000	\$123,356	\$26,644	82%	18%
\$250,000	\$222,235	\$27,765	89%	11%
\$500,000	\$479,310	\$20,690	96%	4%

Source: Calculated by CRS. Assumes all earned income and use of standard deduction.

## Amount of Structural Penalties and Bonuses

This section of the report examines the structural marriage tax penalties and bonuses that occur at selected income levels between \$20,000 and \$500,000. The federal income tax liabilities of married couples with various income splits filing joint returns were calculated and then compared to the combined tax liability if they had filed as two single individuals. Taxes were calculated for tax year 2000 and were based on the assumption that all income was earned income and that the standard deduction was used. Over the appropriate lower income levels, use of the EITC was also included.

Table 3 shows the structural marriage tax penalties and bonuses measured as the dollar amount by which the income tax liability on the joint return is different from that of the combined tax liability on the two single returns. Marriage tax bonuses are shown in parentheses.

For example, table 3 shows that a married couple with \$50,000 of income and a 50/50 income split would pay \$218 more in federal income taxes by filing a joint return than they would have had they been able to file as two single individuals. For married couples whose income is all taxed in the 15% tax bracket, the maximum structural marriage tax penalty is \$218. This is simply 15% of the difference between the standard deduction for a joint return, \$7,350, and the combined total, \$8800, of two standard deductions (at \$4,400 each) for single returns. In dollar terms, the largest marriage tax penalties occur at the upper-end of the income spectrum. For instance, the structural marriage tax penalty for a couple earning \$500,000 with a 50/50 income split is almost \$15,000.

On the other hand, the largest relative marriage tax penalties actually occur in the \$20,000 to \$25,000 income range. Contrary to the general rule of the largest penalties occurring when income is more evenly split, in this income range marriage tax penalties are larger for married couples with income splits of 60/40 and 70/30 than for the couples with 50/50 income splits. The reason for this result is that the EITC would be available for the lower earning spouse at these income splits if the married couple were allowed to file as two singles. Where the income is more evenly divided, both spouses would have incomes that would exceed the limit for qualification for the EITC.

**Table 3. Structural Marriage Tax Penalties and Bonuses in 2000**  
(Assuming all earned income and use of the standard deduction)

		Tax Penalties and Bonuses (Tax Bonuses shown in parentheses)			
Total Income	Income Taxes if Filing Jointly	If income is split between the spouses:			
		50/50	60/40	70/30	100/0
\$20,000	\$1,058	\$276	\$400	\$373	(\$862)
\$30,000	\$2,558	\$218	\$218	\$324	(\$862)
\$40,000	\$4,058	\$218	\$218	\$218	(\$1,714)
\$50,000	\$5,558	\$218	\$218	\$16	(\$3,014)
\$75,000	\$11,674	\$1,530	\$1,082	\$107	(\$4,026)
\$100,000	\$18,674	\$1,530	\$1,530	\$1,082	(\$4,776)
\$150,000	\$33,607	\$2,208	\$1,885	\$1,435	(\$6,033)
\$250,000	\$69,314	\$6,915	\$6,224	\$4,772	(\$7,133)
\$500,000	\$167,758	\$14,864	\$14,986	\$13,590	(\$6,170)

Calculated by CRS

Table 3 clearly shows that, for all but the highest income levels, marriage tax bonuses are far larger than marriage tax penalties. For example, while the maximum

marriage tax penalty for a \$50,000 household is \$218, the maximum marriage tax bonus is \$3,014.

## **Possible Legislative Solutions**

As pointed out earlier in this report, making the federal income tax marriage neutral while maintaining the other two equity goals of progressivity and equal taxation of couples with equal incomes is an impossible task. The major legislative solutions involve some form of compromise between these three equity principles. The four main legislative approaches in the past have been a second-earner marital deduction, separate filing, increasing the standard deduction and tax rate brackets for joint returns, and increasing the standard deduction for joint returns. These approaches are briefly discussed below.

