Tax Policy Center
Urban Institute and Brookings Institution

PRELIMINARY ANALYSIS OF THE FAMILY FAIRNESS AND OPPORTUNITY TAX REFORM ACT

Len Burman, Elaine Maag, Georgia Ivsin, and Jeff Rohaly[1]
Urban-Brookings Tax Policy Center
March 4, 2014

On October 30, 2013, Senator Mike Lee (R-UT) introduced S.1616, The Family Fairness and Opportunity Tax Reform Act. The legislation would significantly expand tax benefits for children and repeal the individual and corporate alternative minimum taxes as well as the surtaxes on earnings and net investment income that were enacted as part of the Affordable Care Act. In order to partially offset the cost of these provisions, the plan would consolidate filing statuses and tax brackets and repeal all itemized deductions other than those for charitable contributions and home mortgage interest (which would be made more broadly available, but would apply to lower limits).

TPC estimates that the plan would reduce tax revenues by $2.4 trillion over the ten-year budget period, 2014-2023 (assuming a January 1, 2014 effective date).[2] In doing so, the plan would remove roughly 12 million tax units from the federal income tax rolls in 2014. It would be possible to modify the plan to achieve revenue-neutrality, but that would require applying the top tax rate at a substantially lower income level than proposed by Senator Lee, scaling back his proposed credits, or much more aggressive base broadening

[1] The authors thank Yuri Shadunsky for expert research assistance, and Kim Rueben, Jim Nunns, Roberton Williams, and Joanna Teitelbaum for their review and editing. Any remaining errors should be attributed to the authors.
[2] This estimate includes the effect of increasing refundable tax credits, which are technically scored as outlays (i.e., spending).

PRELIMINARY ANALYSIS OF THE FAMILY FAIRNESS AND OPPORTUNITY TAX REFORM ACT

SUMMARY OF PLAN ELEMENTS

1. **Consolidate Tax Brackets and Filing Statuses; Retain Current-Law Tax Schedule for Long-Term Capital Gains and Qualified Dividends; Repeal Alternative Minimum Tax**

The proposal would reduce the number of income tax rates from the current six, which range from 10 percent to 39.6 percent, to two rates of 15 percent and 35 percent (Table 1). Most taxpayers would be in the 15 percent rate bracket. The bracket thresholds would be indexed for inflation after 2013. The legislation would also consolidate the single, head of household, and married filing separately filing statuses into one filing status.

Table 1. Tax Bracket Thresholds (in Dollars of Taxable Income) under Current Law and the Lee Proposal, 2013

Current Law					Lee Proposal		
	Filing Status					Filing Status	
Marginal Rate (Percent)	Married Filing Joint	Single	Head of House-hold	Married Filing Separate	Marginal Rate (Percent)	Married Filing Joint	All Other
10	0	0	0	0	15	0	0
15	17,850	8,925	12,750	8,925	35	175,700	87,850
25	72,500	36,250	48,600	36,250			
28	146,400	87,850	125,450	73,200			
33	223,050	183,250	203,150	111,525			
35	398,350	398,350	398,350	199,175			
39.60	450,000	400,000	425,000	225,000			

Note: All tax bracket thresholds are indexed for inflation.

The Lee proposal would continue the practice of taxing long-term capital gains and qualified dividends at lower rates than apply to ordinary income. The proposal would retain the current law rates and rate brackets for long-term capital gains and dividends, even though the definition of taxable income and the rates and brackets that apply to ordinary income would be changed.

Senator Lee's proposal would repeal the individual alternative minimum tax (AMT) as well as the somewhat similar corporate AMT. The individual AMT is a parallel tax system with its own rate schedule that applies to a broader measure of incomes, which adds certain "preference items" to taxable income and applies a fairly large AMT exemption.[3] Although originally intended as a bulwark against tax avoidance by high-income people, the largest AMT preferences are mundane items such as personal exemptions, the standard deduction, state and local tax deductions, and miscellaneous itemized deductions. Large families and people living in high tax states are most likely to pay the AMT. People with incomes between $100,000 and $500,000 are much more likely to be subject to the AMT than millionaires. The AMT is complex and confusing and virtually all tax reform proposals would eliminate it.

2. **Replace the Standard Deduction and Personal Exemptions for Taxpayers and Spouses with a New Credit; Repeal Most Itemized Deductions and Further Limit the Mortgage Interest Deduction**

Senator Lee would replace non-dependent personal exemptions, the standard deduction, and most itemized deductions with a personal nonrefundable credit. Under current law, taxpayers may choose to itemize their deductions or claim the standard deduction. About two-thirds of taxpayers elect the standard deduction because it is larger than their itemizable deductions. The standard deduction varies by filing status, and elderly and blind taxpayers may claim extra deductions. For 2013, the standard deduction is $12,200 for married couples filing joint returns, $6,100 for singles and married couples filing separately returns, and $8,950 for heads of household. The additional standard deduction is $1,500 per elderly or blind taxpayer for single and head of household returns and $1,200 for joint returns. All of these values are indexed for inflation.

