

1987

# Congress as Indian-Giver: "Phasing-out Tax" Allowances under the Internal Revenue Code of 1986

Glenn E. Coven  
*William & Mary Law School*

---

## Repository Citation

Coven, Glenn E., "Congress as Indian-Giver: "Phasing-out Tax" Allowances under the Internal Revenue Code of 1986" (1987). *Faculty Publications*. 498.  
<https://scholarship.law.wm.edu/facpubs/498>

## CONGRESS AS INDIAN-GIVER: "PHASING-OUT" TAX ALLOWANCES UNDER THE INTERNAL REVENUE CODE OF 1986

*Glenn E. Coven\**

The myriad of constraints, both fiscal and political, under which the legislation resulting in the Internal Revenue Code of 1986 was drafted produced a series of compromises that frequently offend, rather than implement, sound income tax policy. This brief paper addresses just one: the rate structure of the new Code.

At the income level at which a tax is first imposed, the effective marginal tax rate is a surprising 25 percent—and can be higher. That tax rate is imposed until adjusted gross income reaches \$17,000 on a joint return, the equivalent of a taxable income somewhere between zero and \$9,000. At that point, the marginal rate declines—but rarely as low as the nominal 15 percent. When taxable income reaches about \$30,000, the marginal rate leaps to 28 percent where it remains until taxable income reaches about \$70,000. At that level of income a taxpayer encounters the final generally applicable tax bracket of 33 percent, but only upon a range of income that varies as a function of the number of children the taxpayer has. The more children (or others) that the taxpayer claims as dependents, the more of his income is taxed at this maximum rate. After the appropriate amount of income has been subject to the 33 percent rate, typically at a taxable income level between \$170,000 to \$200,000, the marginal rate actually declines to 28 percent. Few taxpayers, however, will actually be subject to the nominal rates of tax. At various, and perhaps numerous, levels of income, nearly all taxpayers will be subject to surtaxes that increase the marginal rate of tax to over 150 percent of the nominal tax rate. Thus, some taxpayers will be subject to an effective marginal tax rate in excess of 50 percent. The resulting rate schedule does not at all resemble the reformed two-bracket schedule so widely advertised but rather a line of graffiti inscribed on a New York subway.

---

\* Professor of Law, College of William and Mary; B.A. 1963, Swarthmore College; LL.B. 1966, Columbia University.

For the most part, the new effective marginal tax rates are not found in a table appearing in section 1 of the Code. Rather, they result from the new congressional addiction to disappearing deductions—tax allowances that are progressively denied to taxpayers as their income rises. The 1986 legislation did not initiate the practice of “phasing out” tax allowances; at least one such provision was contained in the 1954 Code as enacted.<sup>1</sup> On the other hand, the recent legislation not only greatly expanded the number of allowances that are subject to phase-outs, but it enormously increased the number of taxpayers adversely affected by these provisions and greatly increased the impact of these phase-outs on their effective marginal tax rates. The phasing out of tax allowances is indeed a characteristic feature of the 1986 Code.

What is most curious about this new legislative technique is that most, if not all, of the affected allowances cannot be phased out. The misguided attempt to do so has merely resulted in a series of irrationally distributed surtaxes that undermine, both in appearance and reality, the equity of the Code and are inconsistent with the fundamental objectives of the 1986 legislation.

## I. THE INCOME TAX CONSEQUENCES OF REMOVING TAX ALLOWANCES

### A. *In General*

In a sense, any time a tax allowance, such as a deduction, is denied to a taxpayer, the general effect of the denial is to increase the rate of tax imposed upon a segment of the taxpayer's income. If a deduction for the expenditure could be claimed, the tax rate imposed upon the income used to make the expenditure would be zero—the deduction would have sheltered that income from tax. Absent the deduction, understandably enough, the taxpayer becomes subject to tax on that income. However, and significantly for present purposes, the rate of tax on that income simply increases to the taxpayer's nominal marginal tax rate. Thus, elimination of the deduction causes a segment of income to become subject to tax

---

<sup>1</sup> The predecessor of the present child care credit was a deduction contained in § 214 of the Internal Revenue Code of 1954 as enacted. See Internal Revenue Code of 1954, Pub. L. No. 83-591, § 214, 68A Stat. 1, 70-71, repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(b)(1), 90 Stat. 1520, 1565.

but produces no other result.

If the tax allowance is denied because of an attribute peculiar to a particular class of taxpayers, the resulting increase in tax liability may quite properly be viewed as a tax imposed upon that attribute. The most obvious illustration of that relationship appears in the series of disallowances that are imposed upon a taxpayer participating in an international boycott. Pursuant to section 999 and related sections, a number of tax allowances, such as the foreign tax credit, are denied to a taxpayer that has participated in an international boycott.<sup>2</sup> Those provisions are intended, quite obviously, as penalties for the proscribed forms of conduct and not as a technical adjustment of the foreign tax credit. Should those penalties be imposed, they would constitute an added cost of engaging in a boycott and not an added cost of being subject to foreign taxation.

In a somewhat less dramatic context, if the attribute that occasions the disallowance of a deduction is an increase in the income of the taxpayer, the resulting increase in tax liability becomes an additional tax imposed upon the receipt of that income. Thus, for example, a taxpayer might be denied the ability to claim a deduction for the full amount of his personal exemptions once his taxable income exceeds a specified level. In that event, the increase in tax liability produced by the loss of the deduction would be an additional cost of earning the income that resulted in the loss of the deduction. The increase in tax liability would not be attributable to, nor constitute a reversal of, the permissible deduction for the personal exemption.

Unlike the simple disallowance of a deduction for reasons unrelated to income levels, the loss of a tax allowance as a function of an increase in income always has at least two consequences for the computation of tax liability. First, the loss of the deduction produces an increase in tax liability upon the segment of income that is no longer sheltered from tax by the deduction. Second, the income that was responsible for the loss of the allowance will also be

---

<sup>2</sup> See I.R.C. §§ 999 (determination of participation in international boycott); 908 (reduction of foreign tax credit for participation in or cooperation with international boycott); 952(a) (determination of "subpart F income" using international boycott factor); 995(b)(1)(F) (taxable income of DISC shareholder determined using international boycott factor).

subject to tax. Thus, the loss, or phase-out, of a tax allowance effectively results in the imposition of two taxes on the increased income that resulted in the disallowance. Since the increased income will itself be subject to tax at the taxpayer's nominal marginal bracket rate, the additional tax liability incurred will unavoidably effect an increase in the taxpayer's effective marginal rate to a level in excess of the nominal marginal rate.

To illustrate in a simplified context, assume that a taxpayer having an adjusted gross income of \$60,000 is entitled to personal exemptions totalling \$4,000 and is subject to a marginal tax rate of 30 percent. Assume further that any increase in income will result in a loss of the ability to deduct personal exemptions by an amount equal to the excess of gross income over \$60,000. Under these circumstances, the receipt of one dollar of income will, of course, result in an increased tax liability of \$0.30. However, that receipt will also result in the loss of one dollar of deductions, thereby subjecting an additional dollar of gross income to tax. This additional tax of \$0.30 will produce an overall tax of \$0.60 on the additional dollar of income and thus an effective marginal tax rate of 60 percent.

