

Key Elements of the U.S. Tax System

INDIVIDUAL INCOME TAX

What is the standard deduction?

Q. What is the standard deduction?

A. The standard deduction reduces a taxpayer's taxable income. It ensures that only households with income above certain thresholds will owe any income tax.

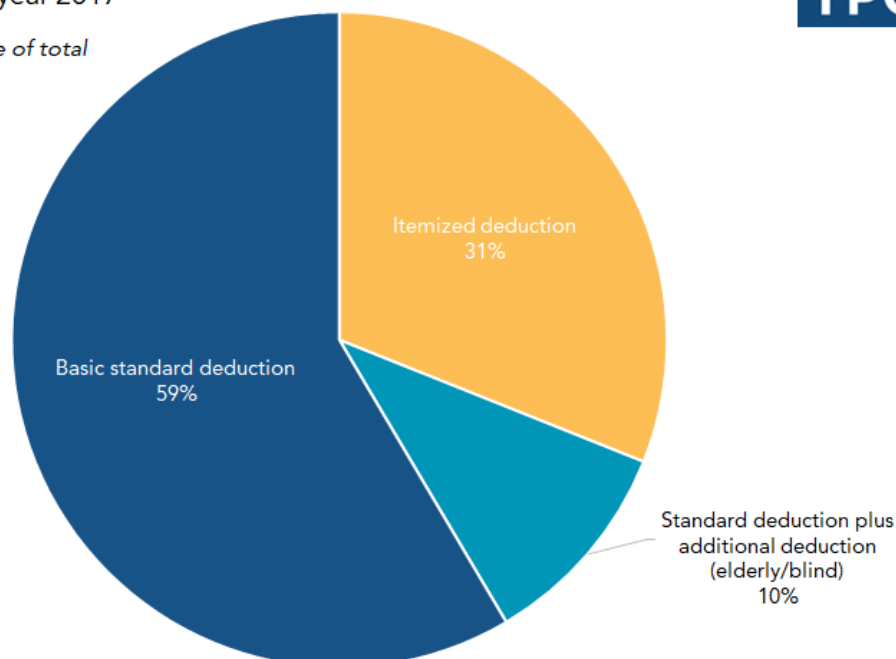
Taxpayers can claim a standard deduction when filing their tax returns, thereby reducing their taxable income and the taxes they owe. In addition to the regular standard deduction, taxpayers can claim an additional deduction if they or their spouse are 65 or older or blind.

Rather than taking the standard deduction, taxpayers can choose to itemize their deductions. In the past, about 70 percent of taxpayers chose to take the standard deduction. Most chose it because it was larger than the itemized deductions they could claim, but some did so because it was easier than identifying and totaling the expenses they could itemize or because they did not realize that itemizing would reduce their tax liability.

FIGURE 1

Returns by Type of Deduction Tax year 2017

Share of total



Source: Internal Revenue Service. Statistics of Income. Table 1.3. "All Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Marital Status, Tax Year 2017 (Filing Year 2018)," September 2019.

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What is the standard deduction?

The Tax Cuts and Jobs Act (TCJA) increased the standard deduction amounts for 2018 well beyond what they would have been in that year, raising the deduction from \$6,500 to \$12,000 for singles, from \$13,000 to \$24,000 for married couples, and from \$9,550 to \$18,000 for heads of household. The additional deduction for those 65 and over or blind is \$1,300 in 2018 (\$1,600 if the person is unmarried and not filing as a surviving spouse). As under prior law, the deduction amounts are indexed for inflation.

The standard deduction amount in 2020 is \$12,400 for single filers, \$24,800 for married couples, and \$18,650 for heads of household. The additional deduction for those 65 and over or blind is \$1,300 (\$1,650 if the person is unmarried and not filing as a surviving spouse).

By raising the standard deduction together with other restrictions on itemized deductions, TCJA will increase the percentage of taxpayers who will take the standard deduction. The Urban-Brookings Tax Policy Center estimates that about 90 percent of households will take the standard deduction rather than itemizing their deductions in 2018.

THE EFFECT OF TCJA ON TAXABLE INCOME THRESHOLDS

Before 2018, taxpayers could also claim a personal exemption for themselves and their dependents in addition to the standard deduction. Together, the standard deduction and personal exemptions created taxable income thresholds, ensuring that taxpayers with income below those thresholds would not pay any income tax.

For example, in 2017 the standard deduction was \$12,700 for a married couple, \$6,350 for a single filer, and \$9,350 for a head of household; each personal exemption was \$4,050. Thus, the taxable income threshold for a married couple without dependents was \$20,800 (the standard deduction plus two personal exemptions) and the threshold for a single person was \$10,400 (the standard deduction plus one exemption). Couples and singles with income below those amounts did not owe any income tax.

TABLE 1

Taxable Income Threshold by Filer Status Tax year 2019



Status	Current Law		
	Standard Deduction	Personal Exemption	Taxable Income Threshold
Single	\$12,200	-	\$12,200
Married, filing jointly	\$24,400	-	\$24,400
Married, filing separately	\$12,200	-	\$12,200
Head of household	\$18,350	-	\$18,350

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What is the standard deduction?

TCJA raised the standard deduction but also set the personal exemption amount, which would have been \$4,150 in 2018, to zero. The loss of personal exemptions offset some of the gain from higher standard deductions, but the net result was a small increase in the taxable income threshold for both singles and couples. Because most of the individual income tax provisions of TCJA expire after 2025, the taxable income thresholds will revert to what they would have been under prior law unless Congress extends or makes permanent current law.

The zero personal exemption amount also applies to the exemptions taxpayers could claim for each of their dependents. However, TCJA also increased the child tax credit, which offset the loss of personal exemptions for many taxpayers with dependents. In many cases, taxpayers with income above the taxable income thresholds can still pay no income tax if they qualify for tax credits such as the child tax credit and the earned income tax credit.

Updated May 2020

Data Sources

Internal Revenue Service. [Statistics of Income](#). Table A. "Selected Income and Tax Items for Selected Years (in Current and Constant Dollars)," Tax Year 2017 and Individual Income Tax Returns. Table 1.2. "All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status," Tax Year 2017

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INDIVIDUAL INCOME TAX

What are itemized deductions and who claims them?

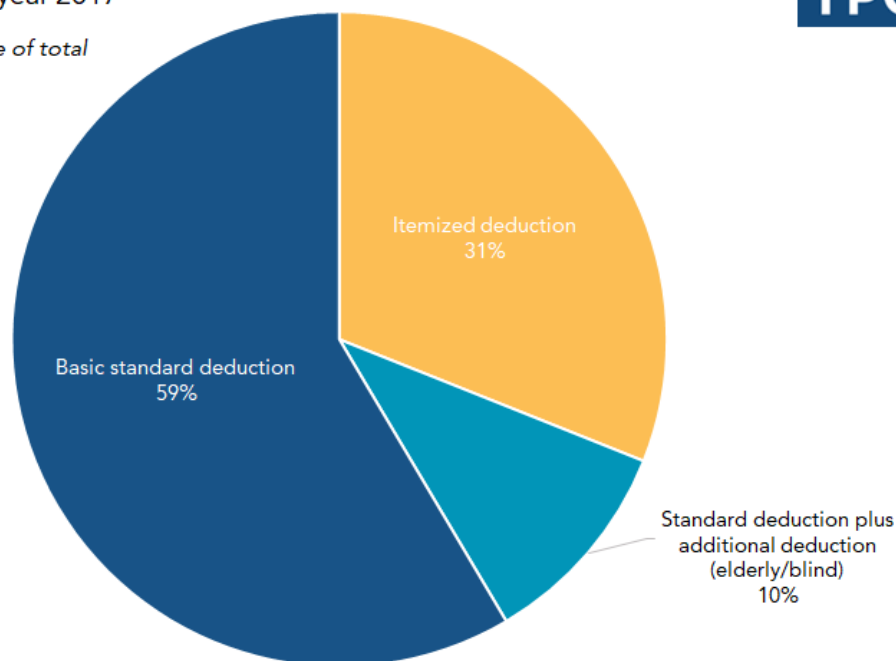
Q. What are itemized deductions and who claims them?