Senator Lee's plan would repeal the standard deduction and eliminate itemization. All taxpayers could deduct charitable contributions and home mortgage interest (subject to lowered limits). Other itemized deductions such as the deduction for state and local taxes would be repealed.

Under current law, taxpayers may deduct interest attributable to the first $1 million of mortgage debt used to buy, build, or improve a home.[4] Senator Lee's plan would reduce this cap to $300,000 for mortgages entered into after December 31, 2013. The proposal would continue to allow deductibility of interest on second mortgages and home equity lines of credit up to $100,000. Neither limit would be indexed for inflation.

---

[3] For 2013, the exemption is $80,800 for married couples filing jointly and $51,900 for singles. For more on the AMT, see Lim, Katherine and Jeffrey Rohaly. 2009. "The Individual Alternative Minimum Tax: Historical Data and Projections, Updated October 2009", Urban-Brookings Tax Policy Center; Washington, DC. October. See http://www.taxpolicycenter.org/taxtopics/AMT_tables_2013.cfm for TPC's latest AMT projections.

[4] The $1 million limit applies to "acquisition" indebtedness (debt used to buy, build, or improve a home). There is a separate $100,000 limit on second mortgages or home equity lines of credit. Courts have ruled that these limits may be combined. Interest on mortgages and home equity lines used for purposes other than to buy, build, or improve the home, however, is a preference item (i.e., disallowed) under the AMT.

Under current law, taxpayers may claim a personal exemption for themselves (couples filing jointly receive two personal exemptions) and each of their dependents. The personal exemption amount is $3,900 for 2013 and is indexed annually for inflation. Senator Lee's plan would repeal the personal exemption for the taxpayer and spouse but would retain dependent exemptions.

In place of the standard deduction and personal exemptions for taxpayers and spouses, Senator Lee's proposal would create a personal nonrefundable credit of $2,000 for singles and $4,000 for married couples filing a joint return.[5] The credit amounts would be indexed for inflation.

Under current law, the personal exemption phase-out (PEP) reduces the deduction for personal exemptions by 2 percent for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income (AGI) exceeds a threshold. The limitation on itemized deductions ("Pease") reduces the value of certain itemized deductions by 3 percent of the amount by which AGI exceeds the same threshold.[6] For 2013, the threshold is $300,000 for married couples filing a joint return, $250,000 for singles, and $275,000 for heads of household. The threshold amounts are indexed annually for inflation. Senator Lee's proposal retains these, and they apply to the retained personal exemptions and itemized deductions.[7]

3. Provide an Additional Child Tax Credit of up to $2,500 per Child

Under current law, a taxpayer may claim a child tax credit (CTC) of $1,000 per eligible child under the age of 17. The credit phases out by $50 for every $1,000 by which the taxpayer's adjusted gross income (AGI) exceeds $75,000 ($110,000 for married couples filing a joint return). The credit is refundable up to 15 percent of the amount by which earnings exceed $3,000. Neither the thresholds nor the $1,000 per-child amount is indexed for inflation.[8]

Senator Lee's proposal would create an "additional refundable credit" of $2,500 for each child who meets the eligibility requirements under current law. The $2,500 increase in the CTC would be refundable, but only up to the amount by which the taxpayer's individual income tax plus payroll taxes (including the portion assessed on employers) exceeds her earned income tax credit.[9] The $2,500 amount would be indexed after 2013 by the growth rate of the national average wage index. Unlike the current CTC, the additional $2,500 CTC amount would not phase out for high-income taxpayers.

---

[5] Any filer who is claimed as a qualifying child for the child tax credit (generally children under the age of 17) would not be allowed to claim this new personal credit.

[6] Pease does not apply to the itemized deductions for medical expenses, investment interest, and casualty and theft losses. The total reduction cannot exceed 80 percent of the value of itemized deductions. Pease does not apply for alternative minimum tax purposes.

[7] The legislation appears to retain the $275,000 threshold for heads of household, which may be a drafting error given that the proposal repeals differential treatment of single parents elsewhere in the tax code.

[8] Absent Congressional action, in 2018, the earnings threshold will revert to $10,000 (indexed for inflation after 2001).

[9] This would include both the employer and employee portions of payroll tax. The maximum refundable portion of the new credit would therefore equal 15.3 percent of earnings minus the refundable portion of the EITC.

For taxpayers with sufficient income and payroll tax liability, the augmented CTC would total $3,500 per qualifying child. Taxpayers who currently receive no or a reduced CTC because their incomes exceed the phase-out threshold could still receive the full $2,500 augmented CTC.

