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# AN OPTION TO REFORM THE INCOME TAX TREATMENT OF FAMILIES AND WORK

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ABSTRACT

The income tax provisions related to families and work—filing status, rate schedules, the standard deduction, personal exemptions, the child and earned income tax credits, and the taxation of dependents—are complex, too small to encourage work for many low earners, and unfair to some families. We describe and analyze a comprehensive option that addresses these issues while minimizing the number of "losers" and reducing average tax burdens in all but the highest income quintile, at a cost of about $100 billion per year. We present alternatives to illustrate different policy tradeoffs that could be made in reforming these provisions.

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## INTRODUCTION

The federal income tax is widely perceived to be needlessly complex, to provide conflicting incentives that distort economic decisions, and to impose tax burdens in an unfair and often haphazard manner. This widespread dissatisfaction has led to bipartisan agreement on the need for federal tax reform, but not to agreement on even the broad outlines of the reform. Some agreement exists, however, on approaches to reforming the family- and work-related provisions. These provisions are central elements of the tax system, so a comprehensive starting point for reforming them could provide the first step toward a broader reform effort. The option we describe and analyze in this paper is intended to help form that comprehensive starting point.

The option draws elements from a number of proposals to reform one or more of the family and work provisions that have been offered by President Obama, President-elect Trump, members of Congress, and public policy groups. For example, we echo the President's Budget, House Speaker Paul Ryan, the Center on Budget and Policy Priorities, and the American Action Forum in calling for an expansion of the earned income tax credit (EITC) for workers without qualifying children.[1] We include a reduction in the number of filing statuses, a provision of the tax plans of President-elect Trump and an element of the tax reform proposals made by former Chairman of the House Ways and Means Committee David Camp and Senators Ted Cruz, Mike Lee, and Marco Rubio.[2] The Trump proposal, the House GOP "Better Way" tax proposal released by Speaker Ryan,[3] and the Camp, Lee, and Rubio proposals all consolidate the standard deduction and personal exemptions for taxpayers, and the last four increase credits for children; we do both in this option. We build on other elements of the Camp proposal and the splitting of the EITC between child- and work-related elements included in the tax proposals of the Bipartisan Policy Center's Debt Reduction Task Force, often referred to as Domenici-Rivlin.[4]

The option would comprehensively reform all the family- and work-related provisions of the income tax, as well as the underlying qualifying requirements, which differ across provisions under current law. In addition to the Camp proposal, we draw on two other proposals which would also comprehensively reform these provisions: the President's Advisory Panel on Federal Tax Reform (2005)[5] and the proposals included in the National Taxpayer Advocate's Annual Reports to Congress for 2008 and 2012.

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[1] Office of Management and Budget (2016), Ryan (2014), Marr, et al. (2016), and Holtz-Eakin, et al. (2016). See also the proposals by Senator Murray (2014) and Representative Rangel (2014). For a description and analysis of a number of previous proposals, see Carasso, et al. (2008) and Maag (2015b).

[2] Trump Campaign (2016), Joint Committee on Taxation (2014a), Cruz Campaign (2015), Lee (2013), and Rubio Campaign (2015). For descriptions and analyses of these proposals see, respectively, Nunns, et al. (2016b), Nunns, et al. (2016a), Nunns, et al. (2014), Rosenberg, et al. (2016), Burman, et al. (2014), and Maag, et al. (2016).

[3] Ryan (2016).

[4] Bipartisan Policy Center (2010). For a description and analysis of similar proposals see Holt and Maag (2009).

[5] Ackerman, et al. (2016) also propose a comprehensive reform that is similar in most repsects to the Advisory Panel's.

This paper describes and analyzes an option to comprehensively reform the basic provisions of the income tax that affect families and work: filing status, tax rates and brackets, the standard deduction, personal exemptions, the child tax credit, the EITC, and the taxation of dependents. The reform includes unification of qualifying requirements. In addition, we describe alternatives to selected provisions of the option to illustrate different policy tradeoffs that could be made in reforming the tax treatment of families and work.

The option seeks to:

- Significantly simplify tax filing for most taxpayers,
- Clarify and increase work incentives for low-wage workers,
- Remove unfair differences in child-related benefits, and
- Reduce marriage penalties.

In achieving these goals, the option would also affect:

- Revenues and
- Distribution of tax burdens across income groups.

We believe the effects of the option on revenues and the distribution of tax burdens can best be evaluated in the context of comprehensive tax reform. We isolate their effects in this paper to help inform broader efforts, which could be spurred by our initial analysis.

The remainder of the paper provides an overview of the main features of the option and its effects on simplification, work incentives, fairness, revenues, and distribution; addresses the need for reform, using examples to illustrate the complexity, economic inefficiencies, and unfairness of the current family and work provisions; and provides a detailed description of the option. For each provision, we describe current law, discuss the reasons to reform current law, and describe the option in detail. We then analyze the effect of the option on representative individuals and families and on simplification, work incentives, fairness, revenues, and distribution. We also describe and analyze seven alternatives to specific provisions of the option that illustrate policy tradeoffs inherent in reforming the family and work provisions. The final section provides conclusions. Appendix A offers detail on the qualifying child, qualifying relative, and qualifying taxpayer requirements that the option would simplify.

## OVERVIEW OF THE OPTION

The option has ten main components:

### *1. Reduce the Number of Filing Statuses*

The option would reduce the number of filing statuses by repealing the head of household and married filing separate filing statuses. There would be only one filing status for all single individuals, and only one for all married individuals (except in very limited circumstances, when spouses would be allowed to file as single). The option would retain the surviving spouse filing status.

### *2. Tax Rates and Brackets*

The option would not change any current tax rates or any tax brackets for joint filers. To mitigate the effect of other changes in the option for single filers, the beginning of the 25 percent bracket would be increased by $7,500 and the beginning of the 28 percent bracket would be decreased by an offsetting amount.

### *3. Increase Standard Deduction Amounts*

The option would increase the standard deduction amounts in 2017 from $6,350 to $11,950 for single filers and from $12,700 to $23,900 for joint filers. The additional standard deduction for age and blindness would be repealed because the increased standard deductions would include these amounts.

### *4. Repeal Personal Exemptions*

Personal exemptions for taxpayers and dependents would be repealed. The proposed standard deduction amounts would include the current amount for taxpayer personal exemptions, and personal exemptions for dependents would be replaced by other provisions.

### *5. Combine All Child-Related Benefits into an Enhanced Child Tax Credit*

The option would enhance the child tax credit to reflect all child-related tax benefits. The current $1,000 child tax credit would be increased by $1,012.50 (25 percent of the value of the personal exemption amount in 2017 of $4,050) to $2,012.50 (indexed for inflation after 2017). The age limit would be raised from under 17 to under 19. In addition, all tax filers could get the full new credit: it would be fully refundable to low-income filers, whether or not they had wages or other earnings, would be allowed against the alternative minimum tax (AMT), and would have no income phaseout.

In addition, a new supplemental child tax credit would replace the child-related benefits of the EITC. This new supplemental child tax credit, like the EITC, would phase in, reach a plateau, and then phase out. The maximum credit would be $2,400 for one child and $4,800 for two or more children. The phaseout rates would be lower than the current EITC and start at higher income levels, with the ranges for married parents double the ranges for single parents.

### *6. New Credit for Other Dependents*

A new nonrefundable credit of $1,012.50 would replace the personal exemption for dependents other than children. This new credit would be indexed for inflation, allowed against the AMT, and have no income phaseout.

### *7. Refocus the EITC on Work Incentives*

With the child-related benefits of the current EITC replaced by the new supplemental child tax credit, the option would restructure the EITC into a worker credit only. The new worker credit would be much larger than the current EITC for workers without qualifying children (often called childless workers), and would be available to all workers. The credit would phase in at 15.3 percent up to $10,000 of earnings, making the maximum credit $1,530 (three times the $510 maximum credit for childless workers in 2017). For single workers, the credit would begin to phase out at $14,500 of earnings (or modified AGI, if higher) at a rate of 20 percent. For married taxpayers, each spouse would be eligible for the credit (based on his or her own earnings), and the phaseout would begin at double the single amount, $29,000 (based on joint income). The option would remove the age restrictions on claiming the credit, but it could not be claimed by dependents. For purposes of the phaseout, AGI would be modified by adding excluded Social Security benefits. All parameters would be indexed for inflation and the worker credit allowed against the AMT.

### *8. Repeal the Child and Dependent Care Tax Credit and Exclusion*

Most working families do not benefit from the child and dependent care tax credit or the exclusion for childcare expenses provided through an employer. Many who do benefit would receive additional benefits of roughly equivalent value from the enhanced child tax credit and the new credit for other dependents. The option would repeal both the child and dependent care tax credit and the exclusion for childcare expenses provided through an employer.

### *9. Simplify Qualifying Child, Qualifying Relative, and Qualifying Taxpayer Requirements*

Most of the current differences in qualifying child, relative, and taxpayer requirements add complexity to the tax code while no longer serving any clear policy purpose. The option would simplify these requirements by making them far more uniform.

*10. Reform Taxation of Dependents*

The current filing thresholds for dependents are quite low, requiring many dependents with no tax liability to file, and the special "kiddie tax" provisions are unnecessarily burdensome. The option would reform and simplify the way dependents are taxed.

Table 1 summarizes the family and work provisions under current law and the option, and notes other proposals that would amend each provision.

*Effects*

The option would improve the family and work provisions by significantly simplifying these provisions, clarifying and increasing work incentives for low-wage workers, and mitigating or removing unfairness in the current provisions. The option would also affect the distribution of tax burdens and revenues.

- Simplification. The option would significantly reduce complexity and the resulting time and out-of-pocket costs that taxpayers incur for record keeping, return preparation and filing, and any subsequent dealings with the IRS due to errors or omissions on returns. The number of itemizers would be reduced by 18.7 million (over 41 percent) in 2017 and the number of taxpayers on the AMT by 1.6 million (over 35 percent).

- Work Incentives. The new worker credit would focus the EITC on work incentives and provide low-wage workers without children a significant incentive to work. For workers with children, the child-related benefits would be less tied to work, so overall the option might somewhat reduce work incentives.

- Fairness. The enhanced child tax credit would provide far more uniform benefits for children than the current provisions and be available to all families. Marriage penalties and bonuses would generally be reduced.

- Revenue. Assuming an effective date of January 1, 2017, the option would reduce revenues over the ten-year budget period, FY2017 through FY2026, by nearly $1.1 trillion. This is a substantial revenue cost, and we examine several alternatives that would reduce that cost, in some cases quite significantly. In the context of a broader tax reform, base-broadening provisions could fully offset the cost of the option.

- Distribution. The option would reduce tax burdens on average for all but the highest income quintile (figure 1). On average, single and joint filers would receive tax cuts in all but the highest quintile and head of household filers in all but the top two quintiles. Families with children, and particularly those with low and moderate incomes, would benefit. Elderly taxpayers would be largely unaffected by the option.

TABLE 1

## Summary of Family and Work Provisions under Current Law and the Option, and Other Proposals to Amend Each Provision

| Provision | Current Law | Option | Other Proposals to Amend Provision[1] |
|---|---|---|---|
| 1. Filing Statuses | Five statuses: Two for married individuals (joint and married filing separate), two for unmarried individuals (single and head of household), and one for surviving spouses | Three statuses: One for married individuals (joint), one for unmarried individuals (single), and one for surviving spouses | Ackerman (2016), Camp (2014), Cruz (2015), Lee (2013), President's Advisory Panel (2005), Rubio (2015), Taxpayer Advocate (2008 and 2012), Trump (2016) |
| 2. Tax Rates and Brackets | Four sets of rate brackets with seven rates of 10% to 39.6% | Two sets of rate brackets with same rates as Current Law | |
| 3. Standard Deduction | Three regular standard deduction amounts and an additional amount (that varies by filing status) for age and blindness | Two amounts that combine the current law regular and additional standard deduction amounts and the taxpayer personal exemption amount(s) | Ackerman (2016), Camp (2014), House GOP (2016), Lee (2013), President's Advisory Panel (2005), Rubio (2015), Ryan (2014), Trump (2016) |
| 4. Personal Exemptions | Allowed for regular tax purposes for taxpayers and dependents, but phased out with income; disallowed for the alternative minimum tax (AMT) | Repealed (replaced by higher standard deduction for taxpayers, larger child tax credit for child dependents, and new credit for other dependents) | Ackerman (2016), Camp (2014), House GOP (2016), Lee (2013), President's Advisory Panel (2005), Ryan (2014), Taxpayer Advocate (2008 and 2012), Trump (2016) |
| 5. Child Tax Credit | $1,000 per child, partially refundable, phases out with income, credit and thresholds not indexed for inflation | $2,012.50 per child, fully refundable, no income phaseout; supplemental credit up to $2,400 for first and second child of low-income workers; fully indexed for inflation | Ackerman (2016), Camp (2014), House GOP (2016), Lee (2013), President's Advisory Panel (2005), Rubio (2015), Ryan (2014), Taxpayer Advocate (2008 and 2012), Trump (2016) |
| 6. Credit for Other Dependents | N/A | $1,012.50 per other dependent, not refundable, no income phaseout, allowed for AMT, indexed for inflation | Ackerman (2016), Camp (2014), House GOP (2016), President's Advisory Panel (2005), Taxpayer Advocate (2008) |
| 7. EITC | Small credit for workers without children; large credits for workers with 1, 2 or 3+ children; credits phase in with earnings and phase out with higher of earnings or AGI | Larger worker credit available to all low-income workers, including both spouses if both work; phases in and out like EITC, but ranges are double for married workers (child-related portion replace by enhanced child tax credit) | Ackerman (2016), Camp (2014); Domenici-Rivlin (2010), Holtz-Eakin (2016), Marr (2016), Murray (2014), President's Advisory Panel (2005), President's Budget (2016), Rangel (2016), Ryan (2014), Taxpayer Advocate (2008 and 2012) |
| 8. Child and Dependent Care Credit and Exclusion | Certain expenses for child and dependent care may qualify for a credit (and/or exclusion, if provided through an employer) | Repealed (replaced by enhanced child tax credit and the new credit for other dependents) | Camp (2014), House GOP (2016) |
| 9. Qualifying Requirements | Differ across provisions | Generally uniform across provisions | Ackerman (2016), Camp (2014), President's Advisory Panel (2005), Taxpayer Advocate (2008 and 2012) |
| 10. Taxation of Dependents | Low standard deduction; complex "kiddie tax" | Higher, simpler standard deduction; simplified and better focused "kiddie tax" | Ackerman (2016), Camp (2014), President's Advisory Panel (2005) |

[1] Full references: Ackerman: Ackerman, et al. (2016); Camp: Joint Committee on Taxation (2014a); Cruz: Cruz Campaign (2015); Domenici-Rivlin: Bipartisan Policy Center (2010); Holtz-Eakin: Holtz-Eakin, et al. (2016); House GOP: Ryan (2016); Lee: Lee (2013); Marr: Marr, et al. (2016); Murray: Murray (2014); President's Advisory Panel: President's Advisory Panel on Federal Tax Reform (2005); President's Budget: Office of Management and Budget (2016); Rangel: Rangle (2014); Rubio: Rubio Campaign (2015); Ryan: Ryan (2014); Taxpayer Advocate: National Taxpayer Advocate (2008) and National Taxpayer Advocate (2012); Trump: Trump Campaign (2016).

FIGURE 1

## Distributional Effects of the Family and Work Option by Filing Status, Demographic Group, and Expanded Cash Income Percentile in 2017

(percentage change in after-tax income)

| Cash income percentile[1] | All Tax Units | Single | Joint |
|---|---|---|---|
| Lowest quintile | 8.3 | 4.8 | 12.2 |
| Second quintile | 3.2 | 1.7 | 6.2 |
| Middle quintile | 1.0 | 0.3 | 1.7 |
| Fourth quintile | 0.2 | 0.5 | 0.3 |
| Top quintile | 0.0 | -0.1 | 0.0 |
| All | 0.8 | 0.8 | 0.6 |
| Addendum | | | |
| 80-90 | -0.1 | 0.2 | -0.1 |
| 90-95 | -0.3 | -0.4 | -0.2 |
| 95-99 | 0.1 | -0.3 | 0.2 |
| Top 1 percent | 0.1 | 0.0 | 0.1 |
| Top 0.1 percent | 0.0 | 0.0 | 0.0 |

| Cash income percentile[1] | Head of Household | All Tax Units With Children | Elderly |
|---|---|---|---|
| Lowest quintile | 11.1 | 13.5 | 1.1 |
| Second quintile | 2.8 | 5.6 | 0.3 |
| Middle quintile | 0.6 | 2.0 | 0.1 |
| Fourth quintile | -0.9 | 0.3 | 0.0 |
| Top quintile | -0.8 | 0.3 | -0.2 |
| All | 1.9 | 1.5 | 0.0 |
| Addendum | | | |
| 80-90 | -1.2 | 0.0 | -0.2 |
| 90-95 | -0.9 | 0.1 | -0.5 |
| 95-99 | -0.3 | 0.7 | -0.3 |
| Top 1 percent | -0.1 | 0.2 | 0.1 |
| Top 0.1 percent | 0.0 | 0.1 | 0.0 |

**Source**: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

[1]The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The incomes used are adjusted for family size by dividing by the square root of the number of people in the tax unit. The resulting percentile breaks are (in 2015 dollars): 20% $16,114; 40% $30,188; 60% $52,080; 80% $86,603; 90% $125,539; 95% $174,819; 99% $419,094; 99.9% $2,163,747.

## THE NEED FOR REFORM OF THE CURRENT FAMILY AND WORK PROVISIONS

A few examples can illustrate much of the complexity, ineffectiveness, and unfairness of the current provisions affecting families and work.[6]

### *Complexity*

Many families in ordinary circumstances can face extraordinary complexities in complying with their income tax recordkeeping and filing requirements. One of the complexities comes from the multitude of filing thresholds, the income levels at which a taxpayer must file a return (table 2). To comply with those filing requirements, a taxpayer must also understand and comply with the often complex rules defining marital status, head of household filing status, gross income, earned income, unearned income, and dependency status.

### *Limited Work Incentives for Childless Workers*

The current EITC for a childless worker, which by design offsets the 7.65 percent employee portion of the payroll tax over the phase-in range, provides only a small work incentive (figure 2).[7] This limited incentive provides additional income (i.e., an added work incentive) only up to $6,670 of wages in 2017 (less than half of full-time earnings at the current federal minimum wage of $7.25 per hour). The incentive on earnings up to $6,670 amounts to only $0.55 per hour for a minimum wage worker. While the low maximum benefit of $510 provides some income support above $6,670 of earnings, this support is completely phased out for single workers at $15,010, not much above earnings from full-time minimum wage work, $14,500.[8]

### *Overlapping, Uneven Child Tax Benefits*

One key feature of current law is that three different provisions provide child tax benefits: the personal exemption for children and other dependents, the child tax credit, and the EITC (figure 3).[9] The many requirements for a child to qualify for each of these benefits differ, so the same child might qualify for only one, two, or all three benefits.[10] Having three overlapping, but not fully consistent, benefits for children adds unnecessary complexity and increases parents' tax filing burdens.