A. Taxpayers can choose to itemize deductions on their tax returns in lieu of claiming a standard deduction. In recent years about 30 percent of taxpayers, mostly high income, have chosen to itemize, but increases in the standard deduction and limits to itemized deductions starting in 2018 will greatly reduce the number of itemizers.

Taxpayers can either take a standard deduction or itemize their deductions to reduce the taxable income on their federal income tax return. Taxpayers typically choose to itemize when they can claim more on itemized deductions than on the standard deduction. In recent years, about 30 percent of taxpayers chose to itemize (figure 1).

FIGURE 1
Returns by Type of Deduction
Tax year 2017

Share of total



Source: Internal Revenue Service. Statistics of Income. Table 1.3. "All Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Marital Status, Tax Year 2017 (Filing Year 2018)," September 2019.

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What are itemized deductions and who claims them?

The most common itemized deductions are those for state and local taxes, mortgage interest, charitable contributions, and medical and dental expenses. The revenue cost of those four deductions was just under \$240 billion in 2017 (table 1).

HOW DID THE TAX CUTS AND JOBS ACT AFFECT ITEMIZED DEDUCTIONS?

The 2017 Tax Cuts and Jobs Act will significantly reduce the number of taxpayers who claim itemized deductions, because it substantially increased the standard deduction while also restricting or eliminating some itemized deductions in 2018 through 2025. The Urban-Brookings Tax Policy Center estimates that the percentage of all households that itemize (including nonfilers) will shrink from 26 percent in 2017 to about 10 percent in 2018.

These changes also will substantially lower the revenue cost of all itemized deductions because fewer taxpayers will claim them and, in some cases, the amount they claim will fall. The revenue cost of the four largest deductions is estimated to fall by about \$100 billion (table 1).

TABLE 1

Cost of Selected Itemized Deductions

Billions of dollars, fiscal years 2018-2020



Tax expenditure	2017	2018	2019	2020
Deduction for all nonbusiness state and local taxes	\$100.9	\$36.6	\$21.2	\$22.5
Deduction for mortgage interest on owner-occupied residences	\$66.4	\$40.7	\$27.0	\$30.2
Deduction for charitable contributions	\$61.0	\$58.3	\$46.7	\$48.0
Deduction for medical expenses and long-term care expenses	\$13.8	\$10.5	\$7.1	\$7.4

Source: Joint Committee on Taxation. "Estimates of Federal Tax Expenditures for Fiscal Years 2019-2023," JCX-55-19, December 2019; Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2017-2021", JCX-34-18, May 2018.

Note: Costs in 2017 and 2018 are from JCX-34-18 and costs in 2019 and 2020 are from JCX-55-19.

WHO ITEMIZES?

The following sections present 2017 Internal Revenue Service data reporting the percentage of taxpayers who itemized and the type and amount of itemized deductions they claimed. The changes made by the Tax Cuts and Jobs Act will significantly affect comparable estimates for 2018.

High-income taxpayers are much more likely to itemize. In 2017, more than 90 percent of tax returns reporting adjusted gross income (AGI) over \$500,000 itemized deductions, compared with under half of those with AGI between \$50,000 and \$100,000 and less than 10 percent of those with AGI under \$30,000 (figure 2).

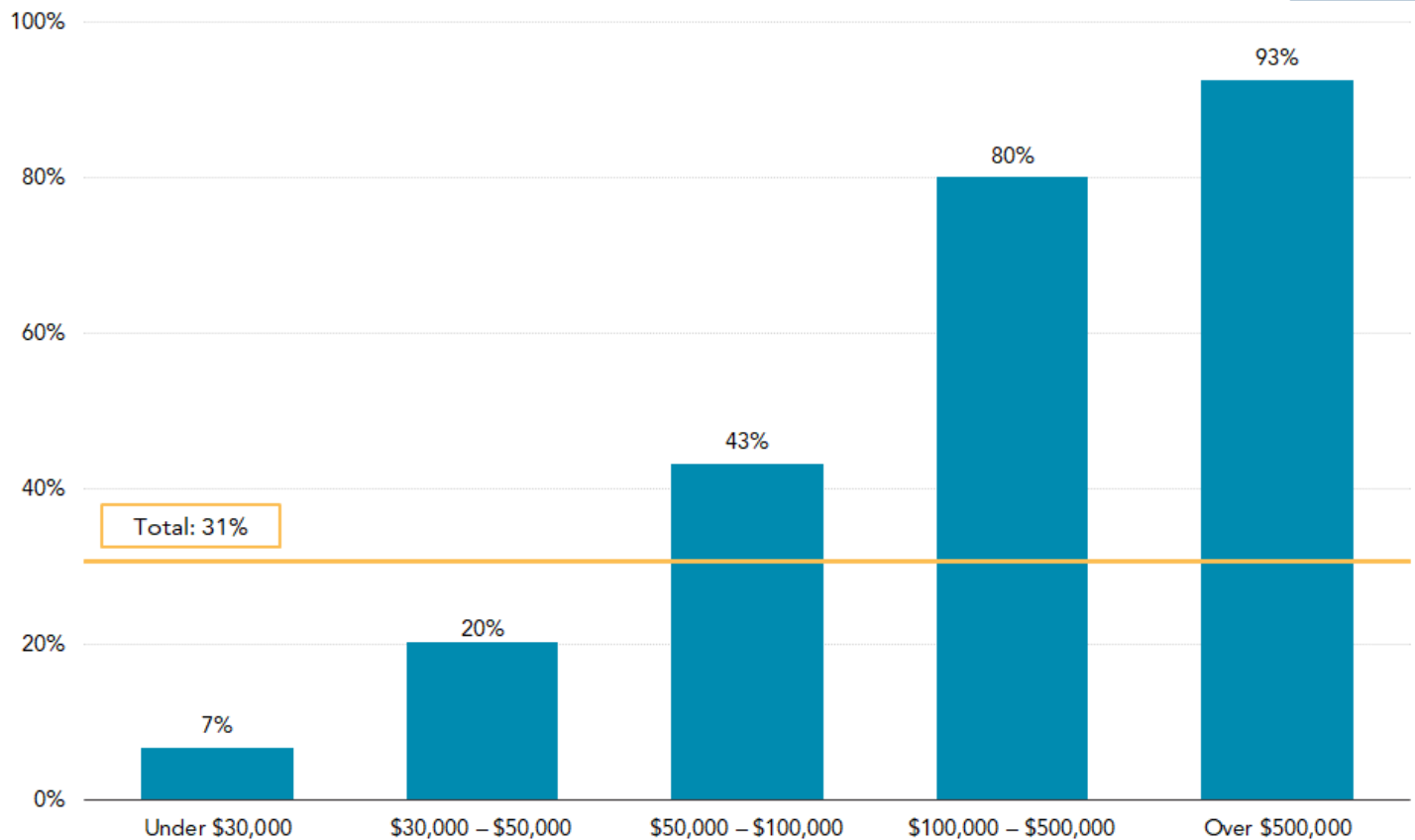
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INDIVIDUAL INCOME TAX

What are itemized deductions and who claims them?

FIGURE 2

Distribution of Returns Claiming Itemized Deductions Share of all returns within AGI class, tax year 2017



Source: Internal Revenue Service. Statistics of Income. Table 1.2. "All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2017 (Filing Year 2018)," September 2019.

WHAT EXPENSES DO ITEMIZERS DEDUCT?

Itemized deductions averaged about \$28,600 in 2017 for the 47 million tax units claiming them. The amount claimed rises with income, from about \$16,000 for taxpayers with AGI under \$50,000, to under \$20,000 for those with AGI between \$50,000 and \$100,000, to over \$30,000 for those with AGI between \$100,000 and \$500,000, to more than \$247,000 for those with AGI over \$500,000 (figure 3).

