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Overview of the Federal Tax System

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Overview of the Federal Tax System

Abstract

The major sources of federal tax revenue are individual income taxes, Social Security and other payroll taxes, corporate income taxes, excise taxes, and estate and gift taxes. This report describes the federal tax structure, provides some statistics on the tax system as a whole, and presents analysis of selected tax concepts.

Keywords

federal tax revenue, income tax, Social Security, tax structure

Comments

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Overview of the Federal Tax System

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Summary

The major sources of federal tax revenue are individual income taxes, Social Security and other payroll taxes, corporate income taxes, excise taxes, and estate and gift taxes. This report describes the federal tax structure, provides some statistics on the tax system as a whole, and presents analysis of selected tax concepts.

The federal income tax is levied on an individual's taxable income, which is adjusted gross income (AGI) less deductions and exemptions. Tax rates, based on filing status (e.g., married filing jointly or single individual) determine the level of tax liability. Tax rates in the United States are progressive, such that higher levels of income are taxed at higher rates. Once tax liability is calculated, tax credits can be used to reduce tax liability. Tax deductions and tax credits are tools available to policymakers to increase or decrease the after-tax price of undertaking specific activities. Individuals with high levels of exemptions, deductions, and credits relative to income may be required to file under the alternative minimum tax (AMT).

Corporate taxable income is also subject to varying rates, where those with higher levels of income pay higher levels of taxes. Social Security and Medicare tax rates are, respectively, 12.4% and 2.9%. In 2013, Social Security taxes are levied on the first \$113,700 of wages. In 2014, the Social Security wage base is inflation-adjusted to \$117,000, reflecting increases in average wages in the economy. Medicare taxes are assessed against all wage income. Federal excise taxes are levied on specific goods, such as transportation fuels, alcohol, tobacco, and telephones.

In FY2012, individual income taxes accounted for 46% of total federal revenue. Social Security taxes accounted for 35%. Corporate income taxes accounted for 10% while excise taxes accounted for 3%. Estate and gift, customs, and miscellaneous taxes accounted for the remaining 6% of total revenue. Over time, the corporate income tax has become much less important as a revenue source while Social Security taxes have provided a larger share of total revenues.

Analysis of tax statistics from the federal tax system as a whole leads to three conclusions: (1) federal revenue as a percentage of GDP is in line with historical trends; (2) the U.S. fiscal position is in line with the fiscal position of other industrialized nations (revenues and expenditures as a percentage of GDP are relatively low); and (3) over the past decade, effective tax rates have fallen for individuals at all income levels, but have fallen more for lower-income individuals, reducing their share of overall tax liabilities.

The final sections of this report analyze a number of tax concepts. Tax expenditures are revenue losses from special tax deductions, credits, and other benefits. Capital gains warrant special attention, as there is debate about their being taxed at a lower rate. Marriage tax penalties and bonuses, while reduced following legislation enacted in 2001 and 2003, still pose an inequity in the tax system. Tax deferral, or the timing of taxes, poses problems related to the timing of taxation, specifically with respect to capital gains. Depreciation is important, as accelerated depreciation schemes or expensing can influence firm behavior. Tax liability also depends on form of business organization. Finally, the issue of whether taxes can influence firms' competitiveness is reviewed.

This report will be updated on enactment of major changes in the federal tax system.

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Federal Taxes: A Description

The individual income tax is the major source of federal revenues, followed closely by Social Security and other payroll taxes. As a revenue source, the corporate income tax is a distant third. Estate and gift and excise taxes play only minor roles as revenue sources.

The Structure of the Federal Individual Income Tax

The individual income tax is based on earnings individuals accrue from a variety of sources. Included in the individual income tax base are wages, salaries, tips, taxable interest and dividend income, business and farm income, realized net capital gains, income from rents, royalties, trusts, estates, partnerships, taxable pension and annuity income, and alimony received.

The tax base is reduced by adjustments to income, including contributions to Keogh and traditional IRAs, some interest paid on student loans and higher education expenses, contributions to health savings accounts, and alimony payments made by the taxpayer. This step of the process produces adjusted gross income (AGI), which is the basic measure of income under the federal income tax. Deductions from the income tax base that result in an individual's AGI are also known as "above the line" deductions. These deductions are available to all taxpayers, whether the taxpayer chooses to take the standard deduction or itemize deductions.¹

The tax base is further reduced by either the standard deduction or individuals' itemized deductions.² Itemized deductions are allowed for home mortgage interest payments, state and local income taxes, state and local property taxes, charitable contributions, medical expenses in excess of 10% of AGI, and for a variety of other items.³ For taxable years 2004 through 2013, at the election of the taxpayer, state and local sales taxes can be deducted as an alternative to state and local income taxes.⁴

The tax base is reduced further by subtracting personal and dependent exemptions. Exemptions are a fixed amount to be subtracted from AGI. Exemptions are allowed for the taxpayer, the taxpayer's spouse, and each dependent. In 2013, the exemption amount per person is \$3,900.^{5,6} For taxpayers with high levels of AGI, the personal and dependent exemptions are phased out.⁷

¹ A full list of "above the line" deductions can be found in the Internal Revenue Code (IRC) §62.

² The elderly and blind are allowed an additional standard deduction.

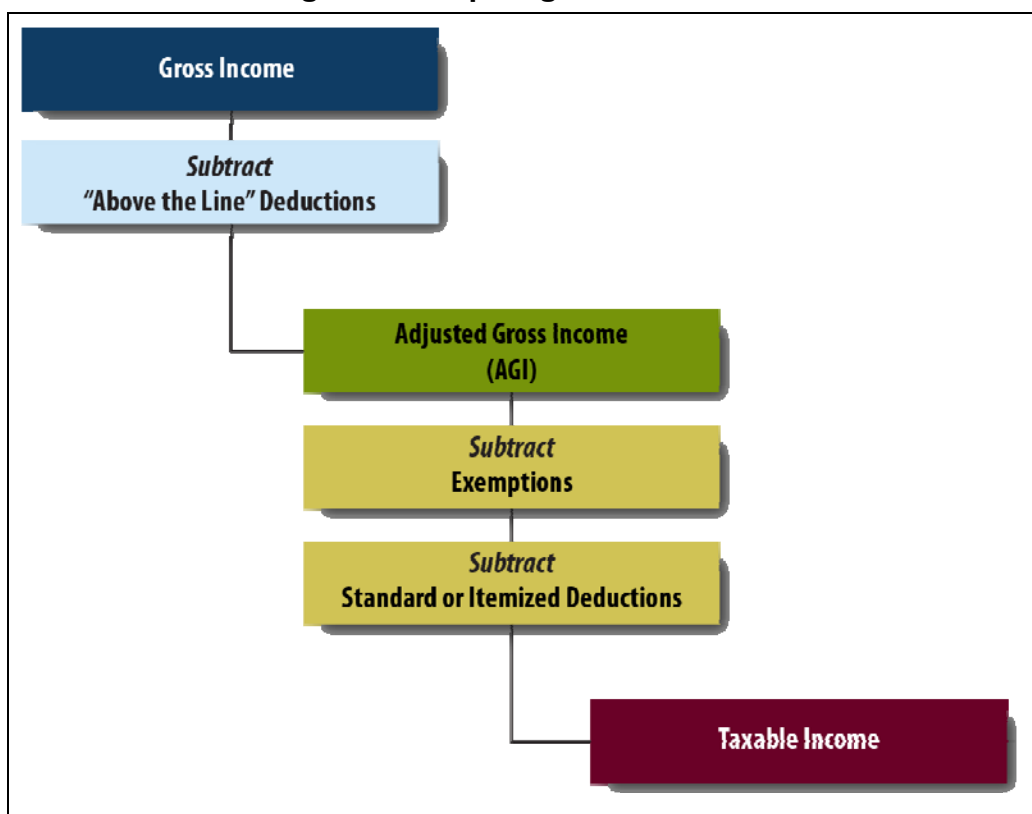
³ For additional information, see CRS Report R42872, *Tax Deductions for Individuals: A Summary*, by Sean Lowry and CRS Report R43012, *Itemized Tax Deductions for Individuals: Data Analysis*, by Sean Lowry.

⁴ This provision was most recently extended by the American Taxpayer Relief Act (ATRA; P.L. 112-240). For additional background, see CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire, for analysis of the deductibility of state and local taxes.

⁵ If a taxpayer was married and had one child being claimed as a dependent, the exemption would be \$11,700 ($\$3,900 \times 3$).

Federal income taxes are assessed on a taxpayer's taxable income. Taxable income equals AGI reduced by either the standard deductions or itemized deductions and personal and dependent exemptions. **Figure 1** illustrates the computation of taxable income.

Figure 1. Computing Taxable Income



Source: CRS

The tax liability depends on the filing status of the taxpayer. There are four main filing categories: married filing jointly, married filing separately, head of household, and single individual. The computation of a taxpayer's tax liability depends on their filing status.

