TAX FOUNDATION

TAX FEATURES©

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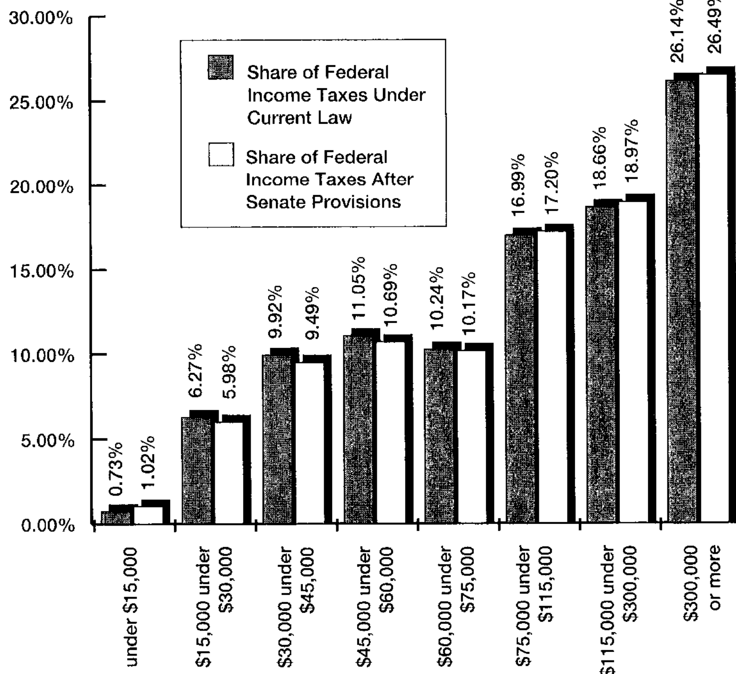
Senate Tax Bill Shifts Share of Taxes Away From Middle-Class, Families

Under the tax provisions recently agreed to by House and Senate conferees, income groups earning between $15,000 and $75,000 would see their share of federal income taxes fall. The provisions are now being considered in the House-Senate conference.



Source: Tax Foundation.

In the Senate plan, the "under $15,000" income group would see a smaller transfer payment due to changes in the Earned Income Tax Credit (EITC), while the middle class would benefit from the $500 per child tax credit.

Tax Foundation Senior Economist Arthur Hall, whose analysis of the Senate tax bill is shown in the accompanying graphs and tables, observed that the shift does not have much effect on the progressivity of the overall tax system.

"Those people earning $75,000 or more are still paying about 60 percent of all federal income taxes, while those tax filers with incomes of $30,000 or less are still paying 7 percent of those taxes," noted Dr. Hall.

If Congress enacts the Senate tax provisions, the average American tax filer could expect tax relief in the range of $940 a year. In fact, all income groups responsible for paying taxes would benefit from the Senate tax provisions. Because of changes in the Earned Income Tax Credit (EITC) program, those earning under $15,000 a year would, on average, receive less transfer payments—though the bulk of this change stems from reversing a provision in the 1993 tax bill that allowed people without children to receive this benefit.

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Two-Income Families See Tax Burden Climb

Total taxes on the median two-income American family continue to climb, according to the Tax Foundation's latest annual study of the typical American family, reaching a record high level in 1995. A median-income family with two income earners can expect to pay 38.2 percent of its income in federal, state, and local taxes. A median-income family with a single earner can expect to pay 36.2 percent, the highest percentage since 1975.

In his *Special Report* "Taxes Force American Family to Tighten Belt," Senior Economist Arthur P. Hall observes that in 1995, the typical two-income family's record-high taxes as a percent of income will also result in another record: the dollar amount of inflation-adjusted tax payments, $21,320. However, the $10,795 of tax payments for a typical single-earner family is below the inflation-adjusted $11,746 it paid in 1975. The single-income family's 1995 taxes will also fall below the $11,602 it paid in 1989, because inflation-adjusted median income for this type of family has been on a general decline since 1989.

