FASB Looks to the Future

Leslie F. Seidman, FASB Chair

Annual Tax Update
• Marriage and Taxes
• Estate Tax Portability
• Tax Preferences for Education
It has been widely reported that President George W. Bush’s tax cuts—enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003—were attempts to remove the so-called marriage penalty from the Internal Revenue Code (IRC). Although this certainly seemed a laudable goal, a review of the current tax code shows that the marriage penalty, alive and well throughout the code, continues to impact high-, middle-, and low-income couples.

The following 20 questions summarize the factors that affect the marriage penalty or marriage bonus, examine the different sections of the IRC that create these penalties or benefits, and discuss the implications of a tax code that rewards some marriages while penalizing others.

1. Why Is the Marriage Penalty an Important Issue?
   In 2007, there were approximately 112.4 million households in the United States, according to the U.S. Census Bureau. Married couples occupied half (55.9 million) of those households. In about 62% of married families, both spouses participate in the workforce. The Congressional Budget Office estimates that the marriage penalty affects 43% of all married couples.
2. What Is a Marriage Penalty (or Bonus)?

There is no explicit marriage penalty tax in the IRC, nor is there a line on any tax form for such a penalty. The marriage penalty occurs because some sections of the IRC create differences in the tax liability of a married filing jointly (MFJ) couple and the combined tax of two single filers. For the purposes of this article, a marriage penalty or, conversely, a bonus, is defined as the difference in federal tax liability between a couple choosing MFJ and what the couple would owe in a combined filing as two single persons. A couple may experience a marriage penalty or bonus depending upon their earnings, credits, and deductions.

3. What Is the Typical Cause of a Marriage Penalty (or Bonus)?

Once a couple is married, the spouses are entitled to file a joint income tax return. While this simplifies the filing process, they may find that their tax liability ends up either higher or lower than their combined liability would have been if each had filed singly.

Higher taxes are most likely due to the combining of income on a joint return; when both spouses file jointly, more of their income is taxed at a higher marginal rate, but their allowable deductions have not increased twofold. As a result, they move into a higher tax bracket, and this result is referred to as the “marriage tax penalty.” One example of a marriage penalty is the tax rate schedule, as demonstrated later in question 4; although the schedule in and of itself is not a direct example of the penalty, it can cause the penalty. Some of the income levels for a given tax bracket of MFJ taxpayers on the tax rate schedules are less than twice the income levels for single taxpayers. This means that MFJ taxpayers will owe more income tax liability than they would have as two single taxpayers.

In some circumstances, however, married taxpayers enjoy tax advantages. When taxes are lower for married couples, it is referred to as the “marriage tax bonus.” A marriage bonus occurs when there is a great difference in the respective incomes of two spouses. High-income individuals can average their income with that of a lower income spouse, and the MFJ couple, therefore, receives the benefit of a lower tax bracket.

4. Is the Marriage Penalty Affected by Tax Rate Schedules?

The progressive income tax system currently used in the United States increases the marginal tax rate applicable to the combined income of married couples. The tax rate schedules are set forth in IRC section 1(a). When both spouses generate income, they get pushed into a higher tax bracket, and are thus taxed at a higher rate.

For a marriage-neutral tax code, the income level at which higher tax rates take effect for MFJ couples should be twice the income level that applies to single individuals. The tax code is marriage-neutral for taxpayers in the lowest two tax brackets, but the penalty is introduced by the rates for higher earning couples. For example, in 2011, the top tax rate for both individuals and married couples takes effect when income reaches $379,150. In order for there to be no marriage penalty, the top tax rate for MFJ should be $758,300, but it is not. Currently, a married couple in which each spouse has taxable income of $379,150 will owe $15,244 more in taxes when filing jointly (marriage penalty) because the income levels presently incorporated in the tax rate schedules are less than twice the level for single filers.