While the income that becomes taxable by virtue of the lost deduction will be taxed at the taxpayer's nominal marginal bracket rate, the effective marginal rate of tax on the increased income will not necessarily be doubled. If the increase in income only results in the loss of a deduction in an amount that is less than the increase in income, the increase in the effective marginal tax rate on the increased income will be correspondingly reduced. Thus, in the previous example, if an increase in income only resulted in the loss of a deduction for the personal exemptions equal to 25 percent of the excess of gross income over \$60,000, a one dollar increase in income would result in the loss of only \$0.25 of deductions. The 25 cents of income that would become subject to tax by virtue of the loss of the deduction would be taxed at the nominal effective rate of 30 percent. However, the additional tax incurred by virtue of the receipt would be only 30 percent of \$0.25 or \$0.075. The resulting tax incurred by virtue of the receipt of a one dollar increase in income would thus be \$0.375, an amount equal to 125 percent of the nominal effective rate.

In either event, whether the additional tax incurred is \$0.30 or \$0.075, that additional tax is attributable to the receipt of the one

dollar increase in income and may only be regarded as a further tax imposed upon that income. Thus, the result of disallowing a tax allowance as a function of increasing income is to increase the effective marginal rate of tax upon that income to a level in excess of the nominal marginal rate. In practical effect, the disallowance enhances the progressivity of the rate structure. The rationality of that approach to progression, however, is disputed below.

*B. The Impossibility of "Phasing Out" Tax Allowances*

The foregoing example suggests that tax allowances cannot be phased out as a function of an increase in income. Rather, the resulting increase in tax liability is attributable to the increased income and simply produces an increase in the effective tax rate imposed upon that additional income. The tax does not produce a reduction in the otherwise allowable deduction. That point is nowhere better illustrated than in the context of the purported phase-out of the 15 percent bracket.

In order to produce a bill that was revenue neutral by income classification<sup>3</sup> but which did not appear to impose a rate of tax in excess of 28 percent, the Conference Committee determined that taxpayers in the very highest income ranges should be subject not just to a marginal tax rate of 28 percent, but to an average tax rate of 28 percent.<sup>4</sup> To accomplish that result, it became necessary in some manner to eliminate the tax savings produced through the normal operation of a progressive rate structure in which the first \$30,000 of taxable income is subject to a tax rate of only 15 percent. The drafting technique adopted to accomplish that phase-out of the 15 percent bracket was to impose an additional income tax liability equal to the difference between the 28 percent maximum rate and the 15 percent initial rate on the amount of income that was subject to the 15 percent tax rate. This additional tax, however, will be collected only at the rate of 5 percent of taxable income and only with respect to taxable income in excess of the ap-

---

<sup>3</sup> See Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., Data on Distribution by Income Class of Effects of the Tax Reform Act of 1986 (1986) (nine statistical tables), reprinted in 33 Tax Notes 73 (Oct. 6, 1986).

<sup>4</sup> See H.R. Conf. Rep. No. 841, pt. 2, 99th Cong., 2d Sess. 5 (1986) [hereinafter Conference Report].

plicable dollar amount, which on a joint return is \$71,900.<sup>5</sup>

At first glance, this 5 percent surcharge would appear a highly inappropriate approach to diminishing the tax benefit obtained from the 15 percent bracket rate. If Congress had wished to reduce the amount of income eligible for the lower rate of tax, it would appear more normal for the statute to have provided that as income rose beyond a certain level, say \$71,900, the amount of income eligible for the 15 percent rate would be progressively reduced. Thus, for example, the statute might have provided that for every \$13 of adjusted gross income in excess of \$71,900, the amount of income eligible for the 15 percent bracket would be reduced by \$5. Thus, once the taxpayer derived taxable income of \$149,900, no amount of income would be eligible for the 15 percent rate and the entire amount of the taxpayer's income would be subject to tax at the 28 percent rate. Thus the average tax rate of 28 percent sought by Congress would be achieved.

A reduction in the amount of income eligible for the 15 percent rate, however, would have effectively imposed a marginal tax rate in excess of 28 percent. As the taxpayer derived \$13 of income in excess of the \$71,900 level, that income would not only be subject to tax at the 28 percent rate but would also precipitate an additional income tax liability attributable to the \$5 reduction in the amount eligible for the 15 percent rate. Thus, an additional tax liability would be imposed equal to 13 percent, the difference between the 15 and 28 percent rates, on an additional \$5 of income resulting in an increased tax liability of \$0.65. Accordingly, each dollar of the additional \$13 earned would result in an additional tax liability of \$0.05. Since each additional dollar earned by the taxpayer thus would result in a tax liability of \$0.33, the reduction in the amount eligible for the 15 percent bracket would be precisely the equivalent of imposing a 5 percent surtax on income in excess of \$71,900. The drafters of the 1986 legislation deserve credit for having explicitly adopted the far simpler mechanism of simply imposing a 5 percent surcharge instead of employing the cumbersome device of reducing the amount eligible for the lower

---

<sup>5</sup> See I.R.C. § 1(g)(3). The applicable dollar amount which triggers the surtax is \$61,650 for heads of households, \$43,150 for unmarried individuals generally, \$35,950 for married taxpayers filing separately, and \$13,000 for estates and trusts. References to income levels discussed in this comment are made with respect to joint filers.

bracket rate.

It is perhaps entirely obvious that, having subjected a range of income to a marginal tax rate below 28 percent, Congress could not achieve an average tax rate equal to 28 percent without imposing a marginal tax rate in excess of the 28 percent rate on some range of income. Nevertheless, it is of some value to explore precisely why the effect of eliminating a tax allowance is identical to the imposition of a surtax, for it illustrates the essential flaw in the use of phased out allowances.

Once an allowance has been granted to taxpayers at low levels of income, its effect cannot be erased from the taxing system. Congress can, if it concludes that taxpayers at a certain level of income would otherwise be undertaxed, impose an additional tax. If Congress deems it rational, it may also limit the amount of income that will be subject to the additional tax. Moreover, the range of income to be subject to the additional tax may be established at an amount that will yield precisely the same tax as the amount of tax saved by some other provision of the Code, such as the deduction for contributions to individual retirement accounts ("IRAs")<sup>6</sup> or the 15 percent bracket. However, what Congress achieves through such a device is not the reversal of the deduction extended to contributions to an IRA or the benefits of the 15 percent bracket, but rather an additional tax liability imposed only with respect to a limited range of income.

While the Conference Report to the 1986 legislation refers to the 5 percent surtax as phasing out the benefit of the 15 percent bracket and applying the 28 percent rate to all of the taxpayer's taxable income,<sup>7</sup> thereby reversing the effect of the previously granted allowance, that result cannot be achieved and the 5 percent surtax does not approximate that effect. A taxpayer whose income places him within the very broad range over which this tax allowance is phased out is not subject to a 28 percent tax on an expanding segment of his income. Rather, the effect of this phase-out is precisely the same as subjecting the taxpayer to a 33 percent tax upon a segment of his income and the 15 and 28 percent rates upon the balance of his income. The 5 percent surtax does not, and cannot, reverse the effect of the 15 percent bracket; it is simply the

---

<sup>6</sup> I.R.C. § 219(a).

<sup>7</sup> See Conference Report, *supra* note 4, at 4-5.



imposition of an additional tax. It necessarily follows that the rationality of the 5 percent surtax cannot be evaluated in terms of the propriety of imposing an average rate of tax of 28 percent, for no such tax is imposed. Rather, the provision must be evaluated in terms of the rationality of imposing a third marginal rate on incomes of between \$71,900 and \$149,900, and imposing a lower marginal rate of tax on incomes in excess of that amount.

In fact, of course, the 5 percent surtax is less rational than described, for the phase-out is intended to eliminate not only the benefits of the 15 percent bracket but also the benefits of the personal exemptions claimed by the taxpayer.<sup>8</sup> As a result, the more children a taxpayer has, the greater the amount of his income that will be subject to the surtax. As in the case of the phase-out of the 15 percent bracket, the additional 5 percent tax measured by the number of a taxpayer's personal exemptions does not produce a pattern of taxation that is the equivalent of disallowing a deduction for personal exemptions. Rather, the effect is precisely the same as imposing a 5 percent surtax on an amount of income measured by the number of a taxpayer's children—a perverse result even for the 1986 legislation.