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[6] The examples assume that all income is from wages and the couple (or single individual) takes the higher of the standard deduction or itemized deductions equal to 20 percent of adjusted gross income (AGI).

[7] The 7.65 percent employee payroll tax rate is the combined Social Security and Disability (OASDI) rate of 6.2 percent and the Medicare (HI) rate of 1.45 percent.

[8] A full-time worker is assumed to work 2,000 hours per year, so annual earnings at the minimum wage are 2,000 x $7.25 = $14,500.

[9] In this and the following example, we measure the benefit of the EITC for the first child as the difference between the EITC for one child and the EITC the taxpayer would receive if he or she were childless.

[10] In Figure 3, all children are assumed to be "qualifying children" for all three benefits.

TABLE 2

## Filing Thresholds under Current Law in 2017

| For Non-Dependents | | |
|---|---|---|
| **IF your filing status is . . .** | **AND at the end of 2016 you were . . .** | **THEN file a return if your gross income was at least . . .** |
| Single | under 65 | $10,400 |
| | 65 or older | $11,950 |
| Married filing jointly | under 65 (both spouses) | $20,800 |
| | 65 or older (one spouse) | $22,050 |
| | 65 or older (both spouses) | $23,300 |
| Married filing separately | any age | $4,050 |
| Head of household | under 65 | $13,400 |
| | 65 or older | $14,950 |
| Qualifying widow(er) with dependent child | under 65 | $16,750 |
| | 65 or older | $18,000 |

| For Children and Other Dependents |
|---|
| **Single dependents. Were you either age 65 or older or blind?** |
| **No. You must file a return if any of the following apply.** |
| • Your unearned income was over $1,050. |
| • Your earned income was over $6,350. |
| • Your gross income was more than the larger of— |
| • $1,050, or |
| • Your earned income (up to $6,000) plus $350. |
| **Yes. You must file a return if any of the following apply.** |
| • Your unearned income was over $2,600 ($4,150 if 65 or older and blind). |
| • Your earned income was over $7,900 ($9,450 if 65 or older and blind). |
| • Your gross income was more than the larger of— |
| • $2,600 ($4,150 if 65 or older and blind), or |
| • Your earned income (up to $6,000) plus $1,900 ($3,450 if 65 or older and blind). |
| |
| **Married dependents. Were you either age 65 or older or blind?** |
| **No. You must file a return if any of the following apply.** |
| • Your unearned income was over $1,050. |
| • Your earned income was over $6,350. |
| • Your gross income was at least $5 and your spouse files a separate return and itemizes deductions. |
| • Your gross income was more than the larger of— |
| • $1,050, or |
| • Your earned income (up to $6,000) plus $350. |
| **Yes. You must file a return if any of the following apply.** |
| • Your unearned income was over $2,300 ($3,550 if 65 or older and blind). |
| • Your earned income was over $7,600 ($8,850 if 65 or older and blind). |
| • Your gross income was at least $5 and your spouse files a separate return and itemizes deductions. |
| • Your gross income was more than the larger of— |
| • $2,300 ($3,550 if 65 or older and blind), or |
| • Your earned income (up to $6,000) plus $1,600 ($2,850 if 65 or older and blind). |

FIGURE 2

Work Incentives under Current Law for a Single Filer with No Children in 2017

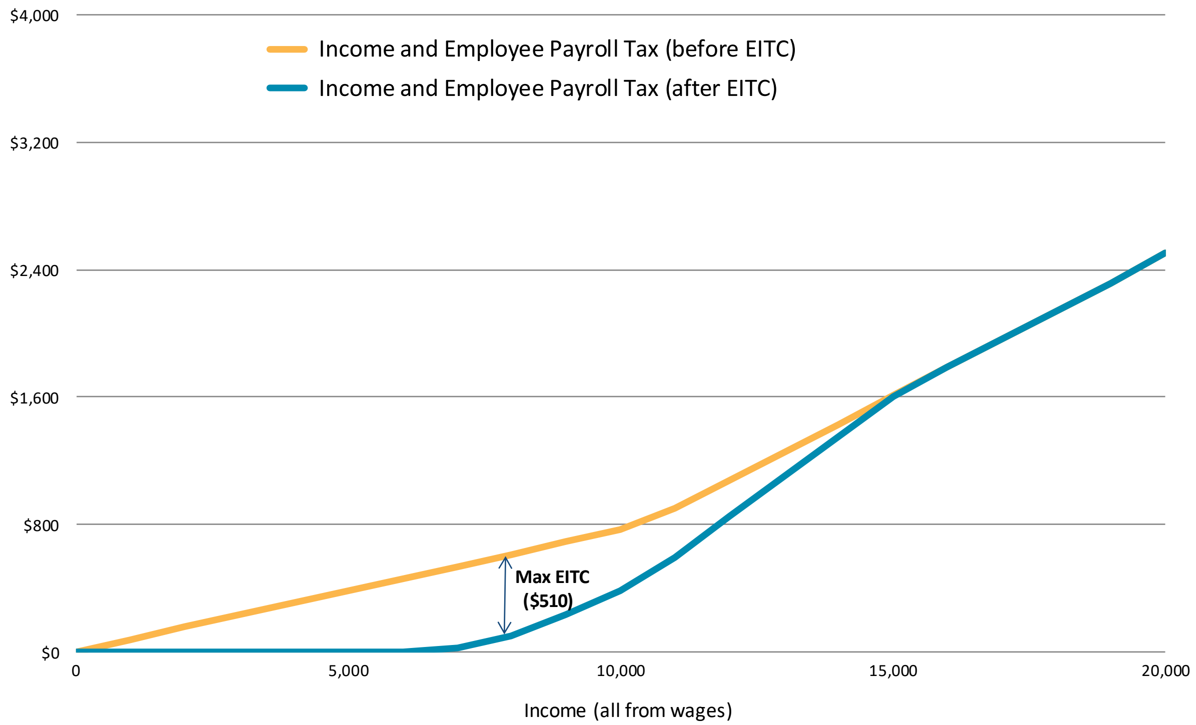
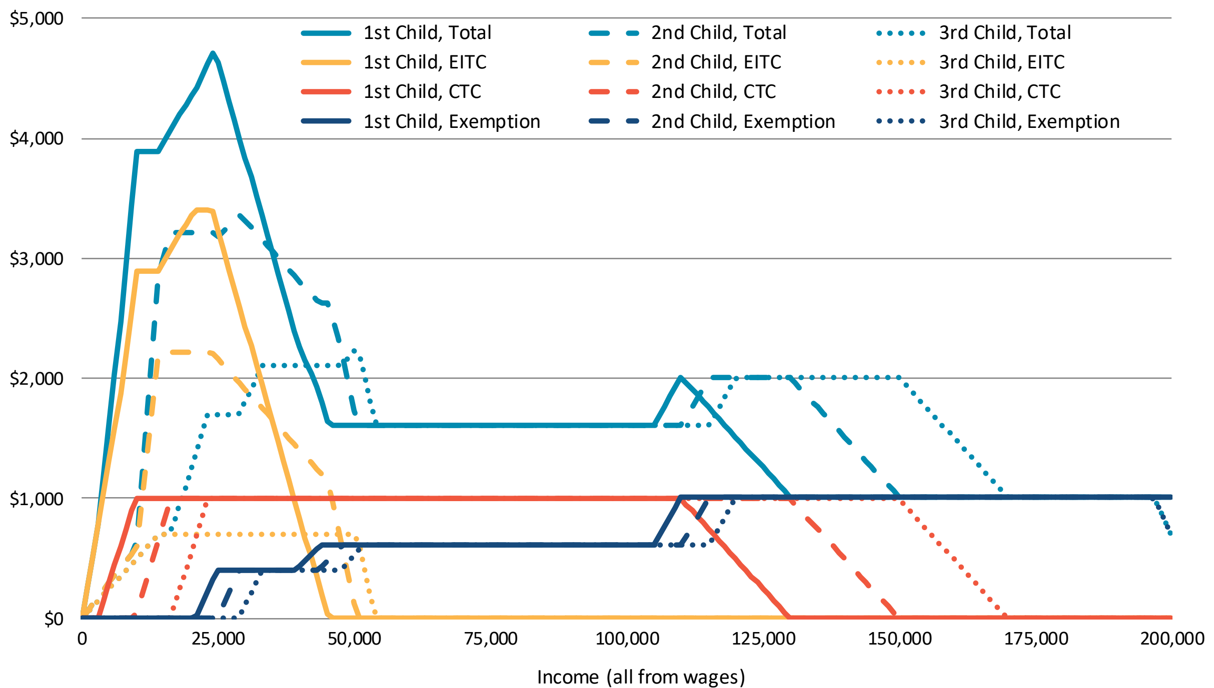



FIGURE 3

Tax Benefits of a Child under Current Law for Married Taxpayers in 2017



A second key feature of current law is that the total tax benefit for each child varies greatly across income levels, and can also vary greatly between the first, second and third child for couples at the same income level. Such wide fluctuations in child-related benefits cause substantial inequities among families while serving no coherent policy rationale.

### *Erratic and Unfair Benefit of Head of Household Filing Status*

A single taxpayer receives highly uneven tax benefits for his or her first child (figure 4). Like married parents, single parents receive benefits from the child tax credit, EITC, and personal exemption for the child. Unlike married parents, however, single taxpayers receive an additional benefit from becoming a parent, the ability to file as a "head of household" and receive a higher standard deduction and more favorable tax brackets than apply to other unmarried taxpayers. The benefit of head of household filing status is erratic, but broadly rises with income (and exceeds all child-related benefits beginning at about $85,000 of income), until it begins to decline as the single parent becomes subject to the AMT. As a result of head of household filing status, the tax benefit of the first child for a single parent can be much larger than for a married couple at some income levels.

### *Large Marriage Penalties*

Two unmarried individuals with two children would file separate returns, the higher earner as a head of household, reporting his or her separate income and claiming the tax benefits for both children, while the lower earner would file as single, reporting her or his separate income.[11] If they married, they would file a joint return, reporting their combined income and claiming the tax benefits for both children. Marriage imposes a tax penalty on two individuals if they pay more tax (or receive a smaller refund) on their combined income filing a joint return than the combined tax they would pay (or refunds they would receive) on their separate income if they were unmarried and filed separate returns; the married couple receives a marriage bonus if its tax is less (or its refund larger). Marriage penalties are generally largest when both individuals earn the same amount, and bonuses are largest when only one individual has income.[12] Between these extremes, marriage penalties are often quite large under current law. Assuming both individuals have income only from wages and the higher earner's wage represents 65 percent of their combined wages, penalties exceed $1,000 over fairly broad income ranges and reach nearly $3,000, while bonuses occur only at low income levels (figure 5). Large marriage penalties are inequitable and provide incentives for misreporting of marital status, but large marriage bonuses reflect inequitable treatment of unmarried individuals; both are too large under current law.

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[11] The individuals are assumed to live in the same household whether or not they are married. To qualify for head of household status a taxpayer must pay more than half the costs of keeping up a home (and meet other requirements), so both individuals could not qualify as heads of household if they lived in the same dwelling unless they maintained separate homes in that dwelling. Generally, the higher earning parent must claim child-related benefits if the parents live together.

[12] See Williams and Weiner (1997) and Bull et al. (1999) for detailed discussions of the definition and measurement of marriage penalties and bonuses.

FIGURE 4

Tax Benefits of the First Child under Current Law for a Single Taxpayer in 2017

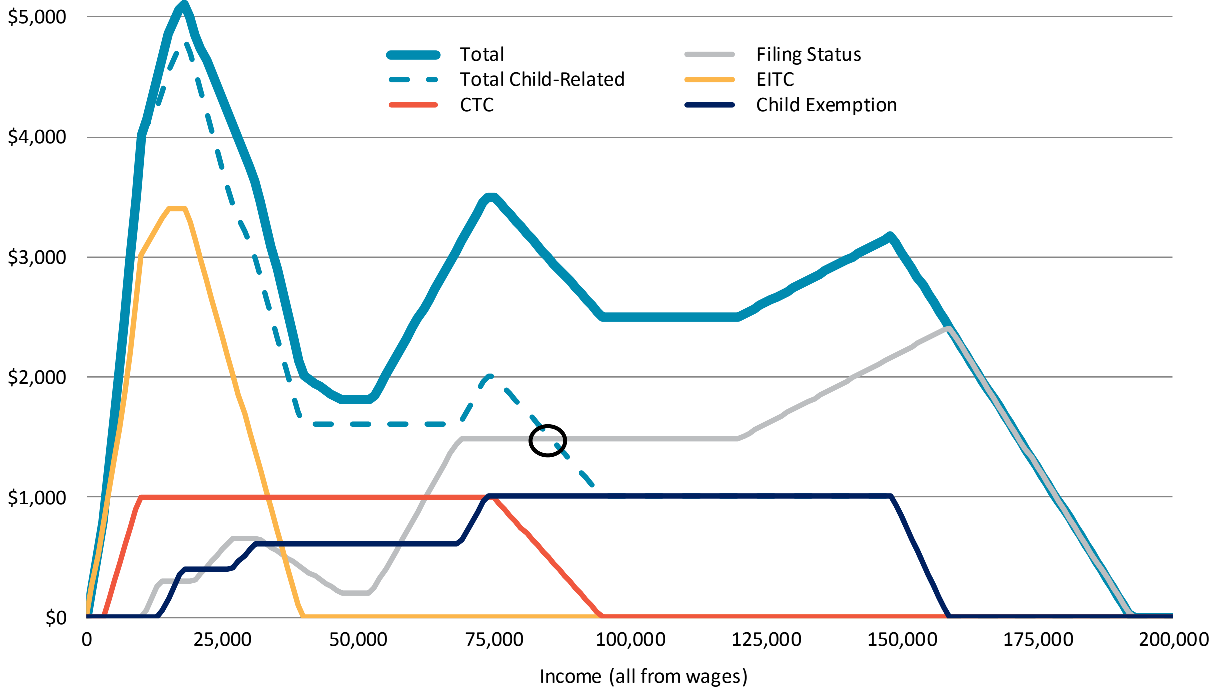
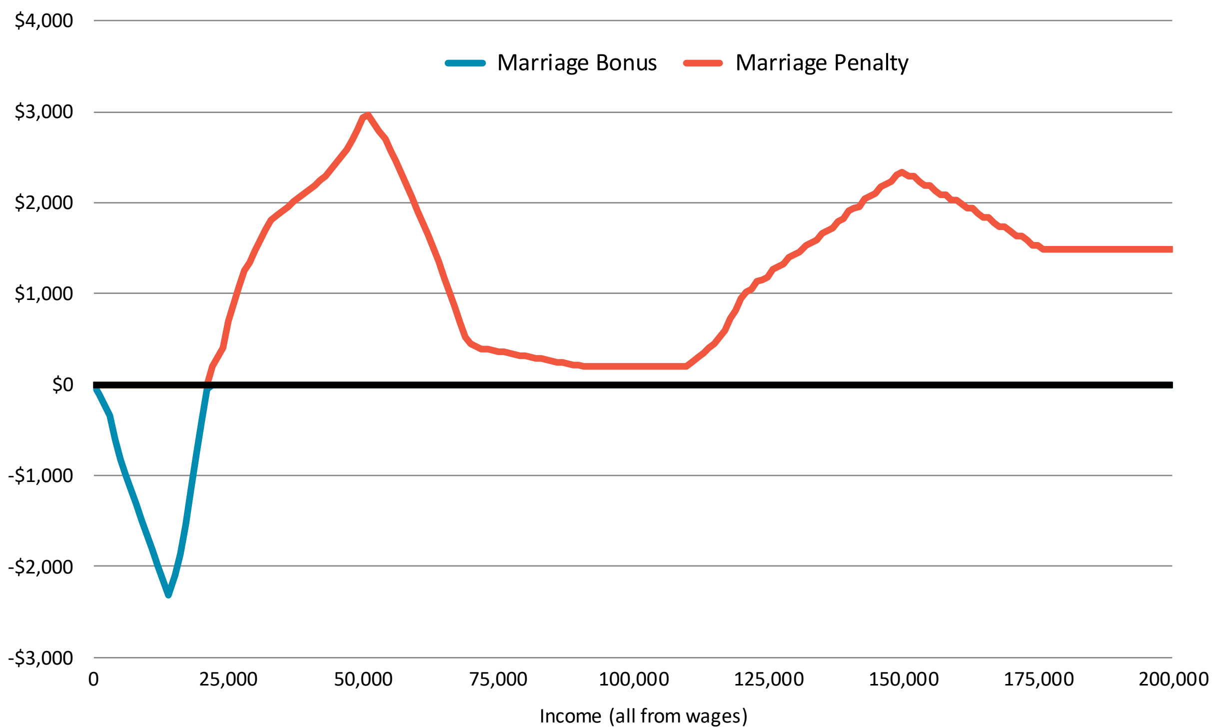



FIGURE 5

Marriage Penalties and Bonuses under Current Law in 2017,
Two Earners with Earnings Split 65 Percent/35 Percent and Two Children



## DETAILED DESCRIPTION OF THE PROPOSAL

The option reforms all of the basic provisions of the income tax that affect families and individuals: filing status, tax brackets, the standard deduction, personal exemptions, the child tax credit, the EITC, the requirements to qualify for family- and work-related benefits, and the taxation of dependents.

### *1. Reduce the Number of Filing Statuses*

#### Current Law

There are five filing statuses under current law: married filing jointly, married filing separately, single, head of household, and qualifying widow(er) (surviving spouse). Tax rate brackets, standard deduction amounts, and other parameters of the income tax differ across some, but not necessarily all, filing statuses. For example, tax rate brackets differ across all filing statuses except married filing jointly and surviving spouse, for which the same brackets apply. Similarly, standard deduction amounts differ across some filing statuses, but the same amount applies for married filing jointly and surviving spouse, and for single and married filing separately.

#### Reasons to Reform

Complying with filing status rules can be difficult, increasing filing costs and leading to inadvertent filing errors. In addition, the filing status distinction between unmarried individuals with and without children provides the most favorable tax treatment to a relatively small number of higher-income taxpayers who qualify as heads of household, who in one circumstance may have no dependents living with them.[13] Note that there is no filing status distinction between married couples with and without children.[14] In combination with the structure of other current provisions (in particular the EITC), head of household filing status can provide much greater tax benefits to single parents than to married parents, imposing significant marriage penalties and providing strong incentives for noncompliance.[15] Providing one filing status for all single individuals would allow benefits for children to be provided separately and uniformly to all parents.

#### Option

The option generally would eliminate the distinction in filing status between single individuals who do not maintain a household for a child or other dependent and those who do by combining the current law single and head of household filing statuses into one

[13] This can occur if head of household status is due to supporting a parent in a separate household.
[14] Married couples also do not qualify for a special filing status if they support a parent who lives in a separate household.
[15] Research by Mok (2014) using linked Census Current Population Report (CPS) and tax return data indicates that fully half of the income tax returns filed with head of household filing status report being either single with no dependents or married in the CPS.

status for all single individuals. However, as under current law, surviving spouses whose qualifying child lived with them the entire year and who meet certain other requirements could use the joint rates and standard deduction for two years following the death of their spouse. The option would also eliminate the married filing separately filing status. Married individuals would be required to file a joint return except (i) a spouse who is legally separated, lives apart from his or her spouse for the last six months of the year, or is a victim of domestic abuse (as defined under current law and regulations) would be allowed to file as single but then could not claim the new supplemental child tax credit (see below); and (ii) if both spouses are dependents of other taxpayers, the spouses could elect to file single returns (as dependents), but only for the purpose of claiming a refund for withheld income tax and estimated tax payments. With these changes, there would be only two sets of tax rate brackets and values for other income tax parameters such as the standard deduction.