For taxpayers at the lower rates (10% and 15% tax brackets), no marriage penalty exists, as tax bracket amounts for MFJ are exactly double the single amounts. Congress did adjust these tax brackets for the purpose of alleviating the effect of the marriage penalty on lower income families. As a result, the marriage penalty associated with the tax rates begins with a married couple who have $139,352 in combined taxable income, with each spouse earning exactly half of the income. This couple will incur a marriage penalty of six cents. Although this penalty starts low, it increases quickly as income rises. A married couple with $160,000 of taxable income earned equally by each spouse faces a $620 marriage penalty from the tax rate schedule alone because $20,650 of the income is taxed at the 28% bracket instead of the 25% bracket.

Tax rate schedules can also lead to a marriage bonus. This generally occurs when there is a great difference in spouses’ respective incomes. Consider a CEO who has taxable income of $200,000 per year but whose spouse earns only $5,000 in taxable income per year. If the CEO were single, he would be in the 33% tax bracket. But because he is married, the couple’s joint taxable income ends up in the 28% bracket. In 2011, the married couple would owe $45,469.50 in federal taxes. If each had filed as a single individual, the two would owe a combined amount of $51,397. This results in a $5,927.50 marriage bonus.

5. Can the Marriage Penalty Be Avoided by Filing Separately?

In general, a married couple cannot avoid the marriage penalty by filing as married filing separately (MFS). In fact, filing as MFS may actually increase their tax liability. Yet, the MFS status may result in a lower combined tax for a couple than if they choose MFJ. This can happen when there is a disparity (the greater the disparity, the more pronounced the effect) in the spouses’ respective incomes and the spouse with the lower income has deductions that are subject to an adjusted gross income (AGI) percentage limitation that would be lost if they choose MFJ.

6. How Is the Marriage Penalty Affected by the Standard Deduction?

The standard deduction amounts are marriage-neutral, as the MFJ amounts are exactly double the single amounts. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended these amounts for two years. (See question 15 for other items that are marriage neutral.)

The additional standard deduction creates a marriage penalty item within IRC section 63(e)(1). The additional standard deduction is available for taxpayers who are over 65 years old or are blind. A taxpayer who is both blind and over 65 years old is entitled to two additional standard deductions. This amount is in addition to the basic standard deduction and benefits taxpayers who do not itemize their deductions. For single taxpayers, the amount is $1,450; however, if the taxpayer is married, the additional standard amount is reduced to $1,150. This $300 reduction can result in a marriage penalty of $30 to $105, depending upon the
marginal rate, for each additional deduction allowed due to age or blindness.

7. How Is the Marriage Penalty Affected by Phaseouts?

There are several provisions in the tax code where tax liability is affected by phaseouts of deductions and credits, the range of which varies depending upon whether a taxpayer is married or single. Many of these provisions require married couples to pay more in taxes than two cohabiting single individuals. Although tax benefits generally decrease as income increases, the income level at which benefits start to decrease is not twice as high for married couples as it is for unmarried couples. For example, the child tax credit in IRC section 24 begins to decrease at $75,000 for single taxpayers and at $110,000 for married taxpayers. (For a more detailed discussion, see question 11.)

A marriage penalty may also occur when spouses have unequal incomes and the couple utilizes itemized deductions that are subject to AGI floors. For example, medical expenses are subject to a 7.5%-of-AGI floor for regular tax purposes under IRC section 213(a), and 10% for taxpayers subject to the alternative minimum tax (AMT) under IRC section 56(b)(1)(B). Casualty and theft losses are subject to a 10%-of-AGI floor under IRC section 165(c), and job expenses and certain miscellaneous deductions are subject to a 2%-of-AGI floor under IRC section 67(a).

Example. A man with an AGI of $100,000 is married to a woman whose AGI is only $20,000 but who has unreimbursed job expenses of $3,000. If she were single, her itemized deduction related to unreimbursed job expenses would be $2,600 ($3,000 − $20,000 × 2%). Married, she would only be allowed an itemized deduction of $600 ($3,000 − [$120,000 × 2%]). (It is assumed in both cases that there are other deductions that would cause the taxpayers to itemize rather than take the standard deduction.) Married couples in this situation might want to consider filing separately, but they first need to carefully consider the other tax consequences of filing independently.