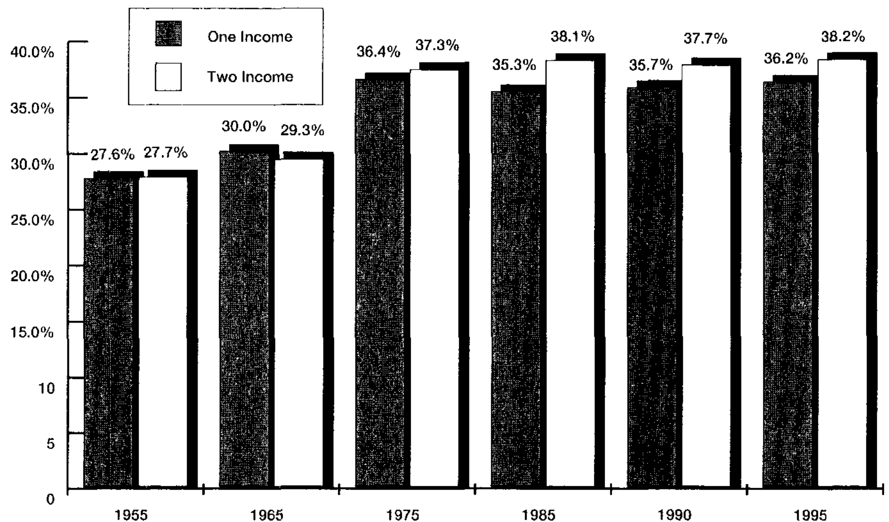
Charts 1 and 3 (on page 6) show the trend in the tax burden on the median two-income family between 1955 and 1995. Dr. Hall estimates that the tax burden as a percent of the typical family's income has grown 10.5 percentage points since 1955—though most of the increase occurred between 1965 and 1975.

Real total taxes have more than tripled since 1955 for the typical two-income family, from $7,046 to $21,320. Since 1990 inflation-adjusted total taxes have climbed nine percent for this family group. As a percentage of income they have risen from 37.7 percent to 38.2 percent.

The two catagories of taxation most responsible for this increase are the upward trend in state and local taxation and the increase in the federal payroll tax used to fund social insurance schemes. State and local taxes combined have, as a share of income, grown about 5 percentage points from

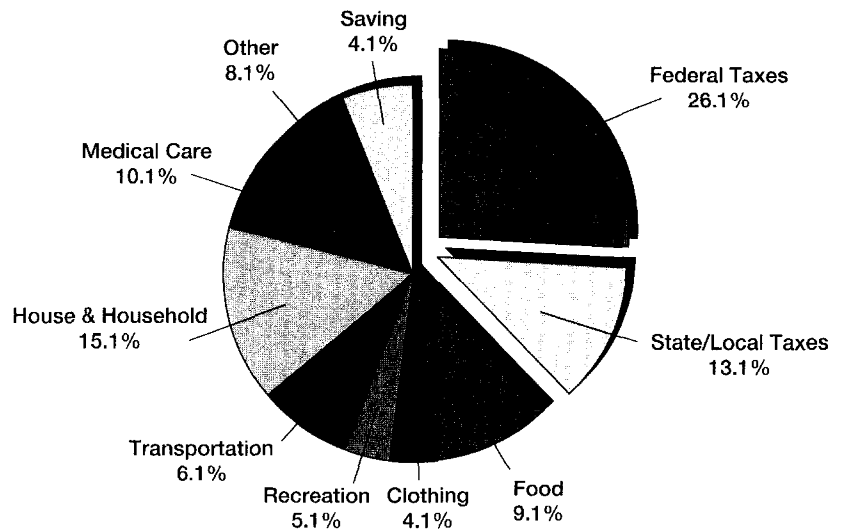
Family *continued on page 6*

Chart 1: Taxes as Percentage of Income for Median One- and Two-Income Family, 1955–1995



Source: Tax Foundation.

Chart 2: Representative Budget for Two-Income Family, 1995



Source: Tax Foundation.

Senate Tax Bill

Continued from page 1

The largest chunk of tax relief in the Senate's bill comes from the family tax credit, which provides for $94.9 billion in tax relief, and capital gains reform, which offers an additional $18 billion.

Some of the smallest proposed changes were not included Dr. Hall's analysis, so that his total tax reduction of $113.2 billion is approximately $1.5 billion less than the reduction actually projected.

State Impact

If the Senate tax plan is enacted, Connecticut residents will average $1,258 in tax relief between 1996 and 2000, according to Dr. Hall. That, of course, is carved out of the largest federal tax burden in the country—Connecticut residents will pay $48,261 per capita in federal taxes over the next four years. The proposed tax relief represents 2.6 percent of Connecticut residents' total federal tax burden in that period.