### *2. Tax Rates and Brackets*

#### Current Law

Seven tax rates, ranging from 10 percent to 39.6 percent, apply to ordinary income under current law. As noted above, tax rate brackets differ across filing statuses with the exception that the same brackets apply to married filing jointly and surviving spouse. Current law taxes capital gains and qualified dividends at special rates of zero (in place of ordinary rates of 10 percent and 15 percent), 15 percent (in place of ordinary rates above 15 percent and below 39.6 percent), and 20 percent (in place of the 39.6 percent rate). Current law also imposes a 3.8 percent surtax on the net investment income (above a threshold) of high-income taxpayers.

#### Reasons to Reform

Reducing the number of sets of tax rate brackets to two is an integral part of the reduction in the number of filing statuses to two. Fewer sets of rate brackets would reduce complexity, remove inequities, and mitigate marriage penalties.

#### Option

The option would retain all current rates and brackets on ordinary income for married filing joint taxpayers. With one modification, all current rates and brackets for single filers would apply to all unmarried (single) filers. The modification would be an increase of $7,500 in the beginning of the 25 percent bracket for single filers, with an offsetting decrease in the beginning of the 28 percent bracket.[16] This modification in brackets would mitigate the

[16] The increase of $7,500 maintains the same ratio (1.67) for the beginning of the 25 percent bracket between joint and single filers that applies under current law for the beginning of the 28 percent bracket. The increase in the size of the 15 percent bracket provides a tax benefit of the rate differential of 10 percent (25 percent – 15 percent) times $7,500, or

effect of the loss of certain tax benefits under the option at about the same income level as typical single filers would enter the 25 percent bracket, while restoring the same tax liability on taxable income as under current law in the current 28 percent and higher brackets.[17] All of the brackets for single filers under the option would be less generous than the current brackets for head of household filers (table 3). The current law rate structure for capital gains and qualified dividends and the 3.8 percent surtax on net investment income would be retained without modification.

TABLE 3

Tax Rates and Brackets under Current Law and the Option in 2017

| Current Law | | | | | Option | | |
|---|---|---|---|---|---|---|---|
| Tax Rate (%) | Filing Status | | | | Tax Rate (%) | Filing Status | |
| | Married Filing Joint[1] | Single | Head of Household | Married Filing Separate | | Married Filing Joint[1] | Single |
| 10 | 0 | 0 | 0 | 0 | 10 | 0 | 0 |
| 15 | 18,650 | 9,325 | 13,350 | 9,325 | 15 | 18,650 | 9,325 |
| 25 | 75,900 | 37,950 | 50,800 | 37,950 | 25 | 75,900 | 45,450 |
| 28 | 153,100 | 91,900 | 131,200 | 76,550 | 28 | 153,100 | 66,900 |
| 33 | 233,350 | 191,650 | 212,500 | 116,675 | 33 | 233,350 | 191,650 |
| 35 | 416,700 | 416,700 | 416,700 | 208,350 | 35 | 416,700 | 416,700 |
| 39.6 | 470,700 | 418,400 | 444,550 | 235,350 | 39.6 | 470,700 | 418,400 |

[1]These rates also apply to surviving spouses.

### *3. Increase Standard Deduction Amounts*

### *and*

### *4. Repeal Personal Exemptions*

<u>Current Law</u>

Taxpayers may take a standard deduction but have the option of itemizing deductions. In 2017, the standard deduction amounts are $12,700 for married filing joint and surviving spouse filers, $9,350 for head of household filers, and $6,350 for other single filers and married filing separate filers, with all amounts indexed for inflation.[18] Taxpayers who are age 65 and older or blind are provided additional standard deduction amounts. In 2017, these additional amounts are $1,250 for each circumstance for married taxpayers (whether or not they file jointly) and surviving spouses, and $1,550 for each circumstance for other taxpayers, with both amounts indexed for inflation.

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$750. To offset that benefit for higher-bracket taxpayers, the beginning of the 28 percent bracket would be reduced by this tax benefit divided by the rate differential of 3 percent (28 percent – 25 percent), a reduction of $25,000.

[17] Typical single taxpayers would begin to itemize, and therefore lose the benefit of the current taxpayer personal exemption (which the option repeals) at about the same income level they would enter the 25 percent bracket.

[18] Married filing separate taxpayers may not use the standard deduction if their spouse files a return and itemizes. Taxpayers who are a dependent of another taxpayer have special standard deduction amounts that are discussed below in the section on taxation of dependents.

Current law also provides a personal exemption in 2017 of $4,050 (indexed for inflation) for taxpayers, spouses, and dependents.[19] The personal exemption is phased out for higher-income taxpayers.[20] Personal exemptions are not allowed in computing the AMT.

**Reasons to Reform**

Reducing the number of standard deduction amounts to two is an integral part of the reduction in the number of filing statuses to two. Fewer standard deduction amounts will reduce complexity, remove inequities, and mitigate marriage penalties.

Itemization of deductions requires detailed record keeping of amounts that might qualify for itemization and increases the complexity of tax filing. Higher standard deduction amounts would be more favorable than itemizing for many current itemizers. Switching to the standard deduction would reduce their record keeping and filing burdens.

The sum of the standard deduction and personal exemption amount for taxpayers (including spouses on a joint return) provides a minimum level of income that is exempt from income tax. Having separate standard deduction and personal exemption amounts simply adds complexity for the more than two out of three taxpayers who use the standard deduction.[21] Most itemizers receive an additional benefit simply because the minimum level of income exempt from tax is provided through two separate provisions rather than a single provision. Only high-income itemizers, for whom personal exemptions are phased out, do not receive this additional benefit.

Personal exemptions for most child dependents are in addition to the benefit of the child tax credit and the EITC. Having these three separate benefits for child dependents simply adds complexity for taxpayers. Further, the benefit of a dependent personal exemption rises as income and tax rates rise. For example, the value of a personal exemption for a taxpayer in the 15 percent bracket is 15% x $4,050 = $607.50, whereas it is nearly double that for a taxpayer in the 28 percent bracket (28% x $4,050 = $1,134.00). At high levels of income personal exemptions are phased out and families subject to the AMT receive no benefit from them; families in these circumstances who have children or other dependents are required to pay the same amount of tax as taxpayers who have no dependents but are otherwise in the same circumstances.

[19] Dependents are not allowed to also claim a personal exemption if they file their own return.
[20] For 2017, the personal exemption phaseout (PEP) applies to joint filers with AGIs starting at $313,800 ($287,650 for head of household filers, $261,500 for single other filers, and $156,900 for married filing separate filers), with all amounts indexed for inflation. The phaseout is over a $122,500 range of AGI (not indexed for inflation) for all filing statuses, regardless of the number of personal exemptions.
[21] In 2014, of the 148.6 million returns filed only 44.0 million (29.6 percent) itemized deductions. Source: SOI (2016a), table 1.4.

**Option**

The option would increase the regular standard deduction amounts to $11,950 for single taxpayers and to double that amount ($23,900) for joint taxpayers, and eliminate the additional standard deductions.[22] As under current law, the standard deduction amounts would be indexed for inflation.

For single filers, the new standard deduction amount in 2017 was determined as follows from current law amounts:

| | |
|---|---|
| Standard deduction for single filer: | $6,350 |
| Personal exemption for taxpayer: | $4,050 |
| Additional standard deduction for age or blindness: | $1,550 |
| Total: | $11,950 |

Note that this level is very close to the federal poverty guideline for a one-person family.[23]

All personal exemptions would be repealed under the option. However, the current exemption amount for taxpayers (including spouses on joint returns) would be included in the standard deduction amounts and personal exemptions for dependents would be replaced by a credit of equal or greater value to most families (see below).

Under current law, taxpayers with incomes below the sum of their standard deduction (including the additional amount for age and blindness) and their taxpayer personal exemption amount (which includes the spousal amount on joint returns) generally have no taxable income, and therefore are not required to file a return.[24] Under the option, taxpayers with incomes below their standard deduction would generally have no taxable income and therefore would not be required to file.[25]

Under the option there would be only two filing thresholds for non-dependent taxpayers, one for married taxpayers and one for single taxpayers, in contrast to the ten thresholds under current law. For all but head of household filers, the filing thresholds would be higher under the option than under current law (table 4).

[22] As under current law, the joint standard deduction amount would also apply for surviving spouses.
[23] The official guidelines for 2017 have not yet been announced by the US Department of Health and Human Services, but in 2016 the guideline for a one-person family (in the contiguous 48 states) was $11,880 whereas the option's standard deduction would have been $11,900.
[24] Many taxpayers with incomes below the filing threshold choose to file a return in order to claim refundable credits, to receive refunds of withholding or estimated payments, and for other reasons.
[25] As under current law, many of these taxpayers would choose to file a return.

TABLE 4

Tax Filing Thresholds for Non-Dependent Taxpayers under Current Law and the Option in 2017

| Current Law | | | | | Option | |
|---|---|---|---|---|---|---|
| Filing Status | | | | | Filing Status | |
| Married Filing Joint[1] | Married Filing Separate[2] | Single | Head of Household | Surviving Spouse | Married Filing Joint[3] | Single |
| | | | | | | |
| ***Taxpayers Under Age 65*** | | | | | | |
| 20,800 | 4,050 | 10,400 | 13,400 | 16,750 | 23,900 | 11,950 |
| | | | | | | |
| ***Taxpayers Age 65 and Over*** | | | | | | |
| 23,300 | 4,050 | 11,950 | 14,950 | 18,000 | 23,900 | 11,950 |

[1]Both spouses are assumed to be under age 65 or age 65 or over; there is an additional filing threshold under current law if only one spouse is age 65 or over (see table 2).

[2]A married taxpayer who files a separate return cannot use the standard deduction if their spouse files and itemizes, so the filing threshold for these filers is just the value of one personal exemption.

[3]Under the option, the filing threshold for married filing joint also applies for surviving spouses.

Note that filing thresholds do not take into account children or other dependents. Under current law personal exemptions for dependents raise the tax entry thresholds, the levels of income at which taxpayers have income tax liability before credits. Dependents would not affect tax entry thresholds under the option because all personal exemptions would be repealed.

### *5. Combine All Child-Related Benefits into an Enhanced Child Tax Credit*

#### Current Law

As described above, current law provides a personal exemption in 2017 of $4,050 (indexed for inflation) for children (and other dependents as well as taxpayers). To be eligible for a dependent personal exemption, a child must be under age 19, age 19 to 24 and a full-time student during at least five months of the year, or any age and permanently and totally disabled, and meet certain other requirements. In most cases, the child must live with the taxpayer claiming the dependent exemption for the child. However, special rules allow noncustodial parents who are divorced, legally separated, or living apart to benefit from the dependent exemption (and the child tax credit).

Under current law, taxpayers can claim a child tax credit of up to $1,000 for each child under age 17. The credit is reduced by 5 percent of AGI over $75,000 for single parents and over $110,000 for married couples. Neither the credit amount nor the phaseout threshold is indexed for inflation. If the credit exceeds income tax liability, taxpayers may receive some or all of the excess as a refund. The refundable portion of the

child tax credit is known technically as the additional child tax credit, and often referred to as the refundable child tax credit. The additional child tax credit equals 15 percent of earnings above $3,000, up to the amount by which the regular child tax credit exceeds tax liability.[26] Families with three or more qualifying children can claim an alternative additional child tax credit amount that is equal to the excess (if any) of their payroll tax payments over their EITC (up to the amount the regular child tax credit exceeds tax liability).[27] The child tax credit, including the additional credit, is allowed against the AMT.

The EITC is a refundable credit that phases in with wages and other earnings to a maximum amount, remains constant over a "plateau" range of earnings, and then phases out with the higher of earnings or AGI. The phase-in rates, maximum credit, income level at which the phaseout begins, and phaseout rates generally vary by the number of eligible children (none, one, two, three or more), and the beginning (and end) of the phaseouts are higher for joint filers. Taxpayers with no eligible children must be at least age 25 and under age 65 to qualify for the EITC. An eligible child must be under the age of 19, or under age 24 and be a full-time student during at least five months of the year, or any age and permanently and totally disabled, while also meeting other residency and citizenship requirements. Dependents and qualifying children cannot claim the EITC. Taxpayers who have a qualifying child for the EITC but choose not to claim the child EITC cannot claim the childless EITC.[28] Taxpayers with investment income over a threshold amount ($3,400 in 2016) are ineligible to claim the EITC. Dollar parameters are indexed for inflation. The EITC is allowed against the AMT.

### Reasons to Reform

Different eligibility rules apply for children to qualify for a dependent personal exemption and for the child tax credit under current law. Most importantly, there are differences in the age requirements: a child must be under age 17 to qualify for the child tax credit, but under age 19 or age 19 to 24 and a full-time student in at least five months of the year to qualify for a dependent personal exemption. These differences add complexity and make benefits uneven due to the loss of the child tax credit for teenagers when they reach age 17, even though most are still in high school and living at home. There is no policy rationale for limiting the child tax credit to children under age 17; it is simply a way to reduce its cost. Benefits are also uneven across family income due to the phaseouts of both the child tax credit and personal exemptions, and the disallowance of personal exemptions for purposes of the AMT. To the extent the child tax credit is meant to reflect differences in ability to

[26] The limitation on the additional child tax credit insures that the sum of the nonrefundable and refundable credits cannot exceed $1,000 per child.
[27] This alternative is a relic of prior law that did not make the additional child tax credit available to all child tax credit claimants.
[28] This happens, for example, when a child is a qualifying child for more than one individual. In such cases, the individual(s) who does (do) not claim the child may not claim the childless EITC.

pay for families with children, the credit should be available to all families, regardless of income.

Unlike the other child-related tax benefits, the child tax credit is not indexed for inflation so the real value of the credit has eroded over time. Since 2003, when the credit amount was doubled from $500 to $1,000, inflation (as measured by the consumer price index-urban) has reduced the real value of the credit by nearly 25 percent, to about $750. This reduction in real value means that the credit no longer provides the level of benefits that were originally intended.

There are several reasons to reform the refundable portion of the child tax credit. Unlike the EITC, which phases in from the first $1 of earnings, refundability of the child tax credit does not begin to phase in until earnings reach $3,000. The lack of any refundability with initial earnings means it provides no incentive for entering the labor force to some parents who can only work part time or for part of the year. Denying or limiting the credit to very low income families most in need of assistance also undermines the basic purpose of the credit. The alternative refundability formula is only available to families with three or more children and adds complexity for all such families (who are directed to compute their credit using both refundability formulas), yet is beneficial to very few families.[29]

The EITC has enjoyed broad-based political support and has been highly successful at encouraging work and reducing poverty.[30] Those benefits extend almost exclusively to workers with children; for workers without children, the EITC is so small that it provides little incentive to work and little reduction in poverty. In addition to providing income support for working families, the EITC helps offset the additional costs for child care incurred when parents work and can no longer provide child care themselves. These costs may be out-of-pocket or may be the extra time and effort required to arrange child care during working hours, but both costs can significantly reduce the benefit of entering the labor force or working more hours. Separating the two work-related incentives of the EITC would allow both to focus better on their policy objective and provide clearer incentives to beneficiaries.

The current EITC also imposes very large marriage penalties, which are unfair and encourage noncompliance.[31]

In addition, the EITC rules for a qualifying child differ from the rules for dependent personal exemptions or the child tax credit, there are separate requirements for a taxpayer to qualify for the EITC, and different definitions of "earnings" apply than for the refundable portion of the child tax credit. This adds complexity, which contributes to errors in claiming

[29] Using TPC's microsimulation model, we estimate that in 2017 about 30 thousand three person families will use the alternative refundability formula.
[30] See, for example, Executive Office of the President and U.S. Treasury Department (2014) and Marr et al. (2015).
[31] See, for example, Acs and Maag (2005).

the EITC and may lead some claimants who would otherwise self prepare their returns to use paid preparers, eroding the value of the credit they receive.

Finally, the investment income test for EITC eligibility can discourage saving by low-income workers and adds further complexity.

## Option

The option would combine the benefits of the personal exemption for children, the child tax credit, and the child-related portion of the EITC into an enhanced child tax credit.

The personal exemption amount for children would be replaced by a credit that is 25 percent of the exemption amount, so in 2017 would be 25 percent x $4,050 = $1,012.50.[32] This credit would simply be added to the current child tax credit amount, making the new basic child tax credit amount $2,012.50. As discussed in more detail below, the current definition of a qualifying child for the child tax credit would largely be retained, but two key changes would be made: the age limit would be raised from under age 17 to under age 19, and the child would have to live in the United States with the parent or other claimant for more than half the year. In addition, this $2,012.50 credit would be available to all eligible children, regardless of the income or earnings of their parent(s); it would not phase in or out with income. The entire credit amount would be indexed for inflation.

As discussed in the following section, the option would refocus the EITC on work incentives. The remaining child-related benefits of the EITC for workers with children would be converted into a refundable supplemental child tax credit. The same qualifying child requirements would apply for this supplemental credit as for the new basic child tax credit. The new supplemental credit would phase in at a rate of 20 percent for families with one child and 40 percent for families with two or more children. The maximum credit would be reached at earnings of $12,000, regardless of the number of children, making the maximum credit $2,400 for each of the first two children. The credit would phase out at a rate of 10 percent for one child and 20 percent for two or more children beginning at $22,150 for single parents and at twice that level, or $44,300, for married parents (regardless of whether one or both spouses worked).[33] The phaseouts therefore end at $46,150 for single parents and $68,300 for married parents. No investment income test would apply to the supplemental child tax credit.

The new child tax credit (including the supplemental portion) would be allowed against the AMT.

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[32] Although most dollar amounts in the tax law are rounded, we use this unrounded amount here and in the following to emphasize how it is derived and therefore compares to current law.
[33] As explained in the next section, these income levels would be the end of the phaseout ranges for the proposed EITC worker credit.

The option would improve the design of child-related tax benefits in three ways (figure 6):[34]

1. Child tax benefits would generally be as high or higher than under current law for all children and at all income levels, except at middle-income levels for the first child of single parents (who would lose the additional benefits of head of household filing status that they receive under current law).

2. Child tax benefits would be far more uniform than under current law.

3. Benefits would not disappear as they do for higher-income parents under current law due to the AMT and the income phaseouts of personal exemptions and the child tax credit.[35]

FIGURE 6

Child-Related Tax Benefits under Current Law and the Option in 2017

[34] The examples in figure 6 assume that all income is from wages, that married taxpayers file joint returns and single parents file as heads of household under current law and as single under the option, and that taxpayers claim the standard deduction until itemizing become advantageous (as in the previous examples, itemizable deductions are assumed to be 20 percent of AGI regardless of the number of children). Because most working parents do not benefit from either the child and dependent care credit or exclusion, the examples ignore these benefits. For single taxpayers, the benefit of filing as a head of household under current law is included as a child-related benefit for the first child.

