TAX FOUNDATION Since 1937

SPECIAL REPORT

April 2010
No. 178

PEP and Pease: Repealed for 2010 But Preparing a Comeback

Two Phase-outs Have Been Phased Out, Repealed and Will Now Be Reinstated: A Monument to Tax Complexity and Uncertainty

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Introduction

In discussions of raising or lowering federal income tax revenue, two common terms are PEP and Pease. These tax provisions are little known to the taxpaying public because only people with annual incomes well above average have to face the consequences of complying with them. However, these provisions are worth understanding.

Since their enactment 20 years ago, the debate over PEP and Pease has been emblematic of a larger debate in tax policy: When the government demands more revenue from taxpayers, what is the least damaging way for it to do so? Should it raise statutory tax rates or repeal targeted deductions and exemptions? And similarly, when the government decides to cut taxes, should it do so by granting more deductions and exemptions, or should it cut statutory tax rates?

This year a discussion of PEP and Pease is especially timely. For the first time in 20 years, neither law is in effect, both having been repealed for tax year 2010 and only that year. They are scheduled to be reinstated on the expiration date of the ten-year, temporary tax cuts commonly known as the Bush tax cuts. Although President Obama's budget proposes

Key Findings

- *Since its inception the federal individual income tax has used personal exemptions to mitigate the impact of taxes on low-income filers. More controversially, it has used itemized deductions to promote spending on particular products and services.*
- *To increase revenue over the past 20 years, the federal government has rescinded the tax benefits of personal exemptions and itemized deductions by phasing them out for high-income people. These are the so-called PEP and Pease provisions which have created significant problems, raising marginal tax rates and adding to tax complexity.*
- *The value of the personal exemptions and itemized deductions were gradually restored starting in 2006, and in 2010 they were completely restored by repealing the PEP and Pease provisions. However, the Obama Budget envisions restoring the PEP and Pease provisions for all single taxpayers with over $200,000 in AGI and couples with over $250,000. This will combine with statutory rate increases to significantly raise the marginal tax rates of high-wage tax filers.*

that most of the Bush tax cuts be kept in law, he calls for PEP and Pease to be reinstated, so in all likelihood the provisions' absence from the 1040 during 2010 will be a one-year phenomenon.

When the government demands more revenue from taxpayers, what is the least damaging way for it to do so? Should it raise statutory tax rates or repeal targeted deductions and exemptions?

The first, PEP, refers to the personal exemption phase-out, which rescinds the benefit of the personal exemption from taxpayers who earn over a certain amount. Pease is a similar phase-out, but instead of applying to the personal exemption, it applies to most of the itemized deductions a taxpayer claims, from the well known deductions for mortgage interest, charitable gifts, and state-local taxes paid to more obscure deductions for union dues, tax preparation fees and safety deposit box expenses. Named after Representative Donald Pease (D-OH) who pushed for its enactment in 1990, this law rescinds up to 80 percent of the value of a taxpayer's itemized deductions if the taxpayer's income is deemed too high.

Background

Federal tax law does not simply levy a tax on individuals' gross incomes. Instead, it allows taxpayers to shelter from taxation a fraction of their income, in some cases a large fraction. One of the best known tax laws that do this is the personal exemption, which is as old as the income tax itself. It is a fixed dollar amount that a single taxpayer is allowed to subtract from his taxable income. A taxpayer with more than one person on his tax return is also allowed to subtract the personal exemption for a spouse and each dependent.

Just as every taxpayer is allowed to take the personal exemption, so every taxpayer is also allowed at least one deduction. There are dozens or even hundreds of possible deductions because Congress never tires of targeting some new type of investment or spending for a federal subsidy through the tax code.

The Personal Exemption

The personal exemption allows taxpayers to exclude a lump sum of their income from taxation, and the lump sum is allowable for each eligible taxpayer and dependent listed on a tax return. The amount for each person is $3,650 for tax year 2010. A married couple with two children multiplies that amount by four and reduces the family's taxable income by $14,600.

What is the justification for this generous tax provision that shelters $900 billion of taxpayers' income each year? The personal exemption has traditionally been defended as a way of providing tax relief to low-income people, especially to families with several children. The lower the income of the family, the greater the share of its taxable income sheltered from taxation by the personal exemption.