The income tax system is designed to be progressive, with marginal tax rates increasing as income increases.⁸ At a particular marginal tax rate, all individuals, regardless of their level of earnings, pay the same tax rate on their first dollar of taxable income. Once a taxpayer's income surpasses a threshold level placing them in a higher marginal tax bracket, the higher marginal tax rate is only applied on income that exceeds that threshold value. Currently, the individual income tax system has seven marginal income tax rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.⁹

(...continued)

⁶ This report includes 2013 tax parameters as the date of publication falls within the 2013 filing season.

⁷ See CRS Report R41796, *Deficit Reduction: The Economic and Tax Revenue Effects of the Personal Exemption Phaseout (PEP) and the Limitation on Itemized Deductions (Pease)*.

⁸ A marginal tax rate is the tax rate on the last dollar earned.

⁹ For historical perspective on marginal tax rates, see CRS Report RL34498, *Individual Income Tax Rates and Other Key Elements of the Individual Income Tax: 1988 to 2013*, by Gary Guenther.

These marginal income tax rates are applied against taxable income to arrive at a taxpayer's gross income tax liability.

After a taxpayer's tax liability has been calculated, tax credits are subtracted from gross tax liability to arrive at a final tax liability. Major tax credits include the earned income tax credit, the child tax credit, education tax credits, and the credit for child and dependent care expenses.

Not all income is subject to the marginal income tax rates noted above. Long-term capital gains—that is, gain on the sale of assets held more than 12 months—and qualified dividend income are taxed at lower tax rates. Net investment income is also subject to an additional tax for taxpayers above certain income thresholds.

Gross Income and Adjustments

In order to levy an income tax, income must first be defined. As a benchmark, economists often turn to the Haig-Simons comprehensive income definitions. Here, taxable resources are defined as changes in a taxpayer's ability to consume during the tax year.¹⁰ Another way to view the individual income tax base is as an approximation of the sum of all labor and capital income earned or received over the course of the year. Under this view, the tax base resembles national income as measured by economists. In addition to labor and capital income, many transfer payments are also subject to taxation.

There are a number of forms of what would broadly be defined as income that are excluded from taxable income in practice. For example, wage income of employees is taxed, although most contributions to employee pension and health insurance plans and certain other employee benefits are not included in wages subject to income tax. Employer contributions to Social Security are also excluded from wages. When pensions are received, they are included in income to the extent that they represent contributions originally excluded. If the taxpayer has the same tax rate when contributions are made and when pensions are received, this treatment is equivalent to eliminating tax on the earnings of pension plans. Some Social Security benefits are also subject to tax.

Passive capital income, in the form of capital gains, interest, and dividends on financial instruments, is also taxed. The tax base excludes capital gains that are unrealized, such that capital gains are only taxed on realization. Unlike capital gains, assets earning interest are taxed on accrual. Taxes are paid on the interest earned in each tax year. Taxable interest income is added to a taxpayer's AGI and taxed according to the taxpayer's marginal tax rate. Interest that is earned on tax-exempt securities, such as those issued by state and local governments, is not subject to taxation. Like capital gains, dividends are taxed at a lower rate than other income. Qualified dividends are taxed at the same rate as capital gains.¹¹

¹⁰ The Haig-Simons comprehensive income definition was first developed in Robert Murray Haig, "The Concept of Income – Economic and Legal Aspects," in *The Federal Income Tax*, ed. Robert Murray Haig (New York, NY: Columbia University Press, 1921), pp. 1-28 and Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1938). An overview of the concept can be found in Jonathan Gruber, *Public Finance and Public Policy*, 2nd ed. (New York, NY: Worth Publishers, 2007).

¹¹ Reduced rates for qualified dividends were introduced under Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27). Most recently, the reduced rates for qualified dividends were extended by the American Taxpayer Relief Act (ATRA; P.L. 112-240).

Income from operating a business through a proprietorship, partnership, or small business corporation that elects to be treated similarly to a partnership (Subchapter S corporation), or through rental property (which reflects returns to both investment and effort) is also subject to tax.¹² This income is the net of gross receipts reduced by such deductible costs as payments to labor, depreciation, costs of goods acquired for resale and other inputs, interest, and taxes. Some investment income of small businesses is subject to favorable treatment through provisions that allow costs of capital equipment to be expensed.¹³ Other income, such as miscellaneous income, gambling winnings, and royalties, is also included in the tax base.

As noted above, there are several adjustments to the income made to determine adjusted gross income (AGI). These are the so-called “above the line” deductions noted above. As was illustrated in **Figure 1**, deductions and exemptions are subtracted from AGI to determine taxable income. The next section provides more detail on these deductions and exemptions.

Deductions and Exemptions

Individuals subtract from their adjusted gross income either the standard deduction or itemized deductions, along with an exemption for each family member. The standard deduction and personal exemption are indexed for inflation. Personal exemptions and standard deductions from 2005 through 2013 are given in **Table 1**.

Personal exemptions are limited for certain high-income taxpayers under current law.¹⁴ Provisions under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) gradually reduced the personal exemption phaseout (PEP), such that the phaseout was completely repealed in 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the repeal of PEP for two years, through 2012. PEP was reinstated as part of the American Taxpayer Relief Act (ATRA; P.L. 112-240).

For 2013, personal exemptions are phased out for single taxpayers with adjusted gross income (AGI) above \$250,000 (\$300,000 for married filing jointly; \$275,000 for head of household filers). Personal exemptions are phased out by 2% for each \$2,500 by which a taxpayer’s AGI exceeds these thresholds.

Table 1. Statutory Personal Exemptions and Standard Deductions

| Filing Status | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Personal Exemptions | \$3,200 | \$3,300 | \$3,400 | \$3,500 | \$3,650 | \$3,650 | \$3,700 | \$3,800 | \$3,900 |
| Standard Deductions | | | | | | | | | |

¹² For background on types of business organizations, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

¹³ For more, see CRS Report RL32254, *Small Business Tax Benefits: Current Law and Main Arguments For and Against Them*, by Gary Guenther.

¹⁴ For further discussion see CRS Report R41796, *Deficit Reduction: The Economic and Tax Revenue Effects of the Personal Exemption Phaseout (PEP) and the Limitation on Itemized Deductions (Pease)*.

| Filing Status | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|-------------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| —Married Filing Jointly | \$10,000 | \$10,300 | \$10,700 | \$10,900 | \$11,400 | \$11,400 | \$11,600 | \$11,900 | \$12,200 |
| —Single Individual | \$5,000 | \$5,150 | \$5,350 | \$5,450 | \$5,700 | \$5,700 | \$5,800 | \$5,950 | \$6,100 |
| —Head of Household | \$7,300 | \$7,750 | \$7,850 | \$8,000 | \$8,350 | \$8,400 | \$8,500 | \$8,700 | \$8,950 |

Source: Internal Revenue Code

Notes: For married couples filing separately the personal exemption and standard deduction is half of that allowed for married couples filing jointly. Information on personal exemption and itemized deduction levels prior to 2005 can be found in CRS Report RL34498, *Individual Income Tax Rates and Other Key Elements of the Individual Income Tax: 1988 to 2013*, by Gary Guenther.

Itemized deductions are also phased out as income exceeds a certain threshold.¹⁵ Like PEP, the limitation on itemized deductions, also known as Pease, was phased out under EGTRRA. By 2010, the Pease limitation was repealed. The Pease-related provisions of EGTRRA were scheduled to expire at the end of 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended repeal of the Pease-limitation through 2012. The Pease limitation was reinstated beginning in 2013 for certain high-income taxpayers as part of ATRA.

For 2013, itemized deductions being to phase out once AGI exceeds \$250,000 for single filers, \$275,000 for head of household filers, and \$300,000 for married taxpayers filing jointly. For these taxpayers, the total of certain itemized deductions is reduced by 3% of the amount of AGI exceeding the threshold. The total reduction, however, cannot be greater than 80% of the deductions (and the taxpayer always has the option of taking the standard deduction). The deductions not subject to the Pease limitation are medical and dental expenses, investment interest, and casualty and theft losses.

Tax Rates

Tax rate schedules for individuals include joint returns for married couples, single returns, and head of household returns for single individuals with dependents. Married couples can file separate returns; the brackets in these schedules are half as wide as brackets in the joint return, so there is no tax rate advantage in filing such a return. The individual income tax rate schedules for 2013 are shown in **Table 2**. Current tax rate schedules were set as part of the American Taxpayer Relief Act (ATRA; P.L. 112-240).¹⁶

¹⁵ *Ibid.*

¹⁶ In 2000, marginal tax rates were 15%, 28%, 31%, 36%, and 39.6%. Marginal tax rates were reduced and the 10% bracket introduced under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16). Tax rates were scheduled to return to 2000 levels in 2011 under EGTRRA. The reduced tax rates were extended for two years, through 2012, by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act (ATRA; P.L. 112-240) set current tax rate schedules, which include seven marginal tax rate brackets ranging from 10% to 39.6%.