[35] For married taxpayers, child benefits disappear at income levels somewhat above the levels shown in figure 5.

### *6. New Credit for Other Dependents*

**Current Law**

Current law provides a personal exemption in 2017 of $4,050 (indexed for inflation) for dependents other than children (as well as for children and taxpayers).

**Reasons to Reform**

The tax benefit of the deduction for personal exemptions for dependents varies with the tax rate of the taxpayer, phases out at higher income levels, and is not available for taxpayers on the AMT. Consequently, the tax benefit varies widely at different income levels and for taxpayers at the same income level who in other respects are quite similar. These wide variations in benefits are unfair, serving no coherent policy rationale.

**Option**

The personal exemption amount for dependents other than children would be replaced with a credit that is 25 percent of the amount, so in 2016 would be 25 percent x $4,050 = $1,012.50.[36] This new credit would not be refundable, just as current deduction for personal exemptions cannot reduce taxable income below zero. This new credit would be indexed for inflation and would not phase out with income. As discussed in more detail below, to qualify for this new credit a person would have to meet the requirements for being a "qualifying relative."

This new credit would be allowed against the AMT. In addition, to simplify tax calculations this credit would be taken before any other nonrefundable credits except the foreign tax credit.

### *7. Refocus the EITC on Work Incentives*

**Current Law**

The pure work incentive in the current EITC is the "childless" portion, which is available to taxpayers between the ages of 25 and 64 who have no eligible children. Dependents and EITC qualifying children cannot claim any portion of the EITC.

**Reasons to Reform**

The current EITC provides very small incentives to individuals without custodial children to either enter the labor force or to work more if they are already in the labor force (figure 2).

[36] We use this unrounded amount here and in the following to emphasize how it is derived and therefore compares to current law, even though most dollar amounts in the tax law are rounded.

Further, childless workers under age 25, for whom labor force participation and the acquisition of skills are particularly important, are not eligible for the current childless EITC. Likewise, workers aged 65 and over, who may need to supplement their Social Security and other retirement income by working, are also ineligible for the childless EITC.

For families with children, the current EITC is designed in part to recognize child care costs related to working. Separating the work and child incentives would better focus both on their policy objectives and provide clearer incentives to beneficiaries.

Finally, the EITC can discourage secondary earners from working because it is based on joint earnings rather than the separate earnings of each spouse.

## Option

The option would restructure the EITC into a worker credit available to all individuals with earnings in the eligible range. The child-related benefits of the current EITC would be replaced by the new supplemental child tax credit discussed above. The proposed EITC would be strictly a worker credit, available to all workers who are not dependents, whether or not they have children, and with no age restrictions. Investment income would not affect eligibility for the credit.

The new worker credit would phase in at the combined employer plus employee payroll tax rate of 15.3 percent, double the current supplement for childless workers. That would provide workers earning the current $7.25 per hour federal minimum wage a supplement of $1.11 per hour. The phase-in would end when earnings reach $10,000, 50 percent above the $6,670 end of the phase-in in 2017. The maximum credit would be $1,530, more than triple the $510 maximum credit for childless workers in 2017. For single workers, the credit would phase out at a 20 percent rate when earnings (or modified AGI, if higher)[37] exceeded $14,500[38] The credit would be fully phased out for single workers at $22,150 (table 5).

For married taxpayers filing jointly, each working spouse would be eligible for a worker credit. The maximum combined credit for a two-earner couple would be $3,060 if both spouses have earnings of at least $10,000 but not over $14,500. The combined worker credits of the spouses would phase out based on joint income (the higher of joint wages or joint AGI), starting at $29,000 (double the level for unmarried workers) at a 20 percent rate. The phaseout range for a one-earner couple therefore would extend from $29,000 to $36,650 and for a two-earner couple from $29,000 to $44,300.

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[37] As discussed more fully below, for purposes of the phaseout AGI is modified to include all excluded Social Security benefits so that older workers do not receive more favorable treatment than younger workers.

[38] The start of the phaseout range equals the annual earnings of a person working full-time at the current $7.25 per hour federal minimum wage (assuming full-time is 2,000 hours per year): 2,000 hours x $7.25/hour = $14,500.

TABLE 5

Parameters of the EITC for Childless Workers under Current Law and the Option's Worker Credit in 2017

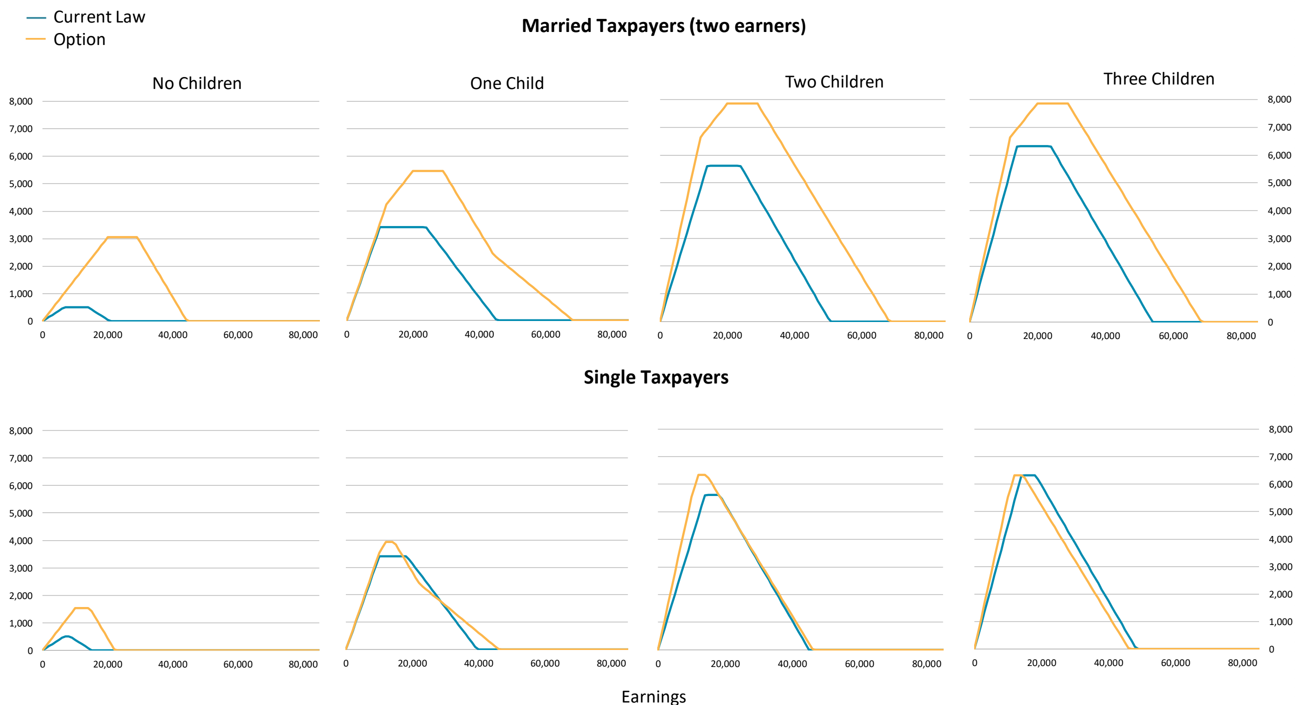
| Parameter | Joint Filers with: | | | | Other Filers | |
|---|---|---|---|---|---|---|
| | One Earner | | Two Earners | | Current Law | Option |
| | Current Law | Option | Current Law[1] | Option | | |
| Phasein rate | 7.65% | 15.30% | 7.65% | 15.30% | 7.65% | 15.30% |
| Phasein ends | $6,670 | $10,000 | $6,670 | $20,000 | $6,670 | $10,000 |
| Max credit | $510 | $1,530 | $510 | $3,060 | $510 | $1,530 |
| Phaseout begins | $13,930 | $29,000 | $13,930 | $29,000 | $8,340 | $14,500 |
| Phaseout rate | 7.65% | 20.00% | 7.65% | 20.00% | 7.65% | 20.00% |
| Phaseout ends | $20,600 | $36,650 | $20,600 | $44,300 | $15,010 | $22,150 |

[1]The EITC for two-earner childless couples is the same as for one-earner childless couples under current law.

For both married and single workers with no children, the proposed worker credit would be significantly larger than the current childless EITC (figure 7). For married two-earner couples, the combination of the worker credit and supplemental child tax credit would be larger than the current EITC for one, two, or three children at all income levels. For single parents with one child and incomes between about $18,000 and $27,000, the combination of these credits would be somewhat smaller than the current law EITC. For single parents with three children and income above $15,000, the combination of these credits would be lower than the current EITC. However, all single parents would benefit from the $2,012.50 basic child tax credit under the option. Families would also be affected by other provisions that may increase or decrease their tax liabilities, as discussed below.

FIGURE 7

Earned Income Tax Credit under Current Law and the Option's Worker Credit Plus Supplemental Child Tax Credit in 2017



### *8. Repeal the Child and Dependent Care Tax Credit and Exclusion*

#### Current Law

The child and dependent care tax credit is allowed for certain employment-related expenses for the care of children under the age of 13 or an incapacitated spouse or other dependent. Expenses are limited to $3,000 for the first qualifying individual and $6,000 for two or more qualifying individuals. Expenses that qualify for the credit cannot exceed earned income (the earned income of the lower-earning spouse on a joint return).[39] The credit rate begins at 35 percent, but phases down to 20 percent for AGI between $15,000 and $43,000, so the maximum credit for one qualifying individual ranges (depending on AGI) from 35 percent x $3,000 = $1,050 to 20 percent x $3,000 = $600, and double those amounts ($2,100 to $1,200) for taxpayers with two or more qualifying children. The credit is not refundable, so few taxpayers, if any, benefit from the highest credit rates, with most beneficiaries receiving a 20 percent credit.

Employees may also exclude up to $5,000 of the value of expenses incurred for the care of one or more dependents that is provided through an employer (such as an on-site child care center or a flexible spending arrangement or FSA). The exclusion is limited to earned income (the earned income of the lower earning spouse on a joint return). Expenses incurred that are in excess of the amount excluded in an FSA can be used for purposes of the credit so long as total expenses do not exceed the $3,000/$6,000 credit caps.

The parameters of the credit and exclusion are not indexed for inflation.

#### Reasons to Reform

Few working parents benefit from either the credit or exclusion for child and dependent care. In 2014, the latest year for which data on use of the credit is available, of the 35.6 million families with working parents only 4.5 million (about 13 percent) claimed the credit and were taxable, and therefore may have benefitted from the credit. Roughly 1.2 million (about 3 percent) received benefits through an employer plan.[40] Benefits were small: the average credit was only $561 and the average exclusion was $3,456, which would reduce income taxes by $518 for a taxpayer in the 15 percent bracket. And benefits were highly uneven: 85 percent of working parents got nothing, a few credit recipients got the $2,100

[39] The limitation on expenses to the earned income of the lower-earning spouse restricts the credit to two-earner couples. However, if a spouse is a full-time student or incapacitated for any month of the year, they are deemed to have earned income of at least $250 ($500 if more than one dependent received care during the year) for that month.
[40] The number of families with working parents (which only counts a married couple if both spouses have earnings) is an estimate from TPC's microsimulation model. The number claiming the credit is from SOI (2016a) Table 3.3 and the number receiving benefits from an employer plan is from SOI W-2 Table 5.A.3 (for 2010, the latest year available).

maximum credit (nearly four times the average credit), and some beneficiaries of the exclusion saved as much as $2,745.[41]

The two provisions also interact in a complicated way—parents can claim both benefits, but not for the same dollars spent on childcare and subject to the limits for each. For example, parents with two or more children and at least $6,000 of child care expenses could exclude up to $5,000 in their FSA and use difference between $6,000 (their expense limit for the credit) and the amount of expenses excluded in their FSA for purposes of the credit. Parents of one child could exclude up to $5,000 of expenses in their FSA, but if they exclude less than $3,000 of expenses in their FSA (because they contributed less than $3,000 or don't have an FSA), they could use the difference between $3,000 (their credit limit) and the amount of expenses excluded in their FSA for purposes of the credit.

In addition to wide discrepancies in benefits, the requirements for the credit and exclusion only provide benefits for a narrow set of parental choices for providing care for children and other dependents. For example, some married couples might be able to provide better care for their children if only one spouse worked or if they paid an older sibling to care for a younger child, but neither arrangement qualifies for the credit or exclusion. In addition, the credit and exclusion impose record keeping and return preparation burdens on the working parents who do benefit. These burdens are magnified by the differences in the benefits provided by the credit and the exclusion and the interaction between them.

**Option**

Both the child and dependent care tax credit and the exclusion for child and dependent care provided through an employer plan would be repealed.

The increase under the option in the basic child tax credit to $2,012.50, which would be fully refundable to all parents regardless of earnings, and the new credit for other dependents of $1,012.50, would provide most working parents an additional tax benefit of at least $405 for each child or other dependent. This amount is close to the typical income tax benefit of the credit or exclusion noted above.[42] Making the new benefits uniform for all custodial parents would allow them to decide how best to provide care for their children and other dependents, and would impose no additional record keeping or filing burdens.

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[41] The tax benefit of the exclusion increases as income tax rates rise with income, and it also provides a payroll tax benefit. For example, the income tax benefit of the average exclusion of $3,456 rises from $346 for a 10 percent bracket taxpayer to $1,369 for a taxpayer in the 39.6 percent bracket. In addition, the payroll tax benefit (including employer and employee shares) could be as high as $529 on the average exclusion, making the total benefit as high as $1,898. Over 25 percent of the beneficiaries of the exclusion receive the maximum amount of $5,000, making the maximum income plus payroll tax benefit as high as $2,745.

[42] Most working parents are in the 0, 10 or 15 percent income tax brackets. For a working parent in the 15 percent bracket, the current law personal exemption reduces taxes by 15% x $4,050 = $607.50 which is $405 less than the increase in the basic child tax credit and the amount of the new credit for other dependents under the option.

### *9. Simplify Qualifying Child, Qualifying Relative, and Qualifying Taxpayer Requirements*

<u>Current Law</u>

Under current law, the qualification rules to be a dependent of a taxpayer differ for "qualifying children" and "qualifying relatives." In addition, a "qualifying child" is defined differently for the dependent exemption, the child tax credit (including the refundable portion, the additional child tax credit), and the EITC. Further, taxpayers must meet different requirements in order to claim benefits for qualifying children and qualifying relatives.

"Earned income" is defined differently for the phase-in of the additional child tax credit and the phase-in (and phaseout, if earned income exceeds AGI) for the EITC. Nontaxable combat pay is included for the child tax credit but not for the EITC (unless a taxpayer elects to include it). In addition, EITC calculations include certain income subject to payroll tax but not income tax, while the additional child tax credit calculations generally do not include such income.

"Earned income" also affects the taxation of dependents. A dependent with earned income may claim a higher standard deduction than a dependent with the same gross income but no earned income. In addition, earned income is defined differently for the taxation of dependents and the kiddie tax provisions than for either the additional child tax credit or the EITC.

<u>Reasons to Reform</u>

Differences in the requirements for the closely related child tax benefits of a personal exemption, the child tax credit, and the EITC add significant complexity to income tax filing for taxpayers with children, especially low- and middle-income parents for whom the benefits are particularly important. Differences in the definition of earned income likewise complicate tax compliance for many taxpayers and for dependents who work. Few of these differences serve a coherent tax policy goal or aid tax administration.

<u>Option</u>

The option would combine all child-related benefits into an enhanced child tax credit with a single set of requirements for a child to qualify (including for the supplemental portion). Specifically, a "qualifying child" would need to be under age 19 (or permanently and total disabled) and to live <u>in the United States</u> with the taxpayer for more than half the year. A child who qualified for the child tax credit would automatically be a dependent. Any other person who qualified for the new dependent credit would also be a dependent. As under current law, a child who was not a "qualifying child" might still be a "qualifying relative."

Also as under current law, the definition of "dependent" as a "qualifying child" or "qualifying relative" would apply generally for all income tax purposes.[43]

The option would use the same definition of earned income for both the supplemental child tax credit and the EITC. That definition follows the current EITC definition except it always includes nontaxable combat pay. The option also would use a single definition of earned income for both the standard deduction for dependent filers and the kiddie tax (see next section). The two definitions of earned income differ slightly: for dependent filers and the kiddie tax, earned income would (1) exclude amounts that are not included in gross income, and (2) include taxable distributions from a qualified disability trust (as under current law).[44]

### *10. Reform Taxation of Dependents*

#### Current Law

Dependents are generally taxed in the same manner as non-dependent taxpayers, but special standard deduction amounts apply to dependents and some children's unearned income is taxed at higher rates.

The standard deduction for dependents in 2017 under current law is:

1. The *smaller* of:

(i) the *greater* of (a) earned income plus $350 and (b) $1,050,

and

(ii) the regular standard deduction for the dependent's filing status.[45]

*Plus*

2. The additional standard deduction amount(s) for age and blindness for the dependent.

Child dependents may also be taxed at higher rates on their unearned income over a threshold amount under current law. These "kiddie tax" provisions are intended to remove the incentive for high-income parents to reduce their families' income tax liabilities by shifting assets to their children who would otherwise be taxed at lower rates. The provisions apply to children: (1) under age 18, or (2) age 18 or age 19-24 and a full time-student in at least five months of the year and who did not have earned income that was

[43] For example, this definition applies for the Affordable Care Act (ACA) health insurance premium tax credit.
[44] Appendix A provides a more detailed discussion of the requirements under current law and the option.
[45] Dependents may not use the married filing separate filing status under current law; the option would repeal that status.

more than half of his or her support, and (3) with at least one parent living at the end of the year, and (4) who do not file a joint return, and (5) who have unearned income of more than $2,100. Unearned income is gross income without the deductions for net operating losses (NOLs) and the foreign earned income and housing exclusions, less the child's earned income and less the above-the-line deduction for early withdrawal of savings.[46] Net unearned income is the excess of a child's unearned income over $2,100 (or $1,050 plus deductions directly connected to the production of the unearned income, if the child itemizes). If net unearned income is positive, the lesser of the child's net unearned income and the child's taxable income is taxed at the higher of the child's rate and the rate of the child's parent(s). Which parent(s) rate applies depends on various circumstances, and may depend on the child having siblings with unearned income; the child may or may not be a dependent of the relevant parent(s). If a child only has income from interest, dividends (including Alaska Permanent Fund dividends), and capital gains distributions, has gross income less than $10,500, and meets certain other conditions, the parent(s) whose tax rate applies (or would apply) to the child's unearned income in excess of $2,100 can elect to include the child's income in their return and the child is then not required to file a return.