4. Repeal Affordable Care Act Surtaxes

The Affordable Care Act (ACA) imposed (1) an Additional Hospital Insurance Tax of 0.9 percent on earnings in excess of $250,000 for married couples ($200,000 for singles) and (2) an Unearned Income Medicare Contribution of 3.8 percent on the minimum of AGI in excess of $250,000 for married couples ($200,000 for singles) and net investment income. Net investment income includes interest, dividends, capital gains, rents, royalties, and certain forms of passive income from partnerships and S-corporations. The high-income thresholds for both surtaxes are not indexed for inflation.

Senator Lee's plan would repeal both of these surtaxes.

ANALYSIS

The Lee proposal represents a new approach to tax reform. Like most reform plans it would broaden the tax base, but rather than use the proceeds to cut marginal tax rates, it would provide new tax credits aimed at families. Because the base broadening is relatively modest and the new family tax credits are large, the plan would add substantially to the deficit. Most households would face lower taxes, but 12 percent would actually pay more. High-income households—particularly married couples with children—would benefit most from the plan.

Many taxpayers would face higher marginal tax rates (the tax rate on the last dollar of income) under the proposal than under current law. Although the plan contains some significant simplifications, such as the repeal of the AMT and many itemized deductions, it also introduces some new complexities, especially for low-income households.

Effect on Revenues

Senator Lee's proposal would reduce federal income tax revenues by about $2.4 trillion over the next ten years (assuming a January 1, 2014 effective date; see Table 2). The $2,000 credit for singles and $4,000 credit for couples would reduce tax revenue by almost $4 trillion over ten years. The $2,500 increase in the child tax credit, which has limited refundability and no income limit, would cost about $1.6 trillion. And the new rate structure and repealing the AMT and ACA surtaxes would reduce revenues by $1.5 trillion. The proposal would partially offset these revenue losses by eliminating the 10 percent bracket, raising marginal rates from 28 percent to 35 percent on most income currently taxed at 28 percent, and taxing all income currently taxed at 33 percent at a 35-percent rate. Repealing head-of-household status would also help reduce revenue losses. The largest offsets, however, would come from repealing personal exemptions for taxpayers and spouses and the standard deductions, and repealing or further limiting itemized deductions; in combination, these changes would boost revenues by $4.6 trillion over ten years.

There already is concern among some critics of the federal income tax system that too few people owe federal income taxes. Senator Lee's plan defies that criticism: it would move an additional 12 million tax units off the federal income tax rolls.

Table 2. Revenue Effects of Lee Proposal (billions of current dollars), 2014-2023

Provision	Fiscal Year						Total
	2014	2015	2016	2017	2018	2019-23	2014-23
1. New rate structure and filing statuses	-14.0	-23.7	-32.9	-42.0	-49.3	-339.4	-501.3
2. Repeal the individual and corporate AMTs	-42.6	-62.3	-68.4	-74.5	-79.8	-442.4	-770.1
3. Repeal ACA surtaxes	-8.6	-11.9	-21.5	-26.9	-29.5	-185.6	-284.0
4. Repeal personal exemption for taxpayer and spouse, standard deduction, and most itemized deductions. Further limit mortgage interest deduction.	278.1	385.6	409.3	434.7	457.0	2,653.6	4,618.5
5. $2,500 increase in child tax credit, with limited refundability and no income limit	-94.1	-130.5	-138.3	-146.4	-155.3	-911.7	-1,576.4
6. Personal credit of $2,000 for single filers and $4,000 for joint filers	-256.7	-353.0	-367.2	-381.3	-391.6	-2,180.9	-3,930.6
Total for all provisions	**-137.8**	**-195.7**	**-219.0**	**-236.5**	**-248.5**	**-1,406.3**	**-2,443.8**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-2)
Notes: Credit amounts would be indexed for inflation after 2013. Revenue estimates include the effects of microdynamic behavioral responses. Proposal is effective for taxable years beginning after 12/31/13. Revenue estimates assume a fiscal split of 75-25 (fiscal year revenue is estimated to be 25 percent of revenue from the previous calendar year and 75 percent of revenue from the current calendar year). The actual effect on receipts could differ.

The Lee proposal could maintain its general framework and become revenue neutral if its statutory tax rates were raised, the tax credits were scaled back, or the tax base were broadened more aggressively. For example, the Tax Policy Center estimates that the proposal would be approximately revenue neutral if the 35 percent tax bracket started at a taxable income of $50,000 for singles and $100,000 for married filers – substantially lower than the proposed $87,850 for singles and $175,500 for married filers. While this modification would prevent the proposal from adding to the deficit, many more taxpayers would face higher marginal tax rates and would have tax increases relative to current law.