### C. *Phase-Outs by Any Other Name*

While the phase-out of the benefits of the 15 percent bracket and the personal exemptions is quite explicitly accomplished in the 1986 legislation, all phase-outs are not so clearly identified. Any phase-out of a tax allowance that is made a function of increased income, however, produces an increase in the effective marginal rate of tax on the increased income. That some phase-outs are characterized differently under the Code conceals the full extent of the increase in effective rates.

When a taxpayer is barred from deducting an expenditure, except to the extent that the expenditure exceeds a given fraction of income, a phase-out of the deduction is achieved. Imposing such a floor on deductions progressively diminishes the taxpayer's ability to deduct the expenditure as his income rises. As a result, until a taxpayer's income reaches the point at which no deductions at all are allowable with respect to the expenditure, the effective margi-

---

<sup>8</sup> I.R.C. § 1(g)(2)(B).

nal tax rate on income derived by the taxpayer increases by the percentage of gross income used to establish the deduction floor.

For example, prior to the 1986 legislation, taxpayers were not entitled to deduct medical expenses except to the extent that they exceeded 5 percent of adjusted gross income.<sup>9</sup> A taxpayer incurring medical expenses in excess of that floor was therefore entitled to some deduction with respect to those expenses. However, an additional dollar of income would not only be subject to the nominal marginal tax rate but would also result in the loss of a deduction for the medical expense in the amount of \$0.05. Thus, the amount of tax imposed with respect to the additional dollar of income would be precisely the same as the tax imposed at the nominal marginal rate on 105 percent of the income actually earned. That result, of course, is precisely the same as if the marginal rate of tax had been increased by the same percentage. A 20 percent tax on \$105 of income is precisely the same as a 21 percent tax on \$100 of income.<sup>10</sup>

The 1986 legislation increased the medical expense floor to 7.5 percent of adjusted gross income<sup>11</sup> and retained the similar 10 percent floor on the deduction of net casualty losses.<sup>12</sup> Of greater significance, however, is the imposition of a new floor equal to 2 percent of adjusted gross income for a broad classification of employee business and investment expenses.<sup>13</sup> Since many more taxpayers will have otherwise deductible employee business and investment expenses in excess of this 2 percent floor than will have medical or casualty losses in excess of the 7.5 and 10 percent floors, many more taxpayers will fall within the phase-out range for these deductions and thus be subject to an increase in their effective rates of tax. As a result of these provisions, the effective rate of tax on a broad spectrum of taxpayers will be from 2 to 19.5 percent higher

---

<sup>9</sup> Int. Rev. Code of 1954 § 213(a).

<sup>10</sup> This equivalence is true, of course, only where the nominal rate of tax is a constant.

<sup>11</sup> I.R.C. § 213(a).

<sup>12</sup> I.R.C. § 165(h)(2).

<sup>13</sup> See I.R.C. § 67(a). Section 67 subjects all "miscellaneous itemized deductions" other than enumerated exceptions to the new 2% floor. *Id.* The reach of this new provision is extensive. Among the expenses not excepted from the 2% floor are union and professional dues, entertainment expenses, employment agency fees, the cost of investment advice, tax return preparation fees and possibly allowable hobby losses. See I.R.C. § 67(b). As may be observed, nearly all of the affected items are entirely legitimate costs of the production of taxable income.

than the nominal 15, 28, or 33 percent marginal rates of tax that appear to confront taxpayers.

#### *D. An Arguable Exception*

The foregoing has demonstrated that when Congress attempts to phase out a deduction to which the taxpayer would have been entitled at a lower income level, the result is a surtax upon a segment of income rather than the disallowance of the prior tax benefit. That result is obtained regardless of whether the taxpayer would have been entitled to the allowance because all taxpayers at low income levels are entitled to the allowance, as in the case of the personal exemptions, or because the taxpayer would incur the expense regardless of the availability of the tax benefit, as is the case with most medical and employee business expenses. On the other hand, the mere barring of a deduction, such as the repeal of the state sales tax deduction, only results in subjecting a segment of income to tax at the nominal marginal rates—no ancillary or surtax is created.

The phase-out of a volitional expense that is largely, if not entirely, tax-induced presents a borderline case. The surtax created by the phase-out of a tax allowance is only applicable, of course, to taxpayers who would have been entitled to the allowance at a lower level of income. Thus, where the phase-out is of a volitional expenditure, taxpayers only encounter the surtax if they incurred the expense, for which the deduction is being eliminated. If a taxpayer did not incur the expense, the fact that he is progressively unable to deduct that expense as his income rises has no tax consequence at all.

Between adjusted gross incomes of \$40,000 and \$50,000, the deduction for contributions to IRAs is phased out.<sup>14</sup> Whether that phase-out should properly be viewed as increasing the effective marginal rate of tax may depend on one's perspective. If one views the contribution to an IRA as an expenditure that the taxpayer has made, or perhaps would make were the deduction not eliminated, this phase-out is indistinguishable from the other phase-outs considered above. On the other hand, if one views the tax-

---

<sup>14</sup> I.R.C. § 219(g)(2). The reduction only applies if the taxpayer or his or her spouse is an active participant in a qualified retirement plan. However, the definition of "active participant" contained in § 219(g)(5) of the Code, is very broad and thus includes most taxpayers.

payer as making a contribution to an IRA only to the extent that it is deductible, the phase-out more nearly resembles the mere repeal of a deduction. The fact that the taxpayer could have contributed and deducted more at a different level of income becomes irrelevant. So viewed, the phase-out does not amount to the reversal of a previously granted deduction but rather a prohibition upon the claiming of a deduction, which, of course, does not have the effect of increasing marginal tax rates.

The analysis of such phase-outs is further cluttered by the potential for disagreement upon when a deduction is volitional and thus a less inappropriate subject for a phase-out. The 1986 legislation now bars taxpayers from claiming losses from most passive business activities against income from sources other than passive businesses.<sup>15</sup> This new limitation upon the claiming of passive losses is subject to an important exception. Taxpayers may claim up to \$25,000 of such losses if they are attributable to a rental real estate activity in which the taxpayer materially participates in the taxable year.<sup>16</sup> That exception, however, is phased out between adjusted gross income levels of \$100,000 and \$150,000.<sup>17</sup> Clearly, investing in a real estate activity that will produce net losses is a volitional act and often one that is tax-motivated. However, once a taxpayer makes such an investment, he may have little control over the extent or timing of the losses generated by the activity. From the perspective of such a taxpayer, phasing out a rental activity loss is indistinguishable from phasing out a personal exemption.

Opinions may well differ upon the proper visualization of the phase-out of such volitional and tax-motivated deductions. Plainly, the case against the phasing out of such deductions is far weaker

---

<sup>15</sup> See I.R.C. § 469(a). Under this section, losses attributable to the conduct of a trade or business, as distinguished from a mere investment activity, in which the taxpayer does not materially participate may not be claimed in excess of the income from similar activities. See I.R.C. § 469. The general effect of the rule is to bar the claiming of tax shelter losses against either earned income or investment (now called portfolio) income. Just as the phase-outs considered here have extended a plausible idea to outrageous lengths, the passive loss rules have extended the schedular approach to the computation of income found in more reasonable form in such provisions as §§ 183 (hobby losses) or 163(d) (investment interest) and in less reasonable form in § 465 (the "at risk" rules).