Table 2. Statutory Marginal Tax Rates, 2013
Tax Schedules by Filing Status

| Married Filing Jointly | | | |
|-------------------------------|------|-----------|--|
| If taxable income is: | | | Then, tax is: |
| \$0 | to | \$17,850 | 10% of the amount over \$0 |
| \$17,850 | to | \$72,500 | \$1,785 plus 15% of the amount over \$17,850 |
| \$72,500 | to | \$146,400 | \$9,982.50 plus 25% of the amount over \$72,500 |
| \$146,400 | to | \$223,050 | \$28,457.50 plus 28% of the amount over \$146,400 |
| \$223,050 | to | \$398,350 | \$49,919.50 plus 33% of the amount over \$223,050 |
| \$398,350 | to | \$450,000 | \$107,768.50 plus 35% of the amount over \$398,350 |
| \$450,000 | plus | | \$125,846 plus 39.6% of the amount over \$450,000 |
| Single Returns | | | |
| If taxable income is: | | | Then, tax is: |
| \$0 | to | \$8,925 | 10% of the amount over \$0 |
| \$8,925 | to | \$36,250 | \$892.50 plus 15% of the amount over \$8,925 |
| \$36,250 | to | \$87,850 | \$4,991.25 plus 25% of the amount over \$36,250 |
| \$87,850 | to | \$183,250 | \$17,891.25 plus 28% of the amount over \$87,850 |
| \$183,250 | to | \$398,350 | \$44,603.25 plus 33% of the amount over \$183,250 |
| \$398,350 | to | \$400,000 | \$115,586.25 plus 35% of the amount over \$398,350 |
| \$400,000 | plus | | \$116,163.75 plus 39.6% of the amount over \$400,000 |
| Heads of Households | | | |
| If taxable income is: | | | Then, tax is: |
| \$0 | to | \$12,750 | 10% of the amount over \$0 |
| \$12,750 | to | \$48,600 | \$1,275 plus 15% of the amount over \$12,750 |
| \$48,600 | to | \$125,450 | \$6,652.50 plus 25% of the amount over \$48,600 |
| \$125,450 | to | \$203,150 | \$25,865 plus 28% of the amount over \$125,450 |
| \$203,150 | to | \$398,350 | \$47,621 plus 33% of the amount over \$203,150 |
| \$398,350 | to | \$425,000 | \$112,037 plus 35% of the amount over \$398,350 |
| \$425,000 | plus | | \$121,364.50 plus 39.6% of the amount over \$425,000 |

Source: Internal Revenue Code

As was noted above, income earned from long-term capital gains and dividends is taxed at lower rates. The maximum rate on long-term capital gains and dividends is 20%. This 20% rate applies to taxpayers in the 39.6% bracket (single filers with taxable income above \$400,000; married filers with taxable income above \$450,000). Taxpayers in the 25%, 28%, 33%, and 35% tax brackets face a 15% tax rate on long-term capital gains and dividends. The tax rate on capital gains and dividends is 0% for taxpayers in the 10% and 15% tax brackets.

Given the complexities of the tax code, most taxpayers do not pay the marginal tax rates associated with their tax bracket. Various tax provisions are available to individuals depending on their level of income. For example, the earned income tax credit (EITC) phases in as income

increases, reducing a taxpayer's marginal tax rate. At higher income levels, as the credit phases out, the taxpayer faces a higher marginal tax rate during that phase out range.

Higher-income individuals with a high ratio of exemptions and deductions to income may be subject to the alternative minimum tax (AMT). There are two marginal tax rates under the AMT, 26% and 28%, that are applied to an expanded base. The AMT is discussed in further detail below.

Tax Credits

Tax credits offset tax liability on a dollar-for-dollar basis. Over time, tax credits have become an increasingly popular method of providing tax relief and social benefits. There are two different types of tax credits: those that are refundable and those that are non-refundable. If a tax credit is refundable, and the credit amount exceeds tax liability, a taxpayer receives a payment from the government. The earned income credit is refundable, and the child tax credit is refundable for all but very low-income families. If credits are not refundable, then the credit is limited to the amount of tax liability. In some cases, unused credits can be carried forward to offset tax liability in future tax years. Non-refundable credits provide limited benefits to many middle- and lower-income individuals who have little or no tax liability. Many credits are phased out as income rises and thus do not benefit higher income individuals. These phaseout points vary considerably across different credits. Tax credits are available for a wide variety of purposes. The major individual income tax credits are described below.

Child Tax Credit¹⁷

The child tax credit allows qualifying taxpayers to receive a credit of up to \$1,000 per qualifying child. The credit for taxpayers with children under 17 was adopted in 1997, and was originally set at \$400 for each qualifying child. Subsequent legislation in 2001, 2003, and 2004 increased the credit to \$1,000 and made the credit partially refundable. Legislation in 2008, 2009, and 2010 temporarily expanded eligibility for the refundable portion of the credit. The American Taxpayer Relief Act (ATRA; P.L. 112-240) made permanent the \$1,000 per qualifying child credit, and extended provisions allowing for greater refundability through 2017. Through 2017, the credit is at least partially refundable for taxpayers with at least \$3,000 in earnings (after 2017, earnings must exceed \$10,000, adjusted for inflation, for the credit to be refundable). This credit is phased out for higher income families.

Dependent Care Credit¹⁸

This credit is provided for the costs of paid care for dependents, mostly children. The maximum credit rate is 35% of costs. The value of the credit is capped at \$3,000 for one dependent and \$6,000 for two or more dependents. The credit rate is reduced when the taxpayer's adjusted gross income (AGI) exceeds \$15,000, but is no less than 20% for higher-income taxpayers. The credit

¹⁷ For more, see CRS Report R41873, *The Child Tax Credit: Current Law and Legislative History*, by Margot L. Crandall-Hollick and CRS Report R41935, *The Child Tax Credit: Economic Analysis and Policy Options*, by Margot L. Crandall-Hollick.

¹⁸ For more, see CRS Report RS21466, *Dependent Care: Current Tax Benefits and Legislative Issues*, by Christine Scott.

is nonrefundable. The current credit amounts were first set under EGTRRA and made permanent under ATRA.

Earned Income Tax Credit¹⁹

The earned income tax credit (EITC) supplements wages for lower-income families and individuals. Since the 1990s, the EITC has been a major component of the federal government's poverty reduction strategy and is currently the largest anti-poverty cash entitlement program.²⁰ For 2013, the maximum credit amount for taxpayers with three or more children is \$6,044. The EITC is refundable (otherwise, it could not fulfill its function). Since the EITC is designed to supplement wages, it phases in for lower-income taxpayers. The tax credit phases out as incomes exceed certain thresholds. In 2013, for married taxpayers with three or more children, the EITC begins to phase out once income reaches \$22,870 and is fully phased out once income reaches \$51,567.

Higher Education Credits²¹

The Hope credit and the Lifetime Learning credit were added to the code in 1997. The Hope credit has been temporarily replaced by the American Opportunity Tax Credit (AOTC) for 2009 through 2017. The maximum value of the AOTC credit is \$2,500 per student annually for the first four years of college. Prior to 2009, the maximum value of the Hope credit was \$1,800, limited to the first two years of college. The Hope credit is scheduled to remain available after the AOTC expires at the end of 2017. The AOTC is partially refundable. Both the Hope credit and the AOTC phase out for higher-income individuals.

Additionally, qualified expenditures on tuition and related expenses may qualify taxpayers for the Lifetime Learning credit. The Lifetime Learning credit rate is 20% of costs up to \$10,000 for qualified tuition and related expenses. The credit is capped at \$2,000. The Lifetime Learning credit is nonrefundable and phases out for higher-income individuals.

Alternative Minimum Tax²²

Individuals may also pay tax under the alternative minimum tax (AMT). Under current law, to calculate the AMT, an individual first adds back various tax items, including personal exemptions and certain itemized deductions, to regular taxable income. This grossed up amount becomes the income base for the AMT. Next, for 2013, an exemption of \$80,800 for joint returns and \$51,900 for single returns is subtracted from this income base to obtain AMT taxable income. These exemption levels are indexed for inflation. The basic exemptions are phased out for taxpayers

¹⁹ For more, see CRS Report RL31768, *The Earned Income Tax Credit (EITC): An Overview*, by Christine Scott; CRS Report RS21352, *The Earned Income Tax Credit (EITC): Changes for 2012 and 2013*, by Christine Scott; and CRS Report RS21477, *The Earned Income Tax Credit (EITC): Legislative Issues*, by Christine Scott.

²⁰ For analysis, see CRS Report R41999, *The Impact of Refundable Tax Credits on Poverty Rates*, by Margot L. Crandall-Hollick.

²¹ For more, see CRS Report R41967, *Higher Education Tax Benefits: Brief Overview and Budgetary Effects*, by Margot L. Crandall-Hollick and CRS Report R42561, *The American Opportunity Tax Credit: Overview, Analysis, and Policy Options*, by Margot L. Crandall-Hollick.

²² For additional information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

with high levels of AMT income. A two-tiered rate structure of 26% and 28% is then assessed against AMT taxable income. The taxpayer compares his AMT tax liability to his regular tax liability and pays the greater of the two.

Most nonrefundable personal tax credits are allowed against the AMT.²³ Temporary provisions, first enacted in 1998, allowed individuals to use all personal tax credits against both their regular and AMT tax liabilities.²⁴ The American Taxpayer Relief Act (ATRA; P.L. 112-240) made permanent provisions that allow most nonrefundable personal tax credits against the AMT.