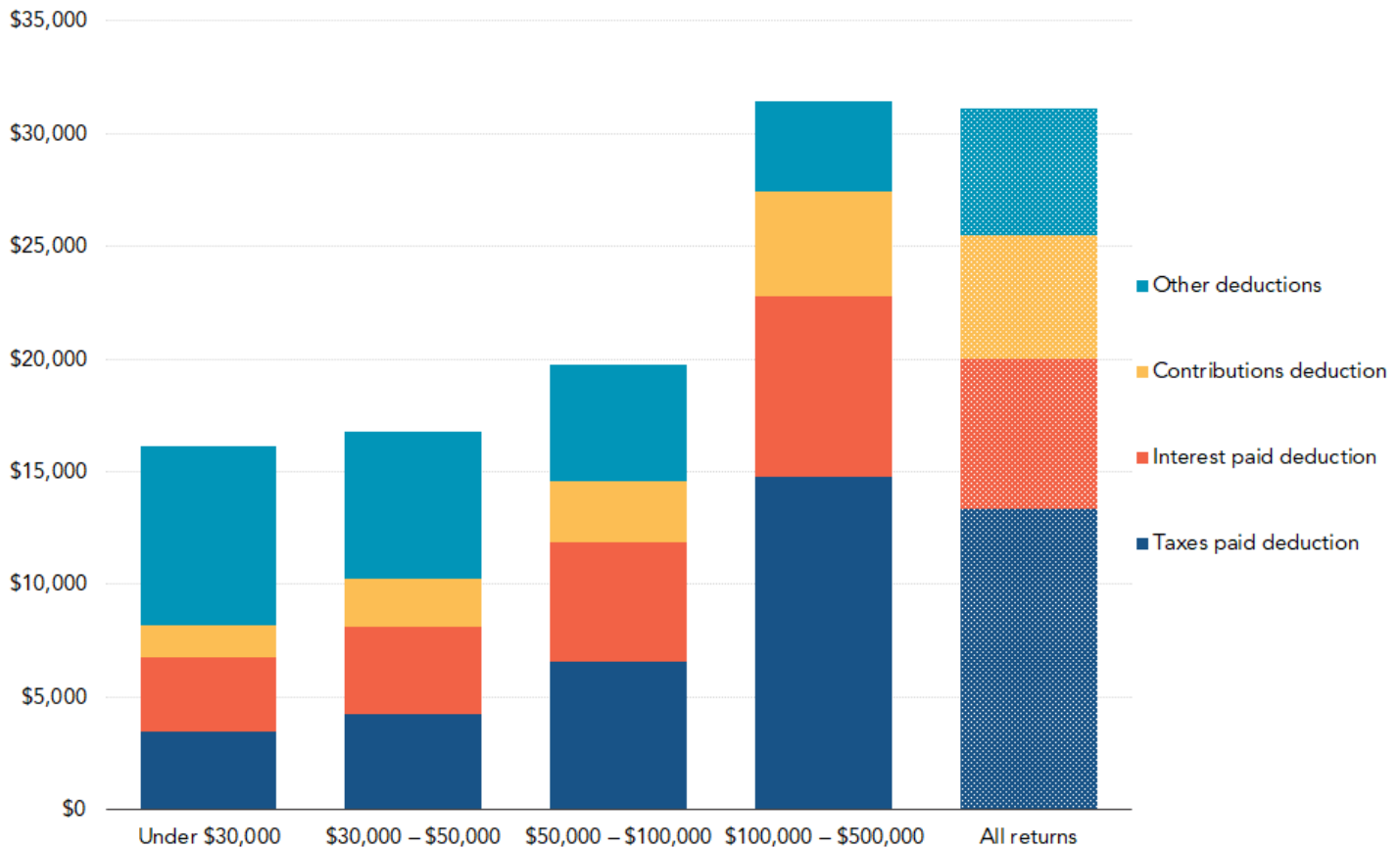
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INDIVIDUAL INCOME TAX

What are itemized deductions and who claims them?

FIGURE 3

Average Itemized Deductions by Type and Adjusted Gross Income (AGI)
Tax year 2017



Source: Internal Revenue Service. Statistics of Income. Table 2.1. "Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, Tax Year 2017 (Filing Year 2018)," September 2019.

Note: This figure omits the "Over \$500,000" AGI class due to scaling; average itemized deductions for those with AGI over \$500,000 is about \$248,000.

State and local taxes accounted for over 40 percent of average itemized deductions in 2017, or about \$13,300. The mortgage and other interest deductions made up another 22 percent, averaging about \$6,700. Charitable contributions and miscellaneous deductions averaged about \$5,500 each, or about 18 percent of total itemized deductions (figure 3).

HOW HAS THE SHARE OF ITEMIZERS CHANGED OVER TIME?

The share of returns that itemize deductions climbed from a low of 28 percent in 1994 to a peak of 36 percent in 2005 before dropping to 31 percent in 2017. A closer look at the three largest deductions—state and local taxes, home mortgage interest, and charitable contributions—helps explain why (figure 4.1).

- **State and local taxes:** Nearly all itemizers deduct state and local taxes. A 2004 law that allowed taxpayers to deduct state and local sales taxes in lieu of income taxes slightly increased the number of itemizers taking this deduction.

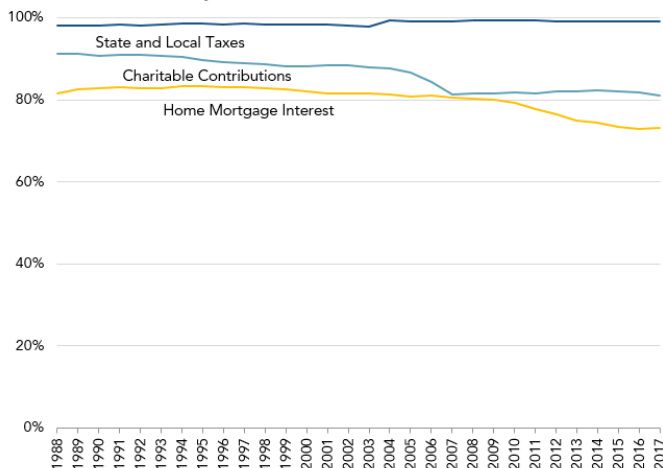
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What are itemized deductions and who claims them?

- **Home mortgage interest:** Before 2006, between 81 and 83 percent of itemizers deducted mortgage interest. But that share steadily dropped to a low of 73 percent in 2016, consistent with the decline in homeownership following the housing bubble collapse and falling mortgage interest rates. The amount of mortgage interest deducted by taxpayers increased sharply from 2004 to 2008 but fell through 2017 because of falling housing values and historically low mortgage rates.
- **Charitable contributions:** The share of itemizers reporting charitable contributions declined from 91 percent in 1988 to 81 percent in 2017. Much of that drop occurred between 2005 and 2007, after Congress required written confirmations of cash gifts and limited deductions for donations of clothing and used vehicles.

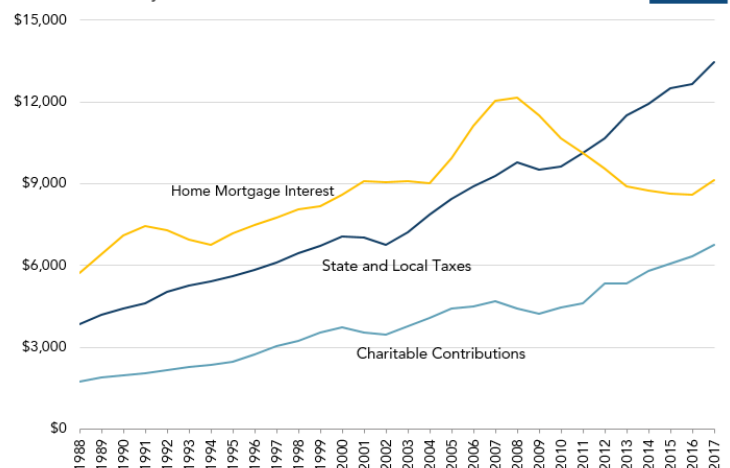
FIGURE 4.1
Returns Itemizing Selected Deductions
Share of all itemizers, tax years 1988 – 2017



Source: Internal Revenue Service. *Statistics of Income*. Table 2.1. "Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, Tax Year 2017 (Filing Year 2018)," September 2019.