<sup>16</sup> I.R.C. § 469(i). The general rule is that "passive activity" includes "any rental activity." I.R.C. § 469(c)(2).

<sup>17</sup> I.R.C. § 469(i)(3)(A).

than is the case against phasing out such allowances as the 15 percent bracket and the personal exemptions. Nevertheless, as described below, Congress believed that taxpayers above the phase-out range for IRA contributions would be making the expenditure in question, i.e., would be making additions to savings, regardless of whether the IRA deductions were available.<sup>18</sup> Thus, Congress viewed its legislation as reversing an otherwise available deduction rather than barring the making of an expenditure. Accordingly, it is appropriate to consider the phase-out of the IRA deduction and of certain real estate loss deductions as increasing the effective marginal rate of tax imposed upon taxpayers having such expenses.

## II. EVALUATING THE 1986 PHASE-OUTS

### A. *The Scope of the Problem*

The phasing-out of a tax allowance effectively increases the marginal tax rate applicable only to those taxpayers whose configuration of income falls within the range over which the allowance is phased out. Once the allowance is fully phased out for a taxpayer (typically because the taxpayer's income exceeds the phase-out range),<sup>19</sup> the disallowance has no further effect upon the taxpayer's marginal tax rate. Indeed, the central impropriety of phasing out tax allowances is that it results in a decline in the effective marginal tax rate as income increases.

Accordingly, the extent of the adverse effect of phasing out tax allowances upon the rationality of the Code is a function of the number of taxpayers affected by the phase-outs and the extent to which the effective marginal rates of tax facing those taxpayers are increased by the phasing out of allowances. Lest the 1986 legislation be viewed as an innocuous extension of prior law, the overall effect of the pre-1986 phase-outs should be contrasted with the present state of the law.

#### 1. *Prior Law*

Phasing out a tax allowance is an exercise in targeting tax bene-

---

<sup>18</sup> H.R. Rep. No. 426, 99th Cong., 1st Sess. 683 (1985) [hereinafter House Report].

<sup>19</sup> For phase-outs in the nature of deduction floors, the complete disallowance of the deductions is a function of both the level of income and the amount of the otherwise deductible expenditures.

fits or burdens. Prior to the 1986 Act, Congress used disappearing allowances to administer a form of welfare through the taxing system for very low income families with dependent children. This program entitled families with dependents to a small refundable "earned income" tax credit, the amount of which declined as income exceeded \$6,500 and disappeared altogether when family income exceeded \$11,000.<sup>20</sup> For 1986, the personal exemption was \$1,080 which, for a family of three, exempted \$3,240 of income from tax. With the zero bracket amount for that year established at \$3,670 on a joint return, such a family would become taxable only on income in excess of \$6,910 although the credit itself would completely eliminate tax until adjusted gross income exceeded \$8,930.<sup>21</sup> As a result, the phase-out of this \$550 credit only affected the marginal tax rate of the very narrow slice of taxpayers whose income fell in the range of about \$9,000 to \$11,000.

Further, an additional credit equal to 10 percent of the cost of child care was extended to families with income below \$10,000.<sup>22</sup> At that level of income, 30 percent, rather than the normal 20 percent, of child care expenditures could be credited against the income tax. However, the additional credit was gradually eliminated at higher income levels and was completely phased out when family income reached \$30,000.<sup>23</sup> While the phase-out of this credit affected a far broader range of taxpayers, the effect of the phase-out upon their marginal brackets was obscured by the manner in which the additional credit was phased out. Unlike other phase-outs of tax allowances, this credit is phased out as income rises in \$2,000 steps. One percentage point of the additional credit is lost as adjusted gross income passes each \$2,000 step above \$10,000.<sup>24</sup> As a result, earning the single dollar of income that causes adjusted gross income to increase from, say, \$12,000 to \$12,001 precipitates the loss of one percentage point of the credit.

Since the maximum amount of expenditures for which a credit

---

<sup>20</sup> Int. Rev. Code of 1954 § 32.

<sup>21</sup> On the facts stated in the text, the tax on that adjusted income prior to the earned income credit would be \$253.80 under § 1(a)(3) of the 1954 Code; the available credit would be \$253 (\$550 — 0.122(\$8,930 — \$6,500)). See Int. Rev. Code of 1954 § 32(b).

<sup>22</sup> See Int. Rev. Code of 1954 § 21.

<sup>23</sup> Int. Rev. Code of 1954 § 21(a)(2).

<sup>24</sup> Id.

could be taken is limited to \$4,800,<sup>25</sup> the loss of that one percentage point of the credit could result in an increase in tax liability of up to \$48. Thus the effective rate of tax on that additional one dollar of income would be 4800 percent, while in a very real sense the marginal rate of tax applicable to the next \$1,999 of income would remain the nominal marginal rate. Having passed to the higher income step, additional income would not result in any further loss of the tax allowance. It might, of course, be more realistic to view the additional tax of \$48 as attributable to the entire amount by which the taxpayer's income exceeded the lower step. So viewed, however, the effect of withdrawing this tax allowance is to increase the marginal rate of tax by a highly variable and seemingly random amount. As income rises, the increase in the effective rate of tax is reduced. Thus if adjusted gross income exceeds the lower step by just \$100, the effective marginal rate of tax on that income would be increased by 48 percent rather than 4800 percent. But, if the excess were \$1,000, the increase in the rate would be only 4.8 percent. Amortizing the tax increase over the entire step produces an increase in the effective rate of tax on a taxpayer entitled to the maximum credit of 2.4 percent—an amount that may be said to represent the average increase in rate over the entire \$10,000 range of income over which this allowance is withdrawn. For the further analytical purposes of this paper, the effect of this phase-out will be so described. Nevertheless, the real effect of phasing out the child care credit is far less rational and does not so directly translate into an increase in the effective rate of tax as do other phase-outs.<sup>26</sup>

Finally, under prior law, the personal deductions for medical expenses and casualty losses were both subject to floors that were defined in terms of adjusted gross income. Thus, medical expenses were not deductible except to the extent they exceeded 5 percent of adjusted gross income<sup>27</sup> and casualty losses were subject to a

---

<sup>25</sup> See Int. Rev. Code of 1954 § 21(c)(2).

<sup>26</sup> Section 22 of the 1954 Code also provided a credit that was phased out as income rose. For taxpayers over 65 years of age or totally disabled, the section provided a maximum credit of \$1,125 that was phased out, on a joint return, over an income range of \$10,000 to \$25,000. That credit was not altered by the 1986 legislation. See I.R.C. § 22. Because of the limited application of this credit, its effect is not considered in the text. Nevertheless, the § 22 credit creates an additional "hump" in the rate schedule.

<sup>27</sup> Int. Rev. Code of 1954 § 213(a).

similar floor of 10 percent.<sup>28</sup> As considered above, the effect of these floors is to phase out tax allowances for taxpayers who have deductions in excess of those floors and who are entitled to itemize their deductions. As the income of such a taxpayer rises, his ability to deduct medical expenses or casualty losses is reduced. Since the increase in the effective rate of tax produced by this form of phase-out is equal to the floor percentage, these provisions could result in a 5, 10 or, in combination, 15 percent increase in the effective marginal rate of tax. Thus, a taxpayer facing a nominal rate of 40 percent would in fact be subject to a rate ranging from 42 to 46 percent.

