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by exempting a certain amount of income from taxation (in effect applying a zero rate to that amount), as well as by limiting the availability of certain deductions and credits to persons with income below some threshold amount.

During most of the history of the income tax in this country, the rate structure for individuals was characterized by a large number of rates and a big difference between the highest and the lowest rate. For example, in 1986, for married couples there were fourteen rates applicable to various levels of income, with a range from 11 percent to 50 percent (plus a zero rate on income that is not subject to taxation because of personal exemptions, the zero bracket amount (now the standard deduction), and a credit for earned income). As of 2011, the number of explicit brackets had been reduced to six ranging from 10 percent to 35 percent. Moreover, the benefits of the personal exemption and certain itemized deductions are phased out as adjusted gross income exceeds a certain threshold amount. See §§68, 151(d). These phaseouts have the effect of increasing marginal tax rates, since the taxpayer loses a tax benefit (and thus pays more tax) for each additional dollar earned above the threshold amount. The significance of the phaseouts depends on the number of personal exemptions and itemized deductions claimed.

It is important to recognize that it is the marginal rate that is relevant for purposes of tax planning and for understanding incentive effects. For example, suppose a couple with an income of $50,000 and a marginal rate of 15 percent contemplates a gift of $1,000 to charity. As you will learn (or perhaps already knew), taxpayers are generally permitted to deduct such gifts in calculating the amount of their income subject to taxation. By making the gift they would reduce their taxable income by $1,000 and save $150 in taxes. In other words, the net cost to the couple of making the gift would not be $1,000, but rather $850. By contrast, for a couple with a taxable income of $150,000 and a marginal rate of 30 percent, the net cost of a $1,000 gift is $700. As these examples illustrate, the bottom line value of a deduction depends on the marginal tax rate at which the taxpayer's income would have been taxed.

In addition, it is the taxpayer's marginal rate that is relevant for purposes of evaluating the incentive effects of the income tax. For example, it is commonly argued that the income tax discourages work by taxing people on their labor income. Consider a taxpayer, Neela, who currently earns $80,000 and is subject to a marginal tax rate of 25 percent. Should Neela work Saturday afternoons to earn an additional salary of $10,000 per year? In making her decision, Neela will of course want to think about how she would otherwise spend her Saturday afternoons and what value that activity has to her. But she shouldn't compare her subjective value of that experience to $10,000 but rather to her after-tax wage, which would be $7,500 after accounting for the income taxes she will owe on the additional earnings.

E. THE TAXABLE UNIT AND THE MARRIAGE PENALTY

Among tax theorists, "taxable unit" means that individual, or group of individuals, who is, or are, treated as a taxpaying unit in the sense that they must

aggregate their income for purposes of calculating the tax payable. Theorists have examined at length the question whether the unit should be the individual; husband and wife; husband, wife, and children; all people in the household; or some other possibility. While that kind of inquiry seems meaningful for some purposes, it is unfortunately not one that is properly framed for a person seeking to understand the present rules of the federal income tax. Those rules do not reflect the kind of logical, coherent approach implicit in the notion of a taxable unit. To some significant extent, the present rules can be understood only by reviewing their history. The historical development is presented later in this book. (See Chapter 7.A, infra.) For the present, it is enough to recognize that the rules governing how taxes are affected by the relationships of people to one another are reflected in the four rate schedules and in the rules for applying them[14] and, to a lesser extent, in the exemptions[15] and certain other provisions.[16] We will see that the rate-schedule rules produce a "marriage penalty" and a seemingly perverse work disincentive for married "secondary" workers.

Married people generally are permitted to file a "joint return," which means a return on which they aggregate their income and deductions so that it does not matter who earned what. However, under the authority of the so-called Defense of Marriage Act (DOMA), the IRS takes the position that same-sex married couples are not married for federal income tax purposes. The rate schedule for joint returns provides the lowest rates of the four schedules provided in the Internal Revenue Code. This rate schedule is also available to "surviving spouses."[17]

Another rate schedule is for "heads of households"[18] and is somewhat less favorable than the one for married couples. Very roughly, a head of household is an unmarried person with a dependent living with him or her. The thought behind the semi-favorable rate schedules is that a head of household has financial burdens similar to those of married couples and should get part of the benefits available to them.

Next is the schedule for "unmarried individuals,"[19] commonly referred to as single people. The rate schedule for such people is less favorable than the one for heads of households.

Finally, there is the least favorable schedule of all, for married people filing separate returns. For reasons explained in Chapter 7B, there is a special rate schedule for married persons filing separate returns. With this rate schedule, the filing of separate returns generally will result in increased aggregate taxes and only rarely will result in reduced aggregate taxes.[20]

Apart from married people who file jointly (as almost all do) and who aggregate their income, taxpayers are not required to include in their income

14 §1.

15 §151.

16 For example, see §21 (child-care credit); §71 (alimony).

17 Defined in §2(a).

18 Defined in §2(b).

19 This is a residual category—that is, one including anyone who is not married, a surviving spouse, or a head of household. §1(c).