The Corporate Income Tax²⁵

Table 3 contains the marginal corporate tax rates faced by U.S. firms. Smaller firms face a progressive tax schedule.²⁶ The tax schedule was designed so that most firms face an effective tax rate of 35%. In order to increase the effective tax rate for larger firms, the statutory rate increases above 35% for two brackets: the 39% bracket for income between \$100,000 and \$335,000 and the 38% bracket for income between \$15,000,000 and \$18,333,333. Having these “bubble” rates, or higher marginal tax rates along part of the schedule, increases the effective tax rate for higher-income corporations. Essentially, these higher “bubble” brackets serve to reduce any tax savings larger corporations would have incurred from having their first \$75,000 in income taxed at lower rates.

Table 3. Corporate Tax Rate Schedule

| Taxable Corporate Income | Corporate Tax Rate |
|---------------------------|--------------------|
| \$0-\$49,999 | 15% |
| \$50,000-\$74,999 | 25% |
| \$75,000-\$99,999 | 34% |
| \$100,000-\$334,999 | 39% |
| \$335,000-\$9,999,999 | 34% |
| \$10,000,000-\$14,999,999 | 35% |

²³ In the past, even taxpayers that do not actually pay the AMT might have seen their regular tax liability affected by the AMT. Nonrefundable tax credits under the regular income tax were limited to the excess of regular income tax over AMT liability. Thus, a taxpayer who had a net \$4,000 regular income tax liability (\$5,000 tax liability less \$1,000 in nonrefundable tax credits) but had an AMT liability of \$4,300 would, effectively, have seen his regular income tax credits reduced by \$300.

²⁴ The Economic Growth and Tax Relief Act of 2001 (EGTRRA; P.L. 107-16) contained provisions allowing the child tax credit, the adoption tax credit, and the IRA contribution tax credit to be claimed against a taxpayer’s regular income tax liability and AMT tax liability. The EGTRRA provisions were scheduled to expire after 2010, but were extended through 2012 by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act (ATRA; P.L. 112-239) provided that most nonrefundable personal credits continue to be allowed against the AMT. For more information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

²⁵ For more on the corporate tax, see CRS Report R42726, *The Corporate Income Tax System: Overview and Options for Reform*, by Mark P. Keightley and Molly F. Sherlock and CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.

²⁶ For more on tax benefits for small businesses, see CRS Report RL32254, *Small Business Tax Benefits: Current Law and Main Arguments For and Against Them*, by Gary Guenther.

| Taxable Corporate Income | Corporate Tax Rate |
|---------------------------|--------------------|
| \$15,000,000-\$18,333,332 | 38% |
| \$18,333,333 and over | 35% |

Source: IRS

Notes: Like the individual income tax, the corporate tax schedule contains marginal tax rates. All firms, no matter what their level of taxable income, pay a 15% income tax rate on the first \$50,000 of taxable income.

The base of the corporate income tax is net income, or profits, as defined by the tax code. In general this is gross revenue less the cost of doing business. Deductible costs include materials, interest, and wage payments. Another important deductible cost is depreciation—an allowance for declines in the value of a firm’s tangible assets, such as machines, equipment, and structures.

In broad economic terms, the base of the corporate income tax is the return to equity capital. Wages are tax deductible, so labor’s contribution to corporate revenue is excluded from the corporate tax base. Income produced by corporate capital investment includes that produced by corporate investment of borrowed funds, and that produced by investment of equity, or funds provided by stockholders. Profits from debt-financed investment are paid out as interest, which is deductible. Thus, the return to debt capital is excluded from the corporate tax base. Equity investments are financed by retained earnings and the sale of stock. The income equity investment generates is paid out as dividends and the capital gains that accrue as stock increases in value. Neither form of income is generally deductible. Thus, the base of the corporate income tax is the return to equity capital.

Because of the nature of its base, the corporate income tax has several broad effects on the allocation of capital investment. First, it favors non-corporate investment—for example, unincorporated business and owner-occupied housing—over corporate investment. Second, it favors corporate debt over corporate equity investment since the former is not subject to the tax. However, while the base of the tax is equity income, the flow of capital out of the corporate sector and other economic adjustments probably cause the burden of the tax to spread to all owners of capital: owners of unincorporated business, bondholders, and homeowners. The tax can also shift from capital income to labor income, or even benefit labor income (with capital bearing more than 100% of the tax). The government agencies that provide distributional analysis allocate most of the corporate tax to capital.

In evaluating the corporate tax, it is useful to ask why corporate profits are subject to separate taxation. Corporate equity profits are taxed twice, once at the corporate level and once under the individual income tax when they are received by stockholders as dividends or capital gains. As a consequence, taxes tend to steer investment away from the corporate sector. Further, corporations are not persons who can bear the burden of taxes, but merely legal entities through which individuals earn income. From this point of view, it is misleading to compare the tax burden of a corporation with that of an individual. The corporate tax, some argue, should be combined (“integrated”) with the individual income tax in some manner.

On the other hand, there are arguments for maintaining the current tax structure where corporate profits are subject to a separate tax. First, it discourages the use of corporations as shelters from the individual income tax. Second, it likely enhances the tax system’s progressivity. Third, integration of the individual and corporate taxes would present administrative difficulties. Fourth,

the corporate tax has a degree of public support. Finally, the corporate tax also raises significant revenue.

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) took measures intended to relieve the double-taxation of corporate income by reducing the tax rate individuals pay on corporate-source dividends and capital gains to 15% for 2003 to 2008. In 2006, the Tax Increase Prevention Reconciliation Act (TIPRA) extended the reduced rates through 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the reduced rates through 2012. Under the American Taxpayer Relief Act (ATRA; P.L. 112-240) the top rate on capital gains and dividends rose from 15% to 20% for taxpayers in the highest income tax bracket (taxpayers with income above \$400,000 (single) and \$450,000 (married)). For all other taxpayers, the 15% maximum rate on capital gains and dividends was permanently extended.

Payroll Taxes

Payroll taxes are used to fund specific programs, largely Social Security and Medicare. Social Security and Medicare taxes make up the largest share of federal payroll taxes by a wide margin. Social Security and Medicare taxes are generally paid at a combined rate of 15.3% of wages, with 7.65% being paid by the employee and employer alike. In 2013, the Social Security part of the tax (6.2% for both employees and employers) was only levied on the first \$113,700 of wages, with the cap adjusted annually for increases in average wages in the economy. The cap for 2014 is \$117,000. The Medicare portion (2.9%) is applied to all wages.

A temporary payroll tax cut was implemented as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312).²⁷ During 2011, employees' share of the payroll tax was reduced by two percentage points, to 4.2%. The temporary reduction was scheduled to expire at the end of 2011, but was extended for two months as part of the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78). The temporary payroll tax rate reduction was extended through the end of 2012 in the Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96) and subsequently allowed to expire at the end of 2012.

The other categories of federal payroll taxes are unemployment insurance taxes (FUTA) and employees' contributions to the federal retirement system. If a state unemployment compensation program complies with all federal rules, the net FUTA tax rate for employers is 0.6% on the first \$7,000 of each worker's earnings.

Estate and Gift Tax

The federal estate tax is imposed when property is transferred at death. The taxable unit is the estate, in contrast to an inheritance tax, which is levied on heirs. The base of the federal estate tax is property transferred at death, less allowable deductions and exemptions. Although the rates of the tax are graduated, the exemption is applied in the form of a credit and offsets taxes applied at the lower rates. Thus the taxable estate is effectively subject to a 40% rate in 2013. An unlimited

²⁷ For additional background, see CRS Report R41648, *Social Security: Temporary Payroll Tax Reduction*, by Dawn Nuschler and CRS Report R42103, *Extending the Temporary Payroll Tax Reduction: A Brief Description and Economic Analysis*, by Donald J. Marples and Molly F. Sherlock.

marital deduction is allowed for property transferred to a surviving spouse. Other allowable deductions include estate administration expenses, transfers to charity, and certain other items. A tax credit (the unified credit) is allowed against the tentative estate tax liability, which has the effect of exempting the first \$5.25 million in 2013.

Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16), the estate tax was repealed in 2010. Since the provisions of EGTRRA were scheduled to sunset after 2010, in 2011 the estate tax was scheduled to return to rates scheduled prior to EGTRRA (a tax credit effectively exempting the first \$1 million of estate from tax and having a top tax rate of 55%).²⁸ The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) established the \$5 million exemption and 35% rate for 2010 and 2011. The American Taxpayer Relief Act (ATRA; P.L. 112-240) established permanent estate tax parameters, setting the exemption amount at \$5 million 2011 dollars (adjusted annually for inflation) and the rate at 40%.²⁹

The federal gift tax operates alongside the estate tax to prevent individuals from avoiding the estate tax by transferring property to heirs before dying. For 2013, the first \$14,000 of gifts from one individual to another is excluded from taxation. Thus, a married couple could each give a child \$14,000 for a total gift of \$28,000. The gift and estate taxes are unified because the same rates and unified credit amount apply to the cumulative taxable transfers over an individual's lifetime and at death.³⁰ For example, a gift tax credit of \$25,000 claimed during a person's lifetime reduces the credit that can be claimed at death under the estate tax by \$25,000. The rate bracket that applies to a transfer at death is based on cumulative gifts over the decedent's lifetime as well as the size of the estate.