8. Is the Marriage Penalty Affected by the AMT?

The AMT, enacted in 1969, was aimed at ensuring that wealthy individuals who had previously avoided taxation by taking legal deductions and credits would pay at least some income tax. Although the AMT was considered a tax on the wealthy, it was not indexed for inflation. For example, it was projected that for tax years 2006 to 2009, the AMT could have affected 4 million to 5 million taxpayers. To avoid ensnaring millions more taxpayers in the AMT, Congress ends up “patching” this problem every year. For the 2011 calendar tax year, the AMT exemption was $48,450 for single taxpayers and $74,450 for MFJ taxpayers. Therefore, the marriage penalty tax is $5,837 for AMT taxpayers in the 26% AMT bracket.

In addition to the marriage penalty for the AMT exemption amounts, there is a marriage penalty built into the phaseout ranges if a married couple’s AMT taxable income is too high. The phaseout ranges for MFJ taxpayers are not double those applicable to singles. For MFJ, the phaseout range for the AMT exemption begins at $150,000 and ends at $447,800 for 2011. For single taxpayers, that range is from $112,500 to $306,300 for 2011. Furthermore, no personal or dependency exemptions are allowed for AMT purposes under IRC section 56(b)(1)(E).

9. Does the Marriage Penalty Increase for High-Income Couples?

Until 2009, there was a limitation of certain itemized deductions for high-income taxpayers under IRC section 68. This limitation reduced itemized deductions by the lesser of 3% of the amount of AGI that exceeded a threshold amount or 80% of the deductions subject to the limitation. The items subject to the limitation were taxes, interest, charitable contributions, and expenses subject to the 2%-of-AGI floor. The threshold amount was $166,800, whether the taxpayers were single or MFJ. Because the threshold amount was the same for both filing statuses, a marriage penalty occurred. This limitation was phased out gradually between 2006 and 2009, and for the 2009 tax year, only one-third of the limitation applied to tax returns.

For high-income earners, personal and dependency exemptions under the regular tax calculation were phased out in 2009 under IRC section151(d)(3). The phaseout began when AGI exceeded $166,800 for single taxpayers. This phaseout could only result in a maximum reduction of $1,217 per exemption. For married taxpayers, the phase-out began when AGI exceeded $250,200. Therefore, married taxpayers who earned equal amounts of AGI of $125,102 began to lose their personal and dependency exemptions if they had remained single, they would not be close to losing them.

In 2010, these phaseouts, as well as the limitation on itemized deductions, were removed. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the elimination of the phaseouts and the limitation.

| EXHIBIT 1 |
| 2011 Phaseout Ranges for Married and Single Taxpayers |

<table>
<thead>
<tr>
<th></th>
<th>Single Begins</th>
<th>Single Ends</th>
<th>Married Filing Jointly (MFJ) Begins</th>
<th>Married Filing Jointly (MFJ) Ends</th>
</tr>
</thead>
<tbody>
<tr>
<td>No qualifying children</td>
<td>$7,590</td>
<td>$13,660</td>
<td>$12,670</td>
<td>$18,740</td>
</tr>
<tr>
<td>One qualifying child</td>
<td>$16,690</td>
<td>$36,052</td>
<td>$21,770</td>
<td>$41,132</td>
</tr>
<tr>
<td>Two qualifying children</td>
<td>$16,690</td>
<td>$40,964</td>
<td>$21,770</td>
<td>$46,044</td>
</tr>
<tr>
<td>Three or more qualifying children</td>
<td>$16,690</td>
<td>$43,988</td>
<td>$21,770</td>
<td>$49,049</td>
</tr>
</tbody>
</table>

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10. Does the Marriage Penalty Affect Low-Income Couples?