20 Even if filing separately would increase total liability, the spouses might want to do so if, for example, they are separated and cannot find one another or are unable to cooperate in filing jointly.

the income of relations, dependents, or members of their households. In other words, marriage aside, the taxable unit is the individual, except that we take account of dependents (in the provision for heads of households). To demonstrate the significance of the basic rule that each individual is a separate taxpayer (spouses aside), consider a hypothetical family consisting of a husband, a wife, and a fifteen-year-old daughter. Suppose that the daughter is entitled each year to the income of $25,000 from a trust set up for her by her grandmother. The child would file her own return. The parents' return would not reflect the $25,000 income of the child (except possibly if some of that income were used to discharge their obligation of support). Moreover, if all the $25,000 were put aside for the child and the parents supplied more than half her support, they would be entitled to claim a deduction for her as a dependent[21] and they could deduct her medical expenses,[22] to the extent allowable.[23]

The relationship between the rate schedules for married people, heads of households, single people, and married people filing separately, and the rules relating to their availability, produce two important effects. First, married single-earner couples are better off than they would be under a system with one schedule for all, since they have the advantage of the most favorable rate. This is sometimes called the "marriage bonus." On the other hand, two-earner married couples typically are worse off than if they had remained single because of the requirement that they file jointly (or use the unfavorable schedule for separate returns of married people). This is true because if they were single each would use a less-favorable rate schedule, but since they would be filing two returns they would get two separate starts at the bottom of the rate schedule. Married couples filing jointly have only one start at the bottom of their rate schedule, albeit that is a more favorable schedule. The result is so-called marriage penalty—that is, the added tax paid by two people who have roughly the same earnings and who marry one another. In 2003, the Code was amended to reduce the marriage penalty by doubling the 10 and 15 percent brackets for married couples filing jointly.

A final point worth noting about the rate-structure rules is that the secondary worker in a married couple is subject to marginal tax rates determined by the income of the primary worker. The "secondary worker" is the person whose income is lower and whose attachment to the labor force is generally weaker than that of the primary worker. In the United States, the secondary worker has historically been the wife rather than the husband, though these labor force patterns have shifted considerably in recent years. For most couples, the secondary worker's income will be thought of as the marginal income, since it is more likely that the couple would consider sacrificing this income than the income of the primary worker. Thus, the marginal rates that must be taken into account by married secondary workers are the relatively high rates resulting from the fact that the primary worker's income uses up the lower rates. This effect is magnified by the fact that the secondary worker's alternative of providing services in the home, rather than working outside the home, results

21 §151.
22 §213.
23 §213(a).

in "imputed" income, which is not taxed at all. Also, one must bear in mind that for secondary workers the Social Security tax is a significant burden.[24]

Both the marriage penalty and the disincentive for secondary workers would be eliminated by a system featuring a single tax rate (i.e., no progressive marginal rates) and a rule making each individual taxable on his or her own income. This, however, might both encourage tax-motivated income shifting between spouses and arguably would result in misclassifying nonworking spouses in high-income households as if they were actually poor.

F. COMPLIANCE AND ADMINISTRATION

1. Self-Assessment, Audits, and Tax Litigation

Our income tax relies on initial self-assessment, which means that once each year each individual or entity subject to the tax makes a calculation of the amount of tax owed. The calculation is based on information supplied by the taxpayer on forms, sometimes called tax returns, devised and provided by the Internal Revenue Service. The Internal Revenue Service, often called the Service or the IRS, is a branch of the Treasury Department, is headed by a person called the Commissioner of Internal Revenue, and is responsible for the administration of the tax laws. The Service makes available some limited amount of assistance in preparing returns, but no government approval or other involvement is required before a return is filed. Before the taxpayer files the annual return, some amount approximating the tax owed will probably have been paid to the government either through withholding from wages by an employer[25] or by special quarterly returns for estimated taxes for people whose income is from sources not subject to withholding (like income from self-employment) or for whom the amount withheld is less than the amount of tax that will be payable.[26] When the annual return is filed, the taxpayer takes a credit against the tax computed on that return for any taxes paid by withholding or as estimated tax and will be entitled to a refund of any overpayment or must pay the amount of any shortfall.

A person who fails to file an income tax return may be subject to both civil and criminal penalties.[27] There is no statutory limit on the time within which the civil penalties must be sought[28] and a six-year limitation on criminal pros-

24 For further discussion and citations of economic studies of the effects on labor-force participation, see Gann, Abandoning Marital Status as a Factor in Allocating Tax Burdens, 59 Tex. L. Rev. 1, 39-46 (1980). For an earlier presentation of similar observations, see Blumberg, Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers, 21 Buffalo L. Rev. 49 (1971). But recall the prior discussion of the barriers to studies of incidence and economic effects.

25 §3402.

26 §§6015, 6153.

27 The basic provisions are §6651(a) (civil) and §7201 (criminal).

28 §6501(c)(3).