Note: Real amounts are calculated using GDP deflators (Federal Reserve Bank of St. Louis, "Gross Domestic Product: Implicit Price Deflator," <https://fred.stlouisfed.org/series/GDPDEF#0>).

FIGURE 4.2
Average Amount Claimed of Selected Deductions
2017 dollars, tax years 1988 – 2017



Updated May 2020

Data Sources

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What are itemized deductions and who claims them?

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Key Elements of the U.S. Tax System

How did the TCJA change the standard deduction and itemized deductions?

INDIVIDUAL INCOME TAX

Q. How did the TCJA change the standard deduction and itemized deductions?

A. The Tax Cuts and Jobs Act nearly doubled the standard deduction and eliminated or restricted many itemized deductions in 2018 through 2025. It also eliminated the “Pease” limitation on itemized deductions for those years.

THE STANDARD DEDUCTION

The Tax Cuts and Jobs Act (TCJA) increased the standard deduction from \$6,500 to \$12,000 for individual filers, from \$13,000 to \$24,000 for joint returns, and from \$9,550 to \$18,000 for heads of household in 2018.

As before, the amounts are indexed annually for inflation. The standard deduction amount in 2020 is \$12,400 for single filers, \$24,800 for married couples, and \$18,650 for heads of household. The TCJA changed the measure used for inflation indexing from the consumer price index for all urban consumers (CPI-U) to the chained CPI-U—a more accurate measure but one that results in a smaller upward adjustment each year.

ITEMIZED DEDUCTIONS

The TCJA eliminated or restricted many itemized deductions in 2018 through 2025. This, together with a higher standard deduction, will reduce the number of taxpayers who itemize deductions. TPC estimates that in 2018 the share of all households that itemize shrank to 10 percent because of the tax overhaul.

State and local taxes (SALT). Taxpayers can still deduct state and local real estate, personal property, and either income or sales taxes in tax years after 2017, but the TCJA capped the total SALT deduction at \$10,000 for tax years 2018 through 2025.

Mortgage interest. The TCJA limited the deduction to the home mortgage interest on the first \$750,000 of mortgage debt (reduced from the pre-TCJA limit of \$1 million of mortgage debt) for mortgage loans taken out after December 15, 2017. Homeowners may no longer deduct interest paid on home equity loans, which was allowed for loans up to \$100,000 before the TCJA, unless the debt is used to buy, build, or substantially improve the taxpayer’s home that secures the loan. Homeowners may still deduct mortgage interest on their primary residence and a second home.

Charitable contributions. The TCJA increased the limit on deductions for charitable contributions from 50 percent to 60 percent of adjusted gross income (AGI).

Medical expenses. Under the TCJA, taxpayers could deduct unreimbursed medical expenses that exceed

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7.5 percent of their AGI in 2017 and 2018. The floor was 10 percent of AGI prior to the TCJA. Congress later extended the lower floor through 2019 but as of now, the floor will revert to 10 percent of AGI in 2020 unless Congress again extends it.

Other itemized deductions. The TCJA eliminated deductions for unreimbursed employee expenses, tax preparation fees, and other miscellaneous deductions. It also eliminated the deduction for theft and personal casualty losses, although taxpayers can still claim a deduction for certain casualty losses occurring in federally declared disaster areas.

Limitation on itemized deductions. The TCJA eliminated the “Pease” limitation on itemized deductions. Before TCJA, taxpayers reduced their itemized deductions by 3 percent of every dollar of taxable income above certain thresholds. The total reduction was capped at 80 percent of the total value of itemized deductions.

THE EFFECT OF TCJA ON MAJOR ITEMIZED DEDUCTIONS

TCJA significantly decreased the number of taxpayers claiming itemized deductions and the average tax saving from claiming them. The following figures compare the estimated percentage of taxpayers with a tax benefit from the three major itemized deductions—state and local taxes, mortgage interest, and charitable contributions—and the tax saving from claiming them in 2017 and 2018, before and after the new law is in place. The tax benefit is measured as the reduction in tax liability from the deduction, accounting for the applicable tax rates in each year, the effects of the alternative minimum tax (which disallows the SALT deduction), and the overall limit on itemized deductions (the “Pease” limit) that was in place in 2017 but eliminated for future years by TCJA.

The percentage of taxpayers with a tax benefit from the SALT deduction fell from about 25 percent in 2017 to 10 percent in 2018, from 20 percent to 8 percent for the mortgage interest deduction, and from 21 percent to 9 percent for the charitable contributions deduction (figure 1).

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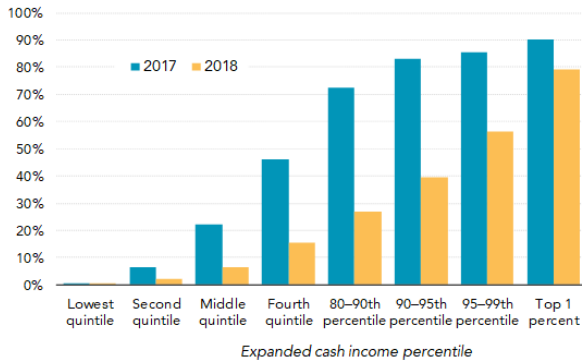
How did the TCJA change the standard deduction and itemized deductions?

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FIGURE 1.1

Itemized Deduction for State and Local Taxes

Share of tax units with benefit, 2017 and 2018



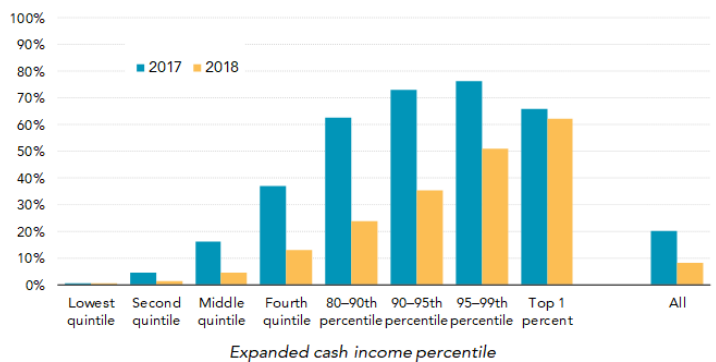
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).



FIGURE 1.2

Itemized Deduction for Home Mortgage Interest

Share of tax units with benefit, 2017 and 2018



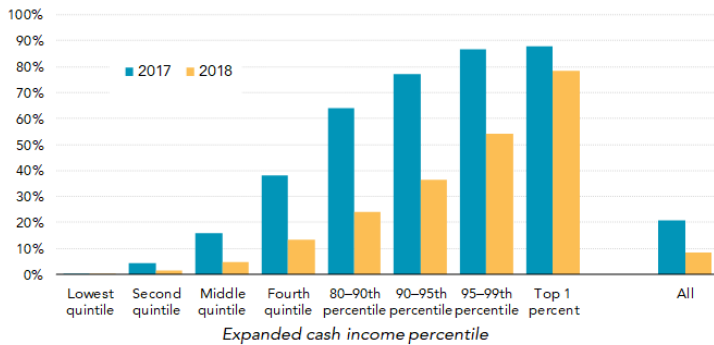
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).



FIGURE 1.3

Itemized Deduction for Charitable Contributions

Share of tax units with benefit, 2017 and 2018



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

The decline in the tax benefit from the deductions is even more dramatic. Measured as a percentage of after-tax income, the tax saving from the SALT deduction in 2018 was about one-quarter of what it was in 2017 overall. For taxpayers in the top 1 percent of the income distribution, the tax saving in 2018 was about one-tenth of the tax saving in 2017 (figure 2). The distribution of the tax benefits from the SALT, mortgage interest, and charitable deductions in 2019 are similar to those in 2018.