Massachusetts and New Hampshire residents would see the second and third highest averages in tax relief, $1,175 and $1,173, respectively. But because their federal tax bills are lower than their Connecticut neighbors' bills, the tax relief would be proportionately greater: 3.0 percent of all federal taxes for Massachusetts residents, and 3.3 percent for New Hampshire residents.

Alabamans would see the lowest per-filer tax cut over the next four years—$607. That represents roughly 2.0 percent of their federal tax burden between 1996 and 2000.

If the Senate bill is enacted, the $936 per capita tax relief for all Americans would represent 2.6 percent of their total federal tax bill over the next four years. •

Distribution and Share of Total Federal Income Distribution and Share of Total Federal Income Tax Burden Before and After Senate Provisions

	Millions of Current Dollars			
Income (AGI) Class	Distribution of Federal Income Taxes Under Current Law (1996-2000)	Distribution of Federal Income Taxes After Senate Provisions (1996-2000)	Share of Federal Income Taxes Under Current Law (1996-2000)	Share of Federal Income Taxes After Senate Plan (1996-2000)
under $15,000	$31,353	$42,579	0.73%	1.02%
$15,000–$29,999	268,814	249,377	6.27	5.98
$30,000–$44,999	425,094	395,921	9.92	9.49
$45,000–$59,999	473,744	446,149	11.05	10.69
$60,000–$74,999	438,746	424,390	10.24	10.17
$75,000–$114,999	728,401	717,653	16.99	17.20
$115,000–$299,999	799,709	791,741	18.66	18.97
$300,000 or more	1,120,589	1,105,484	26.14	26.49
Total	$4,286,449	$4,173,293	100.00%	100.00%

Note: Includes allocation (capital/labor split) of corporate income taxes to individuals.
Source: Tax Foundation.

The Distribution of Senate Tax Reduction Provisions, 1996-2000 (Millions of Current Dollars, Except Per Filer)

Income (AGI) Class	Family Tax Credit	EITC Reforms	Individual Capital Gains Reforms	Other Changes	Total Federal Income Tax Burden	Total Tax Reduction Due to Senate Provisions	Total Tax Reduction Per Income Income Tax Filer
under $15,000	-$333	$13,613	-$43	$-2,011	$31,353	$11,226	$306
$15,000–$29,999	-27,240	12,538	-111	-4,624	268,814	-19,437	-693
$30,000–$44,999	-24,513	0	-341	-4,320	425,094	-29,173	-1,578
$45,000–$59,999	-23,553	0	-214	-3,828	473,744	-27,594	-2,096
$60,000–$74,999	-11,483	0	-358	-2,514	438,746	-14,355	-1,578
$75,000–$114,999	-6,437	0	-1,224	-3,086	728,401	-10,748	-1,096
$115,000–$299,999	-1,370	0	-3,640	-2,958	799,709	-7,968	-1,684
$300,000 or more	0	0	-12,153	-2,952	1,120,589	-15,105	-18,917
Total	-94,929	26,150	-18,084	-26,292	4,286,449	-113,156	-937

Source: Tax Fondation.

Reforming the Tax System through the Unlimited Savings Allowance (USA) Tax Proposal

By Senator Sam Nunn (D-Georgia)

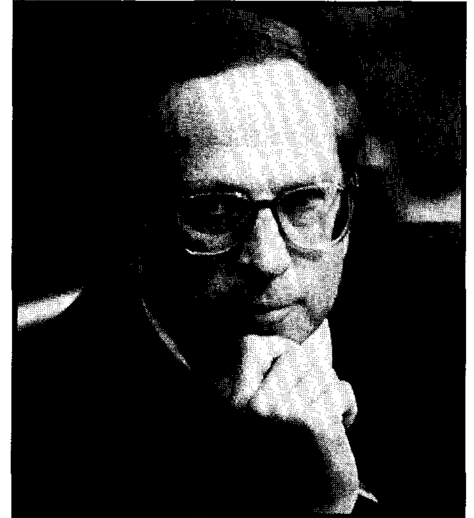
In 1992 the CSIS Strengthening of America Commission, which Senator Pete Domenici (R-N.M.) and I were honored to co-chair, released a comprehensive plan to strengthen our economy, and to strengthen our competitive position in the world.