### **Second-Earner Deduction**

A second-earner deduction would allow the lower-earning spouse to deduct a percentage of his/her earned income (wage and salary income) from the couple's taxable income base. This approach was used in the federal income tax between 1981 and 1986. The Economic Recovery Tax Act of 1981 contained second-earner deduction provisions designed to reduce marriage tax penalties. Under the Act, two-earner married couples were allowed to reduce their taxable income by an amount equal to 10% of the lower earning spouse's earned income. The maximum deduction was \$2,000. This second earner marital deduction was repealed in the Tax Reform Act of 1986.

A second-earner deduction would eliminate marriage tax penalties for some couples, reduce penalties for other couples, and increase or produce marriage tax bonuses for yet other couples. This approach fails to achieve the equity principle that couples with the same total income should pay the same amount of federal income tax. It is, however, one of the least expensive legislative options.

### **Optional Separate Filing**

Optional separate filing would allow married couples the option to file as two single taxpayers rather than file a joint return as a married couple. As the name implies, this option would allow married couples to file as two single individuals on the same return or to continue to file a joint return, the decision being based on which option produced the lowest income tax liability.

In general, optional separate filing would mean that couples who currently incur marriage tax penalties could, by filing as two singles, eliminate their marriage tax penalties. Couples who currently have marriage tax bonuses could continue to file joint returns and thus would see no change in their federal income tax liabilities. Although eliminating marriage tax penalties, this option would not make the federal income tax marriage neutral since it would maintain marriage tax bonuses. Hence, this approach would fail to achieve the equity goal that married couples with similar incomes pay similar amounts of federal income tax. The differences in income tax



liabilities between couples with similar incomes could be much larger than they would be under a second-earner deduction approach.

## **Increasing the Standard Deduction and Tax Rate Brackets for Joint Returns**

Another major legislative approach to solving the marriage tax penalty problem would be to increase the standard deduction and width of the tax rate brackets for joint returns to twice that of single returns. An alternative approach, but one that has the same practical effect is income splitting. Under this approach married couples would add up all their income and then split it into halves. Each spouse would then file as a single individual and pay tax on half of the total income using the standard deduction and tax rate brackets for single individuals.

Assuming the current tax rate schedules, either one of these approaches would give all married taxpayers a tax cut equal to the largest possible marriage tax penalty that could occur at any given income level. Married couples would all receive a tax cut regardless of whether or not they currently incur a marriage tax penalty. This means that married couples who currently receive a marriage tax bonus (they pay less filing a joint return than they would filing two single returns) would have their bonus increased. Other married couples would move from the penalty category into the bonus category.

These approaches would create a singles' tax penalty (one's income tax liability would always go down by getting married) and therefore, in some regards, would move the income tax system further away from marriage neutrality than it is under the current system. Since, it is estimated that in 1998, there were 72 million tax returns filed by single individuals and heads of households versus 49 million returns filed by married couples, adopting an approach that would be perceived by many as creating a large singles' tax penalty might produce a negative reaction. These approaches would probably entail the largest revenue costs of the major options under consideration.

## **Increasing the Standard Deduction for Joint Returns**

While increasing the standard deduction for joint returns so that it is twice the amount of the standard deduction for single returns would be a far less costly option than full income splitting, it would not make the tax system marriage neutral. Although this approach would eliminate the marriage tax penalty for some married couples who do not itemize and mitigate the penalty for other couples who do not itemize, it would increase the marriage tax bonuses for other married couples and not affect couples who do not use the standard deduction, i.e. itemize, and who currently pay a tax penalty.

However, since almost 60% of joint returns see all of their income taxed at the 15% tax bracket, simply increasing the joint standard deduction to twice the amount of the single standard deduction would mean that marriage tax penalties (excluding those introduced by the EITC) would be eliminated for the majority of joint returns.

## **Developments in the 107<sup>th</sup> Congress**

As part of his overall tax cut plan, President Bush has proposed a two-earner marital deduction of 10% of the lower earning spouse's income with a maximum deduction of \$3,000. The two-earner marital deduction would be phased in over a five year period.