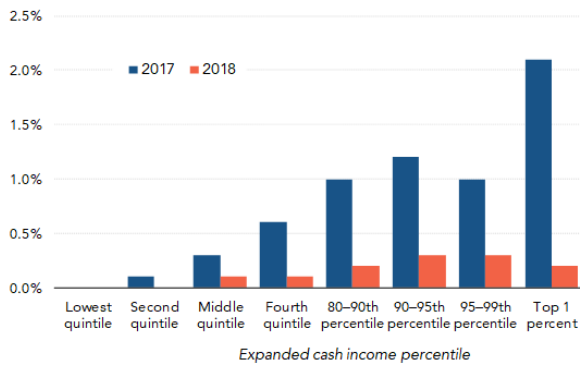
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How did the TCJA change the standard deduction and itemized deductions?

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FIGURE 2.1

Itemized Deduction for State and Local Taxes
Benefit as a share of after-tax income, 2017 and 2018

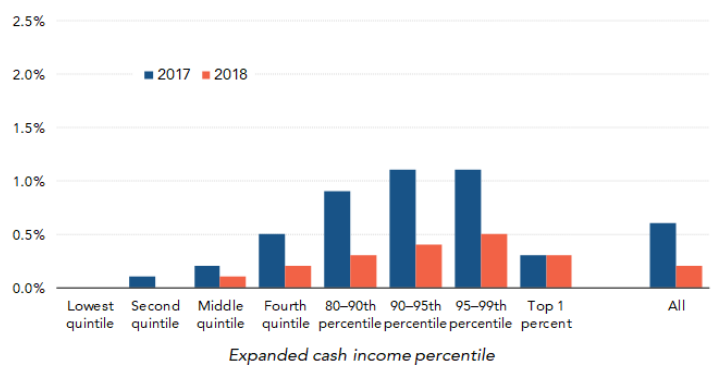


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).



FIGURE 2.2

Itemized Deduction for Home Mortgage Interest
Benefit as a share of after-tax income, 2017 and 2018

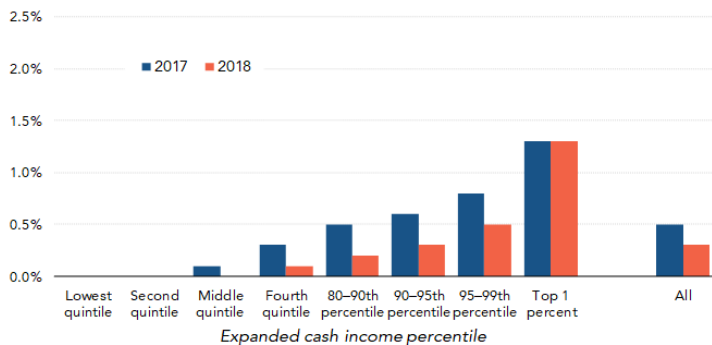


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).



FIGURE 2.3

Itemized Deduction for Charitable Contributions
Benefit as a share of after-tax income, 2017 and 2018



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

Updated May 2020

Data Sources

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Further Reading

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What are personal exemptions?

Q. What are personal exemptions?

A. Along with the standard deduction, personal exemptions provide that only income above a basic level is subject to tax, helping ensure that the poorest households are not subject to the income tax. They also link income tax liabilities to family size, reducing taxes for families with more dependents. The Tax Cuts and Jobs Act eliminated personal exemptions, but raised the standard deduction and the child credit as substitutes.

Before 2018, taxpayers could claim a personal exemption for themselves and each of their dependents. The amount would have been \$4,150 for 2018, but the Tax Cuts and Jobs Act (TCJA) set the amount at zero for 2018 through 2025. TCJA increased the standard deduction and child tax credits to replace personal exemptions.

Personal exemptions have been part of the modern income tax since its inception in 1913. Congress originally set the personal exemption amount to \$3,000 (worth more than \$70,000 in today's dollars), so that very few persons were expected to pay the income tax. While the amount was substantially lower both in real terms and relative to average incomes by 2017, the tax code has added other features since 1913, such as the standard deduction and various tax credits, that have partly offset the exemption's decline in value.

In addition to helping ensure that very low-income households do not pay income tax (and alleviating the administrative burden of collecting the tax on small amounts of income), personal exemptions also link tax liability to household size. For instance, in 2017 when the personal exemption amount was \$4,050 and the standard deduction for a married couple was \$12,700, a married couple with three children and income of \$92,950 (before subtracting five personal exemptions and the standard deduction) and a married couple without dependents and income of \$80,800 (before subtracting two personal exemptions and the standard deduction) had the same taxable income—in this case, \$60,000.

As with other deductions and exemptions, however, the tax benefit from personal exemptions depends upon a taxpayer's marginal tax rate. For instance, a single taxpayer in the 12 percent tax bracket would save \$498 of taxes with a personal exemption of \$4,150, whereas a single taxpayer in the 32 percent tax bracket would save \$1,328. Thus, under a progressive income tax, exemptions are worth more to high-income taxpayers than to low-income taxpayers. In contrast, tax credits can have the same value for all taxpayers. By replacing personal exemptions for dependents with expanded child tax credits, TCJA moved toward equalizing the tax benefit for children and other dependents across households with different incomes.

There were certain limits on personal exemptions under prior law. Since 1990, personal exemptions phased out at higher income levels. In 2017, the phaseout began at \$261,500 for singles and \$313,800 for married

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What are personal exemptions?

couples filing a joint return. Personal exemptions were completely phased out at \$384,000 for singles and \$436,300 for married couples.

In addition, the alternative minimum tax denied taxpayers the use of personal exemptions, making larger families more likely to owe the alternative minimum than smaller families.

Updated May 2020

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How do federal income tax rates work?

Q. How do federal income tax rates work?

A. The federal individual income tax has seven tax rates that rise with income. Each rate applies only to income in a specific range (tax bracket).

CURRENT INCOME TAX RATES AND BRACKETS

The federal individual income tax has seven tax rates ranging from 10 percent to 37 percent (table 1). The rates apply to taxable income—adjusted gross income minus either the standard deduction or allowable itemized deductions. Income up to the standard deduction (or itemized deductions) is thus taxed at a zero rate.

TABLE 1

Tax Year 2020 Schedule and Rates



Single filers			Married couples filing jointly		
Taxable income (\$)		Marginal rate (%)	Taxable income (\$)		Marginal rate (%)
Over	But not over		Over	But not over	
\$0	\$9,875	10%	\$0	\$19,750	10%
\$9,875	\$40,125	12%	\$19,750	\$80,250	12%
\$40,125	\$85,525	22%	\$80,250	\$171,050	22%
\$85,525	\$163,300	24%	\$171,050	\$326,600	24%
\$163,300	\$207,350	32%	\$326,600	\$414,700	32%
\$207,350	\$518,400	35%	\$414,700	\$622,050	35%
\$518,400	and over	37%	\$622,050	and over	37%

Source: Internal Revenue Service. Rev. Proc. 2019-44.

Federal income tax rates are progressive: As taxable income increases, it is taxed at higher rates. Different tax rates are levied on income in different ranges (or brackets) depending on the taxpayer's filing status. In

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INDIVIDUAL INCOME TAX

How do federal income tax rates work?

2020 the top tax rate (37 percent) applies to taxable income over \$518,400 for single filers and over \$622,050 for married couples filing jointly. Additional tax schedules and rates apply to taxpayers who file as heads of household and to married individuals filing separate returns. A separate schedule of tax rates applies to capital gains and dividends. Tax brackets are adjusted annually for inflation.

BASICS OF PROGRESSIVE INCOME TAXATION

Each tax rate applies only to income in a specific tax bracket. Thus, if a taxpayer earns enough to reach a new bracket with a higher tax rate, his or her total income is not taxed at that rate, just the income in that bracket. Even a taxpayer in the top bracket has some portion of income taxed at the lower rates in the tax schedule. For example, a single filer with \$60,000 in taxable income falls into the 22 percent bracket but does not pay tax of \$13,200 (22 percent of \$60,000). Instead, he or she pays 10 percent of \$9,875 plus 12 percent of \$30,250 (\$40,125 - \$9,875) plus 22 percent of \$19,875 (\$60,000 - \$40,125) for a total of \$8,990.