While the effect of these phase-outs, therefore, could be substantial, relatively few taxpayers were so dramatically affected by these provisions. The relatively high standard deduction (or its temporary equivalent, the zero bracket amount) limited the ability to itemize deductions to just under 40 percent of those filing returns for 1984.<sup>29</sup> Of those itemizers, scarcely more than one-quarter were able to claim medical expense deductions in excess of the 5 percent floor.<sup>30</sup> Moreover, and not too surprisingly, roughly 58 percent of the itemizers claiming medical expense deductions had adjusted gross incomes below \$25,000,<sup>31</sup> and thus would not have been subject to a nominal rate of tax in excess of 18 percent under section 1(a).<sup>32</sup> Since a 5 percent increase in an 18 percent marginal rate would only increase the effective marginal tax rate by less than one percentage point, the effect of phasing out personal deductions under prior law was rarely substantial even for the relatively few taxpayers subject to these phase-outs.

## 2. *Current Law*

Under the Internal Revenue Code of 1986, the earned income credit has been retained<sup>33</sup> although the number of taxpayers affected by its phase-out has been greatly expanded. While the old credit was phased out between adjusted gross incomes of \$6,500

---

<sup>28</sup> Int. Rev. Code of 1954 § 165(h)(2).

<sup>29</sup> See Statistics of Income Division, Internal Revenue Service, *Individual Income Tax Returns 1984*, at 13 (1986).

<sup>30</sup> *Id.* at 57-58.

<sup>31</sup> *Id.* at 58.

<sup>32</sup> See Int. Rev. Code of 1954 § 1(a).

<sup>33</sup> See I.R.C. § 32.



and \$11,000<sup>34</sup> and generally only affected the marginal tax rate of families earning over \$9,000,<sup>35</sup> the present credit is phased out over an adjusted gross income range of from \$9,000 to \$17,000.<sup>36</sup> As a result, the number of taxpayers whose effective marginal tax rates will be increased by the phase-out of the earned income credit has been increased quite substantially. For 1984, the most recent year for which data is available, about 48 percent of all taxable returns showed an adjusted gross income of below \$17,000.<sup>37</sup>

On the other hand, the 1986 legislation made no change at all in the phase-out of the child care credit.<sup>38</sup> Thus, over a range of gross income extending from \$10,000 to \$30,000, the phase-out of this credit continues to produce an increase in the effective marginal rate of tax of at least 2.4 percent for a taxpayer claiming the maximum creditable amount.<sup>39</sup>

The floors on the deduction of medical expenses and casualty losses remain related to adjusted gross income, but the former has been increased from 5 percent to 7.5 percent of adjusted gross income.<sup>40</sup> In addition, a similarly defined 2 percent floor has been inserted under the deduction for a wide range of miscellaneous expenses including employee business expenses and expenses relating to investment activities.<sup>41</sup> The increase in the floor on medical expense deductions will reduce the number of taxpayers at all income levels who will be able to deduct any medical expenses, and thus will reduce the number of taxpayers who fall within the range of the phase-out of this deduction. On the other hand, for the relatively few taxpayers who will see their deductions phased out with rising income, the increase in their effective marginal tax rates will be a substantial 7.5 percent.

The introduction of the 2 percent floor on investment and employee business expenses can be expected to affect a far greater range of taxpayers, perhaps nearly all itemizers. However, the re-

---

<sup>34</sup> See Int. Rev. Code of 1954 § 32(b).

<sup>35</sup> See *supra* sentence in text following note 21.

<sup>36</sup> See I.R.C. § 32(b). The \$17,000 figure is reached by applying the formula in § 32(b), under which the credit is \$800 — 0.10(AGI — \$9,000) for taxable years beginning after 1987.

<sup>37</sup> Statistics of Income Division, Internal Revenue Service, Individual Income Tax Returns 1984, at 10 (1986).

<sup>38</sup> See I.R.C. § 21.

<sup>39</sup> See *supra* full paragraph in text accompanying note 25.

<sup>40</sup> I.R.C. § 213(a).

<sup>41</sup> See I.R.C. § 67.

sulting increase in their marginal rates of tax will be correspondingly less.

In addition to these extensions of prior law, the 1986 legislation introduced the phase-out of the 15 percent bracket and the personal exemptions,<sup>42</sup> a phase-out of the ability to deduct contributions to IRAs,<sup>43</sup> and a phase-out of the ability to claim net losses attributable to certain passive business activities.<sup>44</sup> If the taxpayer is unfortunate enough to become subject to the alternative minimum tax, the amount exempted from that tax, \$40,000 on a joint return, is phased out as alternative minimum taxable income exceeds \$150,000.<sup>45</sup>

Tracing the impact of these phase-outs on a typical taxpayer must of necessity be highly imprecise. Some phase-outs are related to taxable income while others are tied to adjusted gross income. Moreover, many of the phase-outs are only applicable to taxpayers who incurred certain categories of expenditures. Given those difficulties, it is nevertheless highly enlightening to attempt to reconstruct the actual marginal tax rates facing taxpayers at different income levels. The following illustration assumes that the taxpayer is married, files a joint return, has one dependent child, and otherwise meets the requirements for obtaining the tax allowance in question. Moreover, the computations assume that the 1986 legislation has been phased in fully. That is, it is assumed that the nominal tax brackets are 15 percent and 28 percent,<sup>46</sup> that the standard deduction on a joint return is \$5,000,<sup>47</sup> and that each per-

---

<sup>42</sup> See I.R.C. § 1(g).

<sup>43</sup> See I.R.C. § 219(g).

<sup>44</sup> See I.R.C. § 469(i)(3). While not so directly affecting individuals, current law continues the phase-out of the graduated rates applicable to corporations. Under prior law, the phase-out commenced at a taxable income of \$1 million. See Int. Rev. Code of 1954 § 11(b). At present, the phase-out begins at \$100,000 and results in an increase in the effective marginal rate of tax from the nominal 34% to 39%. See I.R.C. § 11(b). Thus, for the many small corporations with taxable income between \$100,000 and \$335,000 (the figure at which the maximum increase in tax due to the 5% surtax, \$11,750, is reached), the nominal corporate rate is as illusory as are the nominal rates applicable to individuals.

<sup>45</sup> See I.R.C. § 55(d)(3). This phase-out has the effect of increasing the nominal alternative minimum tax rate by 25% from 21% (for individuals) to 26.25%. One of the defects in the alternative tax approach is that it causes taxpayers to shift between different rate schedules. This temporary increase in the alternative tax rate simply aggravates that problem.

<sup>46</sup> I.R.C. § 1(a).

<sup>47</sup> I.R.C. § 63(c).

sonal exemption is \$2,000.<sup>48</sup>

Under those assumptions, of course, the taxpayer would not have any taxable income until his adjusted gross income exceeded \$11,000. Assuming, as would be typical at that income level, that the entire amount of the taxpayer's income was earned income, the taxpayer would be entitled to an earned income credit although the amount of that credit was in the process of being phased out. At an adjusted gross income of \$13,400, the taxpayer's tax liability, aside from the earned income credit, would equal \$360 and he would be entitled to an earned income credit of precisely the same amount.<sup>49</sup> An additional dollar of income will be subject to tax, but not merely at the nominal 15 percent rate. That additional dollar would also produce a loss of 10 cents of the amount of the earned income credit,<sup>50</sup> thereby subjecting the taxpayer to a tax not of 15 cents but of 25 cents on his first taxable dollar. That 25 percent effective marginal tax rate will persist until the taxpayer's adjusted gross income reaches \$17,000,<sup>51</sup> at which point the earned income credit is entirely eliminated—unless the taxpayer is entitled to a child care credit.