The Personal Exemption Phase-out (PEP)

Because of the personal exemption's poverty-alleviating justification, the granting of the exemption to middle- and high-income individuals has long been called into question. The bipartisan group of tax reformers in Congress who crafted the Tax Reform Act of 1986 (TRA'86) decided that above a rather high income level, they would enact a so-called bubble rate to phase out the benefit of personal exemptions for all tax returns that declared incomes above some amount.[1] Approximately the top-earning three percent of taxpayers lost some or all of the personal exemption's value.

Four years later, the Omnibus Budget Reconciliation Act of 1990 (OBRA'90) retained the concept of rescinding the personal exemption's value from high-income people but

1 Even though TRA'86 is famous for establishing a two-rate system, 15% and 28%, the little-noticed 'bubble rate' of 33% applied to all taxable income of joint filers between $71,900 and $149,250, rescinding exactly the amount of tax savings that the taxpayer had received from the personal exemption and the 15% rate. Above $149,250, the statutory rate fell back to 28%. Similar phase-outs applied to the other filing statuses.

dispensed with the bubble rate. Instead, it put into place a system that gradually phases out the benefit of personal exemptions for filers above income thresholds set in law. This was PEP, the personal exemption phase-out. Substantively, there is little difference between the bubble rate and the exemption phase-out: in both cases the taxpayer slowly pays a higher marginal tax rate until the government has recouped all the money that the taxpayer had saved by claiming the exemption. Since every filer is entitled to personal exemptions, and every filer who earned enough had to pay the bubble rate from 1987 through 1990, and then had to lose his exemption to PEP from 1990 on, it was mostly a computational difference.

In 1991, the first year PEP was in effect, the phase-out threshold for joint tax returns was set at $150,000 in adjusted gross income (AGI). Each person on every tax return that year was given a $2,150 exemption, but as a result of PEP, if the AGI declared on the return exceeded $150,000, the $2,150 exemption started dropping at a rate of 2 percent for every additional $2,500 of AGI.

For example, if a childless couple had combined income in 1991 that equaled the threshold of $150,000, they would keep the full benefit of their two personal exemptions, $2,150 for each person, or $4,300. But if they earned an additional $2,500, they would lose $43 from each exemption (2 percent of $2,150). If they earned an additional $25,000, they would lose 20 percent of their exemptions, and if they earned an additional $125,000, they would lose the entire value. Another way of expressing this is to say that the phase-out range for the personal exemption was from $150,000 to $275,000 for all joint tax returns in 1991.

The PEP thresholds are indexed for inflation, so what began in 1991 as a $150,000 threshold was a $250,200 threshold in 2009. Initially, PEP was set to expire in 1995 but was made permanent by the Omnibus Budget Reconciliation Act of 1993 (OBRA'93).

Phasing Out PEP and Bringing It Back With a Higher Threshold

Economists are always concerned with the marginal tax rate. When a taxpayer gets an opportunity to earn more money, he contemplates what percentage of that extra money he will lose in tax. He includes not only the rate set in law for income at that level but also exemptions, deductions and other tax provisions. Once all those are taken into account, if the marginal tax rate is too high, the taxpayer may decide either that it is not worth earning the extra money, or he may employ a tax-avoidance strategy that clears the way for him to do the extra work. Either way, neither he nor society at large will be as well off as they would have been if the tax were collected in a more efficient manner.

Marginal tax rates can be like a roller-coaster (see Figure 1). At the low end of the income scale, taxpayers qualify for many exemptions, deductions and credits, but when they start earning enough to move into the middle-income range, they lose poverty-reducing credits, and when the loss of the credits is combined with their statutory tax rate, the result can be an extremely high marginal tax rate. As taxpayers move into the upper-middle income ranks, PEP causes their marginal tax rate to rise, affecting incentives to continue earning more.

Supply-side economists argue with particular emphasis that the marginal tax rate is all-important, and so they criticize PEP for raising the marginal tax rate on a broad swath of high-income people. They claim it is economically damaging and adds undue complexity to the code. As a result, when the Republican congress responded to the 2000 election of George W. Bush by proposing a tax cut package that mirrored his campaign promises, they included a provision that repealed PEP. However, due to revenue concerns, it was not immediately repealed. Instead, the version that finally became law as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) phased out the phase-out. That is, it gradually phased out PEP between 2006 and 2009, with taxpayers losing less of the personal exemption's value each year, until finally repealing it in 2010. However, because EGTRRA was enacted as a 10-year temporary measure, calendar year 2010 will probably end up being a short one-year vacation for the PEP.