All tax brackets for married taxpayers are twice the size of those for singles, except for the penultimate bracket. This can cause a “marriage penalty” for some taxpayers in the highest tax bracket, as some couples pay more tax filing a joint return than they would if each spouse could file as a single person. Conversely, because most tax brackets for married couples are twice the size of those for singles, many married couples enjoy a “marriage bonus,” paying less in tax by filing jointly than they would if each partner filed as a single person.

HISTORY OF FEDERAL INCOME TAX BRACKETS AND RATES

Over the 100-plus year history of the modern federal income tax (short-lived income taxes existed before Congress ratified the 16th Amendment in 1913), the number of brackets and rates have changed dramatically and frequently. The federal income tax began with seven brackets but that number exploded to more than 50 by 1920 (figure 1). From then until the late 1970s, there were never fewer than 20 brackets. The last major federal tax reform, the Tax Reform Act of 1986, reduced the number of brackets from 16 to two, but that number has crept up to the current seven over the last three decades.

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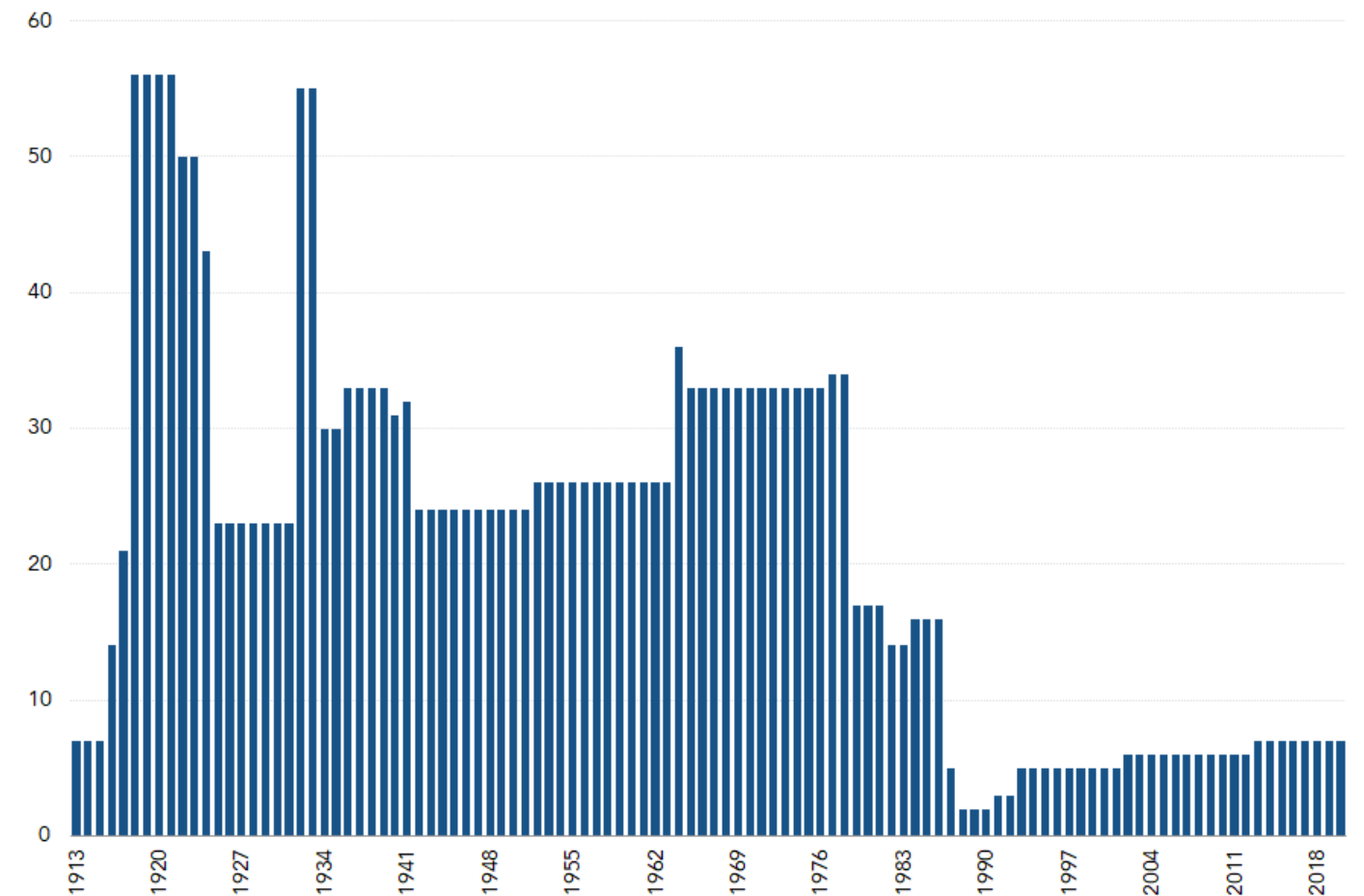
INDIVIDUAL INCOME TAX

How do federal income tax rates work?

FIGURE 1

Number of Federal Income Tax Brackets

Tax years 1913 – 2020



Source: Tax Foundation. "US Federal Individual Income Tax Rates History, 1862–2013 (Nominal and Inflation-Adjusted Brackets)," October 2013 and IRS Revenue Procedures, various years.

Note: The figure shows the largest number of tax brackets for any filing status in each year.

The top marginal federal income tax rate has varied widely over time (figure 2). The top rate was 91 percent in the early 1960s before the Kennedy/Johnson tax cut dropped it to 70 percent. In 1981, the first Reagan tax cut further reduced the top rate to 50 percent, and the 1986 tax reform brought it down to 28 percent. Subsequent legislation increased it to 31 percent in 1991 and to 39.6 percent in 1993. George W. Bush's tax cuts lowered the top rate to 35 percent, but it reverted to 39.6 percent when the American Taxpayer Relief Act of 2012 let the reduced top rate expire as scheduled. The Tax Cuts and Jobs Act lowered the top rate to 37 percent starting in 2018.

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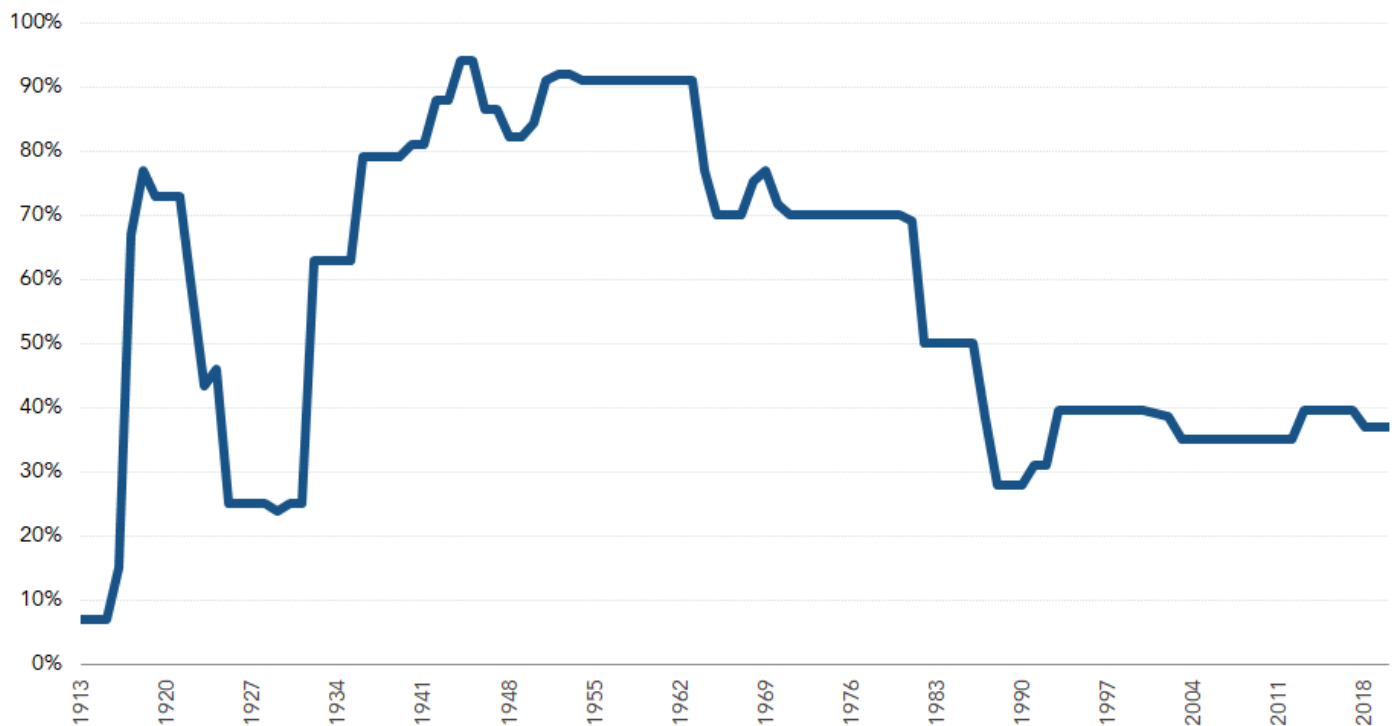
INDIVIDUAL INCOME TAX

How do federal income tax rates work?