In late March 2001, the House passed H.R. 6 which contained marriage tax penalty relief. Under H.R. 6 the standard deduction for joint returns would be increased to twice the amount of the standard deduction for single returns, effective beginning 2002. It would increase the width of the 15% tax bracket for joint returns to twice the width of the 15% tax bracket for single returns. This change would be phased in over the period 2004 to 2009. Finally, H.R. 6 would allow married taxpayers who file a joint return to increase the earned income amount used to calculate the earned income tax credit (EITC) to 110% of their earned income

## Appendix A: Conflicting Equity Goals

To demonstrate the logical inconsistencies of these three concepts of equity (marriage neutrality, progressivity, and equal taxation of couples with equal incomes) consider the case of these four taxpayers Andy (A), Betty (B), Cathy (C), and David (D) expressed in an algebraic form. A and B each have incomes of \$30,000, C has no income, and D has an income of \$60,000. If the tax system is progressive (as opposed to proportional), then the combined tax on A and B cannot equal the tax on D (if the taxes were equal then the tax system would be proportional). Hence:

$$(1) \quad T(A) + T(B) \neq T(D)$$

At the same time, for the tax system to be marriage neutral, then the tax on A and B, if they got married, should be the same as their combined tax liabilities as two singles. Hence:

$$(2) \quad T(A) + T(B) = T(A+B)$$

In addition, to qualify as marriage neutral, the tax on C and D, if they got married should be the same as the tax on D as a single individual (since C had no income and no tax). Hence:

$$(3) \quad T(C) + T(D) = T(C+D)$$

To achieve the goal that couples with equal incomes pay equal tax requires that the tax on A and B should equal the tax on C and D. Hence:

$$(4) \quad T(A+B) = T(C+D)$$

Substituting equations (2) and (3) into equation (4) produces:

$$(5) \quad T(A) + T(B) = T(D)$$

Equation (5) however, contradicts equation (1), which says that for the tax system to be progressive, the combined tax on A and B cannot equal the tax on D. This algebraic representation demonstrates the fact that the tax system can be marriage neutral and tax couples with equal incomes equally only under a proportional tax, but not under a progressive tax.

## Appendix B: Tax Rate Schedules for 2000

### Statutory Marginal Tax Rates, Personal Exemptions, And Standard Deductions, 2000

Personal Exemptions	\$2,800
Standard Deductions	
Joint	\$7,350
Single	4,400
Head of Household	6,450

### Additional Standard Deductions for the Elderly and the Blind

Joint	\$850
Single/Head of Household	1,100

### Marginal Income Tax Rates

If taxable income is: \_\_\_\_\_ Then, tax is: \_\_\_\_\_

#### Joint Returns

\$ 0 - \$ 43,850	15% of the amount over \$ 0
\$ 43,850 - \$ 105,950	\$6,578 + 28% of the amount over \$43,850
\$ 105,950 - \$ 161,450	\$23,966 + 31% of the amount over \$105,950
\$ 161,450 - \$ 288,350	\$41,171 + 36% of the amount over \$161,450
\$ 288,350 +	\$86,855 + 39.6% of the amount over \$288,350

#### Single Returns

\$ 0 - \$ 26,250	15% of the amount over \$ 0
\$ 26,250 - \$ 63,550	\$3,938 + 28% of the amount over \$26,250
\$ 63,550 - \$ 132,600	\$14,382 + 31% of the amount over \$63,550
\$ 132,600 - \$ 288,350	\$35,787 + 36% of the amount over \$132,600
\$ 288,350 +	\$91,857 + 39.6% of the amount over \$288,350

#### Heads of Households

\$ 0 - \$ 35,150	15% of the amount over \$ 0
\$ 35,150 - \$ 90,800	\$5,273 + 28% of the amount over \$35,150
\$ 90,800 - \$ 147,050	\$20,855 + 31% of the amount over \$90,800
\$ 147,050 - \$ 288,350	\$38,292 + 36% of the amount over \$147,050
\$ 288,350 +	\$89,160 + 39.6% of the amount over \$288,350