Just as President Bush entered office promising to cut taxes for everyone, so President Obama entered with a promise to cut taxes for everyone making less than $250,000 but to raise them for everyone whose income exceeded that threshold. As part of his tax plan, then, he proposes to restore PEP but to begin the phase-out at higher income thresholds: $254,550 for couples, $203,650 for singles, $229,100 for heads of households, and $127,275 for married couples filing separately.[2] The same 2-percent loss of value for each additional $2,500 earned will apply to all types filers. If President Obama's proposal becomes law, the phase-out range for PEP in 2011 will be $254,550 to $379,550 for couples and $203,650 to $328,650 for single filers.

Deductions

Every person filing a federal income tax return is given the option of claiming either the standard deduction or itemizing all the individual deductions that he qualifies for according to a massive compendium of tax laws that govern tax deductions. Standard deductions allow filers to exclude a fixed portion of their AGI from taxation. For 2010 single filers will be able to claim a standard deduction of $5,700 while joint filers will be able to claim $11,400. Additional amounts are available to the elderly and blind. The granting of standard deductions is typically justified on equity grounds to forgive from taxation a subsistence level of income, in the same way as the personal exemption.

In lieu of taking the standard deduction, taxpayers may itemize their deductions. Under a pure income tax, the only deductible expenses would be those incurred while earning taxable income, plus uncompensated losses. This is far from the case today.[3] Currently, itemized deductions for mortgage interest paid, taxes paid and gifts to charity account for around 85 percent of all itemized deductions claimed.

Itemized deductions are widely acknowledged to create distortions that reduce economic welfare.[4] Consider the deduction for home mortgage interest. In combination with other housing subsidies, this deduction helps create the situation where investments in owner-occupied housing are not taxed at all while business investment is taxed at around 26 percent.[5] This has the effect of steering investment away from businesses where it would finance wage-enhancing purchases of plant and equipment. Tax-motivated investment in owner-occupied housing at the expense of productive business investment is a perfect example of what economists call sub-optimal allocation of investment, but which might more plainly be called politically motivated waste that harms long-term economic growth.

Enter Pease

Facing a budget deficit in late 1990, President Bush and the Democratic congress chose to raise tax revenue, and the result was the now-famous breaking of President Bush's promise to enact no new taxes. Representative Donald Pease put forth a proposal to raise significant revenue, not by enacting any new tax rates but instead by a technique similar to the PEP. Congress could phase out the benefits of itemized deductions in the same way that it was already phasing out the value of the personal exemption.[6] The idea was accepted, it became part of the Omnibus Budget Reconciliation Act of 1990 (OBRA'90), and the Pease provision has continued in law ever since.

2 Tax Foundation estimates based on 2011 Treasury Green Book.

3 Harvey S. Rosen, *Public Finance,* Boston, MA: McGraw-Hill, 2005, pp. 371-78.

4 Rosen, pp. 371-78. Also see Joel Slemrod and Jon Bakija, *Taxing Ourselves,* Cambridge, MA: MIT Press, 1998, pp. 180-94.

5 President's Advisory Panel on Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System,* November 2005, p. 71.

6 All itemized deductions other than those for medical expenses, investment interest, theft, casualty losses, and wagering losses are limited.

Pease … applies to most of the itemized deductions a taxpayer claims, from the well known deductions for mortgage interest, charitable gifts, and state-local taxes paid to more obscure deductions for union dues, tax preparation fees and safety deposit box expenses.