FIGURE 2

Highest Federal Marginal Individual Income Tax Rate

Tax years 1913 – 2020



Sources: Joseph Pechman, *Federal Tax Policy*; Joint Committee on Taxation, Summary of Conference Agreement on the Jobs and Growth Tax Relief Reconciliation Act of 2003, JCX-54-03, May 2003; IRS Revenue Procedures, various years.

Notes: This figure contains a number of simplifications and ignores factors such as the amount of income or types of income subject to the top rates, or the value of standard and itemized deductions.

Updated May 2020

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Key Elements of the U.S. Tax System

What are tax credits and how do they differ from tax deductions?

INDIVIDUAL INCOME TAX

Q. What are tax credits and how do they differ from tax deductions?

A. Credits reduce taxes directly and do not depend on tax rates. Deductions reduce taxable income; their value depends on the taxpayer's marginal tax rate, which rises with income.

TAX CREDITS

Tax credits are subtracted directly from a person's tax liability; they therefore reduce taxes dollar for dollar. Credits have the same value for everyone who can claim their full value.

Most tax credits are nonrefundable; that is, they cannot reduce a filer's tax liability below zero. As a result, low-income filers often cannot receive the full benefit of the credits for which they qualify. For example, the child and dependent care credit is nonrefundable, so a married couple with income under \$24,800 in 2020 would not be able to use the credit because they have no income tax liability.

Some tax credits, however, are fully or partially refundable: if their value exceeds income tax liability, the tax filer is paid the excess. The earned income tax credit (EITC) is fully refundable; the child tax credit (CTC) is refundable only if the filer's earnings exceed a \$2,500 threshold. The refundable portion of the CTC is commonly called the Additional Child Tax Credit.

MOST POPULAR TAX CREDITS

The EITC is the most commonly claimed credit, showing up on more than 17 percent of 2017 tax returns. The CTC is nearly as popular, claimed on about 14 percent of 2017 tax returns (figure 1).

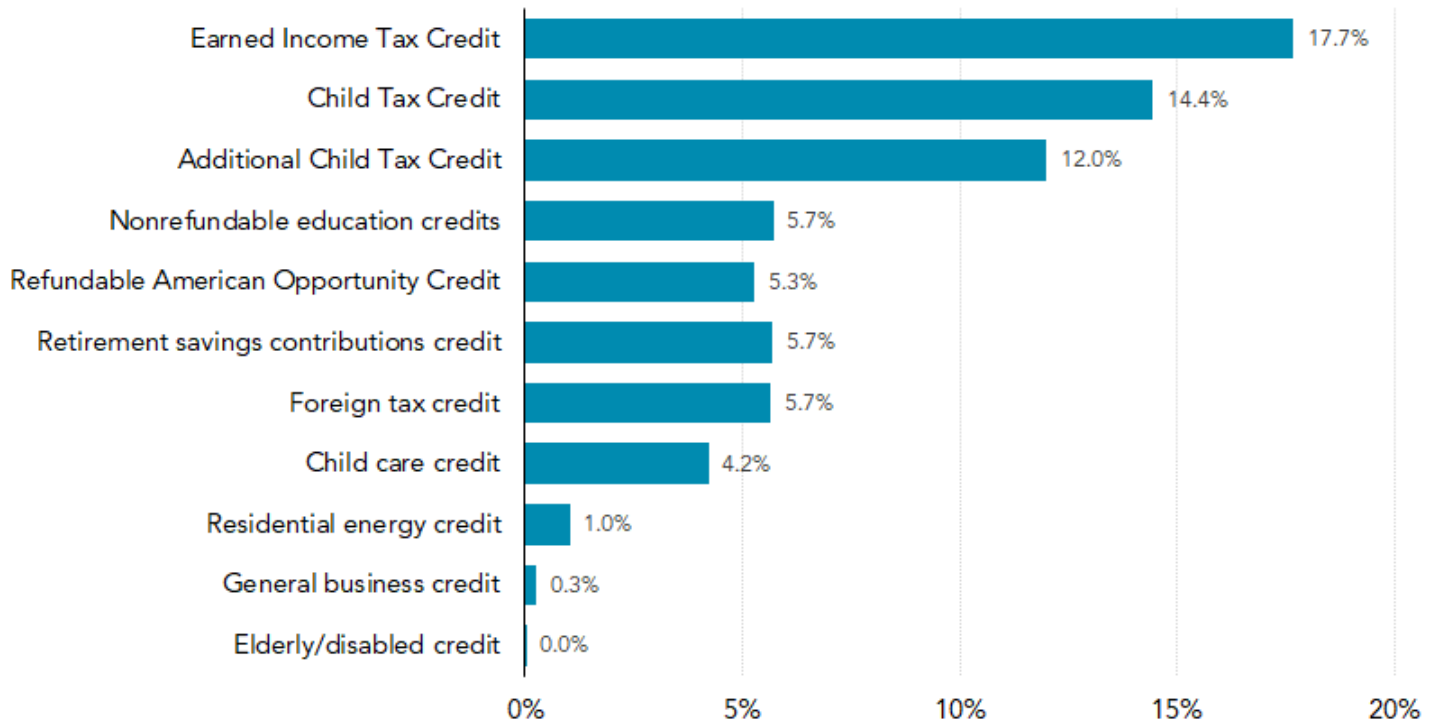
Key Elements of the U.S. Tax System

What are tax credits and how do they differ from tax deductions?

INDIVIDUAL INCOME TAX

FIGURE 1

Total Returns Claiming Selected Credits Share of all returns, tax year 2017



Source: Internal Revenue Service. Statistics of Income. Table 3.3. "All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income," Tax Year 2017.

The EITC is also the costliest tax credit, totaling about \$67 billion in 2017. The CTC (including the refundable portion) was the next largest at roughly \$51 billion (figure 2).