A taxpayer with a single child is entitled to a child care credit on a maximum of \$2,400 of child care expenditures at a rate that declines once adjusted gross income exceeds \$10,000.<sup>52</sup> That additional credit will shelter the taxpayer from tax until his adjusted gross income approximates \$16,000.<sup>53</sup> At that point, the taxpayer is not only subject to an effective marginal rate of 25 percent attributable to the disappearance of the earned income credit, but is also subject to the rate increase produced by the loss of the child care credit. Allocating the increased tax liability produced from passing from one \$2,000 step to another produces an increase in the marginal rate of 1.2 percentage points. Thus, such a taxpayer will be subject to a 26.2 percent marginal rate. Moreover, if the taxpayer

---

<sup>48</sup> I.R.C. § 151(d).

<sup>49</sup> When AGI is \$13,400 the credit equals  $\$800 - 0.10(\$13,400 - \$9,000)$ , or \$360. See I.R.C. § 32(b).

<sup>50</sup> See *id.*

<sup>51</sup> Since the credit is  $\$800 - 0.10(\text{AGI} - \$9,000)$ , there is no credit left when AGI reaches \$17,000. See *id.*

<sup>52</sup> See I.R.C. § 21.

<sup>53</sup> At \$16,000, the maximum child care credit is \$648. See I.R.C. § 21(a). The tax liability of the hypothetical family is \$750. See I.R.C. § 1(a). This amount is reduced by the \$648 credit and the earned income credit, which is  $\$800 - 0.10(\$16,000 - \$9,000)$ , or \$100.

has either medical expenses or employee business expenses in excess of the 7.5 percent or 2 percent floors, any increase in his adjusted gross income will cause a progressive loss of those deductions and an increase in his effective marginal rate of tax. While most taxpayers at this level of income will not have itemized deductions in excess of the standard deduction (and thus will not be affected by the loss of these specific deductions), the unfortunate taxpayer who is entitled to itemize his deductions could find his effective marginal rate of tax increased by up to 9.5 percent. Such a taxpayer would be facing an effective marginal rate of tax of 28.7 percent, an amount slightly in excess of the nominal rate of tax facing taxpayers at the highest income levels.

When the earned income credit is fully phased out at an adjusted gross income of \$17,000,<sup>54</sup> or a taxable income of about \$6,000, the effective marginal rate of tax declines to the nominal 15 percent bracket rate enhanced only by the effect of the loss of the child care credit and any itemized deductions to which the taxpayer is entitled. The marginal rate will again decline, of course, at an adjusted gross income level of \$30,000 for taxpayers who had been entitled to the extra 10 percent child care credit. At that level of income, the taxpayer's marginal rate will have finally declined to the nominal 15 percent bracket rate enhanced only by the possible loss of itemized deductions. A taxpayer who progressively loses his entitlement to those deductions will, of course, never be subject to a marginal tax rate as low as 15 percent.

The nominal 28 percent rate becomes applicable when the taxpayer's taxable income reaches \$29,750.<sup>55</sup> However, at approximately that income level, most taxpayers will begin to lose their ability to deduct contributions to an IRA. The progressive loss of the ability to deduct up to \$4,000 to the IRAs of a working couple as adjusted gross income rises from \$40,000 to \$50,000<sup>56</sup> has the effect of increasing the marginal rate of tax by 40 percent. Such a taxpayer, therefore, may be viewed as not subject to a marginal rate of tax of 28 percent but rather of 39.2 percent. Moreover, such a taxpayer is quite likely to have itemized deductions in excess of the standard deduction and thus simultaneously to be losing an

---

<sup>54</sup> See I.R.C. § 32(b).

<sup>55</sup> See I.R.C. § 1(a).

<sup>56</sup> See I.R.C. § 219.

ability to deduct employee business expenses and perhaps medical expenses. Thus, the actual effective marginal rate of tax facing the taxpayer is likely to be increased by at least 2 percent to an even 40 percent, if not higher.

Once the deduction for IRA contributions has been fully phased out and the floors on medical and business expenses have exceeded the taxpayer's expenditures so that no deductions may be claimed for such items, the taxpayer's marginal effective rate of tax will finally fall to the nominal 28 percent. At this point, where adjusted gross income has exceeded \$50,000, a taxpayer may for the first time be subject to a marginal rate of tax that is equivalent to the bracket rate established by section 1. However, for the 90 percent or more of the taxpaying public whose incomes do not achieve this level, the nominal rate of tax prescribed by section 1 bears little if any relationship to their actual effective tax rate.

On a joint return, the 28 percent effective tax rate persists until the taxpayer has taxable income of \$71,900. At that point, of course, the 5 percent surcharge is first imposed and the effective tax rate increases to 33 percent. For some taxpayers, however, the increase in their effective tax rates does not come to an end. At taxable income levels ranging from approximately \$80,000 to \$120,000, the taxpayer will rapidly lose his ability to deduct losses attributable to rental real property under section 469(i). The relatively rapid phase-out of that allowance results in a 50 percent increase in the marginal rate of tax from 33 percent to 49.5 percent. Should such an unfortunate taxpayer still be entitled to claim medical and employee business expenses, that rate of tax could further be increased by up to 9.5 percent to 54.2 percent.

Finally, having been stripped of the benefits of the earned income credit, the extra child care credit, the IRA deductions, the benefit of the 15 percent bracket, the amount of his personal exemptions and rental activity losses, the taxpayer's marginal effective rate of tax would decline to a permanent 28 percent. At that point, his marginal rate of tax will finally have returned to the marginal rate facing a taxpayer with adjusted gross income of \$16,000.

### *B. The Reasons for the Problem*

Even technically deficient provisions, such as the phasing out of tax allowances, may find a justification in other tax or social objec-

tives. The enormous increase in the use of phased out tax allowances in the 1986 legislation, however, was accompanied by a similar increase in the range of purposes for enacting such provisions. Unfortunately, many of those purposes are far less compelling than were the justifications for the far more modest phase-outs enacted prior to 1986.

The principal phase-outs of prior law, the earned income credit and the additional child care credit, were expressly designed to target economic assistance to workers at the very lowest edge of the income scale. Both provisions executed a negative income tax that constituted the functional equivalent of a federally funded welfare program.

Whether it is reasonable and appropriate to target welfare assistance through a system of disappearing credits may be debatable, since the effect of that approach is to substantially increase the effective marginal tax rate imposed upon the beneficiaries of this relief as they first become taxpayers. Nevertheless, for Congress to wish to limit this form of assistance to the very poorest segments of society in much the same fashion that eligibility for food stamps is limited was entirely rational.

While the 1986 legislation continued, albeit in expanded form, the use of phase-outs to target federal assistance on low income taxpayers, the phase-outs introduced in 1986 were generally fundamentally different from their predecessors. While the continued effect of these new provisions is to grant tax allowances to lower income taxpayers while denying those benefits to upper income taxpayers, the target of these new provisions is not the low income taxpayer but rather the high income taxpayer. Phase-outs that commence at adjusted gross income levels of \$70,000 or \$100,000 can scarcely be viewed as low income relief.

While the need to find revenue to offset the effect of the rate reductions can be said to underlie, and thus partially explain, most of the limitations on deductions contained in the 1986 legislation, the motivation for phasing out deductions of IRA's most nearly resembles the purposes for the pre-1986 phase-outs. Congress viewed this deduction as a technique for stimulating savings and suppressing consumption. Whether the deduction had that effect at any income level was a matter of some debate.<sup>57</sup> Congress con-

---

<sup>57</sup> See Galper & Byce, *Individual Retirement Accounts: Facts and Issues*, 31 *Tax Notes*

cluded, however, that the deduction had little, if any, effect upon taxpayers at moderate to high levels of income. Those taxpayers, it was believed, would save an amount equal to the maximum IRA deduction without the tax incentive and the deduction merely reduced the tax liability of high income taxpayers without increasing the amount saved.<sup>58</sup> In part for these reasons, the Senate proposed the elimination of deductible IRA contributions for participants in qualified retirement plans.<sup>59</sup> However, the deduction was popular and politically difficult to eliminate completely. As a result, the deduction was phased out for taxpayers having adjusted gross incomes in excess of \$40,000.