In 1991, the first year that it was in effect, the income threshold below which a taxpayer would keep the entire value of his itemized deductions was $100,000 in AGI for joint filers and $50,000 for all others.[7] But if a taxpayer declared income above the threshold while claiming any of the itemized deductions that are subject to Pease, then three percent of those extra earnings would be subtracted from his deductions.[8]

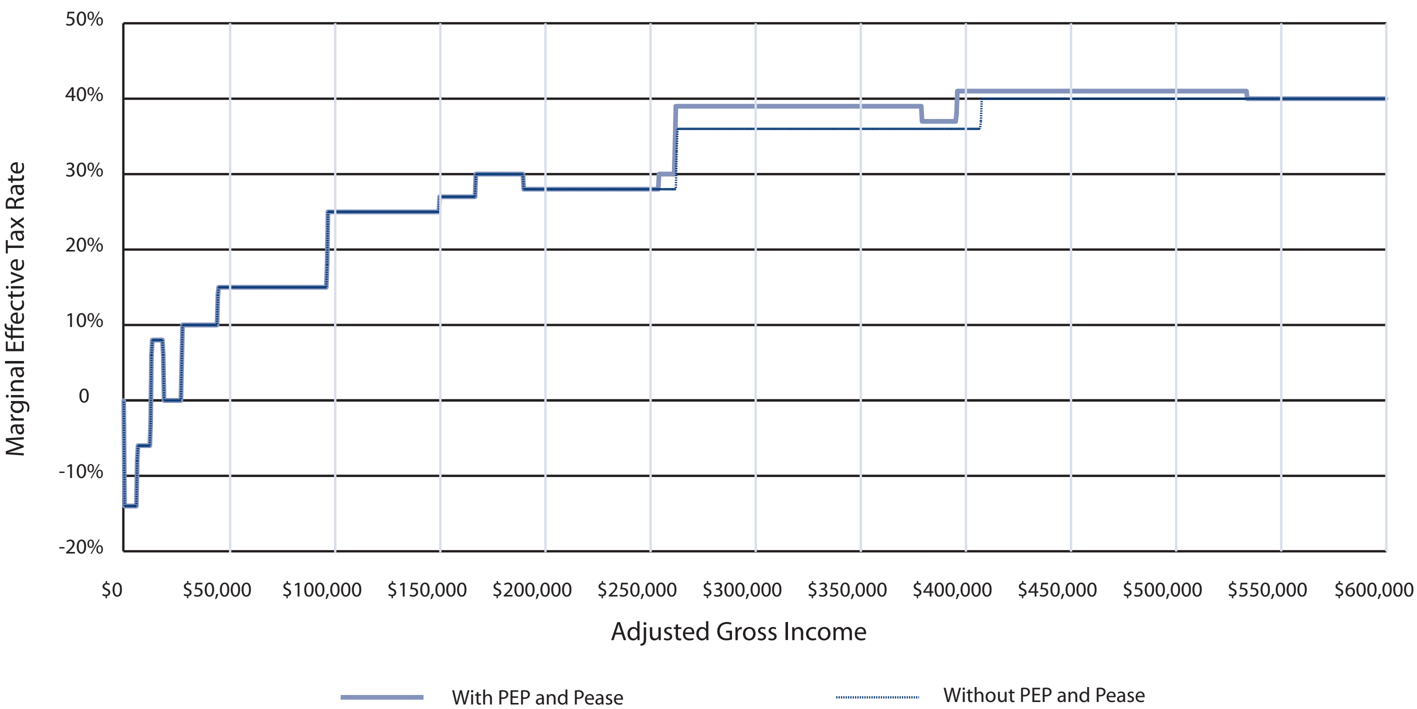
For example, if a couple had combined income of $100,000, they retained the full value of their deductions for mortgage interest, charitable gifts, etc. But if they earned $150,000, and their itemized deductions totaled $20,000, then the couple would have to subtract three percent of the earnings above the threshold from their deductions. In this case, three percent of $50,000 is $1,500, so their deductions would be shaved from $20,000 down to $18,500.[9]

When enacting the Pease provision, Congress decided not to allow it to completely wipe out a taxpayer's deductions. Twenty percent of

Figure 1

Effects of PEP and Pease on Marginal Effective Tax Rates

Calendar Year 2011



7 The three other types of tax returns are single, married filing separately, and head of household.

8 If all of the new tax revenue raised by OBRA'90 had been raised by repealing or limiting the eligibility of special tax breaks, President Bush would probably have been less vulnerable to the criticism that he broke his no-new-taxes pledge. As it turned out, though, he acceded to adding a third tax bracket of 31% and hurt his reputation among anti-tax Republicans.