The marriage penalty does not just target wealthy taxpayers; it can also ensnare some of the lowest income earners. The IRC section 32 earned income credit (EIC) is designed to offset some of the more regressive federal taxes, such as the gasoline tax and Social Security taxes. The EIC phaseouts are tied to the number of children that taxpayers have. See Exhibit 1 for a comparison of the phaseout ranges in 2011 for married and single taxpayers.

Example. Consider two single adults, each of whom earns $7,000 and has no children. If they remain single, they will avoid the phaseout range. If they marry, they will end up in the phaseout range and lose part of their EIC. If they stay single, each will have an EIC of $457—a total of $914 between the two of them. If they marry and have joint earnings of $14,000, their EIC will only be $340 and the couple will incur a marriage penalty of $574, or approximately 4% of AGI—a large penalty for two married individuals only earning $14,000 in income a year.

Note that the previous calculation is based on the 2010 EIC table, as the 2011 table is not yet available; however, the authors do not expect there to be a material change in the table for 2011.

11. How Does Marriage Impact the Child Tax Credit?

The IRC section 24 child tax credit was meant to give tax relief to families with children. As stated above, this provision allows a $1,000 tax credit per child; however, not all families with children receive the credit. Only families that do not earn over a certain amount of income are allowed to take this credit, which is phased out for higher income taxpayers.

The phaseout begins for single taxpayers when their AGI equals or exceeds $75,000. For no marriage penalty to exist, the phaseout should begin for married couples when their AGI exceeds $150,000, but the phaseout for married taxpayers actually begins at $110,000. The child tax credit is reduced by $50 for every $1,000 over the threshold. This means that the marriage penalty could be as much as $2,000 for a couple with at least two children.

12. Does the Marriage Penalty Affect Capital Gains?

Capital losses are deductible against capital gains. If capital losses exceed capital gains, the amount of capital losses that can be used to offset ordinary income is limited to $3,000 by IRC section 1211(b), regardless of whether the taxpayer is single or MFJ.

Example. Consider two individuals, each of whom has a net capital loss of $2,000 and is in the 10% marginal tax bracket. Individually, each would be able to reduce their income by $2,000 and their tax liabilities by $200 ($2,000 × 10%), for a total tax savings of $400. If these two individuals married, and they each had a loss of $2,000—for a total of $4,000—they would only be able to deduct $3,000 and only save $300 in taxes. This results in a marriage penalty of $100. They are allowed to carry forward the $1,000 of nondeductible capital losses into future years.

13. Does the Marriage Penalty Affect Real Estate Transactions?

Qualified mortgage interest expense is fully deductible on the acquisition indebtedness for a primary residence and second home, provided that the taxpayer’s acquisition indebtedness is less than or equal to $1 million. As defined by IRC section 163(h)(3)(B), acquisition indebtedness includes any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence and is secured by such residence.

This $1 million limitation is placed on MFJ taxpayers as well as single taxpayers, and therefore includes a marriage penalty for taxpayers who have a large amount of acquisition indebtedness. This $1 million limitation may only affect a minority of taxpayers, however, and a greater concern tends to be the $100,000 limitation on home equity indebtedness. Interest on home equi-
ty loans is deductible for regular income tax (more specific limitations are applied to AMT taxpayers) on the amount of indebtedness that does not exceed $100,000. This $100,000 is applied to single taxpayers and MFJ taxpayers, and therefore includes a marriage penalty. Depending upon a couple’s marginal tax rate, this could result in a sizable marriage penalty.

Example. Consider two individuals in the 15% marginal tax bracket, each with $75,000 of home equity indebtedness, financed at 4%. The interest deduction for each individual would be $3,000, resulting in a tax savings of $450 and a total savings of $900 for both. If they marry, they will only be able to deduct the interest on $100,000 of home equity indebtedness, which would result in a $4,000 deduction on their MFJ return, a tax savings of only $600, and a marriage penalty of $300.

14. Is There a Marriage Penalty for the Elderly or Disabled?

IRC section 22 provides a credit for elderly and disabled taxpayers equal to 15% of an initial amount and reduced by certain income. This initial amount is $5,000 for a single individual and $7,500 for a married couple where both spouses are either elderly or disabled. This $2,500 reduction in the credit results in a maximum marriage penalty of $375. This $375 is a dollar-for-dollar increase in the couple’s tax bill because this item is a credit, not a deduction.