Distribution of Tax Change

Most households (62 percent) would pay lower taxes under the Lee proposal. The average tax cut in 2015 would be a little over $1,500 or 2.1 percent of income (Table 3). The big winners would be families with children, who would benefit from the large increase in the child tax credit and repeal of the AMT, which disproportionately hits upper-middle income families with children.[10] Nearly three-quarters of married taxpayers would get a tax cut, primarily due to reductions in marginal tax rates for many couples, and, for couples with children, the large increase in the child tax credit. More than 80 percent of households in the top two quintiles would get a tax cut, primarily from the repeal of the AMT and the larger child tax credit in the fourth quintile, and the cut in the top marginal tax rate and repeal of ACA surtaxes at the top (Figure 1). In contrast, almost three-quarters of households in the lowest quintile would see no change in tax because they don't have enough income to benefit from the new tax credits.

[10] Lim and Rohaly, 2009.

Table 3 . Average Tax Change Under Lee Proposal by Income and Demographic Group, 2015

Expanded Cash Income Percentile	Dollars					
	Joint	HOH	Single	With Children	Elderly	All
Lowest Quintile	-218	-138	-58	-152	-6	-79
Second Quintile	-1,501	-899	-105	-1,749	-31	-338
Middle Quintile	-2,388	-1,493	-98	-3,509	-89	-1,114
Fourth Quintile	-2,351	-1,095	-537	-3,856	-101	-2,214
Top Quintile	-6,070	429	-1,257	-7,968	-3,130	-5,903
All	-3,244	-734	-287	-3,262	-567	-1,520
Addendum						
80-90	-3,058	-348	-1,906	-5,111	-1,051	-3,276
90-95	-5,617	2,491	-1,262	-7,587	-2,324	-5,250
95-99	-5,140	5,315	3,112	-6,183	-1,825	-4,560
Top 1 Percent	-39,936	-21,458	-12,111	-46,398	-30,283	-40,121
Top 0.1 Percent	-237,932	-218,042	-131,919	-277,490	-164,729	-239,992

	Percentage of After-Tax Income					
	Joint	HOH	Single	With Children	Elderly	All
Lowest Quintile	1.1	0.7	0.6	0.7	0.0	0.5
Second Quintile	3.6	2.4	0.5	4.0	0.1	1.0
Middle Quintile	3.6	2.7	0.3	5.1	0.2	2.0
Fourth Quintile	2.4	1.4	1.0	3.6	0.1	2.4
Top Quintile	2.5	-0.3	1.0	3.0	1.6	2.4
All	2.7	1.6	0.7	3.4	0.9	2.1
Addendum						
80-90	2.3	0.3	2.4	3.4	1.0	2.5
90-95	3.1	-1.8	1.2	3.6	1.6	2.9
95-99	1.8	-2.4	-1.8	1.9	0.8	1.6
Top 1 Percent	3.0	1.9	1.5	3.0	2.7	2.8
Top 0.1 Percent	4.0	4.0	3.4	4.0	3.3	3.8

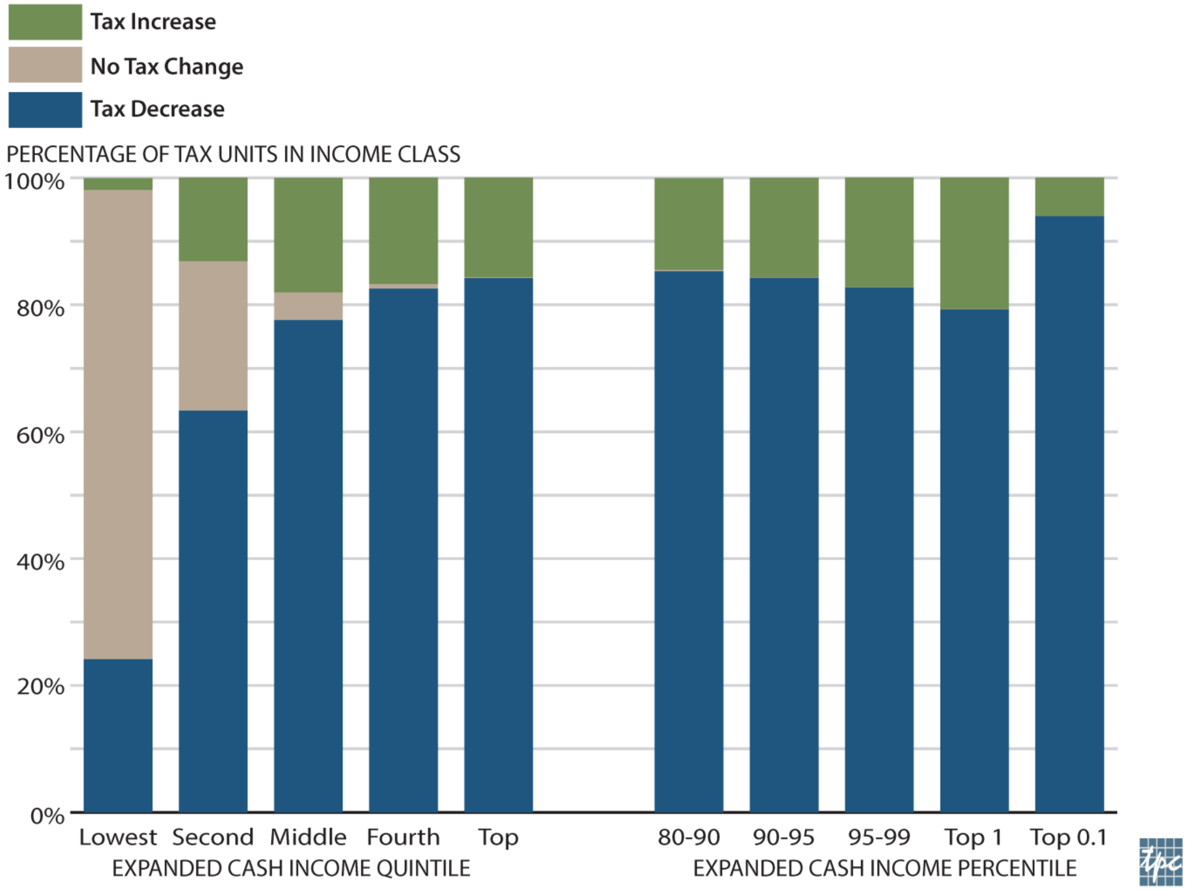
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-2)