The estate and gift tax occupies a minor role in the federal fiscal structure, accounting for less than 1% of federal revenues in 2012.³¹ Over the next decade, roughly 0.2% of decedents will face the estate tax. The estate tax is highly concentrated among high income taxpayers (72% are in the top 1%).³²

Aside from raising revenue, the estate tax has been defended as a means of increasing the overall progressivity of the tax system. The tax falls on those with the greatest wealth, and wealth is widely regarded as a good measure of an individual's ability to pay. Some have argued, however, that the tax impairs operation of the economy by discouraging lifetime saving and capital formation. Whether the estate tax does so, however, is unclear.

The possible impact of the estate tax on small business and farms has often been the subject of debate.³³ Some have argued, for example, that the tax inhibits the transfer of farms and small

²⁸ EGTRRA also repealed the 5% surtax used to recapture the benefits of graduated tax rates on taxable estates over \$10 million.

²⁹ See CRS Report R42959, *The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*, by Jane G. Gravelle.

³⁰ The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) reunified the estate and gift tax exclusion amounts beginning in 2011. In 2010, the gift tax exclusion amount was \$1 million.

³¹ U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2014, Historical Tables* (Washington: GPO, 2011), available at <http://www.whitehouse.gov/omb/budget/Historicals>.

³² See CRS Report R42959, *The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*, by Jane G. Gravelle.

³³ For data on the composition of assets subject to the estate tax, see CRS Report RS20593, *Asset Distribution of* (continued...)

businesses to heirs and prevents them from staying in the decedent's family. As a result of such concerns, the estate tax currently has a number of special rules designed to ease its burden on farms and small businesses. However, tax return data show that the farm and business estates most likely to dispose of assets to pay the estate tax tend to be larger estates.

Excise Taxes³⁴

Excise taxes are a form of consumption tax—levied on the consumption of goods and services rather than income. Unlike sales taxes, they apply to particular commodities, rather than to broad categories. While the federal government has left sales taxes to the states as a revenue source, it levies a variety of excise taxes.³⁵ Federal excise tax revenues are small compared to other federal taxes. In 2012, \$79.1 billion in excise taxes were collected, amounting to 3.2% of total federal receipts.³⁶

Federal excise taxes are levied on a variety of products. The collection point of the tax varies across products; for some goods taxes are collected at the production level while other excise taxes are collected on retail sales. In terms of receipts, the single largest tax is the excise tax on gasoline.³⁷ Other prominent excise taxes are those on diesel fuel, domestic air passengers, distilled spirits, beer,³⁸ cigarettes, and telephone services.

Most federal excise taxes are paid into trust funds devoted to various federal activities rather than remaining in the federal budget's general fund. The largest amount goes into the Highway Trust Fund, and consisted of highway motor fuels taxes (including the gasoline tax), retail sales taxes on tractors and heavy trucks and trailers, and an annual heavy vehicle use tax.

Excise taxes serve a variety of fiscal purposes. Some were enacted simply to raise revenue (for example, the telephone tax and certain fuel taxes were enacted for deficit reduction).³⁹ The taxes linked with trust funds serve to fund expenditure programs by taxing their beneficiaries, or by taxing those responsible for certain problems addressed by expenditure programs. Some excise taxes adjust for the effects of negative externalities—that is, they seek to ensure that the price of products that produce side-effects like the consumption of alcohol and tobacco reflects their true cost to society. Other purposes of excise taxes include adjusting the price of imports to reflect domestic taxes and regulation of activities thought to be undesirable.

(...continued)

Taxable Estates: An Analysis, by Steven Maguire.

³⁴ For additional information, see CRS Report R43189, *Federal Excise Taxes: An Introduction and General Analysis*, by Sean Lowry

³⁵ A national sales tax or a value-added tax has been proposed as alternative or supplementary revenue source. For more information see CRS Report RL33438, *A Value-Added Tax Contrasted With a National Sales Tax*, by James M. Bickley and CRS Report RS22720, *Taxable Base of the Value-Added Tax*, by James M. Bickley.

³⁶ U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2012, Historical Tables* (Washington: GPO, 2011), p. 159. Available at <http://www.whitehouse.gov/omb/budget/Historicals>.

³⁷ For more information on the federal excise tax on gasoline see CRS Report R40808, *The Role of Federal Gasoline Excise Taxes in Public Policy*, by Robert Pirog.

³⁸ CRS Report R43350, *Alcohol Excise Taxes: Current Law and Economic Analysis*, by Sean Lowry.

³⁹ Recent plans for addressing the deficit and stabilizing the debt have included various excise tax revenue proposals. For more information, see CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

The burden of excise taxes is thought to fall on consumption and more heavily on individuals with lower incomes. The tax is believed to be usually passed on by producers to consumers in the form of higher prices. Because consumption is a higher proportion of income for lower-income persons than upper-income individuals, excise taxes are usually considered regressive. However, the incidence of excise taxes in particular cases depends on the market conditions, and how consumers and producers respond to price changes. Further, some economists have argued that consideration of the incidence of excise taxes over an individual's lifetime reduces their apparent regressivity.

The effects of excise taxes on economic efficiency vary, depending on the particular tax. For example, taxes that counter negative externalities probably enhance economic efficiency. On the other hand, excise taxes that reduce economic welfare by distorting prices and consumption choices likely reduce efficiency.

Tax Statistics

Composition and Size of the Federal Tax System

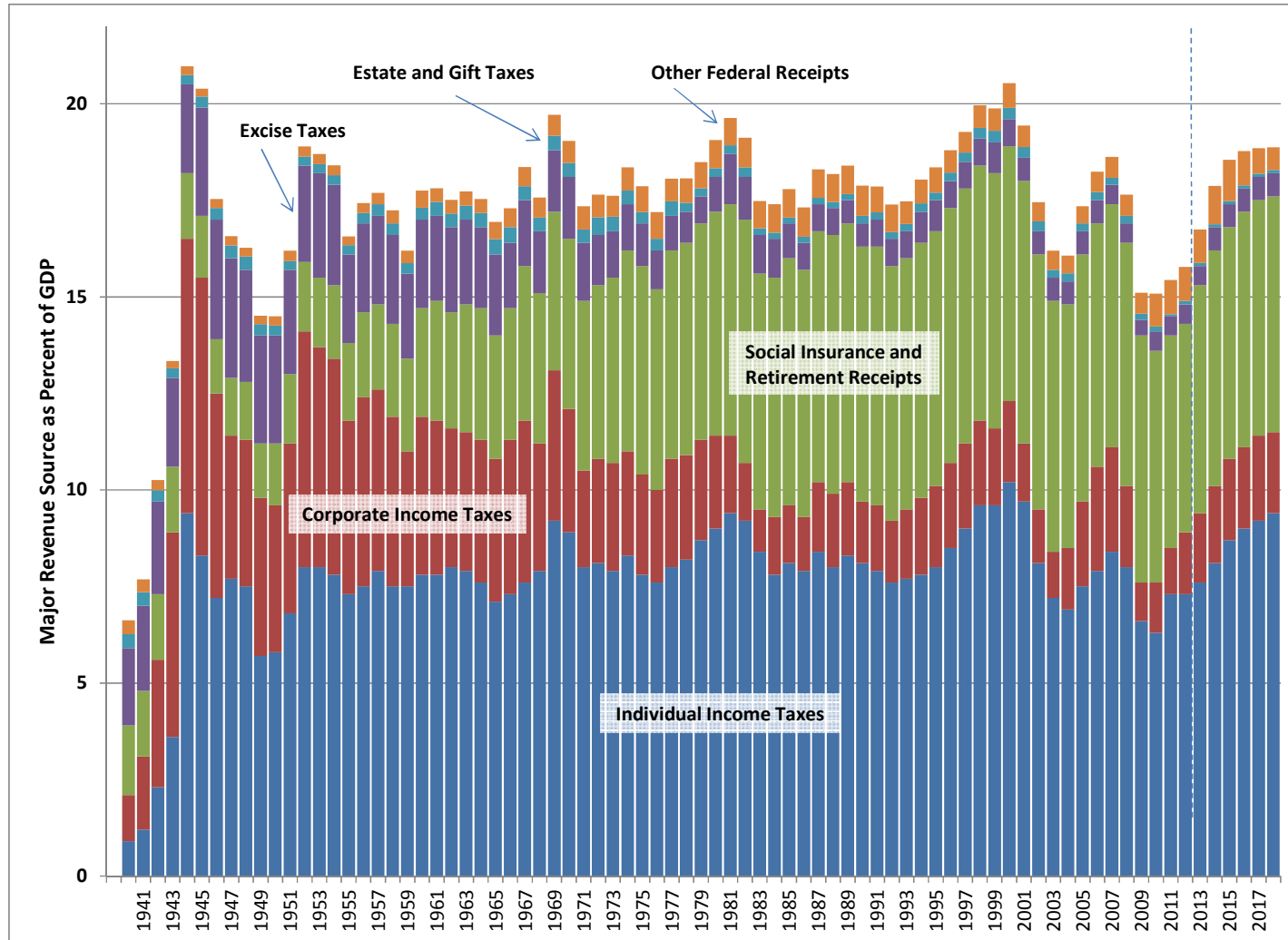
The federal tax system relies on several different revenue sources. In FY2012 the individual income tax accounted for 46% of total federal revenue, the social insurance and retirement receipts for nearly 35% of total revenue, the corporate income tax for 10% of the total, and excise taxes for approximately 3% of the total.⁴⁰ The remaining 6% was collected through the estate and gift tax, customs duties, and other taxes.⁴¹

Figure 2 displays federal tax revenues as a percentage of gross domestic product (GDP). Since the 1960s, total federal revenues have fluctuated between 15% and 21% of GDP, with the average over the period approximately 18% of GDP. After reaching a post-World War II peak of nearly 21% of GDP in 2000, federal receipts measured as a percentage of GDP declined to a 59-year low of 15% of GDP in 2009. Revenues as a percentage of GDP remained at 15% in 2010. Revenues as a percentage of GDP have begun to increase, reaching nearly 16% of GDP in 2012.

