Q. How do phaseouts of tax provisions affect taxpayers?

A. Many preferences in the tax code phase out for high-income taxpayers—their value falls as income rises. Phaseouts narrow the focus of tax benefits to low- and middle-income households while limiting revenue costs, but raise marginal tax rates for affected taxpayers.

Many preferences in the tax code phase out for higher-income taxpayers, meaning their value declines after income reaches a certain level. Phaseouts target tax benefits on middle- and lower-income households and limit the loss of revenue. Phaseouts, however, not only claw back benefits from the more affluent, but also increase the effective marginal tax rate these taxpayers face, decreasing the after-tax gains of earning more income.

Some taxpayers are affected by multiple tax provisions phasing out at the same time, compounding the negative impact on their earning incentives. More broadly, phaseouts complicate the tax code and make taxes more difficult to understand.

HOW DO PHASEOUTS WORK?

Phaseouts are structured in different ways and thus have different effects. Some reduce credits and thus have the same impact on all affected taxpayers. Others reduce deductions, in which case their dollar impact depends on the taxpayer's marginal tax rate: the higher the tax rate, the greater the value of the lost deduction.

Phaseouts reduce tax benefits at different rates depending on their structure and range. Most phaseouts reduce benefits at a constant rate over an income range; that rate depends on the width of the range. For example, for single tax filers, the American Opportunity Tax Credit phases out evenly over a $10,000 range, so the maximum $2,500 credit phases out at a 25 percent rate ($25 per $100 of income above the phaseout thresholds). In contrast, the adoption credit phases out over a $40,000 range, so the maximum $13,840 credit phases out at nearly a 35 percent rate ($34.6 per $100 of income above the threshold).

Some phaseouts, however, reduce benefits by a specified amount for each fixed increment of income. For example, the child tax credit decreases by $50 for every $1,000 or part of $1,000 in additional income above the phaseout threshold. Whether income exceeds the threshold by $1 or by $999, the credit falls by the same $50, so earning a few more dollars could make a taxpayer worse off.

Some phaseouts have more pronounced cliffs, so the benefit drops in large increments when income exceeds the threshold. For example, in 2018, the limit on the deduction for higher education tuition and fees drops

from $4,000 to $2,000 for a single tax filer whose income exceeds $65,000 by even $1. Then the limit drops to zero for filers whose income tops $80,000. Again, just a few dollars of additional income could leave a taxpayer whose income is near the cliff much worse off.

Many phaseouts are indexed for inflation so that the phaseout ranges remain fixed in real terms. Phaseouts that are not adjusted for inflation affect more taxpayers over time, as inflation raises nominal incomes and thus lifts more taxpayers above the phaseout thresholds.

In addition to phaseouts, the tax code also contains phase-ins. For example, a portion of Social Security benefits becomes taxable only when a taxpayer's income reaches certain thresholds, and the taxable portion increases (up to a maximum of 85 percent) as the amount by which income exceeds those thresholds increases.

TABLE 1.1

Family Benefits

Selected phase-ins and phaseouts in 2018 individual income tax code

Description	Effect on marginal tax rate	Filing status	Phaseout begins	Phaseout ends
Earned Income Tax Credit (EITC)[a]				
Credit phases in from first dollar of earnings; phase-in and phaseout rates vary with number of children.	Decreases by credit percentage during phase-in; increases at phaseout.	Single/HoH		
		No children	8,490	15,270
		One child	18,660	40,320
		Two children	18,660	45,802
		Three or more children	18,660	49,194
		MFJ		
		No children	14,200	20,950
		One child	24,350	46,010
		Two children	24,350	51,492
		Three or more children	24,350	54,884
		MFS	Credit not allowed	
Child Tax Credit (CTC)				
$2,000 credit for each qualifying citizen child; $500 credit for each other dependent.	Increases by 5 percentage points throughout phaseout range.	Single/HoH	$200,000	N/A
		MFJ	$400,000	N/A
		MFS	$200,000	N/A
Child and Dependent Care Credit				
Credit of up to $3,000 for each of up to two children; rate falls from 35% to 20% at rate of 1% for each $2,000 of income above threshold.	Increases by up to 3 percentage points, depending on number of children and spending on child care.	Single/HoH	$15,000	$43,000
		MFJ	$15,000	$43,000
		MFS	Credit not allowed	

Source: Various publications from Urban-Brookings Tax Policy Center; Congressional Research Service (2018); Internal Revenue Service (2018); Social Security Administration (2018); and Young (2007).

HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; N/A = not applicable

a) indexed for inflation.

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

WHERE ARE PHASEOUTS MOST COMMON?

Phaseouts are most common in three areas of the tax code: family benefits, education provisions, and retirement savings provisions (table 1). The beginning and ending points of the phaseout range determine who is eligible for these credits or deductions. For example, the earned income tax credit (EITC) begins to phase out at income of $18,660 for single parents and at $24,350 for married couples with children, limiting EITC eligibility to low-income families. In contrast, the child tax credit (CTC) begins to phase out at income of $200,000 for single parents and at $400,000 for married couples with children, extending CTC eligibility to high-income families.

TABLE 1.2

Education Provisions

Selected phase-ins and phaseouts in 2018 individual income tax code

Description	Effect on marginal tax rate	Filing status	Phaseout begins	Phaseout ends
American Opportunity Tax Credit (AOTC)[a]				
Credit of 100% of first $2,000 and 25% of next $2,000 of eligible expenses, up to $2,500; cannot take both AOTC and LLC.	Increases by up to 25 percentage points (12.5 for MFJ), depending on expenses.	Single/HoH	$80,000	$90,000
		MFJ	$160,000	$180,000
		MFS	Credit not allowed	
Lifetime Learning Credit (LLC)[a]				
Credit of 20% of eligible expenses up to $10,000; cannot take both AOTC and LLC.	Increases by up to 20 percentage points (10 for MFJ), depending on expenses.	Single/HoH	$57,000	$67,000
		MFJ	$114,000	$134,000
		MFS	Credit not allowed	
Education tuition and fees deduction				
Maximum deduction of $4,000 below lower threshold; $2,000 between thresholds; zero above upper threshold.	Large discrete increases at each threshold income value.	Single/HoH	$65,000	$80,000
		MFJ	$130,000	$160,000
		MFS	Deduction not allowed	
Coverdell Education Savings Accounts				
Maximum contribution of $2,000, reduced evenly over phaseout range.	No effect on current tax rate, but increases if withdrawn funds not used for educational purposes or exceed qualified expenses.	Single/HoH	$95,000	$110,000
		MFJ	$190,000	$120,000
		MFS	$95,000	$110,000
Student loan interest deduction[a]				
Up to $2,500 of student loan interest deductible.	Increases by up to 16.7 percentage points (8.3 for MFJ) of statutory tax rate.	Single/HoH	$65,000	$80,000
		MFJ	$135,000	$165,000
		MFS	Credit not allowed	
Education Savings Bonds Program[a]				
Interest on savings bonds tax-free if used for higher education.	Depends on amount of interest on redeemed bonds and statutory tax rate.	Single/HoH	$79,700	$94,700
		MFJ	$119,550	$149,550
		MFS	Credit not allowed	

Source: Various publications from Urban-Brookings Tax Policy Center; Congressional Research Service (2018); Internal Revenue Service (2018); Social Security Administration (2018); and Young (2018).

HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; N/A = not applicable

a) indexed for inflation.

TABLE 1.3

Retirement Provisions

Selected phase-ins and phaseouts in 2018 individual income tax code

Description	Effect on marginal tax rate	Filing status	Phaseout begins	Phaseout ends
Saver's Credit[a]				
Credit of up to $2,000 per taxpayer; credit rate falls in steps from 50% to 0%.	No effect on current tax rate, but increases when funds are withdrawn.	Single/MFS	$19,000	$31,500
		MFJ	$38,000	$63,000
		HoH	$28,500	$47,250
Roth IRA Contribution Limits				
Maximum $5,500 for all IRAs.	Increases by up to 20 percentage points (10 for MFJ), depending on expenses.	Single/HoH/MFS[a]	$120,000	$135,000
		MFJ[a]	$189,000	$199,000
		MFS (if lived together at all)	$0	$10,000
Traditional IRA Contribution Limits (own)				
Maximum $5,500 for all IRAs.	Increases by up to 25% of statutory tax rate.	Single/HoH/MFS[a]	$63,000	$73,000
		MFJ[a]	$101,000	$121,000
		MFS (if lived together at all)	$0	$10,000
Traditional IRA Contribution Limits (spouse)				
Maximum $5,500 for all IRAs.	Increases by up to 25% of statutory tax rate.	MFJa	$189,000	$199,000
		MFS (if lived together at all)	$0	$10,000

Source: Various publications from Urban-Brookings Tax Policy Center; Congressional Research Service (2018); Internal Revenue Service (2018); and Young (2018).

HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; IRA = Individual Retirement Account; a) indexed for inflation.

PHASEOUTS CAN CREATE MARRIAGE BONUSES AND PENALTIES

Phaseouts can create both marriage bonuses and penalties. A marriage bonus reduces a couple's combined tax bill compared to what they would pay if they were not married and filed separate returns. For example, in 2018, phaseout of the CTC begins at $400,000 for married taxpayers and $200,000 for all other taxpayers. If one spouse in a couple with a child has $300,000 of income and the other has none, their combined income is under the joint filers' threshold for phaseout of CTC and they can claim a child tax credit. If they were not married, the higher-income spouse could not claim the CTC because his or her income was too high, and the lower-income spouse could not claim the credit because he or she had no income.

Before the TCJA, married couples faced significant marriage penalties because their phaseout range was less than twice that for single tax filers. Under TCJA, most phaseouts for joint filers are exactly twice that for single filers, so many of the marriage penalties are gone.

However, phaseouts still impose marriage penalties on low-income families, and those penalties are often a larger percentage of income than the marriage penalties caused by phaseouts for higher-income taxpayers. For example, in 2018, a single mother who earns $18,000 and has one child pays no income tax and

receives two refundable credits—a $1,400 CTC and a $3,461 EITC (table 2). (In 2018, a single parent with one child begins paying income tax (before credits) when his or her income exceeds $18,000—the standard deduction for a head of household.) If she marries a man making $40,000—whose 2018 income tax as a single person would be $3,170—she would lose all her EITC (the couple's income would cause the credit to phase out completely) but would get more CTC. (In 2018, CTC is worth up to $2,000 per qualifying child. The refundable portion of the credit is limited to $1,400.) Losing the EITC means that the couple would pay $1,699 in income tax when married, compared with receiving a net payment of $1,691 (her $4,861 combined credit minus his $3,170 tax) if they remained single. That difference is a marriage penalty of $3,390, or 5.8 percent of the couple's adjusted gross income.

TABLE 2

Marriage Bonus and Penalty Tax Calculator Example

2018

	Mother	Spouse	Couple
Adjusted gross income	**$18,000**	**$40,000**	**$58,000**
Standard deduction	$18,000	$12,000	$24,000
Taxable income	**$0**	**$28,000**	**$34,000**
Tax before credits	$0	$3,170	$3,699
Child Tax Credit	$1,400	$0	$2,000
Earned Income Tax Credit	$3,461	$0	$0
Tax net of credits	**-$4,861**	**$3,170**	**$1,699**

Tax as two individuals
-$1,691
Tax as a married couple
$1,699
Marriage penalty
$3,390
Difference as a percent of couple's AGI
5.8%

Source: Tax Policy Center Marriage Bonus and Penalty Calculator, 2018.

Data Sources

Internal Revenue Service. 2014. "Individual Retirement Arrangements (IRAs)." Publication 590. Washington, DC: Internal Revenue Service.

———. 2017a. "Child and Dependent Care Expenses." Publication 503. Washington, DC: Internal Revenue Service.

———. 2017b. "Child Tax Credit." Publication 972. Washington, DC: Internal Revenue Service.

———. 2017c. "Earned Income Credit." Publication 596. Washington, DC: Internal Revenue Service.

———. 2017d. "Tax Benefits for Education." Publication 970. Washington, DC: Internal Revenue Service.

———. 2017e. "Your Federal Income Tax: For Individuals." Publication 17. Washington, DC: Internal Revenue Service.

Urban-Brookings Tax Policy Center. "Marriage Penalty Calculator."

Further Reading

Congressional Research Services. 2018.

Gale, William G. 2001. "Tax Simplification: Issues and Options." Testimony before the House Committee on Ways and Means, Washington, DC, July 17.

Social Security Administration. 2018.

Young, James. C. 2018. "Inflation Adjustments Affecting Individual Taxpayers in 2018." Tax Notes. January 1.