### Reasons to Reform

The multiple filing thresholds for dependents are much lower than for other taxpayers (as low as $1,050), most dependent filers do not have any tax liability, and the average liability for most taxable dependents is very low. In 2014 (when the filing threshold for dependents was as low as $1,000), there were 9.0 million returns filed by dependents, of which only 3.9 million (43 percent) had any tax liability after credits. Average liability for all taxable dependents was only $884, and only $187 for the 2.1 million taxable dependents with AGI under $10,000 (80 percent of all dependent filers had AGI under $10,000).[47]

The record keeping and filing burdens associated with filing by most dependents surely exceed their limited tax liability. Higher filing thresholds could therefore significantly reduce these burdens with little revenue loss.

The kiddie tax provisions do not affect many dependents (fewer than 365,000 in 2014), but are particularly complex. Over 40 percent of the total tax paid in 2014 under these provisions was paid on fewer than 3,000 dependent returns reporting incomes of $200,000 or more.[48]

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[46] The effect of this definition is to allocate NOLs and the foreign earned income and housing exclusions to earned income and the penalty on early withdrawal of savings (and no other above-the-line deductions) to unearned income. Only if earned income net of these allocations and net of all other above-the-line deductions and the standard deduction above $2,100 (or applicable itemized deductions) is less than zero is the taxation of unearned income potentially affected. Note that earned income can be less than zero due to losses from self-employment.
[47] Table 1.7 in SOI (2016a). See also Nunns (2015).
[48] Table 1.7 in SOI (2016a).

**Option**

The option would increase and simplify the standard deduction for dependent filers, and simplify and better target the kiddie tax.

Under the option, the "regular" and "additional" standard deduction amounts would be combined for dependents, who could only file as single under the option. This new standard deduction amount was determined as follows from 2017 current law amounts for single filers:

| | | |
|---|---|---|
| Regular standard deduction: | | $6,350 |
| Additional standard deduction for age or blindness: | | $1,550 |
| | Total | $7,900 |

In addition, the minimum standard deduction amount (which generally applies to unearned income) would also be increased from $1,050 to include the additional standard deduction amount of $1,550, so be $2,600, and the same amount would be added to earned income (if positive) for purposes of computing the standard deduction.

The proposed 2017 standard deduction for dependents is therefore:

If earned income is positive, the *smaller* of (i) earned income plus $2,600 and (ii) $7,900;

If earned income is zero or negative, $2,600.

As under current law, these dollar amounts are indexed for inflation.

The determination of a filing requirement would be greatly simplified under the option for dependent filers, because there would be only two conditions to consider. Filing would be required only if:

- Unearned income was more than $2,600, or
- Earned income plus $2,600 was more than $7,900.

In contrast to only two filing requirements under the option, current law has six conditions not based on income (whether married or single, whether or not age 65 or over, and whether or not blind) and four income conditions for each of these, for a total of 24 thresholds (see table 2).

Under the option, the kiddie tax provisions would apply to children: (1) under the age of 16, (2) who are a qualifying child of any taxpayer, and (3) who have more than $2,600 of

unearned income. Unearned income would be defined as under current law, but earned income would be defined somewhat differently.[49] Net unearned income would be the excess of a child's unearned income over $2,600 (or deductions directly connected to the production of the unearned income, if the child itemized). If net unearned income was positive, the lesser of the child's net unearned income and the child's taxable income would be taxed at the higher of the child's rate and the income tax rates that apply to trusts and estates, which the option would not change (table 6). As under current law, the remainder (if any) of the child's taxable income would be taxed at the same income tax rates that apply generally to single filers. The election for the parent(s) to include a child's income on their return would be repealed.

TABLE 6

Tax Rates and Brackets for Trusts and Estates in 2017

| Tax Rate (%) | Bracket Begins |
|---|---|
| 15 | 0 |
| 25 | 2,550 |
| 28 | 6,000 |
| 33 | 9,150 |
| 39.6 | 12,500 |

## EFFECTS OF PROPOSAL ON REPRESENTATIVE INDIVIDUALS AND FAMILIES

The option would reduce income tax liabilities for most current single filers with incomes below $40,000 due to the EITC worker credit and the increase in the standard deduction, but liabilities would then rise somewhat as the taxpayer approaches the income level at which itemization becomes advantageous and the benefit of the current personal exemption (which the option would repeal but add into the standard deduction amount) would be lost (figure 8).[50] Note that in 2017 only about one-third of single filers without children are expected to have incomes over $40,000.

In this and other examples discussed below, we assume that income is only from wages and that taxpayers use the standard deduction until itemizing becomes advantageous.[51] All provisions of current law and the option are taken into account.

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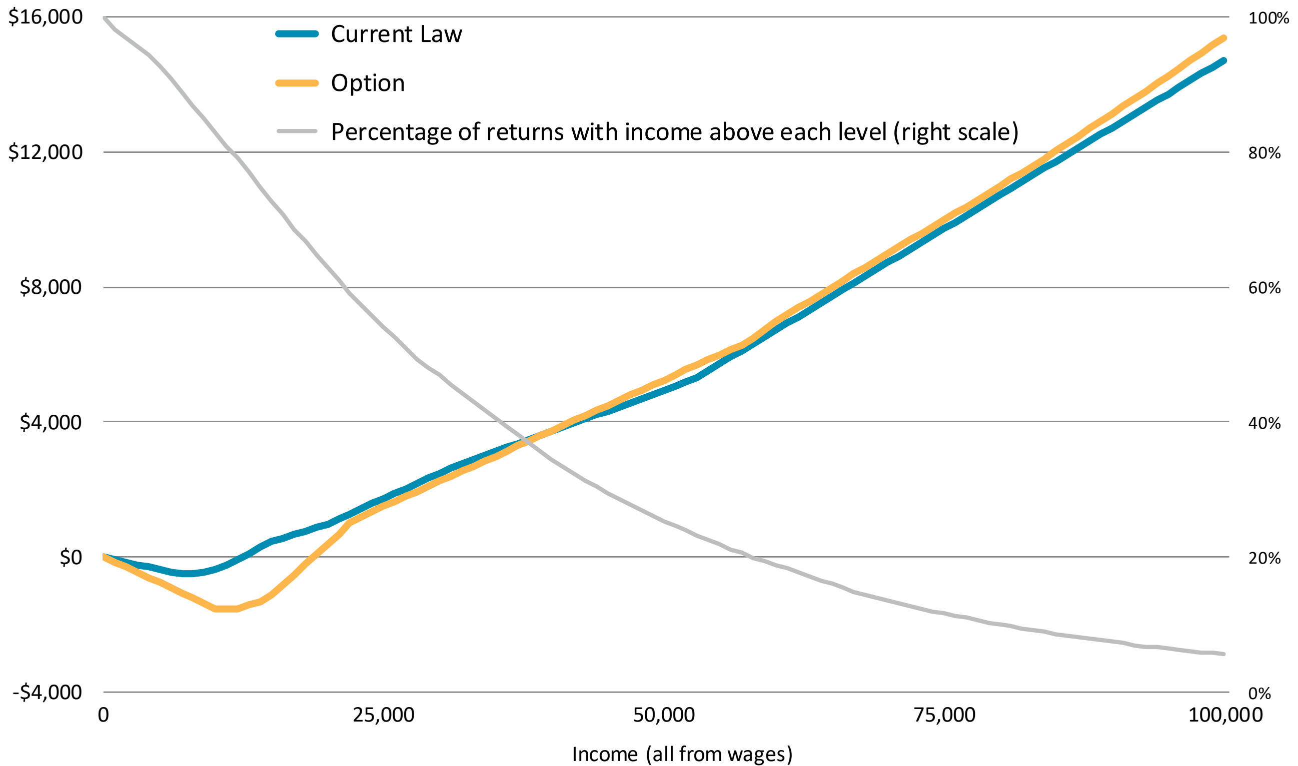
[49] Under the option the foreign earned income and housing exclusions would be deducted from earned income, so not need to be added back to gross income to calculate unearned income, and the above-the-line deduction for one-half of self-employment taxes would be deducted from earned income, so would need to be added back.

[50] The filer is assumed to be over age 24 and under age 65 (so eligible for the childless EITC under current law as well as the EITC worker credit under the option, which has no age restrictions).

[51] Itemizable deductions are assumed to be 20% of AGI and the current law standard deduction for single filers is $6,350, so itemization becomes advantageous for single filers when income reaches $6,350/.2 = $31,750. Under the option, itemization becomes advantageous for a single filer when income reaches $11,950/.2 = $59,750.

FIGURE 8

Income Tax under Current Law and the Option for a Single Filer with No Children in 2017




The option would reduce income tax liabilities for single filers with one child and income under about $18,000 by sizable amounts because the higher child tax credit would more than offset other changes that would increase taxes for such filers (figure 9). These taxpayers are assumed to file as a head of household under current law and to qualify for a dependent personal exemption, the child tax credit, the additional child tax credit, and the EITC. Those with incomes between $18,000 and about $50,000 would generally have somewhat lower income tax liabilities under the option than under current law. Note that about 75 percent of single filers with one child are expected to have incomes below $50,000 in 2017. Above $50,000, these filers would generally have higher liabilities under the option, not because of the proposed changes in tax benefits specifically related to children, but rather to the repeal of head of household filing status.[52]

The effect of the repeal of head of household filing status versus other changes under the option is illustrated in figure 10, which shows the total change in income tax liability between current law and the option for a single filer with one child, and the change in liability due only to repeal of the larger standard deduction and more generous tax

[52] Under current law, when parents are divorced, separated or living apart, the custodial parent can qualify as a head of household and the EITC, and the noncustodial parent qualify for the dependent personal exemption and child tax credit. Under the option, the new child tax credit could only be claimed by the custodial parent.

FIGURE 9

Income Tax under Current Law and the Option for a Single Filer with One Child in 2017

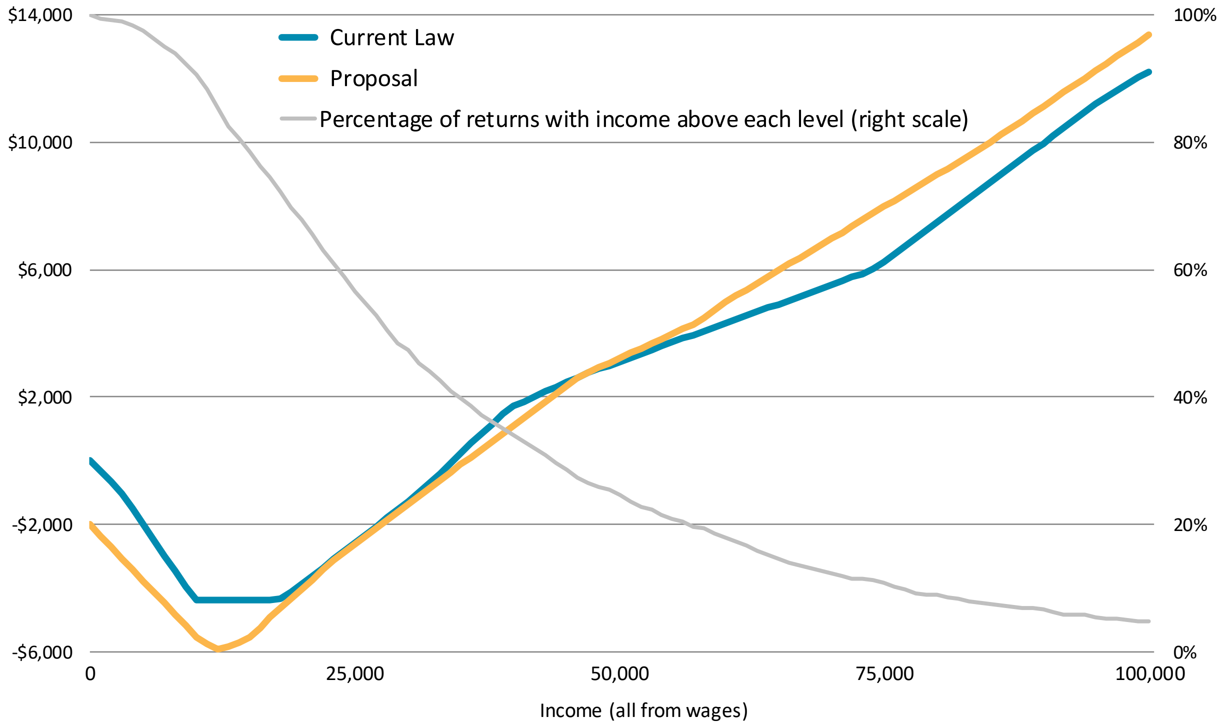
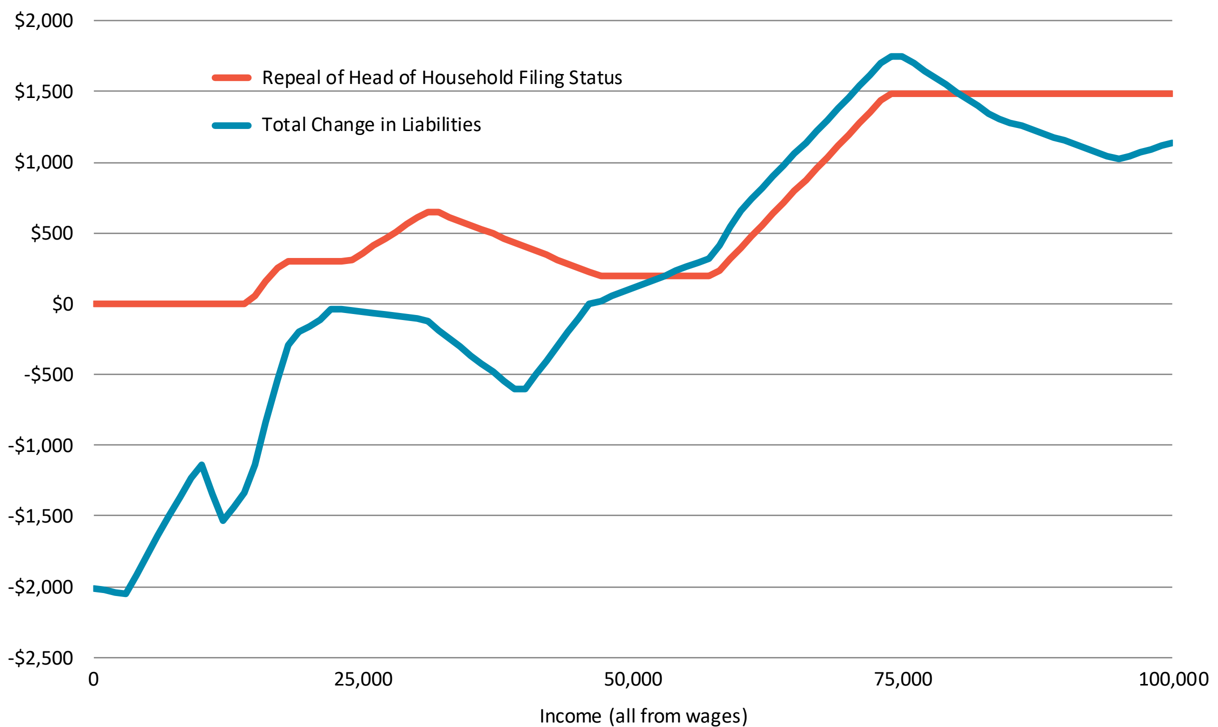



FIGURE 10

Change in Income Tax Liabilities Due to the Option for a Single Filer with One Child in 2017

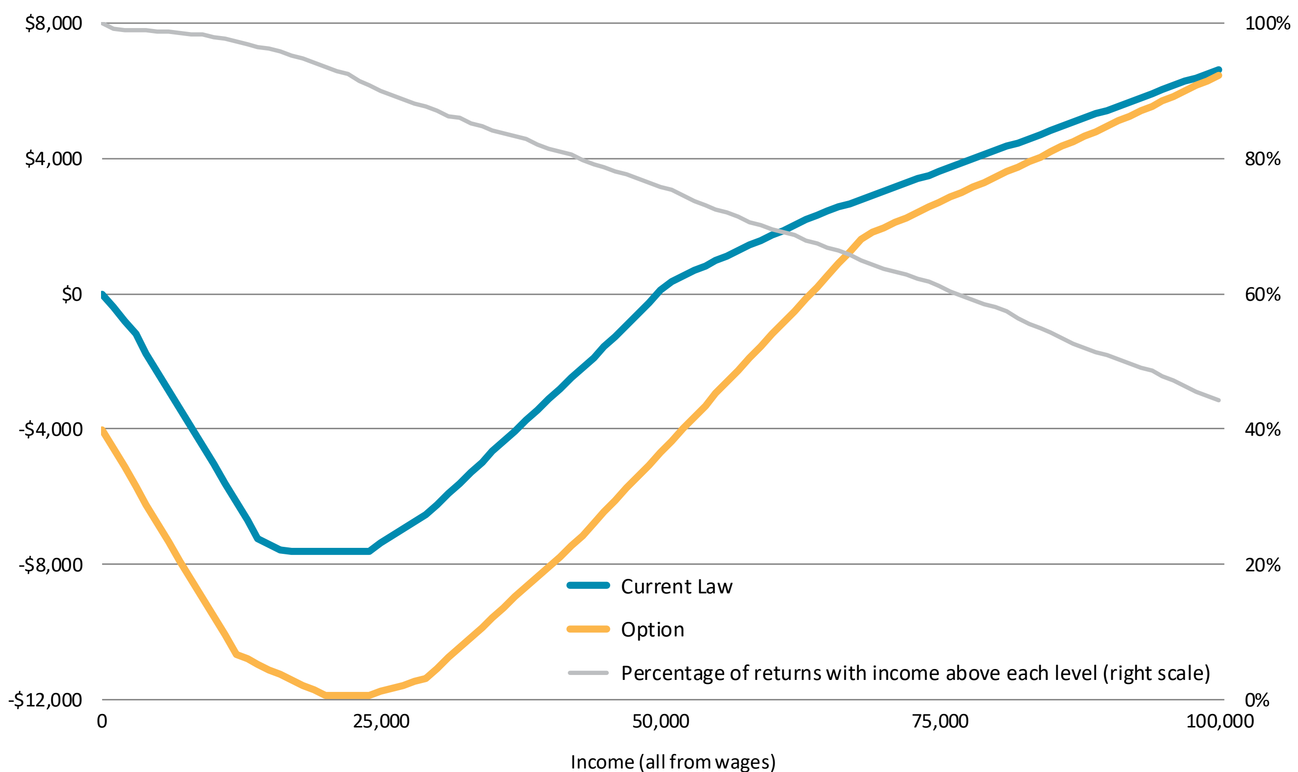


brackets for head of household filers.[53] Most, if not all, of any increase in tax liabilities at incomes above $50,000 would be due to repeal of head of household filing status. Head of household filing status provides a peculiar pattern of tax benefits: below $14,000 of income it provides no benefit at all, then the benefit rises to over $650 at about $31,000 of income, then falls to just over $200 at about $47,000 of income, then begins to rise again at about $57,000 of income, eventually reaching nearly $1,500.[54]

The combined effects of the option's higher standard deduction, higher child tax credit, and EITC worker credit would reduce income tax liabilities significantly for two-earner married couples filing jointly with two children and income up to about $70,000 (figure 11). Those with income between $70,000 and $100,000 would also pay less tax, but the tax savings would shrink as the couple's income nears the level at which they begin to itemize deductions, reducing the benefit of the higher standard deduction under the option because their taxpayer personal exemptions would be repealed.