15. Are Any Items Marriage-Neutral?

There are several provisions in the tax code that are marriage-neutral, such as the standard deduction amounts mentioned in question 6. Another example is that single initial purchasers of IRC section 1244 small business stock may deduct up to $50,000 against their ordinary income if the stock becomes worthless. This deduction amount is doubled to $100,000 for MFJ taxpayers.

The deductible IRA contribution amount is $5,000 for a single taxpayer and $10,000 for MFJ taxpayers, with each spouse allowed $5,000 by IRC sections 219(b)(1) and (c)(2). The catch-up provisions allowing an additional $1,000 of contribution are also marriage-neutral.

The MFJ phaseout ranges for student loan interest deductions set forth in IRC section 221 are exactly double the single amounts. The phaseout range is $55,000 to $70,000 for single taxpayers and $110,000 to $140,000 for married taxpayers.

The American Opportunity and the Lifetime Learning credits were enacted in IRC section 25A to assist low- to middle-income individuals with college costs. The American Opportunity credit is generally used for undergraduate education, whereas the Lifetime Learning credit is generally used for graduate education. The phaseout ranges, although different for the two credits, do not result in a marriage penalty. The phaseout ranges for the American Opportunity credit are $80,000 to $90,000 for single taxpayers and $160,000 to $180,000 for MFJ taxpayers. The phaseout ranges for the Lifetime Learning credit are $50,000 to $60,000 for single taxpayers and $100,000 to $120,000 for MFJ taxpayers.

### EXHIBIT 2
A Summary of Items Affecting Marriage and Taxes

<table>
<thead>
<tr>
<th>Bonus Items</th>
<th>Neutral Items</th>
<th>Penalty Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate schedules: uneven</td>
<td>IRC section 1244 stock losses</td>
<td>Tax rate schedules: higher income, even income between spouses</td>
</tr>
<tr>
<td>$100-per-event floor casualty losses</td>
<td>IRA contribution amounts</td>
<td>Percent adjusted gross income (AGI) limitation on certain itemized deductions</td>
</tr>
<tr>
<td>Estate passes tax-free to spouse</td>
<td>Student loan interest deduction phaseout amounts</td>
<td>Overall limitation on itemized deductions, prior to 2010 and after 2013</td>
</tr>
<tr>
<td></td>
<td>Educational credit phaseout amounts</td>
<td>Additional standard deduction</td>
</tr>
<tr>
<td></td>
<td>Gain on sale of a principal residence</td>
<td>Personal and dependency exemption phaseout</td>
</tr>
<tr>
<td></td>
<td>Standard deduction amounts</td>
<td>Child tax credit phaseout</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Acquisition and home equity indebtedness limitation</td>
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<tr>
<td></td>
<td></td>
<td>Alternative minimum tax (AMT) exemption amounts and phaseouts</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Earned income credit (EIC) phaseout</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capital loss limitation</td>
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<tr>
<td></td>
<td></td>
<td>Credit for the elderly or permanently and totally disabled</td>
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</tbody>
</table>
Taxpayers are allowed to exclude the gain on the sale of a principal residence, subject to certain limitations, from their gross income under IRC section 121(b). For single taxpayers, the excluded gain allowed is $250,000; for MFJ taxpayers, the excluded gain is double that amount—$500,000.

The standard deduction amounts for taxpayers in the 10% and 15% brackets are marriage-neutral until 2013, as discussed in question 6—that is, unless Congress chooses to further extend the standard deduction for such married filers at double the standard rate.

