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The PEP and Pease Provisions of the Federal Individual Income Tax

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Summary

The personal exemption phaseout (PEP provision) and the limitation on itemized deductions (Pease provision) were enacted as part of the Omnibus Budget Reconciliation Act of 1990. In 2001, the Economic Growth and Tax Relief Reconciliation Act enacted a phased-in repeal of these provisions beginning in 2006.

Repeal of these provisions greatly reduces the complexity of the federal individual income tax. Repeal of these provisions, however, will reduce federal revenues by approximately $33 billion over the next five years. In addition, the tax benefits from repeal of these two provisions are highly concentrated in the upper end of the income spectrum.

This paper will be updated as legislative action warrants or as new data become available.

In October 1990, Congress passed the Omnibus Budget Reconciliation Act of 1990 (OBRA90), an assortment of spending cuts and tax increases that was expected to reduce the federal budget deficit by an estimated $496 billion over five years. On November 5, 1990, OBRA90 became P.L. 101-508 after it was signed by President George H. W. Bush.

At the time, it was estimated that OBRA90's tax increases would raise, on a net basis, $146.3 billion. This represented only about 29% of the estimated total five-year deficit reduction. Two of these provisions, the phaseout of the personal exemption and the limitation on itemized deductions, accounted for approximately 20% of the net tax increase under OBRA90. Although the spending reductions constituted the vast majority of this deficit-reduction package, it was OBRA90's tax increases that were the focus of most of the debate.

In May 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). On June 5, 2001, EGTRRA became P.L. 107-15 after it was signed by President George W. Bush. EGTRRA contained provisions for a phased-in repeal of the personal exemption phaseout and the limitation on itemized deductions beginning in 2006. This report examines these two tax provisions and issues raised by their repeal.

Personal Exemption Phaseout (PEP)

Prior to OBRA90, provisions in the Tax Reform Act of 1986 (TRA86) had created an individual marginal income tax rate structure that consisted of two statutory marginal tax rates, 15% and 28%. TRA86, however, also created a 5% surcharge on the taxable income of certain high-income taxpayers, which effectively created a third marginal tax rate of 33% (28% statutory rate plus the 5% surcharge) and produced an anomaly that came to be known as the tax rate "bubble."

Because the surcharge was phased out as incomes increased, marginal tax rates rose to 33% but then fell back to 28% and, hence, created the tax rate "bubble." Ostensibly, the surcharge was created to phase out the tax benefits of the 15% tax bracket and the personal exemptions for high-income taxpayers. In reality, the surcharge was adopted so that TRA86 would not change the distribution of the tax burden relative to its distribution under pre-1986 tax law, would meet the needed revenue targets, and yet would allow TRA86 to be characterized as having only two statutory marginal income tax rates.

OBRA90 created an explicit three-tiered statutory marginal rate structure and eliminated the tax "bubble" by repealing the 5% tax surcharge. Although OBRA90 eliminated the 5% tax surcharge, it instituted a new and explicit approach to phasing out the tax benefits of the personal exemption for high-income taxpayers.

This new phaseout of the tax benefits of the personal exemption (PEP) was structured as follows. Each personal exemption was phased out by a factor of 2% for each $2,500 (or fraction of $2,500) by which a taxpayer's adjusted gross income (AGI) exceeded a given threshold amount. In 1991, the threshold amount for a joint return was set at $150,000; for a single return the threshold was $100,000; and for heads of households the threshold was set at $125,000.

For example, in 1991, a joint household whose AGI was $183,000 would lose 28% of their total personal exemptions claimed. The AGI amount in excess of the threshold in this instance would be $33,000 — $183,000 AGI less $150,000 threshold limit. The $33,000 excess divided by $2,500 would produce a factor of 13.2, which when rounded up would equal 14. This figure is multiplied by 2% to arrive at the final disallowance amount of 28%. Hence, if the family had claimed two personal exemptions, which at $2,150 each would total $4,300, they would be allowed to deduct only $3,096 ($4,300 total personal exemptions less the $1,204 disallowance, which is 28% of the total).

For tax years after 1991, these threshold amounts were to be indexed for inflation. Under OBRA90 provisions, the PEP rules were originally scheduled to expire after 1995. Continued budgetary pressures, however, led to the passage of a second round of tax increases in 1993. Under provisions of the Omnibus Budget Reconciliation Act of 1993 (OBRA93), the PEP provisions were made permanent.