The plan consisted of three intertwined recommendations:

1) a 10-year plan to balance the federal budget, primarily through the control of entitlement spending;

2) a long-term plan to increase investment in U.S. human and physical capital; and

3) a proposal to replace the current individual and corporate income tax and to create in its place a tax code which promotes saving and investment.



What do we mean by a tax system that works? We mean a system that encourages saving and investment. We mean a system that is fair and is perceived to be fair. We mean a system that is understandable and that reduces the complexity of paying taxes . . .

Senator Domenici and I concluded that our tax system needs a transplant, not more Band-Aids. If we are serious about our nation's future, we have to scrap the current tax system and put in its place a system that will work for our people and for our country.

We introduced this plan (S. 722) earlier this year and we call it the USA Tax system. USA stands for Unlimited Savings Allowance, which is the key feature of our proposal. Simply put, under the USA plan any income you save in a bank account or invest in stocks, bonds, mutual funds or other financial assets is exempt from taxation until you withdraw those funds from the national savings pool and consume them. We believe this represents a fundamental change in the way America taxes itself, the way America saves, and the way America invests.

What do we mean by a tax system that works? We mean a system that encourages saving and investment. We mean a system that is fair and is perceived to be fair. We mean a system that is understandable and that reduces the complexity of paying taxes for ordinary Americans by taking less time, fewer forms, and fewer dollars to comply with. We mean a system that is attuned to the international competitive realities and gives U.S. companies and their employees a chance to compete fairly in the global marketplace. We mean a tax system that is fiscally responsible, which is why our plan is designed to be revenue neutral.

Senator Domenici and I believe that the central goal of any reform of the tax system should be to raise the level of national savings. Higher savings lead to more investment. More investment increases the productivity of American workers. The more productive our workers are, the more competitive we are, the better jobs we have. The better jobs we have, the higher income the American people have. That is the chain reaction we

want to set in motion. There is a direct connection between savings and higher real income for the American people, and that is the essence of the USA Tax system.

The USA proposal consists of a single tax in two parts that work together: a low, flat-rate tax at the business level where wealth is created, and a progressive income tax at the individual level where wealth is received. The USA proposal is a revolutionary idea and its potential advantages are very important to our country.

The first advantage: this proposal will increase national savings by eliminating the bias in the current tax code against saving, without increasing the budget deficit. Increasing the pool of private savings will in turn allow increased investment at lower cost, which will help to increase the productivity of our workers.

The first advantage: this proposal will increase national savings by eliminating the bias in the current tax code against saving, without increasing the budget deficit.

Second, it will level the international playing field for U.S. companies and promote U.S. exports of domestically produced goods by excluding exports from the business tax, and it will equalize the tax treatment of American-made and imported goods by applying the business tax to imports, just as American exports are taxed when they are sold in foreign markets.

Third, it will make our tax code more understandable and more efficient which will save, I believe, both billions of dollars and millions of hours preparing individual and business tax returns, and it will do so without sacrificing the principle of fairness in allocating the tax burden.

Fourth, the USA Tax plan is the only tax reform proposal that integrates the income tax with the Social Security payroll tax. The USA plan includes a tax credit for both the employer and employee shares of the payroll tax. This tax credit would offset the effects of the most regressive, anti-job part of our current tax system, the payroll tax. It will help create new jobs by reducing the current disincentive to hire low skill workers, while at the same time promoting progressivity. To compare the tax rates under the USA Tax plan to any other system, the payroll tax must be subtracted from the income tax rates in the USA plan or added to the income or sales tax rates stated in any other plan.

Finally, we believe the USA plan will foster greater personal responsibility by clearly showing every individual the costs and benefits of saving versus consuming, without distorting that choice.

Today, every family in America, if they are saving money for an automobile or a college education, has to pay taxes before they save. The USA Tax plan would give lower- and middle-income taxpayers a way to save out of their pre-tax incomes. I believe our proposal will help all American families save, and that as a result, all of us will be better off.

The current tax system is broken and, in my opinion, it cannot be fixed. We must begin anew. The USA Tax system provides a way to eliminate the complexities, the special subsidies, and the crippling biases present in the current code. By enacting real reform of the tax system, we can take a giant step toward securing our country's future.