Note: Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see

http://www.taxpolicycenter.org/TaxModel/income.cfm

FIGURE 1

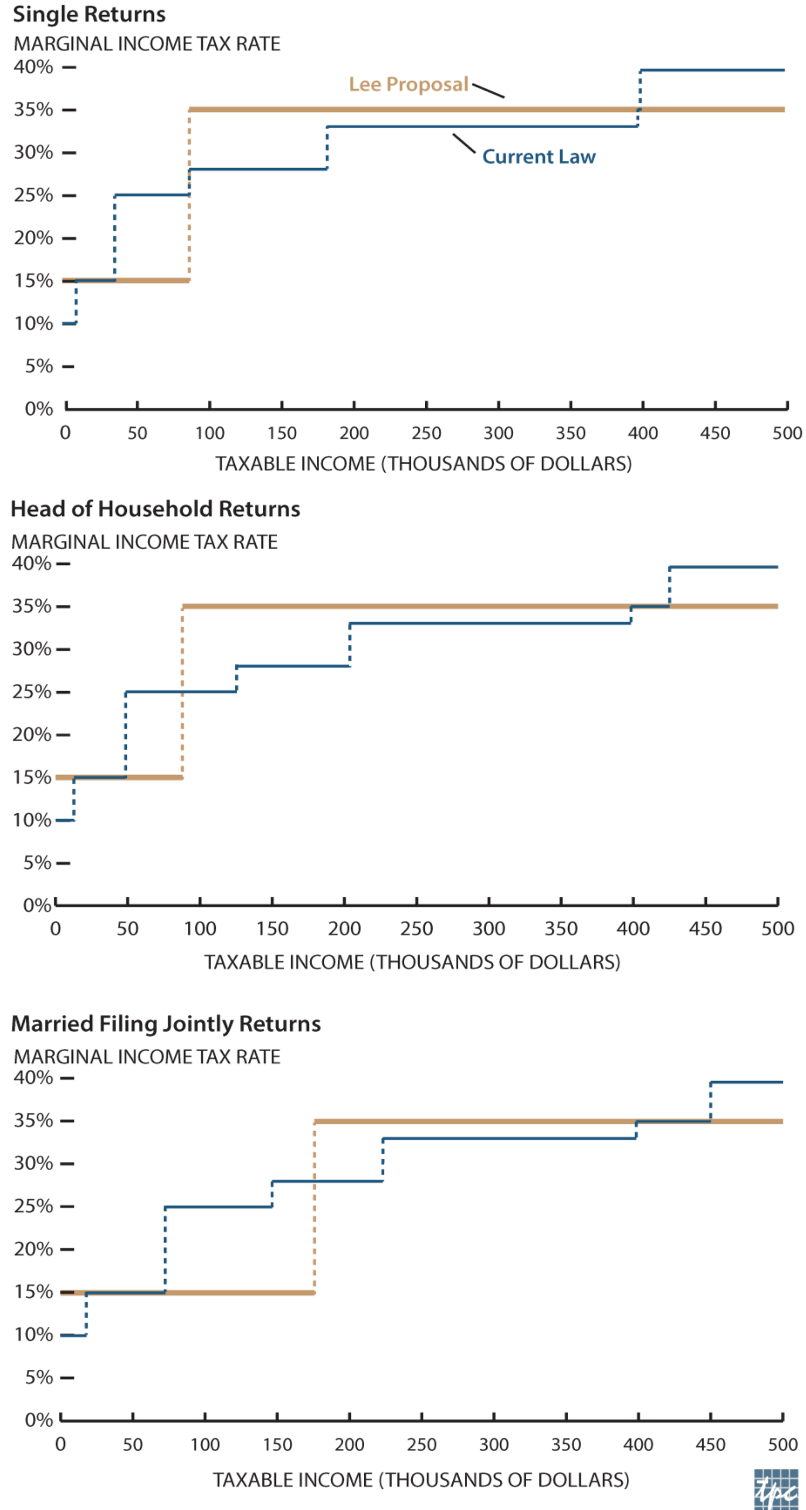
Percentage of Tax Units with Tax Increase and Tax Decrease Under the Lee Proposal
by Expanded Cash Income Percentile, 2015