The phase-out of the IRA deduction may thus be seen as an attempt to target tax relief at the lower end of the income scale—although not exactly upon low income taxpayers. As in the case of the similar phase-out of the child care credit, that congressional objective is not inappropriate. As a result, this phase-out, which is technically the most defensible, may also be the most rationally motivated.

On the other hand, the phase-outs of the effect of the 15 percent bracket and the personal exemptions were nothing more than thinly (if at all) disguised attempts to restore to the taxing system some of the progressivity that was eliminated in moving to a nominal maximum bracket of 28 percent. The complex political maneuvering that seemed necessary for the enactment of any legislation required the appearance of a maximum bracket of about 28 percent. On the other hand, revenue neutrality, both on an overall and income class basis,<sup>60</sup> required that more tax be collected from the higher income taxpayers than a 28 percent bracket would provide. For that scarcely rational reason, the benefits of the 15 percent bracket, the personal exemptions and the exemption from the passive loss limitation were phased out.<sup>61</sup> Put harshly, but not entirely inaccurately, the purpose that underlies these phase-outs was political deceit.

The reason for phasing out the deductions for employee business

---

917 (June 9, 1986); Summers, Letter, 31 Tax Notes 1014 (June 9, 1986).

<sup>58</sup> House Report, *supra* note 18, at 683.

<sup>59</sup> See S. Rep. No. 313, 99th Cong., 2d Sess. 543 (1986).

<sup>60</sup> See Steuerle, Lessons from the Tax Reform Process, 32 Tax Notes 145 (1986).

<sup>61</sup> See Tax Reform Act of 1986, Interview with Chief Counsel John Colvin, 33 Tax Notes 792, 794 (Dec. 1, 1986).

expenses and investment expenses through the adoption of a 2 percent floor is not entirely clear. The announced reasons for this provision were simplification and administrative convenience,<sup>62</sup> but the case for those benefits is weak indeed. Those results can only be achieved for the relatively few taxpayers who can itemize their deductions (less than one-third of all taxpayers) and who in addition will not have miscellaneous deductions in excess of the 2 percent floor. Moreover, even those benefits must be offset by the complexity and manipulation created by plans to avoid the new floor.<sup>63</sup> While this is not the forum in which to debate the merits of this new floor on deductions, it is clear that the justification for such a provision is dubious. Accordingly, the adverse effect of this provision on marginal rates becomes harder to justify.

Moreover, it is not irrelevant that the 2 percent floor on income-related deductions is the third "personal" deduction that is phased out by an income-related floor. While the modest effect on marginal rates created by the older 5 percent floor on medical expenses may have been too small to be of concern, it does not follow that the existing 2, 7.5, and 10 percent floors on business, medical and casualty loss deductions are similarly inconsequential. Rather, it is the congressional tendency, illustrated by the 1986 legislation, to expand the use of phase-outs that has produced a cumulative effect on marginal rates that may not be acceptable.

### *C. The Effect of Phase-Outs on the Taxing System*

The argument made here has been that tax allowances, once granted at lower levels of income, cannot be "phased out." At the very most, Congress may impose a tax at a given level of income that is sufficient to restore the tax savings generated by a tax allowance. The significance of this point is that, as a result, the numerous provisions of current law that purport to phase out tax al-

---

<sup>62</sup> See House Report, *supra* note 18, at 109-10.

<sup>63</sup> Section 67, for instance, applies the 2% floor on miscellaneous business deductions to individuals. See I.R.C. § 67(a). Thus, employee expenses that are reimbursed by the employer are not subject to the 2% floor, nor, of course, are expenses of the employer that incidentally benefit the employee. Tax planning now requires shifting employee business expenses to employers in one way or another. Some plans will be less successful than others, which will precipitate audits, litigation, and perhaps even further legislation. See Diss & Ruby, *Miscellaneous Itemized Deduction Floor Is Bad Policy*, 34 Tax Notes 689 (February 16, 1987).



lowances cannot be evaluated in terms of the rationality of denying certain deductions, credits or rate relief to high income taxpayers. The effect of a phase-out is not to withdraw the benefits of the allowance, but rather, is to impose an effective marginal rate of tax that is higher than the nominal rate on a limited segment of income. The propriety of the phase-out, therefore, must be appraised in those terms.

### 1. *Vertical Equity*

Phase-outs, designed to recapture the amount of tax savings produced by a tax allowance, such as the phase-out of the effects of the 15 percent bracket, result in an increase in the marginal tax rate that is only temporary. Once the tax savings in question has been fully recaptured, the "second" tax ceases and the effective marginal rate returns to its nominal level. Thus, the propriety of these provisions must be evaluated in terms of the real net effect of the provisions upon taxpayers: the imposition of a third marginal rate upon a limited segment of income so that over some ranges of income, marginal rates actually decline as income rises. The 5 percent surtax, for example, can be justified only if it is reasonable and appropriate for Congress to impose a higher marginal tax rate on the last dollars earned by a moderately wealthy taxpayer than upon the last dollars earned by a very wealthy taxpayer.

If the purported phase-outs of these tax allowances are viewed properly, there is little that can or need be said concerning the propriety of the effect of these phase-outs upon the vertical equity of the new Code. While the case for progressivity may indeed be "uneasy,"<sup>64</sup> the case for regressivity is untenable—should anyone wish to make it. The reduction of the marginal tax rate on very high income taxpayers (especially those with few children!) quite simply was immoral and is unacceptable. That limitation on the 33 percent bracket should be repealed immediately.

While continued essentially unchanged from prior law, the phase-outs that affect taxpayers at the very bottom of the income scale are particularly inappropriate. To require families earning in the neighborhood of \$15,000 to pay 25 percent, or more, of their

---

<sup>64</sup> See W. Blum & H. Kalven, *The Uneasy Case for Progressive Taxation* (1953).

increased earnings in federal income taxes (aside from social security withholding) when families earning twice as much are subject to a marginal rate of tax scarcely more than one-half that level is essentially unjust. That consequence of the phase-out of the earned income and child care credits may have escaped criticism under prior law because of the relatively few taxpayers who experienced an increase in their marginal bracket rates by virtue of these provisions. However, by vastly increasing the number of low income taxpayers affected by these phase-outs, Congress greatly multiplied the number of taxpayers who are treated unfairly, and thus, rendered these low income phase-outs both more visible and less acceptable. That consequence of the 1986 legislation is unlikely to pass without notice and will do little to restore the ebbing respect for the taxing system.

Sophisticated tax writers may view the phase-out of the earned income and additional child care credits as extraneous to the taxing system and thus of no consequence to the rate structure. Both credits are a form of negative tax or subsidy to low income wage earners, and it is not unreasonable to diminish the amount of these subsidies as earnings increase. Nevertheless, for whatever reason, Congress chose to implement this subsidy through the taxing system, and the phasing out of these allowances is in fact accomplished by temporarily increasing the tax rate payable by low income taxpayers. Having adopted the taxing system as the mechanism for implementing these subsidies, it cannot now be contended that the taxing system is not affected by the form of the subsidy.<sup>65</sup>

## *2. Horizontal Equity*

The essential unfairness of the phasing out of tax allowances is not limited, however, to the resulting regression in marginal rates that occurs at various ranges of income. Taxpayers whose level of income places them beyond the range over which a tax allowance is phased out are not subject to the increase in marginal rates that the phase-out produces. However, if these taxpayers incur the expense for which the tax allowance has been withdrawn, they are

---

<sup>65</sup> See generally Steuerle & Wilson, *The Taxation of Poor and Lower Income Workers*, 34 *Tax Notes* 695 (February 16, 1987).

nevertheless adversely affected by the phase-out because they are denied a deduction. If that deduction, in the context of the taxing system as a whole, is necessary to the proper definition of their taxable income, the horizontal equity of the Code will have been diminished.