Individual, Business Tax Rules Under "USA"

Individual Tax Rules

- *Income:* Wages; salaries; interest; dividends; capital gains; distribution from a business to an owner; distributions from a pension, trust, or estate; proceeds from sale of personal property or interest in a property; 85% of Social Security benefits.
- *Deductions:* Family Living Allowance deduction (preliminary levels, which will be adjusted for inflation: $7,400 for married filing jointly, $4,440 for single filers, $6,500 for head of household filers); all net savings (including reinvested interest, dividend and capital gains income); qualified education expenses; charitable contributions; home mortgage interest; alimony payments.
- *Exemptions:* Preliminary levels, which will be adjusted for inflation: $2,550 for personal and each dependent.
- *Tax Rates:* Preliminary joint return brackets, bracket levels will be adjusted for inflation: 10% on first $5,400; 20% on $5,401 through $24,000; and 39% on taxable income over $24,000 (four year phase-in rates of 15%, 27%, and 40%). The bracket levels for single, head of household, and married filing separately will likely keep the same proportion as current law to married filing jointly brackets.
- *Tax Credits:* Payroll tax credit equal to the employee portion of Social Security and Medicare payroll taxes paid on wages up to the Social Security wage cap under current law (the 1995 cap is $61,200), Earned Income Tax Credit of current law will be retained (but possibly modified).

Business Tax Rules

- *Business Income:* Gross revenue from sales of goods and services.
- *Deductions:* Purchases of goods, services, materials, capital equipment, and land; revenue received from the sale of exported goods and services.
- *Tax Rate:* 10% (preliminary)
- *Tax Credits:* Employer portion of the Social Security and Medicare payroll tax.Special Note: The deduction from income of revenue received from exported sales is counterbalanced by a tax on imports set at a rate equal to the business tax rate (the 10% preliminary rate). The import tax would be levied on a foreign business that operates outside the U.S. but sells its goods or services in the U.S. market.

New Study Examines Federal Tax Incentive in Debt of Closely Held Corporations

Taxpayers will take on more debt as the value of their tax shield rises, concludes a new Tax Foundation analysis authored by Professors C. Bryan Cloyd, Stephen T. Limberg, and John R. Robinson of the University of Texas's Accounting Department. This, they point out, has significant implications for tax policy.

The authors produced the report — "The Impact of Federal Taxes on the Use of Debt by Closely Held Corporations" — as part of the Tax Foundation/Ernst & Young Visiting Professor program. "The results of the study," note the authors, "represent an important step toward understanding the more complex question of how tax incentives affect the mix of debt and equity in a firm's capital structure."

By regressing the level of interest on the estimated marginal tax rate, the level of nondebt "tax shields," and the correlation between these two factors, the authors concluded that the tax benefits associated with interest expense encourage firms to use debt. Yet, the report observes, the use of debt may be related to tax rates only after controlling for nondebt tax shields, as well as nontax determinants of debt utilization.

Debt *continued on page 7*

Family

Continued from page 2

1955 to 1995. Federal payroll taxes as a share of total family income have grown about 5.6 percentage points from 1955 to 1995. Moreover, economists assume that the employer's share of the federal payroll tax reduces wages by the amount of the tax, so that a median-income family's gross wages are about 7.5 percent lower than they would be at 1955 payroll tax levels.

Chart 2 shows that taxation continues to dominate the family budget. For a median two-income family, the tax burden will exceed the combined expenditures for housing and household operations, medical care, food, and clothing.

This year's report on the typical American family documents income and tax levels of both single- and dual-income families. While in the past the report has specified a two-earner married couple with two children, this year's typical family adheres to the Census Bureau's broader definition — two or more related people living in the same residence. Despite the change in procedure, approximately 90 percent of the families represented in the report are married couples with an average of about one child per family. •