About one in eight tax units would pay higher taxes. Taxpayers who live in high-tax states are disproportionately affected by the elimination of the deduction for state and local taxes. Because the proposal would eliminate the head of household filing status, many single-parent families would find themselves in higher tax brackets (Figure 2), and they would lose other benefits provided by current law. Overall, nearly one-quarter of heads of household would pay higher taxes under the proposal. Although more than 40 percent of elderly taxpayers would see their taxes fall under the plan, nearly one in five would face a tax hike.[11] Few elderly taxpayers would benefit from the increase in the child tax credit, and many would be hurt by the repeal of the additional standard deduction for the elderly and the deduction for medical and dental expenses (which is used primarily by the elderly).

FIGURE 2

Marginal Income Tax Rate Under Current Law and the Lee Proposal by Filing Status, 2013



[11] We define an elderly household as one in which either the primary taxpayer or spouse (if applicable) is age 65 or over.

Notably, taxable income (shown in Figure 2) differs between current law and Senator Lee's proposal. Under current law, taxable income is defined as adjusted gross income minus standard or itemized deductions and personal exemptions. The repeal of the standard deduction, most itemized deductions, and personal exemptions for taxpayers and spouses means that more income will be taxable. The proposed personal credit for taxpayers and spouses will offset some of the taxes owed by being taxed at higher rates. For example, a single parent with two children and earnings of $20,650 would have no taxable income under current law. Under Senator Lee's proposal, this family would have taxable income of $12,850 and would owe $1,927 in tax on those earnings. That amount would be offset entirely by the $2,000 personal credit afforded this family.

Economic Effects

The proposal could affect the economy in various ways. It would affect economic incentives by lowering marginal tax rates on average, although some groups would face higher rates. It would also change some other incentives; most notably, it would lower the costs of having children for middle- and upper-income households.

And it would substantially add to the deficit, which could create a drag on the economy and might entail significant economic costs if it results in much higher tax rates in the future.

Marginal tax rates. Similar to many other reform plans, the Lee proposal would reduce the top statutory marginal tax rate and repeal the surtaxes imposed by the ACA, both of which would significantly cut tax rates for those with very high incomes. But the plan would also eliminate the bottom 10 percent tax bracket, which would raise effective marginal tax rates on some low-income households. Moreover, by setting the top marginal rate at 35 percent, Senator Lee's plan would retain a higher top tax rate than many other reform plans. And the plan would not change the statutory tax rates on long-term capital gains and qualified dividends, although repeal of the ACA surtaxes would cut marginal rates on capital income for high-income taxpayers.

On balance, the plan would cut average effective marginal tax rates by about 4 percentage points on wages, 3 percentage points on long-term capital gains, and 2 percentage points on qualified dividends and interest (Table 4.) Taxpayers with moderately high incomes—those in the 80th to 95th percentiles—would see their effective tax rates on wages fall by between 5 percentage points to 6 percentage points. This results primarily from expanding the 15 percent bracket and repealing the AMT (which can impose quite high effective tax rates). However, rates on capital gains and dividends would rise for taxpayers in the 80th to 90th percentile: the taxable income brackets for the special rates on this income would be based on current law, but taxable income would be higher under the Lee proposal because it would repeal non-dependent personal exemptions and most itemized deductions and would further limit the mortgage interest deduction.