FIGURE 11

Income Tax under Current Law and the Option for a Two-Earner Married Couple Filing Jointly with Two Children in 2017




[53] The change in liabilities due only to repeal of head of household filing status was computed as the difference in liability under current law for a single individual with one child that qualified for the dependent exemption, child tax credit, additional child tax credit, and the EITC for unmarried taxpayers with one child, and who filed as single, and the same individual who instead filed as a head of household.

[54] The benefit of head of household filing status is even larger at some income levels above those shown in figure 9 (see figure 4). For filers fully on the AMT, however, it provides no benefit at all.

## ANALYSIS OF THE OPTION

Our analysis of the option assumes that it would go into effect in 2017, and we evaluate revenue and most other effects over the FY2017-FY2026 budget period. None of the provisions of the option would phase in or out over time, so we present distributional and certain other estimates only for 2017.

### *Simplification*

The option would significantly simplify the income tax for most taxpayers, reducing the time and out-of-pocket costs that taxpayers incur for record keeping, return preparation and filing, and any subsequent dealings with IRS about errors or omissions on returns.

- Reduction in the number of itemizers. Because the option would increase the standard deduction for most taxpayers, many current itemizers would switch to using the standard deduction. As a result, many fewer taxpayers would need to keep records or perform calculations just for the purpose of itemizing. We estimate that in 2017 there would be 18.7 million fewer itemizers under the option, 41 percent fewer than under current law. However, the reduction in the number of itemizers declines over time: by 2026 there would be 15.6 million fewer itemizers under the option, a 30 percent reduction.[55]

- Repeal of personal exemptions. Personal exemptions for taxpayers would be replaced by the increased standard deduction, for children by the increased child tax credit, and for other dependents by a new credit. Replacing personal exemptions with other tax provisions that the option would retain simplifies tax preparation for most taxpayers by eliminating a separate calculation. Repeal of personal exemptions would also help remove many large families from the AMT, and eliminate the calculation of the personal exemption phaseout for higher-income families.

- Repeal of head of household filing status. The rules for qualifying as a head of household can be complicated for affected taxpayers to learn about and comply with. Repeal of this filing status would remove those complications.

- Repeal of additional standard deductions. The additional standard deduction amounts for age or blindness would be repealed, but reflected in the increased standard deductions. Removal of these separate amounts would reduce complexity in determining filing requirements and the proper amount of the standard deduction available for taxpayers.

[55] Fewer itemizers would switch to the standard deduction over time because average itemizable deductions are expected to increase faster than standard deductions (which increase only with inflation, not real growth).

- Combination of all child-related benefits into an enhanced child tax credit. Combining the benefits of the dependent exemption for children, the child tax credit, and the child-related portion of the EITC into a single credit with a uniform set of qualifications would provide significant simplification.

- Repeal of the child tax credit income phase-in and phaseout. The current phase-in and phaseout require additional calculations by affected taxpayers.

- Repeal of the child and dependent care tax credit and exclusion. Elimination of the credit and exclusion would remove the need for determining and keeping records of eligible expenses, filing a separate form to claim the credit and/or the exclusion, and determining which provision is more advantageous.

- Reduction in the number of taxpayers on the AMT. Replacing personal exemptions (which are disallowed for AMT purposes) with an enhanced child tax credit and a new credit for other dependents would remove many families from the AMT. We estimate that in 2017 there would be 1.6 million fewer taxpayers on the AMT, a reduction of 35 percent. The reduction rises to 1.8 million fewer taxpayers on the AMT, a reduction of 37 percent, by 2026.

- Reform of dependent filer and kiddie tax rules. Higher and greatly simplified filing and taxability thresholds for dependents would generally reduce filing burdens and eliminate them for many dependents.

### *Work Incentives*

The option would restructure the EITC into a worker credit, with double the phase-in rate and a much longer phase-in range than the current EITC for workers without qualifying children. This structure would provide very low-income childless workers greater rewards for working than the current EITC. However, the option would also phase out the higher credit amount at a faster rate than under current law, which may reduce work incentives for moderate income childless workers.

The proposed EITC worker credit would also be available to workers with children, as a replacement for a portion of the current EITC. However, under the option both spouses could receive the worker credit, providing an incentive for eligible spouses who are not in the labor force to take jobs or for those who work only part-time to increase their hours of work. Also, the phaseout rate of the worker credit and the supplemental portion of the child tax credit do not overlap and are lower for families with two or more children than the phaseout rate for the EITC.

In addition to changes to the EITC, the option would affect the marginal tax rate on earnings of many taxpayers by repealing the phase-in and phaseout of the child tax credit.

For low-income workers with children, repeal of the phase-in would increase marginal rates whereas repeal of the phaseout would reduce marginal rates for higher-income taxpayers in the phaseout range. Marginal tax rates on wages would also be affected for some workers through the changes in standard deductions (which would reduce marginal rates for some single and joint filers, but increase marginal rates for some current head of household filers); the repeal of personal exemptions (which might increase marginal rates for taxpayers with children and taxpayers who itemize, but reduce marginal rates for taxpayers with non-child dependents and those subject to the phaseout of personal exemptions);[56] and repeal of the child and dependent care tax credit (which would reduce marginal rates over the income range where the credit rate falls).

To capture the net effect of all of these provisions on work incentives, we used TPC's microsimulation model to estimate effective marginal tax rates (EMTRs) on wages in 2017 under current law and the option.[57] For workers with incomes below $10,000 the option would reduce the average EMTR on wages from -5.8 percent to -15.0 percent (table 7). Above that income level, the option would increase average EMTRs on wages except in the top quintile, with the largest increases at relatively low income levels. At low and moderate income levels, the increase in EMTRs on wages is due primarily to the elimination of the phase-in of the child tax credit and the replacement of personal exemptions for dependents with credits. These changes would increase marginal tax rates and also reduce average tax rates, reducing work incentives at these income levels.[58] In the top quintile, average EMTRs on wages fall slightly, due primarily to the elimination of the phaseouts of the child tax credit and personal exemptions. Note that even with these changes, EMTRs on wages would continue to rise significantly with income, as they do under current law.

### *Fairness*

Current law provides highly disparate child-related benefits, imposes large tax penalties on many married couples, and creates differentials in liabilities among taxpayers with the same ability to pay. The option would reduce or eliminate these effects created by family and work provisions in current law.

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[56] Taxpayers with children and taxpayers who itemize generally enter tax brackets at lower levels of income than they would under current law. The new credit for dependents who are not children is nonrefundable, so affects marginal rates in the same way as the current dependent exemption, but reduces marginal tax rates for some taxpayers because it is generally larger than the tax savings from the replaced dependent exemption.

[57] To calculate EMTRs under each law, the model increments wages for each worker by $1,000, computes the change in tax and divides it by $1,000, and then weights this ratio by the worker's total wages.

[58] Higher marginal tax rates discourage work be making not working (leisure time) more attractive (what economists refer to as the substitution effect), while lower average tax rates discourage work because the same level of consumption can be purchased with lower wage income (the income effect).

TABLE 7

## Change in Effective Marginal Tax Rate on Wages by Expanded Cash Income Levels

Within the Lowest Quintile and Percentile, 2017

| Expanded Cash Income Levels ($000) or Percentiles[1] | Effective Marginal Tax Rate, Individual Income Tax | | |
|---|---|---|---|
| | Current Law | Option | Change (Percentage Points) |
| Less than 10 | -5.8 | -15.0 | -9.1 |
| 10-20 | 0.9 | 8.2 | 7.3 |
| | | | |
| Lowest Quintile | 1.7 | 7.4 | 5.7 |
| Second Quintile | 15.7 | 18.9 | 3.2 |
| Third Quintile | 19.0 | 20.5 | 1.5 |
| Fourth Quintile | 19.9 | 21.4 | 1.5 |
| Top Quintile | 31.0 | 30.6 | -0.3 |
| All | 24.6 | 25.4 | 0.8 |
| | | | |
| Addendum | | | |
| 80-90 | 25.3 | 25.0 | -0.3 |
| 90-95 | 27.6 | 27.3 | -0.3 |
| 95-99 | 33.2 | 32.6 | -0.6 |
| Top 1 Percent | 39.0 | 39.0 | 0.0 |
| Top 0.1 Percent | 39.3 | 39.3 | 0.0 |

**Source:** Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

[1]The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% $23,099; 40% $45,153; 60% $80,760; 80% $142,601; 90% $209,113; 95% $295,756; 99% $732,323; 99.9% $3,769,396.

## Uniformity of Child-Related Tax Benefits

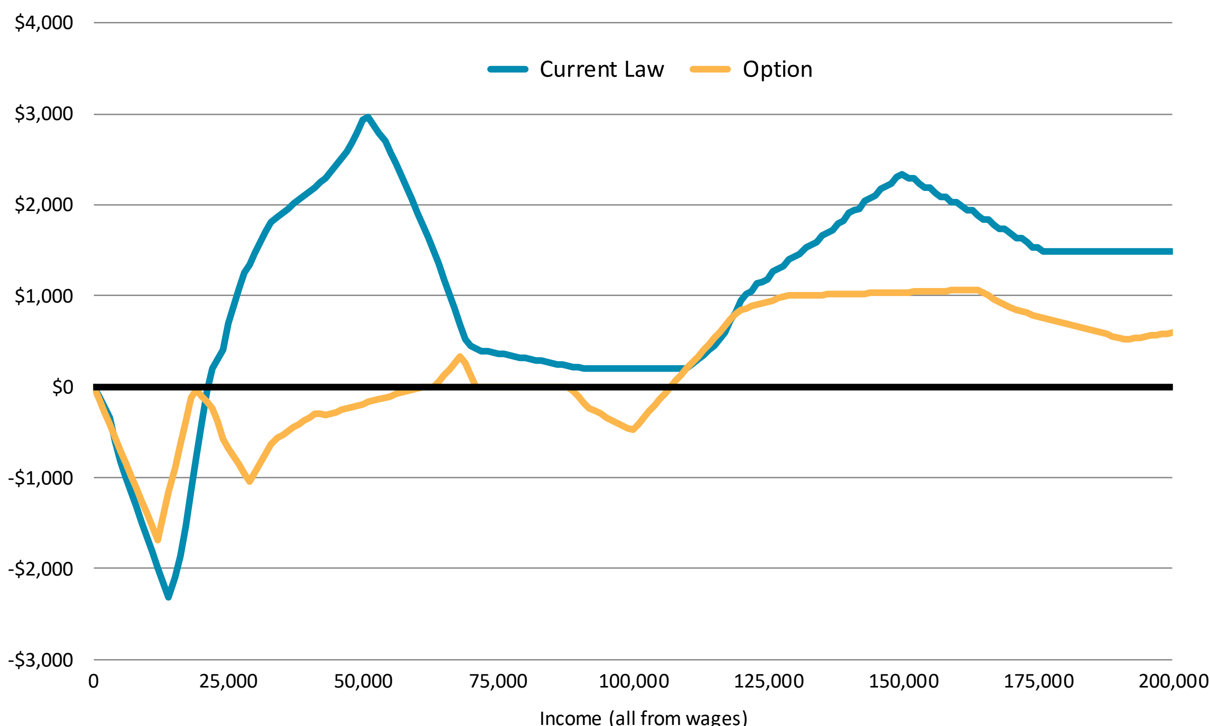
Current law provides multiple child-related tax benefits: personal exemptions, the child tax credit (including the additional child tax credit), a higher EITC, and the child and dependent care tax credit and exemption. The availability and size of each of these benefits for a child generally differ depending on the child's age, the number of children in the family, the marital status of parents, family income, and the child's caregiver while the parent(s) work. While some differences may serve broader purposes, it is difficult to discern any such purposes that would justify the large disparities in the pattern of child-related tax benefits under current law.

The option would replace the current child-related tax benefits with an enhanced child tax credit that includes a supplemental portion for low-income working families. The option's child tax credit would provide far more uniform benefits for children than the current provisions (see figure 5 above). These benefits would be higher for low-income working families, for whom the costs of child care can be a significant barrier to labor force participation, but otherwise benefits would be completely uniform and not vary with the characteristics of the child or the parents, including family income. In contrast, under current law the disallowance of personal exemptions for AMT purposes and the phaseouts of personal exemptions and the child tax credit unfairly result in high-income families with children and other dependents being treated as having the same ability to pay as taxpayers with the same income who have no dependents.

## Marriage Penalties

The option would generally reduce both marriage penalties and marriage bonuses. The new standard deduction amount, the 10 percent and 15 percent rate brackets, and the relevant parameters for the new EITC worker credit and the supplemental portion of the child tax credit for joint filers would all be double the amounts for unmarried filers. As a result, for two-earner couples the option would reduce marriage penalties as well as bonuses, or convert penalties into small bonuses, at most levels of income (figure 12).

FIGURE 12
Marriage Penalties and Bonuses under Current Law and the Option in 2017,
Two-Earner Couple with Earnings Split 65 Percent/35 Percent and Two Children



## Other Provisions

The option would address several other provisions of current law that create differentials in liabilities among taxpayers.

- Repeal of the head of household filing status would provide uniform tax treatment for all unmarried taxpayers, apart from benefits directly related to children.
- Folding the value of personal exemptions for taxpayers into the standard deduction amounts would remove the equivalent of a special standard deduction received only by taxpayers who itemize.
- Folding the value of personal exemptions for children and other dependents into the enhanced child tax credit and new credit for other dependents would remove the disproportionate effect of the AMT on large families.
- Uniform definitions for qualifying children, qualifying relative, qualifying taxpayer, and earnings would remove unwarranted differences in the application of the family and work provisions across taxpayers.

### *Revenue Effects*

If the option went into effect in 2017, we estimate that it would reduce revenues by $1,089 billion over the ten-year budget period, FY2017 through FY2026 (table 8).

TABLE 8

Revenue Estimates for the Family and Work Option, Fiscal Years 2017-2026

($ Billions)

| | Fiscal Year | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2017-2026 |
| Family and work option | -75 | -102 | -105 | -107 | -110 | -112 | -116 | -118 | -121 | -123 | -1,089 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

The revenue cost of the option is substantial, and below we examine several alternatives that would reduce that cost. But the cost should also be considered in the context of broader tax reform. For example, the Office of Tax Analysis in the U.S. Treasury estimates that the tax expenditure for itemized deductions of non-business state and local taxes will total $1,145 billion over the ten-year period FY2016-FY2025.[59] Toder,

[59] Office of Tax Analysis (2015).

Rosenberg, and Eng (2014) examine six approaches to broadening the individual income tax base by limiting tax expenditures, all of which were estimated to raise about $1.1 trillion over the FY2014-FY2023 period.[60] Including such base broadening provisions in a broader tax reform could fully offset the cost of this option.

### *Distributional Effects*

In 2017, tax units in all income quintiles on average would receive tax cuts under the option, although units in the 80th to 95th percentiles would have small average tax increases (table 9). Some tax units in the bottom four quintiles would have a tax increase (only 1.1 percent of units in the bottom quintile, rising to 37.3 percent of units in the fourth quintile), but in no income group would these tax increases average more than 1 percent of income. And while over half the units in the top 1 percent would receive tax cuts, relative to income these cuts would be very small. The average tax reductions for units in the bottom three quintiles would be less than $800, but represent a sizable fraction of their current after-tax incomes: 5.4 percent in the lowest quintile and 2.4 percent in second quintile.

TABLE 9

Distributional Effects of the Family and Work Option by Expanded Cash Income Percentile in 2017

| Expanded Cash Income Percentile[1] | Tax Units with Tax Increase or Cut: With Tax Cut | | Tax Units with Tax Increase or Cut: With Tax Increase | | Percent Change in After-Tax Income | Share of Total Federal Tax Change | Average Federal Tax Change ($) | Average Federal Tax Rate | |
|---|---|---|---|---|---|---|---|---|---|
| | Percent of Tax Units | Average Tax Cut ($) | Percent of Tax Units | Average Tax Increase ($) | | | | Change in Percentage Points | Under the Option |
| Lowest Quintile | 48.0 | -1,490 | 1.1 | 140 | 5.4 | 35.4 | -710 | -5.2 | -1.1 |
| Second Quintile | 61.0 | -1,320 | 12.8 | 230 | 2.4 | 30.5 | -770 | -2.2 | 5.8 |
| Middle Quintile | 66.1 | -1,200 | 24.3 | 380 | 1.3 | 25.1 | -700 | -1.1 | 12.4 |
| Fourth Quintile | 60.6 | -860 | 37.3 | 770 | 0.3 | 7.0 | -240 | -0.2 | 16.7 |
| Top Quintile | 41.0 | -1,700 | 51.5 | 1,280 | 0.0 | 0.9 | -40 | 0.0 | 25.6 |
| All | 55.5 | -1,290 | 21.1 | 770 | 0.8 | 100.0 | -550 | -0.6 | 19.2 |
| Addendum | | | | | | | | | |
| 80-90 | 41.8 | -940 | 56.8 | 1,170 | -0.2 | -3.5 | 270 | 0.2 | 20.0 |
| 90-95 | 30.3 | -1,320 | 65.4 | 1,400 | -0.3 | -3.2 | 520 | 0.2 | 21.9 |
| 95-99 | 48.8 | -2,990 | 31.0 | 1,460 | 0.3 | 4.7 | -1,000 | -0.2 | 24.8 |
| Top 1 Percent | 57.2 | -4,470 | 2.4 | 2,490 | 0.2 | 2.9 | -2,490 | -0.1 | 32.8 |
| Top 0.1 Percent | 55.5 | -4,980 | 1.7 | 2,590 | 0.0 | 0.3 | -2,720 | 0.0 | 34.2 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

[1]The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% $23,099; 40% $45,153; 60% $80,760; 80% $142,601; 90% $209,113; 95% $295,756; 99% $732,323; 99.9% $3,769,396.

The option's impact would differ considerably depending on filing status (table 10).[61] Average tax cuts and increases in after-tax income would be larger for the bottom two

[60] The parameters for the six approaches were set so that they all raised approximately the same revenue.