Chart 3: Taxes and the American Family (Dual Income) Selected Years, 1955–1995

	1955	1965	1975	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995e
Median Family Income	$5,250	$7,983	$16,058	$33,411	$35,108	$36,799	$38,702	$40,658	$42,146	$43,623	$45,779	$47,424	$49,678	$52,039
Federal Income Tax	513	727	1,918	3,853	3,906	3,367	3,519	4,216	4,261	4,280	4,334	4,490	4,703	4,926
Payroll Taxes:														
Employee Portion	84	174	825	2,261	2,410	2,526	2,790	2,931	3,095	3,204	3,362	3,483	3,648	3,822
Employer Portion	84	174	825	2,261	2,410	2,526	2,790	2,931	3,095	3,204	3,362	3,483	3,648	3,822
Other Federal Taxes	407	562	808	1,247	1,259	1,441	1,535	1,610	1,565	1,624	1,713	1,800	2,093	2,244
Total Federal Taxes	1,088	1,636	4,376	9,623	9,985	9,860	10,634	11,688	12,017	12,312	12,770	13,255	14,092	14,813
Total State/Local Taxes	392	751	1,915	3,977	4,284	4,474	4,601	4,848	5,028	5,352	5,684	5,887	6,162	6,506
Total Taxes	1,480	2,387	6,291	13,600	14,269	14,334	15,235	16,536	17,044	17,664	18,454	19,142	20,254	21,320
After-Tax Income	3,854	5,770	10,592	22,072	23,249	24,991	26,257	27,053	28,197	29,163	30,687	31,765	33,073	34,541
Total Taxes as a Percent of Income	27.7%	29.3%	37.3%	38.1%	38.0%	36.5%	36.7%	37.9%	37.7%	37.7%	37.6%	37.6%	38.0%	38.2%
Inflation-Adjusted Total Taxes (1995$)	$7,046	$10,900	$16,598	$18,685	$19,099	$18,591	$19,018	$19,767	$19,529	$19,448	$19,913	$20,103	$20,815	$21,320

Note: The burden of federal and state corporate income taxes are included. After-tax income does not deduct employer's share of payroll taxes because the burden of the payroll tax is assumed to reduce income before the "gross" seen on paychecks. "Total taxes as a percent of income" is calculated by adding the employer's share of the payroll tax to the median family income.

Source: Tax Foundation.

Debt

Continued from page 6

The authors investigated the impact of federal income taxes on debt use by analyzing the actions of a sample of closely held corporations — that is, taxable corporations and electing Subchapter S corporations — after passage of the Tax Reform Act of 1986 (TRA86). Previous studies have explored this issue with samples of large, publicly held corporations. For a variety of reasons, however, closely held businesses may be more likely to arrange their capital structures to minimize the corporate income tax. Prior to the publication of this study, there was little empirical evidence pertaining to these small firms.

The authors' analysis indicates that both taxable and Subchapter S corporations incur more interest expense as their tax rates increase, supporting the general hypothesis that taxpayers will take on more debt as the value of the tax shield rises. The study's results also supported the hypothesis — known as "tax exhaustion" — that the extent to which firms substitute nondebt tax shields for debt tax shields depends upon their marginal tax rates. Specifically, small, closely held corporations with high tax rates substitute nondebt shields for debt shields at a higher rate than similar firms with low tax rates.

In addition, the authors contend, the use of debt tax shields decreases as the level of nondebt tax shields increases, possibly implying that lenders are less willing to make loans to firms as the percentage of gross profits dedicated to covering non-interest operating expenses increases.

In terms of public policy, the report provides evidence that taxes significantly influence the decision to use debt in small, closely held firms.

The Ernst & Young/Tax Foundation Professor program is an ongoing attempt by both organizations to bring important new academic research into the mainstream of the policy debate. •

FOUNDATION MESSAGE

Honoring a Tax Reformer

Every year the Tax Foundation presents a public sector and a private sector Distinguished Service Award at its annual November Dinner. This year, the private sector award will be presented to Mr. Alfred C. DeCrane, Chairman and Chief Executive Officer of Texaco Inc. Texaco is one of the Tax Foundation's oldest and most active supporters. Through the efforts of Mr. Michael Ambler of the Tax Foundation's Policy Council and Mr. Tony Saggese of the Program Committee, Texaco and Mr. DeCrane have helped assure the Tax Foundation's active role in informing policymakers and the public about important issues in tax policy.

The 1995 public sector Distinguished Service Award will be presented to U.S. Sen. Sam Nunn, Democrat of Georgia. Senator Nunn is well known and respected as a true expert on matters relating to defense policy and foreign affairs. In recent years, however, he and Sen. Pete Domenici (R-N.M.) have teamed up to take a very fundamental look at our nation's long-term fiscal policy. Perhaps the most important consequence of this effort has been the introduction of legislation to enact the USA Tax System.

J.D. Foster
Executive Director and Chief Economist

The USA Tax System would replace the personal income tax with a personal consumption tax, and would replace the corporate income tax with a subtraction-method Value-Added Tax (VAT). The USA Tax System would neatly relieve the multiple taxation of saving; it would improve the tax treatment of physical capital; it may have salutary effects on the nation's terms of trade through the border tax adjustment mechanism; and it would almost certainly dramatically reduce the extraordinary compliance and administrative costs of the federal income tax system.