⁴⁰ U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2014, Historical Tables* Table 2.2 (Washington: GPO, 2011). Available at <http://www.whitehouse.gov/omb/budget/Historicals>.

⁴¹ The share of total tax collections from various revenue sources may not sum to 100% due to rounding.

Figure 2. Federal Revenue as a Percentage of GDP
1940 - 2018



Source: CRS calculations using data from U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2014, Historical Tables* (Washington: GPO, 2013).

Notes: Revenues for 2013-2018 are projections based on the President's FY2014 budget proposal. FY2013 is noted with the vertical dotted line.

Since the mid-1940s, the individual income tax has been the most important source of federal revenue. Between 2000 and 2010, however, the individual income tax receipts decreased relative to the size of the economy, falling from more than 10% of GDP in 2000 to just over 6% in 2010. Individual income tax receipts increased to 7.3% of GDP in 2012. Over time, the corporate income tax has fallen from the second- to the third-most important source of revenue. In the late 1960s, corporate taxes were replaced by Social Security taxes as the second-leading revenue source. Excise taxes and estate and gift taxes have also decreased in relative importance over time.

The U.S. Fiscal Position Compared to Other Nations

Given congressional interest in the U.S. fiscal position, the question of how the U.S. public sector compares to other nations often arises (the public sector includes state and local governments, in addition to the federal government). Using aggregate budget data for all levels of government relative to economic output (budget aggregates as a percentage GDP) as one measure of the size of public sectors, several observations can be made:

- Compared with the other major industrialized nations, the public sector (including all levels of government) in the United States is relatively small.
- In terms of revenue, the U.S. public sector collects the least amount of revenue relative to economic output.
- In terms of outlays, the U.S. public sector has a relatively low level of outlays relative to its economic output.

Table 4 presents Organization for Economic Cooperation and Development (OECD) estimates of government revenues, expenditures, and deficits/surpluses as a percentage of GDP for seven major industrialized countries in 2013. Among this group, the United States had the third-highest budget deficit in 2013 at 6.5% of GDP.

Table 4. U.S. Fiscal Position Compared to Other Industrialized Nations, 2013

| | Government Revenues as a % of GDP | Government Expenditures as a % of GDP | Surplus/Deficit as a % of GDP |
|----------------|--------------------------------------|--|----------------------------------|
| Japan | 32.9% | 42.9% | -10.0% |
| United States | 32.1 | 38.7 | -6.5 |
| Canada | 38.3 | 41.4 | -3.0 |
| United Kingdom | 40.3 | 47.2 | -6.9 |
| Germany | 44.6 | 44.5 | 0.1 |
| Italy | 48.4 | 51.4 | -3.0 |
| France | 52.8 | 57.0 | -4.2 |

Source: OECD Economic Outlook, Annex Tables, available at <http://www.oecd.org/eco/outlook/economicoutlookannextables.htm>.

Notes: U.S. data exclude the operating surplus of public enterprises. Revenues include those collected by all levels of government.

Distribution of the U.S. Federal Tax Burden Across Income Classes

The distribution of the federal tax burden is a perennial topic of concern and debate. Tax burdens could be distributed such that all taxpayers pay the same percentage of their income in taxes regardless of their income level, a proportional distribution. Alternatively, the tax burden could be distributed such that lower income taxpayers pay a higher percentage of their income in taxes than do upper-income taxpayers, a regressive distribution. Or the tax burden could be distributed progressively such that taxes as a percentage of income increase as incomes increase.

Economic theory does not provide an answer as to how the tax burden should be distributed among people with unequal incomes. While few would argue that the tax system should be regressive, the degree to which it should be progressive involves subjective value judgments. A consensus seems to have evolved that the federal tax system should be progressive, a goal that, over time, has been achieved. Economists refer to this notion as vertical equity—the principle that those with a greater ability to pay taxes (higher income or higher wealth) should pay more.

Table 5 shows that effective tax rates fell for all income groups between 2000 and 2010. In relative terms, effective tax rates declined more for the lowest income quintile than for the highest income quintile. As a result, higher income groups paid a larger share of federal tax liabilities in 2010 than in 2000. The positive effective tax rates for those in the lowest income quintile are driven by payroll taxes.⁴²

Table 5. Average Federal Tax Rates for All Households: 2000 and 2010

| Income Category | Effective Tax Rate 2000 | Share of Tax Liabilities 2000 | Effective Tax Rate 2010 | Share of Tax Liabilities 2010 |
|---|-------------------------|-------------------------------|-------------------------|-------------------------------|
| Lowest quintile | 6.8% | 1.4% | 1.5% | 0.4% |
| Second quintile | 12.4 | 4.9 | 7.2 | 3.8 |
| Middle quintile | 16.5 | 9.8 | 11.5 | 9.1 |
| Fourth quintile | 20.6 | 17.7 | 15.6 | 17.6 |
| Highest quintile | 27.7 | 66.0 | 24.0 | 68.8 |
| 91 st – 95 th percentiles | 25.3 | 10.8 | 21.6 | 11.9 |
| 96 th – 99 th percentiles | 27.9 | 15.7 | 24.9 | 17.2 |
| Top 1% | 32.4 | 24.9 | 29.4 | 24.2 |
| All quintiles | 22.7 | 100.0 | 18.1 | 100.0 |

Source: U.S. Congress, Congressional Budget Office, *The Distribution of Household Income and Federal Taxes, 2010* (December 2013). Available at <http://www.cbo.gov/publication/44604>.

Notes: The average tax rate includes individual income taxes, social insurance (or payroll) taxes, corporate income taxes, and excise taxes.

⁴² For further analysis see CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle.

Selected Tax Concepts

The final sections of this report review a number of important tax concepts. First, tax expenditures are discussed. Tax expenditures represent revenue losses from tax deductions, credits, and other tax benefits. Tax expenditures are used to provide incentives or disincentives regarding various behavior via the tax code. Capital gains are reviewed in further detail, as there is ongoing debate surrounding the preferred tax treatment of this form of income. The tax consequences of marriage are also discussed. While marriage tax penalties have been reduced (and bonuses increased) in recent years, the possibility that marriage can change a couple’s tax liability still exists. The concepts of tax deferral and depreciation are also reviewed, as changes in policies here can have broad implications for tax liability. The final sections note how forms of business organization can impact tax liability, and assess the possibility of tax policy enhancing firm or industry competitiveness.

Tax Expenditures

Tax expenditures are revenue losses from special tax deductions, credits, and other tax benefits. The Joint Committee on Taxation lists revenue losses from these tax provisions by functional spending categories. **Table 6** lists the top individual tax expenditures. These 10 expenditure categories account for 70% of total tax expenditures on individuals.

In 2013, the sum of individual tax expenditures was \$1,140 billion. While it is not precisely correct to add up all tax expenditures, which are estimated individually yet have some interactive effects, these totals provide some notion of the magnitude of these provisions. Individual income tax receipts are projected to be \$1,264 billion in 2013.⁴³ Thus, tax expenditures are large relative to total receipts.

It is also important to note that tax expenditures measure the revenue effects of provisions on a cash flow basis, so they may not reflect the true benefit to the taxpayer (e.g., when the value of a benefit arises from a deferral of taxes). The initial revenue effects of a repeal of a provision may differ from the costs reflected in the tax expenditure budget.

Table 6. Largest Tax Expenditures for Individuals, FY2013

Billions of Dollars

| Tax Expenditure | Amount |
|--|--------|
| Reduced rates of tax on dividends and long-term capital gains | 160.8 |
| Exclusion of employer contributions for health care | 131.7 |
| Exclusion of contributions and earnings to retirement plans ^a | 117.2 |
| Deduction for mortgage interest | 69.7 |
| Exclusion of Medicare benefits ^b | 67.0 |
| Earned income tax credit | 60.9 |

⁴³ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023*, Washington, DC, February 2013, p. 9, <http://www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf>.

| Tax Expenditure | Amount |
|---|--------|
| Child Tax Credit | 57.3 |
| Deduction of state and local taxes | 50.3 |
| Exclusion of capital gains at death | 42.8 |
| Deduction for charitable contributions ^c | 39.0 |

Source: CRS analysis of data from U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012 - 2017*, 112th Cong., February 1, 2013, JCS-1-13.