[61] Table 10 shows results for tax units with income adjusted for family size. The adjustment is made by dividing each unit's income by the square root of the number of people in the tax unit. So, for example, a family of four with income of

TABLE 10

Family Size Adjusted Distributional Effects of the Family and Work Option

By Demographic Group, Filing Status, and Expanded Cash Income Percentile in 2017

| Expanded Cash Income Percentile[1] | Average Tax Change ($) | | | | | | Percent Change in After-Tax Income | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | All Tax Units | Single | Joint | Head of House-hold | With Children | Elderly | All Tax Units | Single | Joint | Head of House-hold | With Children | Elderly |
| Lowest Quintile | -1,060 | -450 | -2,400 | -2,250 | -2,870 | -130 | 8.3 | 4.8 | 12.2 | 11.1 | 13.5 | 1.1 |
| Second Quintile | -890 | -370 | -2,490 | -1,010 | -2,260 | -70 | 3.2 | 1.7 | 6.2 | 2.8 | 5.6 | 0.3 |
| Middle Quintile | -480 | -110 | -1,140 | -350 | -1,360 | -30 | 1.0 | 0.3 | 1.7 | 0.6 | 2.0 | 0.1 |
| Fourth Quintile | -190 | -300 | -270 | 740 | -290 | -10 | 0.2 | 0.5 | 0.3 | -0.9 | 0.3 | 0.0 |
| Top Quintile | 40 | 90 | -10 | 1,380 | -740 | 370 | 0.0 | -0.1 | 0.0 | -0.8 | 0.3 | -0.2 |
| All | -550 | -280 | -790 | -920 | -1,540 | 0 | 0.8 | 0.8 | 0.6 | 1.9 | 1.5 | 0.0 |
| Addendum | | | | | | | | | | | | |
| 80-90 | 120 | -130 | 150 | 1,470 | 10 | 210 | -0.1 | 0.2 | -0.1 | -1.2 | 0.0 | -0.2 |
| 90-95 | 450 | 440 | 450 | 1,440 | -250 | 720 | -0.3 | -0.4 | -0.2 | -0.9 | 0.1 | -0.5 |
| 95-99 | -270 | 520 | -460 | 630 | -2,370 | 660 | 0.1 | -0.3 | 0.2 | -0.3 | 0.7 | -0.3 |
| Top 1 Percent | -1,870 | -350 | -1,930 | 2,010 | -4,110 | -650 | 0.1 | 0.0 | 0.1 | -0.1 | 0.2 | 0.1 |
| Top 0.1 Percent | -2,260 | -330 | -2,040 | 1,790 | -4,300 | -1,220 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

[1]The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The incomes used are adjusted for family size by dividing by the square root of the number of people in the tax unit. The resulting percentile breaks are (in 2015 dollars): 20% $16,114; 40% $30,188; 60% $52,080; 80% $86,603; 90% $125,539; 95% $174,819; 99% $419,094; 99.9% $2,163,747.

quintiles when income is adjusted for family size (compare tables 10 and 9). Conversely the top quintile would show a small average tax increase rather than a small tax cut. Low-income joint and head of household filers, who generally have children, would receive the largest tax cuts, while higher-income head of household filers would have the largest tax increases.[62]

Because the option provides increased work incentives for very low-income workers and larger child-related tax benefits for most families with children, more tax units would have no income tax liability, or receive a refund, under the option than under current law. Over 8 million additional tax units would have zero or negative income tax under the option in 2017 (table 11). As a percentage of the total number of tax units in 2017, the increase is 4.8 percent, from 44.4 percent to 49.2 percent. Thereafter, the number rises slowly through 2021 and then is little changed, but falls slightly between 2025 and 2026 from 8.9 million to 8.8 million.

$100,000 would have an adjusted income of $50,000 and be classified accordingly in table 10. Because of that adjustment, quintile breaks in table 10 differ from those in table 9.

[62] Note that figure 1 above illustrates the second set of columns in table 10 (percent change in after-tax income).

TABLE 11

Number of Tax Return Units with Zero or Negative Income Tax under Current Law and the Family and Work Option, 2017-2026

(Millions)

| | Calendar Year | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
| Current Law | 77.1 | 77.4 | 77.2 | 76.6 | 76.4 | 75.9 | 75.4 | 75.3 | 74.8 | 74.5 |
| Work and Family Proposal | 85.4 | 85.8 | 85.7 | 85.3 | 85.2 | 84.8 | 84.4 | 84.1 | 83.7 | 83.3 |
| Change Due to Proposal | 8.3 | 8.4 | 8.5 | 8.6 | 8.8 | 8.8 | 8.9 | 8.9 | 8.9 | 8.8 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

## ALTERNATIVES

The family and work option, like any tax reform, requires weighing various policy tradeoffs. To illustrate the effects of these policy tradeoffs, we examine six alternatives to the basic option:

Alternative 1: Set the proposed standard deduction amount in 2017 for singles at $10,400, the sum of the current standard deduction and one personal exemption. That amount is $1,550 less than in the basic option, which is the additional standard deduction allowed for age and blindness. The standard deduction for joint filers would be double that amount—$20,700.

Alternative 2. Change the age limit for qualifying children to receive the expanded child tax credit (including the supplemental portion) from under 19 to:

a. Under 17 (like the current child tax credit); or

b. Under 19, or 19 to 24 and a full-time student for at least five months of the year (like the current personal exemption and EITC).

Alternative 3. Increase the basic option's child tax credit in 2017 by $500–from $2,012.50 to $2,512.50–for each qualifying child under age 6.

Alternative 4. Reduce the amount of the basic option's child tax credit in 2017 from $2,012.50 to $1,607.50 (15 percent of the current personal exemption amount of $4,050, which is $607.50, plus the current $1,000 child tax credit amount), and reduce the new nonrefundable credit for other dependents to $607.50 in 2017.

Alternative 5. Decrease the option's EITC worker credit for single workers by decreasing the phase-in range from $10,000 to half the income of a full-time federal minimum wage worker, which is $7,250 (reducing the maximum credit from $1,530.00 to $1,109.25) and reduce the beginning of the phaseout range to $7,250 in 2017, but also reduce the phaseout rate to 10 percent. Correspondingly reduce the amount for joint filers.

Alternative 6. Phase in the basic option's child tax credit ($2,012.50 in 2017) at a 15 percent rate starting with the first dollar of earnings rather than making it fully refundable for all families.

Because each alternative retains the basic structure of the option and only modifies a single provision, the alternatives generally have the same qualitative effects as the basic option, and in many cases very similar quantitative effects. We therefore focus here only on important differences between the effects of the alternatives and the basic option.

### *Simplification*

Alternative 1 reduces the basic option's standard deduction amounts, and that would reduce the number of itemizers who switch to using the standard deduction in 2017 by 5.0 million (from 18.7 million to 13.7 million), rising to 5.8 million in 2026. Those reductions mean that Alternative 1 is much less effective than the basic option in moving taxpayers from itemizing deductions to using the standard deduction. In other respects, all of the alternatives provide simplification benefits similar to those of the option.

### *Work Incentives*

All but one of the alternatives would affect average EMTRs on wages either more or less than the basic option (table 12—the exception is Alternative 3, which would provide a higher child tax credit for children under age 6). The lower standard deduction amounts in Alternative 1 would raise EMTRs on wages in all income quintiles more than the basic option, with the largest effect in the first (lowest) quintile. Alternative 2a would reduce EMTRs on wages in the first three quintiles because children aged 17 and 18 would qualify for the new nonrefundable credit for "other" (i.e., non-child) dependents rather than the new child tax credit. Conversely, Alternative 2b would increase EMTRs on wages in the second and third quintiles because children aged 19 to 24 who are full-time students would qualify for the new child tax credit rather than the new nonrefundable credit for other dependents. Alternative 4 reduces the amount of the new nonrefundable credit for other dependents, so some taxpayers would enter a higher tax bracket at lower income levels than under the option. Alternatives 5 and 6 have the largest effects on wage EMTRs. Alternative 5 reduces the new EITC wage credit, which raises EMTRs significantly for very low-income workers, but the reduction in the phaseout rate reduces EMTRs for moderate- and middle-income workers. Alternative 6 makes the new basic child tax credit phase in with wages, which reduces EMTRs in all but the top income quintile.

TABLE 12

## Difference Between EMTRs on Wages under the Alternatives and under the Basic Option by Expanded Cash Income Levels

Within the Lowest Quintile and Quintile, 2017

| Expanded Cash Income Levels ($000) or Percentiles[1] | Alternative | | | | | | | Addendum: |
|---|---|---|---|---|---|---|---|---|
| | 1 | 2a | 2b | 3 | 4 | 5 | 6 | EMTRs on Wages under the Option[2] |
| Less than 10 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 6.7 | -1.7 | -15.0 |
| 10-20 | 1.1 | -0.2 | 0.0 | 0.0 | 0.0 | 1.1 | -3.3 | 8.2 |
| | | | | | | | | |
| Lowest Quintile | 1.1 | -0.2 | 0.0 | 0.0 | 0.1 | -0.4 | -3.0 | 7.4 |
| Second Quintile | 0.6 | -0.2 | 0.1 | 0.0 | 0.2 | -1.5 | -1.7 | 18.9 |
| Third Quintile | 1.4 | -0.1 | 0.1 | 0.0 | 0.1 | -0.7 | -0.5 | 20.5 |
| Fourth Quintile | 0.4 | 0.0 | 0.0 | 0.0 | 0.0 | -0.5 | -0.1 | 21.4 |
| Top Quintile | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 30.6 |
| All | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 | -0.3 | -0.3 | 25.4 |

**Source:** Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

[1]The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2015 dollars): 20% $23,099; 40% $45,153; 60% $80,760; 80% $142,601; 90% $209,113; 95% $295,756; 99% $732,323; 99.9% $3,769,396.

[2]From table 7.

### *Fairness*

The $500 higher child tax credit for children under age 6 in Alternative 3 would remove the uniformity of the credit across all ages of children, as would the phase-in of the new basic child tax credit with wages in Alternative 6. In other respects, all of the alternatives would improve fairness in the same way as the basic option.

### *Revenue Effects*

Alternatives 1, 2a, 4, 5 and 6 would all reduce the revenue cost of the basic option, by amounts ranging from $148 billion (Alternative 2a) to $434 billion (Alternative 4) over the FY2017-FY2026 period (table 13). Alternatives 2b and 3 would both increase revenue costs, by $234 billion and $150 billion respectively, over the ten-year period. These are all sizeable differences in revenue costs, which can be weighed against differences in other policy effects.

TABLE 13

Difference Between the Revenue Cost of the Alternatives and the Revenue Cost of the Basic Option, FY 2017-2026

($ billions; positive number indicates alternative reduces cost)

| | Fiscal Year | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2017-2026 |
| Alternative 1 | 23 | 31 | 32 | 33 | 34 | 34 | 35 | 37 | 38 | 39 | 336 |
| Alternative 2a | 10 | 14 | 14 | 14 | 15 | 15 | 16 | 16 | 16 | 17 | 148 |
| Alternative 2b | -16 | -21 | -22 | -23 | -23 | -24 | -25 | -26 | -27 | -27 | -234 |
| Alternative 3 | -10 | -14 | -14 | -15 | -15 | -16 | -16 | -16 | -17 | -17 | -150 |
| Alternative 4 | 29 | 40 | 41 | 42 | 43 | 45 | 46 | 48 | 49 | 50 | 434 |
| Alternative 5 | 24 | 33 | 34 | 34 | 35 | 36 | 36 | 37 | 38 | 38 | 345 |
| Alternative 6 | 17 | 23 | 24 | 24 | 24 | 24 | 24 | 24 | 25 | 25 | 234 |
| **Addendum:** | | | | | | | | | | | |
| Option (from table 8) | -75 | -102 | -105 | -107 | -110 | -112 | -116 | -118 | -121 | -123 | -1,089 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

## *Distributional Effects*

The alternatives would have somewhat different distributional effects than the basic option (figure 13). Alternatives 1, 2a, 4, 5 and 6 would raise more revenue than the basic option and thus would reduce the gains in after-tax income. The differences would be fairly significant in the bottom three income quintiles under Alternatives 4, 5 and 6. Alternatives 2b and 3 would both increase the gains in after-tax income across the income distribution, with the gains diminishing as income increases.

All of the alternatives except Alternative 6 would also affect the number of tax return units with zero or negative income tax (table 14). Reducing the standard deduction amounts (Alternative 1), reducing the qualifying age for children eligible for the child tax credit (Alternative 2a), reducing the amount of the enhanced child tax credit (Alternative 4), and reducing the new EITC worker credit (Alternative 5) would result in between 0.3 million and 3.4 million more tax units owing tax each year than under the basic option. Alternatives 2b and 3 would have relatively modest effects on the number of tax units without income tax liability.

FIGURE 13

## Differences between the Distributional Effects of the Alternatives and the Basic Option by Expanded Cash Income Percentile in 2017

(difference in percentage change in after-tax income)

| Cash income percentile | Alternative 1 | Alternative 2a | Alternative 2b | Alternative 3 |
|---|---|---|---|---|
| Lowest quintile | -0.2 | -0.4 | 0.5 | 0.4 |
| Second quintile | -0.4 | -0.3 | 0.3 | 0.3 |
| Middle quintile | -0.4 | -0.1 | 0.2 | 0.2 |
| Fourth quintile | -0.4 | -0.1 | 0.1 | 0.1 |
| Top quintile | -0.1 | 0.0 | 0.1 | 0.1 |
| All | -0.3 | -0.1 | 0.2 | 0.1 |
| Addendum | | | | |
| 80-90 | -0.3 | -0.1 | 0.2 | 0.1 |
| 90-95 | -0.1 | -0.1 | 0.2 | 0.1 |
| 95-99 | 0.0 | -0.1 | 0.1 | 0.0 |
| Top 1 percent | 0.0 | 0.0 | 0.0 | 0.0 |
| Top 0.1 percent | 0.0 | 0.0 | 0.0 | 0.0 |

| Cash income percentile | Alternative 4 | Alternative 5 | Alternative 6 |
|---|---|---|---|
| Lowest quintile | -0.7 | -2.0 | -1.6 |
| Second quintile | -0.7 | -0.9 | -0.7 |
| Middle quintile | -0.5 | -0.3 | -0.2 |
| Fourth quintile | -0.3 | 0.0 | 0.0 |
| Top quintile | -0.2 | 0.0 | 0.0 |
| All | -0.3 | -0.3 | -0.2 |
| Addendum | | | |
| 80-90 | -0.3 | 0.0 | 0.0 |
| 90-95 | -0.2 | 0.0 | 0.0 |
| 95-99 | -0.1 | 0.0 | 0.0 |
| Top 1 percent | 0.0 | 0.0 | 0.0 |
| Top 0.1 percent | 0.0 | 0.0 | 0.0 |

[1] A positive number means Alternative increases after-tax income more, or reduces it less, than the basic option.

TABLE 14

Difference Between the Number of Tax Return Units with Zero or Negative Income Tax under the Alternatives and under the Basic Option, 2017-2026

(Millions)

| | Calendar Year | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
| Alternative 1 | -2.4 | -2.5 | -2.3 | -2.4 | -2.6 | -2.5 | -2.4 | -2.4 | -2.5 | -2.5 |
| Alternative 2a | -0.3 | -0.3 | -0.3 | -0.4 | -0.4 | -0.4 | -0.4 | -0.4 | -0.4 | -0.5 |
| Alternative 2b | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| Alternative 3 | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 |
| Alternative 4 | -1.4 | -1.4 | -1.4 | -1.5 | -1.5 | -1.6 | -1.5 | -1.6 | -1.6 | -1.6 |
| Alternative 5 | -3.4 | -3.3 | -3.3 | -3.4 | -3.4 | -3.5 | -3.4 | -3.5 | -3.4 | -3.5 |
| Alternative 6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Addendum:** | | | | | | | | | | |
| Option (from table 11) | 85.4 | 85.8 | 85.7 | 85.3 | 85.2 | 84.8 | 84.4 | 84.1 | 83.7 | 83.3 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-4).

## CONCLUSIONS

Widespread dissatisfaction with the complexity, economic inefficiency and unfairness of the federal income tax has led to bipartisan agreement on the need for federal tax reform, but not yet to agreement on even the broad outlines of the reform. There are some areas of agreement, however, on reforms of the family and work related provisions, which are central elements of the tax system. We describe and analyze an option for comprehensive reform of these provisions, which would significantly simplify the provisions, clarify and increase work incentives for low-wage workers, and mitigate or remove unfairness in the current provisions. The option could serve as a component of a broader reform, or be enacted as a standalone reform.

## APPENDIX A. QUALIFYING CHILD, QUALIFYING RELATIVE AND QUALIFYING TAXPAYER REQUIREMENTS

The current law requirements for a "qualifying child", "qualifying relative", and for a taxpayer to qualify for tax benefits related to qualifying children and relatives that would be revised under the option, along with the proposed revision, are described in the following sections. Current law requirements that would be retained under the option, such as the relationship requirements for a qualifying child and a qualifying relative, are not described below but are included in the accompanying tables.

### Qualifying Child Requirements

Age. Under current law, to qualify for a dependent personal exemption and the EITC a child must be under age 19, or age 19 but under age 24 and a full-time student in at least five months of the year, or permanently and totally disabled. To qualify for the child tax credit, a child must be under age 17. All qualifying children (except children who are permanently and totally disabled) must be younger than the taxpayer (or the taxpayer's spouse, if married filing jointly).

Under the option, to qualify for the child tax credit (including the supplemental portion) the child would need to be under age 19 or permanently and totally disabled. The current law rule concerning a child being younger than the taxpayer would be retained.

Note that qualifying children under current law who are age 19 but under age 24 and a full-time student for at least half the year might be a "qualifying relative" for the option's credit for other dependents. If such a child failed to be a "qualifying relative" because they did not meet the gross income test due to earned income, the child could qualify under the option for the EITC (the worker credit).

Residency. Under current law, to qualify for a dependent personal exemption, the child tax credit, or the additional child tax credit, a child must live with the taxpayer for more than half the year. To qualify for the EITC, the child must live with the taxpayer in the United States for more than half the year. There are special rules for temporary absences and children who are born or died during the year.

The option would replace the current personal exemption for dependents with a credit that for children is added to the child tax credit, and makes the basic ($2,012.50) child tax credit fully refundable with no phase-in. The option would also add a supplement to the child tax credit that would replace the child-related portions of the current EITC. These expansions of the child tax credit would raise policy issues similar to those raised by the current EITC for workers with children. The option therefore requires that the child live with the taxpayer in the United States for more than half the year to qualify for the child tax credit.

Divorced or separated parents. Under current law, by the terms of a pre-2008 divorce or separation agreement or by filing Form 8332, if certain other conditions are met a child that would otherwise be the qualifying child of the custodial divorced or separated parent for purposes of the dependent personal exemption and the child tax credit (but not the EITC) can be transferred to the noncustodial parent.

Under the option, such transfers of qualifying children to the noncustodial parent would not be allowed for children born, or divorces or separations that take place, on or after the date of enactment.

Support. Under current law, to qualify for a dependent personal exemption, the child tax credit, and the additional child tax credit, a child cannot provide more than half of his or her own support. This requirement does not apply for a child to qualify for the EITC.

Under the option, to qualify for the child tax credit a child's earned income could not be more than half of his or her support.

U.S. citizenship. Under current law, to qualify for a dependent personal exemption a child must be a U.S. citizen, a U.S. national, a U.S. resident alien, or a resident of Canada or Mexico. To qualify for the child tax credit and additional child tax credit, a child must be a U.S. citizen, a U.S. national, or a U.S. resident alien. There are no explicit requirements on the child for the EITC, but implicit requirements through the requirement that a taxpayer claiming the EITC must be a U.S. citizen or be a U.S. resident alien the entire year.

Under the option, to qualify for the child tax credit the child would need to be a U.S. citizen, a U.S. national, or a U.S. resident alien.

Note that a child who is a resident of Canada or Mexico might meet the requirements to be a qualifying relative under the option.

Social Security Number (SSN). To qualify under current law for a dependent personal exemption or the child tax credit, a taxpayer must report the child's valid SSN, ITIN (Individual Taxpayer Identification Number, issued by IRS to individuals who do not qualify for an SSN), or ATIN (Adoption Taxpayer Identification Number, issued by IRS for a dependent placed for legal adoption with a taxpayer who does not know the dependent's SSN). To qualify for the EITC, a child must have a valid SSN without work restrictions.[63] There are special rules for children who are born or died during the year.