Unlike many of the other tax reform proposals currently in circulation, the USA Tax System addresses a host of important technical and transition issues that would arise in replacing the current system. Some observers have criticized it for being too complicated compared to competing tax proposals. But for the most part these criticisms reflect either an incomplete understanding of the proposal and how markets would respond to it, or a failure to appreciate the honest effort made to answer tough questions generally ignored by other proposals.

One such source of complexity is the employer and employee payroll tax credit system that is an important part of the overall proposal. Under the USA Tax System, for example, an individual would be able to take a full credit against his or her personal tax for payroll taxes paid. While this provision certainly creates more complexity than would be the case without it, the effect of the provision is to integrate the existing payroll taxes into the overall USA Tax System.

The USA Tax System also avoids many of the problems of the alternative tax reform proposals. For example, a flat tax would provide a tremendous windfall to the wealthy because it does not tax capital income such as dividends and interest. In contrast, because the tax base under the USA Tax is what individuals spend, rather than what they earn, that plan would yield a much smaller windfall.

The USA Tax System is not without its problems. There is a real question, for example, about how financial institutions should be brought into the system. Similarly, while the treatment of physical plant and equipment may be neutral under the system and better than occurs under current law, the treatment of intellectual capital may not be neutral, and may be worse than is the case under current law.

It seems very likely that tax reform will become a major issue in the upcoming presidential campaigns and will continue to grow in importance in the years immediately thereafter. Without question, Sen. Nunn has done a tremendous service for the country in advancing such a comprehensive alternative to the federal income tax. His leadership and dedication to finding a better way warrant the Tax Foundation's presentation of the 1995 Distinguished Service Award.

Social Security "Investment" a Bad Deal for Working Americans

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Reneé Nowland

Editor and Associate Director/ Communications Director
Stephen Gold

Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax

Most people retiring within the next decade will begin to receive a negative real rate of return on their combined employer/employee Social Security payroll taxes, according to a new study by the Tax Foundation. Unless, of course, they've already begun to receive negative returns.

In essence, says Senior Economist Arthur P. Hall, Social Security has become a bad deal for almost all Americans. When he estimated the benefits that Americans will receive under the current system (calculating the net present value of the benefits), Dr. Hall concluded that Americans are getting a negative real rate of return—in essence, losing money on the deal.

If employees could opt out of the system, Dr. Hall observed, investing their retirement funds instead into private annuity accounts, they could more easily earn a profit.

As the accompanying table shows, single males would be the best candidates to opt out of Social Security. The table shows the retirement year in which the average worker in several profile categories would start realizing negative rates of return. For example, high-wage single males who retired in 1987 are already earning a net loss on their payments. The chart also shows that, although Social Security benefits are designed to give disproportionate benefits to low-income workers, a low-wage male as old as 39 would still benefit financially from taking his employer/employee payroll payments and investing them elsewhere.

The age threshold for other types of taxpayers is much lower than for single males for two related reasons. First, all other taxpayers (family types) include females, and females on average live about four years longer than males. Second, females default to their husband's Social Security benefit level when he dies. The four extra years of life at increased benefit levels substantially improve the cost/benefit calculation of Social Security.

Dr. Hall's analysis examines several categories of employees, including low-wage earners, middle-wage (or average) earners, and high-wage earners. The accompanying table shows the year in which retirees begin to receive negative real rates of return on combined payroll taxes, as well as the maximum age at which taxpayers could profitably opt out of the system. •

Opting Out of Social Security

Taxpayer Profile	Year in which Retirees Begin To Realize Negative Returns	Maximum Opt-out Age*
Low Wage Earner		
Single Male	1999	39
Single Female	n/a	n/a
Male w/ Dep. Spouse	2008	24
Couple	2007	23
Average Wage Earner		
Single Male	1989	49
Single Female	n/a	24
Male w/ Dep. Spouse	1994	37
Couple	2001	30
High Wage Earner		
Single Male	1987	53
Single Female	2003	30
Male w/ Dep. Spouse	1994	43
Couple	1998	37

* Includes the current law income taxation of Social Security benefits.
Source: Tax Foundation.

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