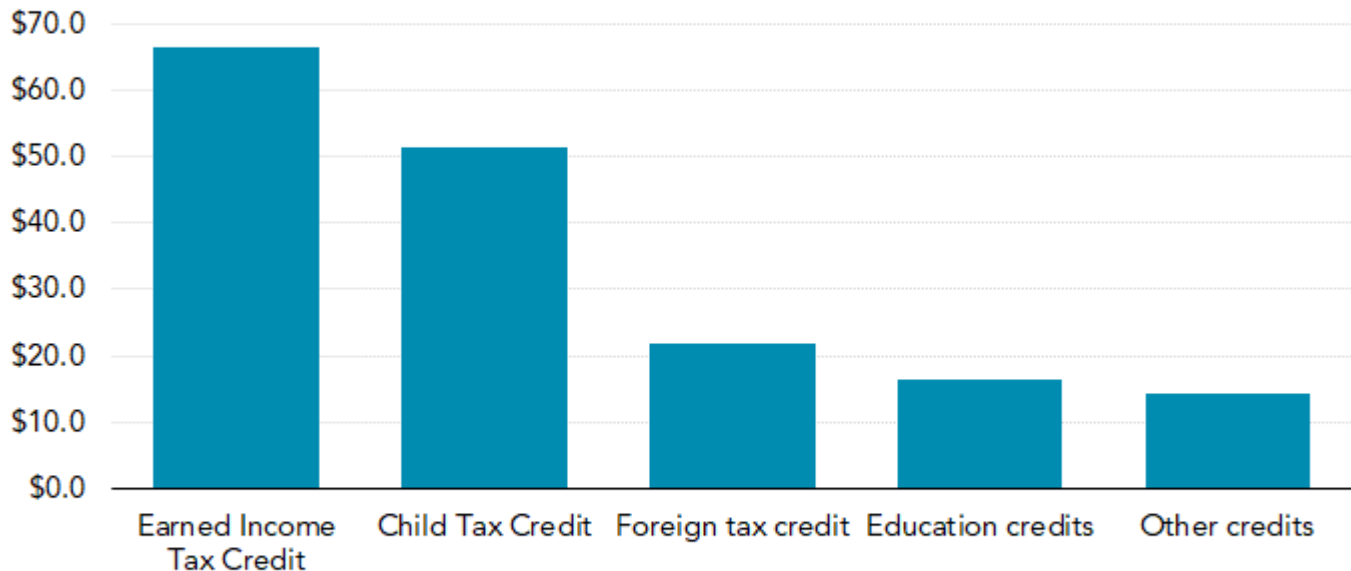
Key Elements of the U.S. Tax System

What are tax credits and how do they differ from tax deductions?

INDIVIDUAL INCOME TAX

FIGURE 2

Total Amount Claimed for Selected Credits Billions of dollars, tax year 2017



Source: Internal Revenue Service. Statistics of Income. Table 3.3. "All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income," Tax Year 2017.

Note: "Child Tax Credit" = Child Tax Credit + Additional Child Tax Credit; "Education Credits" = Nonrefundable Education Credits + American Opportunity Credit; "Other Credits" = Retirement Savings Contribution Credit + General Business Credit + Child Care Credit + Residential Energy Credit + Credit for the Elderly/Disabled.

TAX DEDUCTIONS

Tax filers have the choice of claiming the standard deduction or itemizing deductible expenses from a list that includes state and local taxes paid, mortgage interest, and charitable contributions. In either case, filers decrease their taxable income by the amount of the allowed deduction.

Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These deductions (technically "adjustments to income") are sometimes called "above the line" deductions because they come before the line that determines adjusted gross income on tax return form 1040. Adjustments to income include contributions to individual retirement accounts, educator expenses, and interest on student loans.

The value of all deductions, itemized or otherwise, depends on the taxpayer's tax liability and marginal tax rate. A deduction cannot reduce taxable income below zero, so taxpayers lose the value of excess deductions once they reach that limit. Taxpayers can, however, carry over some unused deductions into future years. By reducing taxable income, a deduction lowers tax liability by the amount of the deduction times the taxpayer's marginal tax rate. Deductions are thus worth more to taxpayers in higher tax brackets. For example, a \$10,000 deduction reduces taxes by \$1,200 for people in the 12 percent tax bracket, but by \$3,200 for those in the 32 percent tax bracket.

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What are tax credits and how do they differ from tax deductions?

INDIVIDUAL INCOME TAX

The alternative minimum tax (AMT) disallows the standard deduction and some itemized deductions. For example, AMT taxpayers may not deduct state and local tax payments. The AMT reduces but does not eliminate other deductions.

Updated May 2020

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Key Elements of the U.S. Tax System

INDIVIDUAL INCOME TAX

How do phaseouts of tax provisions affect taxpayers?

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 \$14,300 credit phases out at about a 35 percent rate (\$35.75 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 2020, the limit on the deduction for higher education tuition and fees

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How do phaseouts of tax provisions affect taxpayers?

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.

WHERE ARE PHASEOUTS MOST COMMON?

TABLE 1.1

Family Benefits

Selected phase-ins and phaseouts in 2020 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	8,790	15,820
		One child	19,330	41,576
		Two children	19,330	47,440
		Three or more children	19,330	50,954
		MFJ		
		No children	14,680	21,710
		One child	25,220	47,466
		Two children	25,220	53,330
		Three or more children	25,220	56,844
		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; and Internal Revenue Service (2020).

HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; N/A = not applicable
a) indexed for inflation.

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How do phaseouts of tax provisions affect taxpayers?

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 \$19,330 for single parents and at \$25,220 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 2020 individual income tax code



Description	Effect on marginal tax rate	Filing status	Phaseout begins	Phaseout ends
American Opportunity Tax Credit (AOTC)				
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	\$59,000	\$69,000
		MFJ	\$118,000	\$138,000
		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	\$220,000
		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	\$70,000	\$85,000
		MFJ	\$140,000	\$170,000
		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	\$82,350	\$97,350
		MFJ	\$123,550	\$153,550
		MFS	Credit not allowed	

Source: Various publications from Urban-Brookings Tax Policy Center and Internal Revenue Service (2020).

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

INDIVIDUAL INCOME TAX

How do phaseouts of tax provisions affect taxpayers?

TABLE 1.3

Retirement Provisions

Selected phase-ins and phaseouts in 2020 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	\$19,500	\$32,500
		MFJ	\$39,000	\$65,000
		HoH	\$29,250	\$48,750
Roth IRA Contribution Limits				
Maximum \$6,000 for all IRAs.	Increases by up to 20 percentage points (10 for MFJ), depending on expenses.	Single/HoH/MFS ^a	\$124,000	\$139,000
		MFJ ^a	\$196,000	\$206,000
		MFS (if lived together at all)	\$0	\$10,000
Deductible Traditional IRA Contribution Limits (own)				
Maximum \$6,000 for all IRAs.	Increases by up to 25% of statutory tax rate.	Single/HoH/MFS ^a	\$65,000	\$75,000
		MFJ ^a	\$104,000	\$124,000
		MFS (if lived together at all)	\$0	\$10,000
Deductible Traditional IRA Contribution Limits (spouse)				
Maximum \$6,000 for all IRAs.	Increases by up to 25% of statutory tax rate.	MFJ ^a	\$196,000	\$206,000
		MFS (if lived together at all)	\$0	\$10,000

Source: Various publications from Urban-Brookings Tax Policy Center and Internal Revenue Service (2020).

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 2020, 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 2020, 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 \$3,584 EITC (table 2). (In 2020, a single parent with one child

Key Elements of the U.S. Tax System

INDIVIDUAL INCOME TAX

How do phaseouts of tax provisions affect taxpayers?

begins paying income tax (before credits) when his or her income exceeds \$18,650—the standard deduction for a head of household.) If she marries her partner making \$40,000—whose 2020 income tax as a single person would be \$3,114—she would lose all her EITC (the couple's income would cause the credit to phase out completely) but would get more CTC. (In 2020, 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 \$1,644 in income tax when married, compared with receiving a net payment of \$1,870 (her \$4,984 combined credit minus her partner's \$3,114 tax) if they remained single. That difference is a marriage penalty of \$3,514, or 6.1 percent of the couple's adjusted gross income.

TABLE 2

Marriage Bonus and Penalty Tax Calculator Example 2020



	Mother	Spouse	Couple	
Adjusted gross income	\$18,000	\$40,000	\$58,000	Tax as two individuals
Standard deduction	\$18,650	\$12,400	\$24,800	-\$1,870
Taxable income	\$0	\$27,600	\$33,200	Tax as a married couple
Tax before credits	\$0	\$3,114	\$3,589	\$1,644
Child Tax Credit	\$1,400	\$0	\$2,000	Marriage penalty
Earned Income Tax Credit	\$3,584	\$0	\$0	\$3,514
Tax net of credits	-\$4,984	\$3,114	\$1,644	Difference as a percent of couple's AGI
				6.1%

Source: Tax Policy Center Marriage Bonus and Penalty Calculator, 2020.

Updated May 2020

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How do phaseouts of tax provisions affect taxpayers?

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