The attempted phase-out of the personal exemptions is illustrative. For a taxpayer subject to this extension of the surtax, the tax produced must be evaluated in terms of the rationality of the imposition of a tax on an amount of income measured by the number of dependents claimed by the taxpayer. So evaluated, the surtax is indefensible. For a taxpayer whose income is high enough that he is not entitled to any deduction for personal exemptions, the effect of the surtax is identical to the denial of the ability to claim deductions with respect to dependents—precisely the result intended by Congress in phasing out these deductions. That result, however, is equally unfair.

The fundamental notion that supports not taxing the first few dollars earned by a taxpayer is that each individual should be entitled to provide for his own and his family's basic essentials before being asked to contribute to the maintenance of government. Accordingly, some income, which represents the basic consumption needs of each individual, has traditionally been exempted from tax. This concept of fairness has caused the taxing system to discriminate among taxpayers on the basis of the number of the taxpayer's personal exemptions in determining his tax-paying capacity. If that discrimination is appropriate among individuals of modest wealth, it remains appropriate for individuals of great wealth.

The observation that individuals of great wealth are able to support their dependents without the assistance of the personal exemption is not responsive to this criticism. Such an argument, which would support the elimination of all deductions for high income taxpayers, misses the point of the initial grant of a deduction. Maintenance of fairness within the taxing system requires that taxpayers in unequal tax-paying circumstances be treated unequally but in proportion to their tax-paying capacity. The personal exemption is just as necessary to discrimination among high income taxpayers as it is to discrimination among low income taxpayers. The failure to discriminate results in an unfair allocation of the taxation burden.

Aside from the phase-out of the 15 percent bracket, the burden of the increase in marginal tax rates is not distributed among taxpayers in any uniform or defensible manner. Rather, the burden of these additional taxes is borne by randomly selected groups of taxpayers who either have dependent children, make contributions to retirement accounts, invest in real estate, or engage in any of the other discrete activities that generate deductions that are phased out. That distribution of the incidence of the surtaxes has disrupted the horizontal equity of the Code.

### 3. *Efficiency Considerations*

The propriety and significance of increasing the effective marginal tax rates payable by middle and upper income taxpayers is in part a function of the reasons underlying the adoption of the nominal 28 percent rate. No single reason can be ascribed for the relatively abrupt transition from a progressive rate schedule attaining rather high levels to a relatively flat schedule containing far more modest rates. Many were attracted to the simple, but unachieved, notion of a reduction in the burden of the income tax. Others envisioned massive simplification, which was also unachieved, flowing from a flatter rate schedule, and anticipated that a low, flat rate would eliminate much of the incentive to engage in tax sheltering or tax evasion activities. Still others believed that lower income tax rates would stimulate productivity and capital formation. Some, perhaps, simply viewed progression as unfair.

Regardless of which of these reasons, or others, one adopts for the 1986 legislation, the ad hoc and partially concealed increases in marginal rates produced by the phase-out of tax allowances are as inconsistent with those objectives as explicit creation of a third or fourth bracket. It is unlikely that taxpayers who are sufficiently tax-conscious and sophisticated to engage in complex tax reduction pursuits will be fooled by the structure of the 1986 legislation into believing that they are only subject to a marginal tax rate of 28 percent. To the contrary, taxpayers forced into effective marginal rates of 40 and 50 percent by the phasing out of various tax allowances can be anticipated to respond to those rates in exactly the same manner as they would respond to a more straightforward

approach to progression.<sup>66</sup> As to those taxpayers, the phase-outs affecting moderate and high income taxpayers are plainly inconsistent with all of the varied purposes that underlie the enactment of the current nominal rate structure.

Even if disguised increases in the marginal tax rate produce a smaller aggregate loss in efficiency because less than all taxpayers are affected by the rate increases, this minor success must be balanced against the equity losses that this technique creates. On that subjective issue, opinions can be expected to vary. However, after weighing the evident unfairness imposed upon the large number of taxpayers whose marginal rates are inflated by the proliferation of phase-outs against the speculative efficiency gains of the 1986 legislation, most observers should agree that the taxing system has not been improved by the adoption of the artifice of the disappearing deduction.

### III. CONCLUSION

The adoption of the Internal Revenue Code of 1986 was a grand exercise in compromise and political expediency. Much that resulted may evolve into a major and permanent improvement in the taxing system. Much more, unfortunately, corrupted the fairness and principled rationality of the law. The phasing out of tax allowances was immediately perceived as unfair and has detracted from the popular acceptance of Congress' efforts.<sup>67</sup> This article argues here that these provisions are not only unfair but also technically unsound. The phasing out of tax allowances is an inappropriate technique that should be eliminated from the Code.

---

<sup>66</sup> See Hevener, *The Hidden Fifty Percent Marginal Rates of H.R. 3838*, 31 *Tax Notes* 1341 (June 30, 1986).

<sup>67</sup> See *id.*

# VIRGINIA TAX REVIEW

VOLUME 6, NUMBER 3

WINTER 1987

## MANAGING BOARD

### *Editor-in-Chief*

ROBERT W. SAUNDERS

### *Senior Executive Editor*

G. FRANK RILEY III

### *Executive Editors*

STUART C. JOHNSON

MICHAEL J. MAIMONE

M. DIANNE SULLIVAN

### *Articles Editors*

SUZANNE W. DOGGETT

TIMOTHY K. KULIK

### *Notes Editors*

JOEL M. McDONALD

SUSAN S. RESSEL

LAUREN JILL SLEPIN

### *Managing Editor*

J. JEFFREY TINKHAM

### *Research and Articles Development Editor*

KATHLEEN M. DELANEY

### *Projects and Production Editor*

LINDA A. HUTCHINSON

## SENIOR EDITORIAL BOARD

CANNON F. ALLEN

MICHAEL R. BENNETT

PHILIP M. COMERFORD, JR.

ELAINE R. JORDAN

MICHAEL J. KEANE

STEPHEN IAN MCINTOSH

CHARMAINE D. RUSSELL

CRAIG E. STEWART

CHARLES H. TENSER, III

## EDITORIAL BOARD

LUIS ALVAREZ, JR.

PETRA J. BRADBURY

ROBERT M. BUELL

CHRISTOPHER W. CLUBB

MARK W. DEGLER

SHARON A. DOCHERTY

J. BENJAMIN ENGLISH

RICHARD A. FORSTEN

MARIANNE GAVLAK

RICHARD A. GOLDMAN

STEPHEN K. GREENE

CATHY L. GRIMES

GEORGE A. HAGERTY

AMY C. HALLMAN

CARLA M. HAUNZ

GREGORY A. HAYES

WILLIAM D. JAMES

CATHERINE C. KENTON

FRANK R. MARVIN, JR.

MICHAEL R. O'DONNELL

PAMELA O'HANLON

PAUL R. PESCATELLO

PATRICK T. QUINN

SARAH J. ROBINSON

TODD R. SHINAMAN

TARA H. SNYDER

ROSS D. TAYLOR

JOSEPH W. WEIKEL

RUSSELL P. WILSON

---

---

*Published by Law Students of the University of Virginia*

---

---