9 In this case, itemized deductions would have been limited according to the following formula: ($20,000 – (0.03*($150,000 - $100,000))).

the deductions can be kept no matter how high the taxpayer's income.

Like many other parameters of the federal tax code, the phase-out threshold was indexed for inflation. Today the phase-out threshold for joint filers is $166,800 and $83,400 for other types of filers. Initially, the Pease provision was set to expire in 1995. It was made permanent along with PEP, however, by the Omnibus Budget Reconciliation Act of 1993.

Since enactment the Pease provision has become one of the most controversial features of the federal tax code. As explained above in regard to PEP, supply-side economists object to any provision that raises marginal tax rates over a large swath of the income spectrum. Their arguments are more strenuous in regard to Pease than to PEP because the hike in marginal rates is generally so much larger.

Other critics have charged less persuasively that it adds complexity to the code and prevents the government from promoting beneficial activities such as homeownership and charitable giving.

In response to these criticisms of Pease, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually phased it out between 2006 and 2009 and totally eliminated it for tax year 2010. EGTRRA, however, is set to expire on December 31, 2010, and under current law Pease is scheduled to once again be the law of the land in 2011.

As with PEP, President Obama has proposed raising the thresholds for Pease to $254,550 for tax returns filed jointly by married couples, $203,650 for singles, $229,100 for heads of households, and $127,275 for married couples filing separately. Filers above these thresholds would once again be subject to the full Pease phase-out. In addition, the president has proposed further limiting the benefit of itemized deductions by capping their benefit to that enjoyed by filers in the 28 percent bracket, but Congress has given that suggestion the dead-on-arrival treatment.

Figure 1 shows the effect that reinstituting PEP and Pease will have on the marginal effective tax rates (METRs) faced by a childless couple earning up to $600,000 in 2011. The couple is assumed to have $20,000 in itemized deductions. The solid line shows the effect of President Obama's tax proposals with PEP and Pease restored. The dashed line shows what METRs would be in the absence of PEP and Pease, that is, if the full repeal in effect this year were extended to 2011.

A widely recognized problem with the existing income tax system is that its base is riddled with holes, so much so that around 60 percent of personal income escapes taxation entirely.

Under the budget proposed by President Obama, there would officially be six income tax brackets, 10, 15, 25, 28, 36 and 39.6 percent. Other provisions in the tax code, however, effectively create other tax brackets along the AGI spectrum. Two laws that would affect a couple reporting low or moderate income on a joint tax return are the earned income credit and the making-work-pay credit.

The earned income credit would provide the couple with a subsidy equal to 7.65 percent of income for every dollar that they earned up to $6,090. After this level the subsidy would remain constant at $466 until their income reached $12,620. At this point the subsidy is reduced by 7.65 cents for every additional dollar earned until it is totally eliminated at $18,710. The making-work-pay credit works in a similar fashion. It pays workers a subsidy equal to 6.2 percent of earnings up to $12,903. At this point the subsidy becomes constant at $800 until the couple's income reaches $150,000. After this point the subsidy is gradually phased out at a rate of 2 cents for every additional dollar earned until the subsidy is entirely eliminated at $190,000.

At the low end of the income spectrum, the combined effects of the earned income credit and the making-work-pay credit create a negative 13.85 percent tax bracket over the $0 to $6,090 income range. In this range, the couple receives $1.1385 in benefits for every dollar they earn. When the couple's income reaches $6,090 the value of the earned income credit becomes fixed at $466 and the couple's METR rises to negative 6.2 percent, reflecting just the effect of the making-work-pay credit. At $12,620 the couple begins to lose the benefit of the earned income credit and for the first time, their METR becomes positive at 7.65 percent.

Table 1

Federal Individual Income Tax Rates Under the President's Budget Proposal Calendar Year 2011