Table 4. Average Effective Marginal Tax Rates under Current Law and the Lee Proposal by Expanded Cash Income Percentile, 2015

Expanded Cash Income Percentile	Tax Units (thousands)	Wages and Salaries		Long-term Capital Gains		Qualified Dividends		Interest Income	
		Current Law	Proposal	Current Law	Proposal	Current Law	Proposal	Current Law	Proposal
Lowest Quintile	43,476	2.8	1.7	0.8	0.8	1.3	0.5	2.6	2.4
Second Quintile	36,374	15.7	11.9	1.2	1.3	1.8	1.9	9.1	9.6
Third Quintile	32,412	19.3	14.6	5.0	7.6	7.5	12.0	18.6	17.1
Fourth Quintile	26,575	19.4	16.5	8.4	10.2	10.1	13.1	21.0	19.1
Top Quintile	23,244	30.4	26.8	22.1	18.3	21.9	18.2	33.2	30.1
All	163,798	23.7	20.2	20.4	17.1	18.9	16.5	24.5	22.3
Addendum									
80-90	11,605	24.4	19.1	11.9	12.7	12.7	14.3	23.7	20.6
90-95	5,784	27.1	20.9	15.3	13.7	15.2	14.7	26.9	23.7
95-99	4,669	32.3	33.3	20.5	15.0	21.5	15.5	33.9	30.5
Top 1 Percent	1,185	39.1	35.2	23.5	19.6	24.2	20.2	36.7	33.6
Top 0.1 Percent	121	40.3	35.1	23.8	19.9	24.3	20.3	36.4	33.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-2)
(1) Calendar year. A tax unit's effective marginal individual income tax rate is calculated by adding $1,000 to the income source and then dividing the resulting tax change by $1,000. The averages are calculated by weighting by the initial value by the appropriate income source.

Charitable giving. The proposal would allow all taxpayers to claim charitable deductions—that is, taxpayers would no longer have to itemize deductions to benefit—which might boost charitable giving somewhat.[12] High-income taxpayers would face a decreased incentive to donate due to lower marginal tax rates, offset by higher after-tax incomes under the proposal. Overall, the amount of giving is unlikely to change much. Making the deduction more widely available would benefit many of the two-thirds of households who currently claim the standard deduction, most of whom have relatively modest incomes. The overall amount of giving, however, is unlikely to increase much because most of the total amount donated comes from high–income taxpayers who already itemize deductions.

Housing. The tighter cap on mortgage interest deductions might affect the amount that higher-income households are willing to spend on housing, which could put some downward pressure on home prices, although this is likely to be modest.[13] It also would likely result in somewhat less borrowing, because taxpayers with sufficient financial assets would have an incentive to use

[12] Colinvaux, Roger, Brian Galle, and Eugene Steuerle. 2012. "Evaluating the Charitable Deduction and Proposed Reforms", Tax Policy and Charities, Urban Institute. Washington, DC. June. http://www.urban.org//UploadedPDF/412586-Evaluating-the-Charitable-Deduction-and-Proposed-Reforms.pdf

[13] Capozza, Dennis, Richard Green, and Patric Hendershott. 1997. "Taxes and House Prices", The Charles A. Dice Center Working Paper Series 97-16. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=48961

more of them for a down payment to avoid the mortgage interest limit. Homeownership costs would be cut modestly for low- and moderate-income households who get little or no benefit from the current itemized deduction, either because they do not itemize deductions or save little by itemizing because their deductions barely exceed the standard deduction.

State and local governments. The proposed repeal of the deduction for state and local taxes could affect the design of overall state and local tax systems. Taxpayers who itemize their state and local taxes pay less than a dollar for a dollar in state taxes, and state and local governments have an incentive to design their tax systems to take advantage of this fact. Because the deduction is worth more to high-income taxpayers (who are also more likely to itemize), the incentive to state and local governments favors a more progressive tax system. And because the deduction is allowed for state and local income taxes or sales taxes, but not both, there is an incentive to raise taxes using either an income or a sales tax, but not both. Empirical studies have shown that the federal deduction for state and local taxes exerts a substantial influence on subnational progressivity,[14] and a significant and large effect on the use of deductible taxes at the state and local level.[15]

The Lee proposal would also affect the specific design of state and local income taxes, most of which "piggyback" on the design of the federal income tax. The proposed federal reforms could affect revenues, the distribution of tax burdens, and incentive effects of state and local income taxes absent legislative action in jurisdictions that piggyback.

Cost of earning income. Some of the itemized deductions that the Lee proposal would repeal, such as the deductions for employee business expenses and investment interest, represent the costs of earning income. Repealing these deductions would increase the cost of earning related income, which could discourage certain activities.

Child bearing. The proposed $2,500 boost in the child tax credit would significantly increase the economic incentive to have children. Past research has shown that the availability of a personal exemption for children significantly increases fertility, and has even more important effects on the timing of child birth (children are more likely to be born on December 31 than January 1).[16] The $2,500 increase in the child tax credit would be worth more than four times as much as the personal exemption for a taxpayer in the 15-percent tax bracket, so adoption of the proposal might lead to more births.