- a. This figure includes tax expenditures related to pension contributions and earnings as well as items related to individual retirement accounts (IRAs).
- b. This includes benefits under hospital insurance (Part A), supplementary medical insurance (Part B) and prescription drug insurance (Part D).
- c. This includes charitable contributions related to education and healthcare.

Capital Gains

Under current income tax law, a capital gain or loss can result from the sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price, then the sale produces a capital gain. If the asset is sold for a lower price than its acquisition price, then the sale produces a capital loss. Under current law, capital assets held for more than 12 months are considered long-term assets, while assets held 12 months or less are considered short-term assets. The holding period to qualify for long-term capital gain tax treatment was reduced to 12 months in 1998. Capital gains on short-term assets are taxed at regular income tax rates.

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA; P.L. 108-27) reduced the maximum tax rate on long-term capital gains income. For 2008 through 2010, the tax rate on capital gains is 0% for those in the 10% and 15% tax brackets. JGTRRA reduced the maximum capital gains tax rate to 15% for taxpayers in marginal income tax brackets exceeding 15%. These changes were initially effective for assets sold or exchanged on or after May 6, 2003, and before January 1, 2009, but the Tax Increase Prevention and Reconciliation Act of 2006 (P.L. 109-222) extended the applicability of reduced rates through 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the reduced rates through 2012.

Reduced rates on long-term capital gains were permanently extended for most taxpayers as part of the American Taxpayer Relief Act (ATRA; P.L. 112-240). The top tax rate on long-term capital gains was increased from 15% to 20% for single taxpayers with taxable income above \$400,000 (\$450,000 for married joint filers; \$425,000 for head of household filers).⁴⁴

Beginning in 2013, taxpayers with modified adjusted gross income (MAGI) above \$200,000 (\$250,000 for married taxpayers filing jointly) will be subject to a 3.8% tax on net investment income.⁴⁵ The \$200,000 and \$250,000 thresholds are not adjusted for inflation. Net investment

⁴⁴ The 20% rate applies to taxpayers in the 39.6% tax bracket, which will inflation adjust from 2013.

⁴⁵ For more, see CRS Report R41413, *The 3.8% Medicare Contribution Tax on Unearned Income, Including Real Estate Transactions*, by Mark P. Keightley.

income includes taxable net capital gains, as well as interest, dividends, non-qualified annuities, royalties, and rents. This unearned income Medicare contribution tax was enacted as part of the Health Care and Education Reconciliation Act of 2010 (HCERA; P.L. 111-152).

Some economists argue that lowering capital gains taxes would significantly reduce “lock-in” effects, allowing capital to flow more freely to where it can be used most efficiently. Reducing capital gains taxes could lead to more capital gains realizations, potentially offsetting some of the cost of cutting capital gains taxes. There is, however, considerable uncertainty about the magnitude of this unlocking effect. As an alternative to reduced capital gains tax rates, lock-in could be reduced by taxing capital gains on an accrual basis (as opposed to the current system, which taxes capital gains when they are realized) or by taxing capital gains passed on at death. These alternative solutions, however, face a variety of technical problems, and the idea of taxing gains at death has been unpopular.

Arguments have also been made that cutting capital gains taxes could increase saving and investment, thus stimulating economic growth. While evidence on the effect of tax cuts on savings rates and, thus, economic growth is difficult to obtain, most evidence does not indicate a large response of savings to an increase in the after-tax rate of return on assets. Further, many economists argue that reduced capital gains tax rates are unlikely to provide short-run economic stimulus.⁴⁶

A case might be made for cutting capital gains taxes on corporate stock since corporate equity capital is subject to taxation both under the corporate and individual income taxes. This double taxation encourages corporations to take on debt and directs capital to the non-corporate sector. On the other hand, reducing the capital gains tax would increase the relative penalty that applies to dividends and introduce tax distortions into the decisions of firms to retain earnings.

A major complaint made by some is that cutting capital gains taxes would primarily benefit very high-income individuals. Capital gains are concentrated among higher-income individuals both because these individuals tend to own capital and because they are especially likely to own capital that generates capital gains income.⁴⁷

Marriage Penalties and Bonuses

Defining the married couple as a single tax unit under the federal individual income tax violates the principle of marriage neutrality. Some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus).⁴⁸ This can be viewed as a

⁴⁶ Temporary reductions in capital gains taxation may lead investors to sell stock, but does not necessarily provide an incentive to invest. Investors may actually reduce investment if it is believed that a higher capital gains tax rate will be faced in the future. The selling of stock in response to temporarily low capital gains tax rates could depress stock prices and consumer confidence. For additional background, see CRS Report R40411, *The Economic Effects of Capital Gains Taxation*, by Thomas L. Hungerford.

⁴⁷ For more information, see CRS Report R40411, *The Economic Effects of Capital Gains Taxation*, by Thomas L. Hungerford and CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle.

⁴⁸ Research looking at 2007 tax law found that amongst cohabiting unmarried couples, if those couples were to marry, 48% would experience a marriage penalty while 38% would have a marriage bonus. See Emily Y. Lin and Patricia K. Tong, “Marriage and Taxes: What Can We Learn From Tax Returns Filed by Cohabiting Couples,” *National Tax Journal*, vol. 65, no. 4 (December 2012), pp. 807-826.

violation of the principle of horizontal equity, whereby individuals with equal income should have similar tax burdens.

The most important structural factors affecting the marriage neutrality of the income tax are the earned income tax credit (EITC), the marginal tax rate schedules, and the phaseout of credits and deductions for higher-income individuals. Under the current tax system, single individuals, heads of households, and married couples are subject to different tax rate schedules.⁴⁹ In addition, the EITC amounts and phaseout ranges vary based on the number of dependents claimed. These differences give rise to structural marriage tax bonuses and penalties.

Generally, the more evenly divided the earned income of the two spouses, the more likely they are to have a structural marriage tax penalty. Hence, married couples in which each spouse earns 50% of the total earned income have the largest marriage tax penalties. Specifically, two individuals having \$80,000 each in taxable income would be in the 25% marginal tax bracket when being taxed as individuals. Their federal income tax liability would be \$15,928.75 each (or \$31,857.50 jointly).⁵⁰ However, were these same persons taxed as a married couple, they would be in the 28% marginal tax bracket and have a joint federal income tax liability of \$35,539. The marriage tax penalty for this couple would be \$408.

On the other hand, married couples where one spouse earns all the earned income have the largest marriage tax bonuses. For example, an individual with a taxable income of \$100,000 would have a federal income tax liability of \$21,283.25. If that individual took a spouse who had no earnings, the tax liability for a couple with \$100,000 in taxable income is \$16,857.50. Hence, this couple would have a marriage tax bonus of \$4,435.75.

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) accelerated provisions initially introduced in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) aimed to reduce the marriage tax penalty. Specifically, the 2001 and 2003 legislation made the standard deduction for married couples filing jointly twice that of the standard deduction for individuals. The 2001 and 2003 legislation also increased the 15% bracket for married couples filing jointly to extend to twice the income level as for single individuals. Both of these measures were initially temporary for the 2003 and 2004 tax years but were extended through 2010 by the Working Family Tax Relief Act of 2004 (WFTRA). These measures were extended through 2012 by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) and made permanent as part of the American Taxpayer Relief Act (ATRA; P.L. 112-240). While these changes did reduce the marriage tax penalty for some, higher-income couples and low- to middle-income couples with children are still likely to face a marriage tax penalty.⁵¹

It is widely accepted that achieving equity in the individual income tax should involve (1) not influencing the choice of individuals regarding their marital status, (2) being progressive, and (3) taxing couples with equal income (whether that income comes from one or two earners) equally. Regardless of how these three concepts of equity are juggled, under current definitions an income

⁴⁹ Prior to 2003, the standard deduction for married couples filing jointly was less than twice the standard deduction available to individual filers, leading many filers to experience a marriage tax penalty.

⁵⁰ Calculations in this section are based on 2013 tax schedules.

⁵¹ U.S. Congress, Senate Committee on Appropriations, Subcommittee on District of Columbia, *The Widespread Prevalence of Marriage Penalties*, Testimony, 109th Cong., 2nd sess., May 3, 2006.

tax can achieve only two of the goals; it cannot simultaneously achieve all three. The current income tax has chosen progressivity and equal taxation of couples with equal incomes at the expense of marriage neutrality. A critical point in this debate is that there are no unambiguous answers to the question of which of these three competing goals of equity is the most important.

Tax Deferral

One perplexing problem associated with taxing income involves the issue of tax deferral. Ideally, a tax levied on income should be assessed when the income accrues to the taxpayer. However, as a result of many factors, taxes are often deferred into the future. This can happen when income is taxed when it is realized, rather than when it accrues or when there is a mismatch between when income is earned and the expenses associated with earning that income. Since money has a time value (a dollar today is more valuable than a dollar in the future), tax deferral effectively lowers the tax rate on the income in question.