By 2006, indexation had increased the PEP phaseout threshold amount for a joint return to $225,750; for a single return to $150,000; and for heads of households to $188,150.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which was signed into law on June 7, 2001, contained provisions for a phased-in repeal of the personal exemption phaseout. Under EGTRRA, the PEP provisions are to be phased out over a five-year period starting in this year. For 2006 and 2007, the personal exemption phaseout is scheduled to be reduced by one-third and, for 2008 and 2009, it is scheduled to be reduced by two-thirds. Finally, the PEP provisions are to be repealed for tax years after 2009.[1]

Congress cited three main reasons for the repeal of the PEP provisions.[2] First, the personal exemption phaseout was too complex. Second, the phaseout constituted a hidden way of raising marginal income tax rates, and thus undermined respect for the tax system. Third, the phaseout imposed excessively high effective marginal tax rates on families. At the time, the Joint Committee on Taxation (JCT) estimated that the phaseout of the PEP provision would reduce federal revenues by $8 billion over the 2006 through 2010 time period.

Limitation on Itemized Deductions (Pease Provision)

OBRA90 also contained the so-called Pease provision limiting the amount of itemized deductions high-income taxpayers could claim in any given year. (This provision takes its name from former Representative Don Pease of Ohio who was its author.) Under this provision, for tax years starting in 1991, otherwise allowable itemized deductions were reduced by 3% of the amount by which a taxpayer's AGI exceeded $100,000 (for married couples filing separate returns the AGI limit was set at $50,000).

For example, if a taxpayer's AGI were $110,000 then his otherwise allowable deductions would be reduced by $300 ($110,000 less $100,000 threshold times 3%). This provision effectively raises the marginal income tax rate of affected taxpayers by approximately one percentage point. (A dollar of income in excess of the $100,000 AGI threshold is taxed as if it were $1.03, since in addition to the extra dollar of income the taxpayer loses $0.03 of itemized deductions.)

Allowable deductions for medical expenses, casualty and theft losses, and investment interest were not subject to the limitation. Also, total deductions subject to the limit cannot be reduced by more than 80%. For tax years after 1991, the $100,000 AGI threshold was indexed for inflation. This provision, like the PEP provision, was

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[1] All of the changes in EGTRRA (including the PEP and Pease provisions) will expire (sunset) after 2010. Congress included the sunset in EGTRRA to avoid a Byrd rule (Section 313 of the 1974 Congressional Budget Act, as amended) violation in the Senate. The Byrd rule prohibits "extraneous matter" in reconciliation legislation. Under the rule, extraneous matter includes, among other things, language that would cause an increase in the budget deficit (or reduce budget surpluses) in a fiscal year beyond those covered by the reconciliation legislation. As a result of the Byrd rule, EGTRRA contained language providing for the expiration of all of its provisions at the end of calendar year 2010, since the years after 2010 were outside the reconciliation budget window.

[2] Joint Committee on Taxation, JCS-1-03, *General Explanation of Tax Legislation Enacted in the 107th Congress*, Jan. 2003, p. 14.

originally scheduled to expire after tax year 1995. As mentioned earlier, however, continued budgetary pressures led to the passage of a second round of tax increases in 1993. Under provisions of the OBRA93, the Pease provision was made permanent.

By 2006, indexation for inflation had increased the AGI threshold at which otherwise allowable itemized deductions are limited to $150,500.

As was the case with the PEP provision, EGTRRA contained a provision for the phased-in repeal of the Pease provision. Under, EGTRRA, the Pease provision is scheduled to be repealed over a five-year period. For tax years 2006 and 2007, the overall limit on otherwise allowable itemized deductions is reduced by one-third, for tax years 2008 and 2009 the limit is reduced by two-thirds, and for tax years after 2009 the limit is repealed.

Complexity was the main reason cited by Congress for the repeal of the Pease provisions. The JCT estimated that the phased-in repeal of the Pease provision would reduce federal revenues by $25 billion over the five-year period.

Issues

Some of the complexity of the current tax system can be traced to the attempt to accurately measure real net economic income. However, this is not the case with the PEP and Pease provisions. The PEP and Pease provisions were adopted as a means of raising additional revenue without having to explicitly raise marginal income tax rates. They were also designed so that the resultant tax increases were borne by taxpayers at the upper end of the income spectrum.

Hence, while repealing the PEP and Pease provisions unambiguously reduces the complexity of the tax system, it will also reduce federal revenues and affect the distribution of the tax burden. In total, the JCT estimated that repealing both the PEP and Pease provisions would reduce federal revenues by $33 billion over the five-year budget horizon.

Repeal of these provisions will also affect the distribution of the federal income tax burden. Although no official estimates of the distributional effects of repealing the PEP and Pease provisions are available, non-governmental estimates show that the tax reductions from repeal of these two provisions are highly concentrated in the upper end of the income spectrum.[3]

These estimates indicate that in 2010 the tax benefits from repeal of these two provisions accrue to only 3.3% of all taxpayers, and that those taxpayers have incomes in excess of approximately $150,000. The largest average tax reductions, around $19,000, accrue to taxpayers with incomes in excess of $1 million.

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[3] Urban-Brookings Tax Policy Center, "Effects of the PEP/Pease Repeal," Table T05-0023, [http://www.taxpolicycenter.org/TaxModel/tmdb/TMTemplate.cfm].