---

[14] *See, e.g.*, Howard Chernick, *On the Determinants of Subnational Tax Progressivity in the U.S.*, 58 NAT'L TAX JOURNAL 93 (2005).

[15] See Gilbert Metcalf, *Assessing the Federal Deduction for State and Local Tax Payments,* National Tax Journal, June 2011, 64 (2, part 2) , 565-590.

[16] Whittington, Leslie A. "Taxes and the Family: the Impact of the Tax Exemption for Dependents on Marital Fertility." *Demography* 29, no. 2 (1992): 215-226.

Economy. The net effect of the proposal on the economy is ambiguous because the tax rate cuts would be financed by borrowing. If the deficits would ultimately be offset by higher future taxes, the economy could be weaker than it would be absent the short-term tax cuts. If large deficits ultimately led to a debt crisis, that could produce an economic downturn with significant economic costs.

Complexity

The Lee proposal would simplify the tax system for many households, but would also make an already complex system worse for lower-income families with children. The major simplification would be the repeal of most itemized deductions, although more people would have to keep track of charitable contributions and mortgage interest if they wanted to take advantage of those deductions. Repeal of the AMT would also simplify tax preparation for about 4 million households in 2014. Oddly, the proposal would retain the complex phaseouts of both personal exemptions and itemized deductions. And by using a refundability formula for the $2,500 increase in the child tax credit that differs from the retained formula for the current $1,000 child tax credit, the proposal would make already confusing rules even more difficult to comply with.

Effect on Families with Children

The $2,500 increase in the child tax credit included in the Lee proposal would benefit families with children under age 17. Two-thirds of families with children would receive a tax cut, but nearly 11 percent of families with children would pay more tax. Among families in the lowest income quintile, taxes would rise only for those with no children under age 17. Taxes would rise for these families because they would lose the benefit of the head of household filing status and the 10 percent bracket, which would more than offset the benefit of the new $2,000 personal credit that would replace the standard deduction and personal exemptions for taxpayers and spouses. For example, a single parent with $20,000 of earnings and one child over age 17 would have $2,250 in taxable income and owe $225 before credits under the current tax system. Under the Lee proposal, this family would have $15,100 in taxable income, tax liability before credits of $2,265, and after the personal credit of $2,000 is subtracted, would owe $265, a net increase of $40. (This family would receive the same EITC under current law and the Lee proposal.)

Because the proposal would have no income limit on the additional CTC, it would provide a substantial tax subsidy for children in high-income families that currently cannot claim the full CTC. Families with children under 17 who have income above the phase-outs for the current $1,000 CTC ($75,000 for single parents and $110,000 for married parents) lose some or all of the current CTC but would qualify for the full $2,500 increase in the CTC.

Single parents would be among the groups of taxpayers most likely to owe more tax under Senator Lee's proposal, primarily because they could no longer claim head of household filing status. TPC estimates that 24 percent of all single parents would see their taxes rise while 45 percent would see their taxes drop. Single parents in the 90th-99th percentile would have an average tax increase, the result of having more income taxed at higher rates.

Moving Forward

Tax benefits for families with children are significant under current law.[17] But unlike in Senator Lee's proposal, the benefits go largely to lower-income families. TPC estimates that families with children in the bottom two quintiles received 54 percent of all tax benefits related to children in 2013. Families in the highest income quintile received just 9 percent.[18] By not phasing out the new refundable child benefit, Lee's proposal would make the total benefits for families with children less progressive.

Conclusion

Senator Lee's Family Fairness and Opportunity Tax Reform Act proposes far-ranging tax reform that would repeal both the individual and corporate alternative minimum taxes and the surtaxes on earnings and net investment income that were part of the Affordable Care Act. The plan would also significantly increase the child tax credit and make the increased amount available to families at much higher incomes than the current credit. In order to partially offset the cost of these parts of the proposal, Senator Lee would consolidate filing statuses and tax brackets, repeal all itemized deductions other than those for charitable contributions and home mortgage interest, and further limit the mortgage interest deduction. TPC estimates that if it were enacted in 2014, the plan would reduce tax revenues by $2.4 trillion over the next ten years. In order to bring the plan closer to revenue neutrality and keep the proposal basically the same, the bracket for the top rate proposed by Lee (35 percent, compared to 39.6 percent under current law) would need to start at $50,000 for single filers and $100,000 for joint filers, rather than at $87,850 for single filers and $175,000 for joint filers as proposed by Senator Lee. Revenue neutrality could also be achieved by scaling back the child benefits in the plan or broadening the tax base more than the proposal currently does.

[17] Maag, Elaine. 2013. "Child Related Benefits in the Federal Income Tax". Low Income Working Families, Brief #27. The Urban Institute, Washington, DC. December.
[18] Maag, 2013.