16. Which Items Create a Marriage Bonus?

IRC section 165(c)(3) includes a floor level of $100 per event and a 10%-of-AGI test that must be applied to casualty and theft losses for personal use property. The $100-per-event floor can result in a marriage bonus. If a married couple suffers a loss, the deductible loss is reduced by $100. If two single people are living together and suffer a loss, they will each have to reduce the losses by $100. Thus the loss is reduced by $200, rather than $100 for MFJ. Although the amount is minimal, it is indeed a marriage bonus. As a further clarification, the spouses do not need to have assets in their own names; however, if two single people are living together, two $100 floors are applied to the assets because they file separate tax returns. If they are married, only one $100 floor is applied because they would file a joint return.

In the estate of a married person, a decedent spouse can pass all property to the surviving spouse, tax free, by virtue of IRC sections 2056 and 2056A. This tax-free passage is called the marital deduction. This represents a substantial tax break on estates that single people do not receive. Consider a woman who leaves all of her $8 million estate to her husband. This $8 million is a deduction on the estate tax return, and no estate tax is imposed. If, instead, this woman were not married and left $8 million to her companion, her estate would owe $1.05 million in estate tax. The 2011 estate tax rate is 35% on estates over $5 million, but the first $5 million can be transferred tax free.

As discussed in question 4, the tax rate schedules can also lead to a marriage bonus. This occurs when there is a large difference in spouses’ respective incomes.

17. Can the Issue of Marriage and Taxes Be Summarized?

The effects of tax code sections on the computation of liability that results in marriage penalties are numerous. The marriage penalty can affect marriages at all income levels, including poor, middle-income, and upper-income couples. The upper-income marriage penalty is significant, given the number of progressive taxes that are targeted at higher income taxpayers. Although the Bush tax cuts resulted in some relief, there are still many provisions in the tax code that create a marriage penalty.

This article has discussed a number of tax code provisions that can result in a marriage penalty or bonus. Exhibit 2 compiles and summarizes specific provisions related to marriage and taxes.

18. Which Policies Could Eliminate the Marriage Penalty?

It does not seem fair that marital status should affect a couple’s tax liability. To correct this inequity, the authors suggest that the following modifications be made to sections of the current income tax code:

- Flatten tax rates: Implementing a flat tax where deductions and credits are eliminated and the tax rate is equal at all income levels would be the best way to eliminate the marriage penalty.
- Change phaseouts of credits and deductions: Eliminate or double the phaseouts of tax credits and deductions for married couples.
- Individual filing status: Allow married couples to file tax returns as individuals, without the attendant penalties of MFS.

19. What Does the Future Hold?

To understand what the future will bring, consider the recently enacted Patient Protection and Affordable Care Act (ACA). In 2013, the ACA will result in an additional 0.9% Medicare tax on individuals earning in excess of $200,000. For MFJ taxpayers, the 0.9% tax will be on any earnings above $250,000. This results in another marriage penalty of $1,350.

Senator John Kerry (D-Mass.) has proposed the Strengthen the Earned Income Tax Credit Act of 2011. It seeks to continue some of the marriage penalty relief given by the American Recovery and Reinvestment Act of 2009 and extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. It certainly appears that MFJ status will continue to have an effect on tax liability in the future.

20. What Does the Current System Mean for Public Policy?

The tax effects surrounding a marriage contract create incentives and disincentives to marriage. Marriage creates the formation of families and environments positive- ly associated with the raising of productive, healthy, and educated children. Numerous studies have shown that children whose parents are married are significantly less likely to use drugs, have emotional problems, drop out of school, or get into trouble with the law. In addition, researchers consistently find that married adults tend to be happier, healthier, and more prosperous than their unmarried peers. The positive effects of marriage for society are well documented. Any disincentive to marriage created by the tax code will not serve to maximize a nation’s prosperity.

The marriage penalty creates a disincentive to get or stay married. Under the theory that we get a reduction of what we penalize (marriage and families) and more of what we subsidize (single-parent households), the authors ask why the U.S. government effectively taxes marriage. The marriage penalty puts financial pressure on the basic family units that are the building blocks of a stable society.

The authors recommend that Congress promote and initiate marriage-neutral policies. In the spirit of fairness, there should not be a marriage penalty or bonus at any level of income.

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