2011		Rate
Single		
From	To	
$ 0	$ 8,525	10%
$ 8,525	$ 34,650	15%
$ 34,650	$ 83,900	25%
$ 83,900	$ 194,150	28%
$ 194,150	$ 380,500	36%
$ 380,500	and over	39.6%
Married Filing Joint and Widow(er)		
From	To	
$ 0	$ 17,050	10%
$ 17,050	$ 69,300	15%
$ 69,300	$ 139,850	25%
$ 139,850	$ 235,550	28%
$ 235,550	$ 380,500	36%
$ 380,500	and over	39.6%
Married Filing Separately		
From	To	
$ 0	$ 8,525	10%
$ 8,525	$ 34,650	15%
$ 34,650	$ 69,925	25%
$ 69,925	$ 117,775	28%
$ 117,775	$ 190,250	36%
$ 190,250	and over	39.6%
Head of Household		
From	To	
$ 0	$ 12,150	10%
$ 12,150	$ 46,400	15%
$ 46,400	$ 119,850	25%
$ 119,850	$ 214,850	28%
$ 214,850	$ 380,500	36%
$ 380,500	and over	39.6%

Source: Tax Foundation estimates based on President Obama's 2011 budget submission.

When their earned income credit is completely eliminated at $18,760 their METR becomes zero, they receive $1.00 in disposable income for every $1.00 they earn.

Conceptually, fixing Pease is fairly straightforward: eliminate economically unjustified preferences for all, not just some. Politically, this may be very difficult to do, however, since many of these preferences have powerful interests supporting them.

At $27,400 of AGI ($0 taxable) the couple will enter the 10 percent bracket. For each dollar of the next $17,050 they earn (the width of the 10 percent bracket) they will receive 90 cents in disposable income. At $44,450 of AGI ($17,050 taxable) they become subject to the 15 percent rate, and the next $52,250 of their income will be taxed at that rate.

The couple enters the 25 percent bracket when their income equals $96,700 of AGI ($69,300 taxable). In the absence of the making-work-pay credit their METR would be the same as their marginal tax rate (25 percent) until the 28 percent bracket began at $167,250 of AGI ($139,850 taxable). The phase-out of the making-work-pay credit beginning at $150,000 of AGI, however, causes the METR to climb to 27 percent at this point. When the couple enters the 28 percent bracket they face a METR of 30 percent until the making-work-pay credit is completely phased out at $190,000 of AGI. At this point the METR is equal to the 28 percent marginal tax rate.

At $254,550 of AGI the effect of the PEP and Pease phase-outs come into play. Initially these two provisions increase the METR faced by the couple by about 2.5 percentage points over the 28 percent tax rate. When the 36 percent bracket begins at $262,950 of AGI ($235,550 taxable), the METR rises to 39.2

percent. It stays at this level until $379,550 at which point the PEP phase-out is complete, and the METR falls to 37.1 percent.

At $407,900 of AGI ($380,500 taxable) the couple enters the 39.6 percent bracket, raising their METR to 40.8 percent. It stays at that level until the couple's itemized deductions are reduced to 20 percent of their initial value and can fall no more. At this point their METR and marginal tax rate converge at 39.6 percent.

Conclusion

A widely recognized problem with the existing income tax system is that its base is riddled with holes, so much so that around 60 percent of personal income escapes taxation entirely.[10] This dramatically forces up tax rates on the remaining 40 percent and adversely affects economic growth.

After pleasing voters by enacting generous tax deductions and exemptions, often with no support in the principles of taxation, Congress frequently rescinds the benefit for higher-income people as a way to raise revenue. The history of PEP and Pease over the last two decades highlights the pitfalls of this approach.

On the other hand, if a deduction is merely a giveaway piled on top of other subsidies that benefit the same industry, as is the case with mortgage interest and many other tax deductions, then we can take some solace in the fact that by reinstating Pease Congress is limiting the economic damage that they caused in the first place by enacting unwarranted tax preferences, especially compared to the more damaging alternative of statutory tax rates. Of course, it would be better for the economy if such deductions were never enacted in the first place.

Conceptually, fixing Pease is fairly straightforward: eliminate economically unjustified preferences for all, not just some. Politically, this may be very difficult to do, however, since many of these preferences have powerful interests supporting them.

What to do about personal exemptions is a more difficult issue. Many feel that a progressive rate structure should be used for equity reasons. Personal exemptions essentially give the system a 'zero bracket' which varies by family size. Any effort to remove this zero bracket or the benefit of any other bracket(s) for middle- and high-income individuals will necessarily mean an increase in marginal tax rates over some income range, with adverse effects on economic growth.

TAX FOUNDATION Since 1937

SPECIAL REPORT (ISSN 1068-0306) is published at least 6 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4–20 pp.
Single copy: free
Multiple copies: $5 each

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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