Income from capital gains can be used to illustrate the benefits of tax deferral. For capital gains, the tax is assessed when the gain is realized rather than as it accrues. If a capital asset is acquired for \$100 and appreciates at a rate of 10% per annum, by the end of the first year it has appreciated in value to \$110 and by the end of the second year it is worth \$121. Assuming a marginal tax rate of 15%, if the gain were realized at the end of the second year, then a tax of \$3.15 (\$21 times 15%) would be levied on the realized appreciation. The after-tax return would be \$17.85.

In contrast is the case of a \$100 investment in an interest-bearing account earning a 10% rate of return with no deferral. At the end of the first year, the account would yield \$10 in interest. Tax on the interest, assuming a 15% marginal income tax rate, would be \$1.50, leaving \$108.50 in the account. By the end of the second year, the account would yield \$10.85 in interest. Tax on the second year's interest would be \$1.63, leaving \$117.72 in the account, for an after-tax return over the two-year period of \$17.72.

It is apparent from the examples above that the investment in the asset yielding capital gains income earns a higher after-tax return than the comparable investment in an interest-bearing account. In essence, the reason for this result is simply that, for the asset producing a capital gain, the tax on the appreciation in the first year was deferred, with the deferred tax remaining in the account and earning interest. The benefits of tax deferral increase the longer an asset is held and tax can be deferred.

Tax deferral not only affects the taxation of assets producing capital gains income, but also is of concern in other areas of tax policy, such as the taxation of contributions to retirement accounts, depreciation allowances, and the taxation of foreign source income of U.S. multinational corporations.

Depreciation

When a business purchases a tangible asset such as a machine or structure, it is not incurring a cost. Rather, the business is simply exchanging one asset—for example, cash—for another. The full purchase price of an asset is therefore usually not tax deductible in the year the asset is bought. Assets do, however, decline in value as they age or become outmoded. This decline in value (depreciation) *is* a cost. Because assets gradually depreciate until they are worthless, the tax code permits firms gradually to deduct the full acquisition cost of an asset over a number of years.

The tax code contains a set of rules that govern the rate at which depreciation deductions can be claimed. The rules determine the tax depreciation rate by specifying a *recovery period* and a *depreciation method* for different types of assets. An asset's recovery period is the number of years over which deductions for the asset's full cost must be spread. The applicable depreciation method determines how depreciation deductions are distributed among the different years of the recovery period. The slowest method is straight-line, in which equal deductions are taken each year. Declining balance methods, in which a fixed fraction of the cost less prior depreciation is deducted, cause larger shares to be taken in earlier years.

Because of the time value of money, a tax deduction of a given dollar amount is worth more to a business the sooner it can be claimed. Further, the sooner a tax deduction can be claimed, the sooner the tax savings it generates can be invested and earn a return. It follows that the tax rules governing when depreciation deductions can be claimed are quite important to businesses. If depreciation deductions can be claimed faster than an asset actually declines in value, a tax benefit exists; depreciation is said to be *accelerated*. If, on the other hand, depreciation deductions can be claimed more slowly than the corresponding asset actually depreciates, a tax penalty occurs. Only if depreciation deductions are claimed at the rate an asset actually depreciates do taxes confer neither a tax benefit nor a tax penalty.

According to some estimates, current tax depreciation for some types of equipment is somewhat accelerated compared to economic depreciation. "Bonus" depreciation allowances that recent tax acts have provided for temporary periods may have further accelerated depreciation for certain equipment.⁵² Generally, depreciation for most structures is probably not accelerated. Thus, firms have a tax incentive to use more equipment and fewer of other types of assets in their production process than they otherwise would. This influence of taxes in the allocation of capital can reduce economic efficiency.

Forms of Business Organization

The Internal Revenue Code recognizes several different forms of business organization and their tax treatment varies. The principal forms are *C corporations*, *S corporations*, *partnerships*, and *sole proprietorships*.⁵³

Apart from taxes, corporations are a legally defined form of business organization, with ownership stakes represented by shares that may or may not be publicly traded. Shareholders' liabilities are limited to their stake in the corporation. The Internal Revenue Code normally subjects corporate profits to the corporate income tax under its subchapter C; corporations subject to income tax are thus often referred to as "C corporations." As explained more fully above, in the report's section on the corporate income tax, the part of C corporation income generated by equity investment is subject to two layers of tax: the corporate income tax and the individual income tax. In contrast, corporations that qualify as "S corporations" are not subject to the corporate income tax. Instead, their net profits are passed on a pro rata basis through to the individual shareholders who are taxed on the profits under the individual income tax. To be classified as an S corporation, the organization may have no more than 100 shareholders.

⁵² CRS Report RL31852, *Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 113th Congress, and Economic Effects*, by Gary Guenther.

⁵³ For more information see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

Taxes aside, partnerships are like corporations in that they have multiple owners. In contrast to corporations, some partnerships convey a liability for debts that is not limited to partners' contributions to the enterprise. Partnerships are also less likely than corporations to be publicly traded, although some forms of partnerships ("master limited partnerships") are. Like S corporations, partnerships are not subject to the corporate income tax; partners are subject to their share of partnership earnings under the individual income tax.

Limited liability companies (LLCs) have some of the characteristics of both partnerships and corporations. Under IRS "check the box" regulations, LLCs can elect to be taxed either as corporations or as partnerships. Other specially defined business entities include real estate investment trusts (REITs), which are required to engage primarily in passive investment in real estate and securities. Qualifying REITs are permitted to deduct dividends they pay to shareholders, which effectively exempts REITs from the corporate income tax. Regulated investment companies (RICs), who invest primarily in securities and distribute most income, are also permitted to deduct dividends. The simplest forms of business organization are sole proprietorships. Sole proprietorships have only one owner; there is no legal distinction between the business and the business's owner. For tax purposes, business profits earned by a sole proprietor are taxed to the owner under the individual income tax. The corporate income tax does not apply.

Taxes and Competitiveness

Competitiveness can be defined in a variety of ways (indeed, some would argue that it has no concrete meaning at all, at least at the national level). But regardless of how competitiveness is defined, standard economic analysis suggests that most tax measures can do little to enhance it. Indeed, some observers argue that many of the tax provisions designed to improve U.S. performance in the world economy actually reduce U.S. economic welfare, world economic welfare, or both.

An individual firm or its employees might defend competitiveness as its ability to withstand the threat of foreign competition. If asked, they might recommend some manner of tax benefit targeted at their industry: perhaps favorable depreciation rules or tax credits for consumers who buy their product. Economic analysis predicts that such measures might well improve the position of the targeted industry: its costs would fall because its taxes have fallen, introducing the possibility of reduced prices, larger market shares, and more jobs.

Economic theory, however, also predicts that the effects of a targeted tax benefit will ripple through the economy and ultimately confound the policy's competitiveness goals for the economy as a whole. Because the nation's resources are limited, the theory holds, a narrowly targeted tax benefit will simply reshuffle the way resources are employed, drawing them into the favored industry and away from alternative uses. While exports in the favored sector may rise (or imports fall), theory predicts that the performance of other sectors will decline. Further, economics predicts that the effect of taxes on how the economy's resources are deployed diminishes the nation's economic vitality: market forces, not tax rules, are usually the best way to guarantee that resources are used efficiently.

Policymakers or others at the national level may take a broader view of competitiveness and define it as the ability of the country as a whole to sell its exports—not just the performance of one sector. Such a view might recommend, for example, a tax incentive for exporting, regardless of the product. But in this case, economic theory suggests that exchange rate adjustments will

stymie any effect the export subsidy may have in improving the trade balance. Although implementation of an export subsidy may initially increase exports, the increase in exports raises the price of the dollar in currency markets, which, in turn, makes U.S. exports more expensive and imports cheaper. As a result, exports are predicted to fall and imports increase until any initial improvement in the balance of trade that may have occurred disappears. Further, to the extent that part of the export tax benefit is passed on to foreign consumers as lower prices, analysis indicates that the measure transfers economic welfare from U.S. taxpayers to foreign persons.

Many economists would argue that taxes can alter the balance of trade in the short and medium term, but not in the way that is perhaps commonly thought. If a country runs a trade deficit, it is using more than it produces; and to do so, it must, in effect, borrow from abroad, importing the foreign investment that finances the deficit. The trade balance thus mirrors the balance on capital account, and it follows that taxes alter the trade balance not by their direct application to exports or imports, but by altering capital flows. For example, a cut in taxes on business investment in the United States increases the U.S. appetite for investment; foreign capital inflows accordingly increase and net U.S. exports (imports minus exports) fall. Or, a tax cut that increases the federal budget deficit can be expected to exert upward pressure on real interest rates, thereby attracting additional foreign capital and expanding the trade deficit. Conversely, a tax increase that reduces the budget deficit can also reduce the trade deficit.

Finally, there are questions regarding whether tax preferences on capital rather than trade can enhance competitiveness for U.S. firms. For example, can taxes improve the economy by making U.S. firms that operate abroad more competitive, cutting their costs and helping them compete more effectively against foreign firms? Again, economic theory is doubtful, holding that economic performance is enhanced by a neutral tax policy that neither discourages nor encourages overseas investment.⁵⁴

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⁵⁴ For further information, see CRS Report RS22445, *Taxes and International Competitiveness*, by Donald J. Marples.