[63] To be valid, the child's Social Security card cannot have "Not Valid for Employment" printed on it because the card was issued only for the purpose of applying for or receiving a federally funded benefit, and if "Valid for Work Only with DHS Authorization" is printed on the card the DHS authorization must still be valid.

To qualify for the child tax credit under the option, the child would need to have a valid SSN without work restrictions. As with the residency requirement, the stricter requirement for the child tax credit is intended to address the same policy issues underlying the current law EITC requirement. The special rules for children who are born or died during the year would be retained.

Joint filing. Under current law, to qualify for a dependent personal exemption, a child tax credit, or the EITC the child cannot file a joint return unless the joint return is filed only for the purpose of claiming a refund of income tax withheld or estimated tax paid.

Under the option, to qualify for the child tax credit the child could not file a joint return. Note, however, that if each spouse qualified as a dependent of another taxpayer (other than the spouse) the option would allow the spouses to file single returns but only for the purpose of claiming a refund of income tax withheld or estimated tax paid.

**Qualifying Relative Requirements**

Two of the current law requirements for an individual to be a qualifying relative for purposes of the dependent personal exemption would be amended to conform to the option's qualifying child requirements.

Divorced or separated parents. Under current law, a child who is a qualifying relative can be transferred to the noncustodial parent in the same circumstances a qualifying child can be transferred.

Under the option, such transfers of children to the noncustodial parent would not be allowed for children who are born or otherwise newly become dependents, or divorces or separations that take place, on or after the date of enactment.

Joint filing. Under current law, to qualify for a dependent personal exemption the relative cannot file a joint return unless the joint return is filed only for the purpose of claiming a refund of income tax withheld or estimated tax paid.

Under the option, to qualify for the new credit for other dependents the relative could not file a joint return.

**Requirements for a Taxpayer to Qualify for Tax Benefits Related to a Qualifying Child or Qualifying Relative**

Age. Current law has no explicit age requirement for a taxpayer to claim a dependent personal exemption for a qualifying child or qualifying relative, or the child tax credit or EITC for a qualifying child (as defined for those credits), although a qualifying child must be younger than

the taxpayer (or the taxpayer's spouse, if filing jointly) unless the child is permanently and totally disabled. However, a taxpayer (or the taxpayer's spouse, if filing jointly) must be at least age 25 and under age 65 to claim the childless EITC.

The option would have no explicit age requirement for a taxpayer to claim the child tax credit, the new credit for other dependents, or the EITC. The current law requirement that a qualifying child be younger than the taxpayer (or the taxpayer's spouse, if filing jointly) would be retained. Note that with one very limited exception, married individuals would be required to file jointly under the option.

U.S. citizenship and residency. Taxpayers are generally eligible under current law to claim a personal exemption for each dependent, and a child tax credit and additional child tax credit for each eligible child, whether the taxpayer is a U.S. citizen, a U.S. national or a U.S. resident alien, and in some circumstance if the taxpayer is a nonresident alien. To be eligible to claim the EITC, a taxpayer must be a U.S. citizen or be a resident alien for the entire year. For married couples filing jointly, one spouse can be a nonresident alien if they elect to be taxed as a resident alien. In addition, to claim the childless EITC the taxpayer (and the taxpayer's spouse, if filing a joint return) must have their main home in the United States for more than half the year.

Under the option, eligibility requirements to claim the new credit for other dependents would be unchanged from the current law requirements for claiming a dependent personal exemption and the child tax credit. To be eligible to claim the child tax credit or the EITC, a taxpayer would need to be a U.S. citizen or a U.S. resident alien for the entire year and (consistent with the proposed requirement for qualifying children) live in the United States with the qualifying child for more than half the year. For married couples filing jointly, one spouse could be a nonresident alien if they elected to be taxed as a resident alien.

Social Security Number (SSN). In general, under current law all taxpayers are required to have a valid SSN (or ITIN, if they cannot obtain an SSN). The requirement is stricter for claiming the EITC: the taxpayer must have an SSN that permits work in the United States (taxpayers with ITINs are not eligible).

Under the option, the current law general rule on SSNs would be retained as a requirement to claim the new credit for other dependents. The current law EITC requirement that the taxpayer must have a valid SSN that permits work in the United States would apply for eligibility to claim the child tax credit or the EITC.

Dependent or qualifying child of another taxpayer. If a taxpayer (or their spouse, if filing a joint return) is a dependent of another taxpayer for the year, under current law the taxpayer cannot claim personal exemptions for dependents, the child tax credit, the additional child tax credit, or the childless EITC. In addition, a taxpayer cannot claim the EITC for qualifying children if the

taxpayer can be a qualifying child of another person, unless that person is not required to file a return or files a return only to receive a refund of withheld income tax or estimated payments.

Under the option, a taxpayer could not claim the child tax credit, the new credit for other dependents, or the EITC if the taxpayer (or their spouse, if married) qualified as a dependent of another person.

Foreign earned income and housing exclusions. Under current law, a taxpayer is allowed to claim the foreign earned income and housing exclusions and the additional child tax credit, but cannot claim either exclusion and the EITC.

Under the option a taxpayer could claim the exclusions and the new credit for other dependents, but neither the child tax credit nor the EITC could be claimed if either exclusion is claimed.

AGI. Under current law, for purposes of the phaseout of the child tax credit AGI is modified by adding back excluded income from Puerto Rico, excluded foreign earned income and housing expenses, and income excluded by residents of American Samoa. AGI is not modified for purposes of the phaseout of the EITC.

The option would not phase out the child tax credit, so the current law modifications would not be relevant. For the EITC, which would have no age restrictions, AGI would be modified by adding back excluded Social Security (and equivalent Railroad Retirement) benefits.

Table A-1 shows the current law and option's requirements for a qualifying child, qualifying relative and for a taxpayer to qualify for tax benefits related to a qualifying child or qualifying relative (except the definition of earned income, which is shown in table A-2).

TABLE A-1

## Qualifying Child, Qualifying Relative, and Taxpayer Requirements under Current Law and the Option

| Qualification requirement | Current Law: Dependent exemption | Current Law: Child tax credit and additional child tax credit[1] | Current Law: EITC[2] | Option: Child tax credit (including supplemental portion)[3] | Option: New credit for other dependents[3] | Option: EITC (worker credit) |
|---|---|---|---|---|---|---|
| | | | ***Qualifying child*** | | | |
| **Relationship** | Child (including step, adopted, and foster children), sibling (including step and half siblings), or a descendent of any of them | | | Same as Current Law | N/A | |
| **Age** | Under 19, or under 24 and full-time student, or disabled[4] | Under 17 or disabled[4] | Under 19, or under 24 and full-time student, or disabled[4] | Under 19 or disabled[4] | N/A | |
| **Residency** | Must live with taxpayer for more than half the year[5] | | Must live in U.S. with taxpayer for more than half the year[6] | Must live in U.S. with taxpayer for more than half the year[6] | N/A | |
| **Divorced or separated parents, or parents living apart** | In certain circumstances, the custodial parent can, in writing, waive these benefits to the noncustodial parent | | Custodial parent cannot waive benefit | Custodial parent cannot waive these benefits for a child born, or a divorce or separation that takes place, after date of enactment | N/A | |

| Qualification requirement | Current Law | | | Option | | |
|---|---|---|---|---|---|---|
| | Dependent exemption | Child tax credit and additional child tax credit[1] | EITC[2] | Child tax credit (including supplemental portion)[3] | New credit for other dependents[3] | EITC (worker credit) |
| **Gross income** | No requirement | | | Same as Current Law | N/A | |
| **Support** | Child cannot provide more than half of own support | | No requirement | Child could not have earned income that is more than half of his or her support | N/A | |
| **U.S. citizenship** | Child must be a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico[7] | Child must be a U.S. citizen, U.S. national, or U.S. resident alien[7] | No requirement | Child need to be a U.S. citizen, U.S. national, or U.S. resident alien | N/A | |
| **SSN** | Child must have a valid SSN, ITIN or ATIN | | Child must have a valid SSN without work restrictions | Child needs to have a valid SSN without work restrictions | N/A | |
| **Joint filing** | Child cannot file a joint return, except in limited circumstances[8] | | | Child could not file a joint return | N/A | |
| **Qualifying child of more than one taxpayer** | If a child is a qualifying child of more than one taxpayer "tiebreaker" rules apply to determine which one of these taxpayers my claim all of these benefits | | | Same as Current Law, except parents could not waive credit to nonparent | | |

| Qualification requirement | Current Law | | | Option | | |
|---|---|---|---|---|---|---|
| | Dependent exemption | Child tax credit and additional child tax credit[1] | EITC[2] | Child tax credit (including supplemental portion)[3] | New credit for other dependents[3] | EITC (worker credit) |
| ***Qualifying relative*** | | | | | | |
| **Relationship or member of household** | Relatives (child, sibling, parent, certain of their descendants), or any other person who is a member of the taxpayer's household for the entire year[5] | N/A | | N/A | Same as Current Law | N/A |
| **Not a qualifying child** | A child who is a qualifying child of any taxpayer cannot be a qualifying relative[9] | N/A | | N/A | Same as Current Law | N/A |
| **Residency** | No requirement, except for "any other person" | N/A | | N/A | Same as Current Law | N/A |
| **Age** | No requirement | N/A | | N/A | Same as Current Law | N/A |
| **Gross income** | Individual's income cannot exceed $4,050 (in 2016, indexed) | N/A | | N/A | Same as Current Law | N/A |
| **Support** | Taxpayer must | N/A | | N/A | Same as Current | N/A |

| Qualification requirement | Current Law | | | Option | | |
|---|---|---|---|---|---|---|
| | Dependent exemption | Child tax credit and additional child tax credit[1] | EITC[2] | Child tax credit (including supplemental portion)[3] | New credit for other dependents[3] | EITC (worker credit) |
| | provide over half of the individual's support[10] | | | | Law | |
| **Divorced or legally separated parents, or parents living apart** | In certain circumstances, the custodial parent can, in writing, waive the personal exemption for a child to the noncustodial parent | N/A | | N/A | Custodial parent could not waive the credit for children who are born or otherwise newly become dependents, or a divorce or separation that takes place, after date of enactment | N/A |
| **U.S. citizenship** | Individual must be a U.S. citizen, U.S. national, U.S. resident alien, or a resident of Canada or Mexico[7] | N/A | | N/A | Same as Current Law | N/A |
| **SSN** | Individual must have a valid SSN, ITIN or ATIN | N/A | | N/A | Same as Current Law | N/A |
| **Joint filing** | Relative cannot file a joint return, except in limited circumstances[8] | N/A | | N/A | Relative could not file a joint return | N/A |

| Qualification requirement | Current Law | | | Option | | |
|---|---|---|---|---|---|---|
| | Dependent exemption | Child tax credit and additional child tax credit[1] | EITC[2] | Child tax credit (including supplemental portion)[3] | New credit for other dependents[3] | EITC (worker credit) |
| ***Requirements for a taxpayer to qualify for tax benefits related to a qualifying child or qualifying relative*** | | | | | | |
| **Age** | No explicit requirement, but a qualifying child (other than a child who is permanently and totally disabled) must be younger than the taxpayer (or the taxpayer's spouse, if filing jointly) | | For childless EITC, taxpayer must be at least age 25 and under age 65 | No explicit requirement, but a qualifying child (other than a child who is permanently and totally disabled) needs to be younger than the taxpayer (or the taxpayer's spouse, if filing jointly) | | N/A |
| **U.S citizenship and residency** | Taxpayer can be a U.S. citizen, a U.S. national, a U.S. resident alien, and in some circumstances a nonresident alien | | Taxpayer must be a U.S. citizen or be a U.S. resident alien the entire year | Taxpayer needs to be a U.S. citizen or be a U.S. resident alien the entire year, and live with the child in the U.S. for more than half the year | Taxpayer could be a U.S. citizen, a U.S. national, a U.S. resident alien, and in some circumstances a nonresident alien | Taxpayer needs to be a U.S. citizen or be a U.S. resident alien the entire year |
| **SSN** | Taxpayer must have a valid SSN or ITIN | | Taxpayer must have a valid SSN without work restrictions | Taxpayer needs to have a valid SSN without work restrictions | Taxpayer needs to have a valid SSN or ITIN | Taxpayer needs to have a valid SSN without work restrictions |
| **Dependent or qualifying child of another taxpayer** | Taxpayer cannot be a dependent of another taxpayer | | For childless EITC, taxpayer cannot be a dependent of another taxpayer; for child EITC, taxpayer cannot be the qualifying child of another taxpayer (except | Taxpayer could not be a dependent of another taxpayer | | |

| Qualification requirement | Current Law | | | Option | | |
|---|---|---|---|---|---|---|
| | Dependent exemption | Child tax credit and additional child tax credit[1] | EITC[2] | Child tax credit (including supplemental portion)[3] | New credit for other dependents[3] | EITC (worker credit) |
| | | | in limited circumstances)[9] | | | |
| **Earned income** | N/A | See table A-2 | | See table A-2 | N/A | See table A-2 |
| **Foreign earned income and housing exclusions** | N/A | Taxpayer can claim these credits and these exclusions | Taxpayer cannot claim the EITC and either exclusion | Taxpayer could not claim this credit and either exclusion | Taxpayer could claim this credit and these exclusions | Taxpayer could not claim this credit and either exclusion |
| **AGI** | N/A | Modified by adding back excluded foreign earned income and housing expenses, income from Puerto Rico and income of residents of American Samoa | Not modified | N/A | N/A | Would be modified by adding back excluded Social Security benefits |

[1] Under current law, a qualifying child must be a dependent (so, meet the dependent exemption requirements) to qualify for the child tax credit or additional child tax credit.

[2] Under current law, a child need not be a dependent to qualify for the EITC.

[3] Under the option, any child who is a qualifying child for the child tax credit and any other person who is a qualifying relative for purposes of the new credit for other dependents would be a dependent for all income tax purposes.

[4] Disability must be total and permanent.

[5] A child or other individual is considered to be living with the taxpayer they otherwise live with during any period that either is temporarily absent due to illness, education, business, military service, or detention in a juvenile facility.

[6] U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States for that period.

[7] If the taxpayer is a U.S. citizen or a U.S. national, a legally adopted child who is not a U.S. citizen, U.S. national, or a U.S. resident alien but lived with the taxpayer the entire year is a dependent.

[8] A child who files a joint return and otherwise qualifies is a dependent if the child and his or her spouse file only to receive a refund of income tax withheld or estimated payments (they cannot file to receive a refundable credit).

[9] The child is not considered to be the qualifying child of another taxpayer if the individual for whom the child would be a qualifying child is not required to file an income tax return and either does not file a return or files only to receive a refund of income tax withheld or estimated payments (they cannot file to receive a refundable credit).
[10] If no taxpayer provides over half the support for the individual but two or more taxpayers do, in certain circumstances one of these taxpayers is treated as meeting the support requirement.

TABLE A-2

## Definition of Earnings for Purposes of the Supplemental Child Tax Credit, EITC, and Taxation of Dependents under Current Law and the Option

| Earned income/(Tax return reference) | Current Law | | | Option | |
|---|---|---|---|---|---|
| | Additional child tax credit[1] | EITC | Taxation of dependents[2] | Supplemental child tax credit and EITC | Taxation of dependents[2] |
| **1. Wages and salaries (Form 1040, line 7)** | Included | | | Included | |
| **Adjustments to 1:** | | | | | |
| **a. Certain taxable scholarships and fellowships[3]** | Deducted | | Deducted only for "kiddie tax" | Deducted | |
| **b. Wages received for work while an inmate in a penal institution** | Deducted | | Not deducted | Deducted | |
| **c. Pension or annuity from a nonqualified plan (Form W-2, box 11)** | Deducted | | | Deducted | |
| **d. Nontaxable combat pay (Form W-2, box 12 with code Q)** | Added | Added at taxpayer's election | Not added | Added | Not added |
| **e. Foreign earned income and housing exclusions (Form 2555, line 45)** | Deducted | N/A (taxpayer cannot claim EITC and these exclusions) | Not deducted | N/A (taxpayer could not claim these credits and these exclusions) | Deducted |

| Earned income/(Tax return reference) | Current Law | | | Option | |
|---|---|---|---|---|---|
| | Additional child tax credit[1] | EITC | Taxation of dependents[2] | Supplemental child tax credit and EITC | Taxation of dependents[2] |
| **2. Statutory employee income (Schedule C, line 1)** | Included | | | Included | |
| **3. Net farm profit (or loss) (Schedule SE, line 1a less line 1b)[4]** | Included | | Included for standard deduction; for "kiddie tax" limited to 30% of net (positive) profits and capital is a material income-producing factor) | Included | Included (and optional method would not be allowed) |
| **4. Net nonfarm profit (or loss) (Schedule SE, line 2)[5]** | Included (and optional method not allowed) | Included | Same as above | Included | Included (and optional method would not be allowed) |
| **5. Adjustment for certain benefits of clergy included in net nonfarm profit (or loss)** | Deducted | No adjustment | Deducted | No adjustment | Deducted |
| **6. Optional farm and nonfarm income (Schedule SE, line 4b)** | Farm amount included if less than actual farm profit (and there was no farm loss) | Included | N/A (all net farm and nonfarm profit (or loss) included in 3 or 4) | Included | N/A (all net farm and nonfarm profit (or loss) would be included in 3 or 4) |
| **8. Church employee income (Schedule SE, line 5a)** | Included | | | Included | |

| Earned income/(Tax return reference) | Current Law | | | Option | |
|---|---|---|---|---|---|
| | Additional child tax credit[1] | EITC | Taxation of dependents[2] | Supplemental child tax credit and EITC | Taxation of dependents[2] |
| **9. Deduction for ½ of SECA tax (Form 1040, line 27)** | Included (i.e., deducted) | | Included (i.e., deducted) only for standard deduction | Included (i.e., deducted) | |
| **10. Child's taxable distribution from a qualified disability trust** | N/A (a child cannot claim these credits) | | Included | N/A (a child could not claim these credits) | Included |
| **11. Community property earned income** | Not included | | | Not included | |

[1] Earned income for purposes of the additional child tax credit uses the same definition as used for the EITC, except nontaxable combat pay is always included and other amounts not included in gross income are excluded.
[2] The definitions of earned income apply, except as noted, for purposes of both the dependent standard deduction and the kiddie tax provisions. Under the option, the definition would also apply for the determination of whether a child is not a qualifying child because the child's earned income exceeds half of his or her support.
[3] These are scholarships and fellowships not included on form W-2 (so, not compensation) in excess of amounts used for tuition and fees, and required books, etc. for courses.
[4] Taxpayers who use the optional farm method do not complete these lines of Schedule SE, but under current law and the option dependents compute their net farm profit (or loss) earned income without using the farm optional method.
[5] Taxpayers who use the optional nonfarm method do not complete line 2 of Schedule SE, but under current law and the option dependents compute their net nonfarm profit (or loss) earned income without using the nonfarm optional method.

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