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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 deduction 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 2010, Social Security taxes are levied on the first $106,800 of wages, with the wage cap adjusted annually for 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 FY2009, individual income taxes accounted for 44% of total federal revenue. Social Security taxes accounted for 42%. Corporate income taxes accounted for 7% while excise taxes accounted for 3%. Estate and gift, customs, and miscellaneous taxes accounted for the remaining 5% of total revenue. Over time, 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 7.5% of AGI, and for a variety of other items. For taxable years 2004 through 2009, at the election of the taxpayer, state and local sales taxes can be deducted as an alternative to state and local income taxes.[3] Proposals have been made to extend the sales tax deduction option through 2010. An extension of the sales tax deduction option was approved by the House on December 9, 2009, as part of the Tax Extenders Act of 2009 (H.R. 4213). The American Jobs and Closing Loopholes Act of 2010 (a revised version of H.R. 4213) also contains provisions that would extend this sales tax deduction option.

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 2010, the exemption amount per person is $3,650.[4] For taxpayers with high levels of AGI, the personal and dependent exemptions are phased out.[5]

[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] See CRS Report RL32781, *Federal Deductibility of State and Local Taxes*, by Steven Maguire, for analysis of the deductibility of state and local taxes.

[4] If a taxpayer was married and had one child being claimed as a dependent, the exemption would be $10,950 ($3,650 ×
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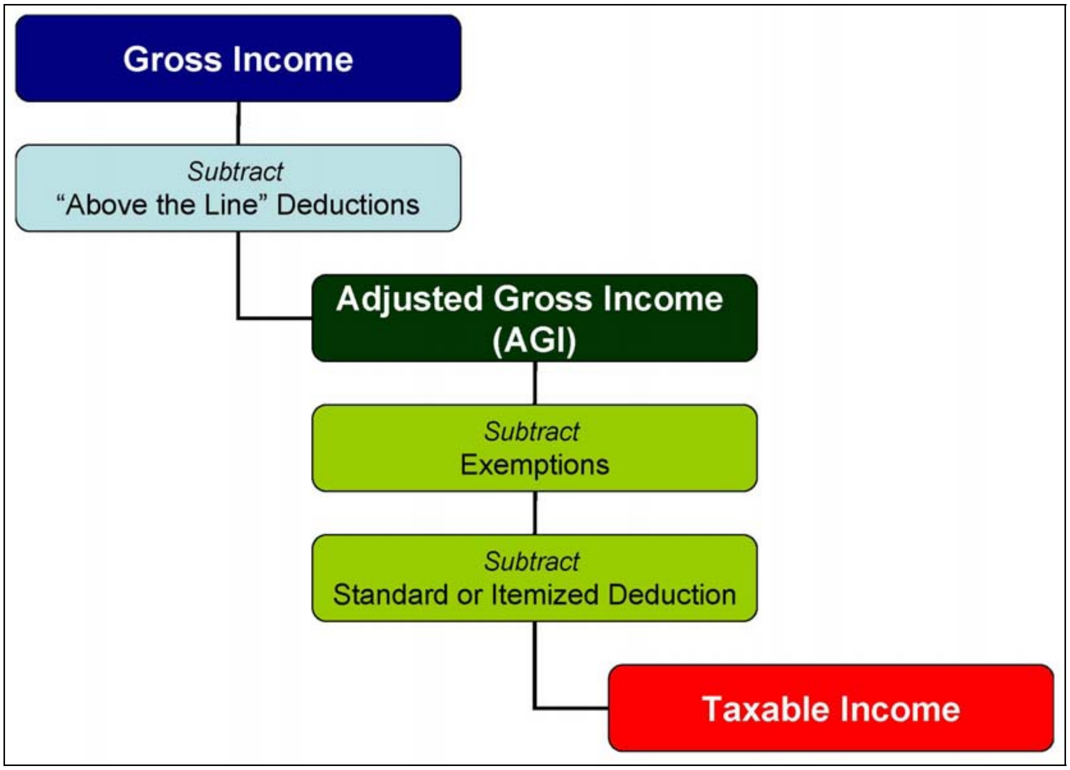
Federal income taxes are assessed on a taxpayer's taxable income. Taxable income equals AGI reduced by either the standard deductions or itemized deductions and personal and dependent exemptions. **Figure 1** illustrates the computation of taxable income.

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.[6] 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 six marginal income tax rates: 10%, 15%, 25%, 28%, 33%, and 35%.[7] These

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3).

[5] See CRS Report R40508, *Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease)*, by Maxim Shvedov.

[6] A marginal tax rate is the tax rate on the last dollar earned.

[7] For historical perspective on marginal tax rates see CRS Report RL34498, *Statutory Individual Income Tax Rates and Other Elements of the Tax System: 1988 Through 2010*, by Maxim Shvedov.

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.[8]

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.[9] 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. The current tax rate on realized capital gains is 15%.[10] Unlike capital gains, assets earning interest are taxed on accrual. Taxes are paid on the interest earned in each tax year.[11] 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

[8] See CRS Report R41394, *Tax Treatment of Long-Term Capital Gains and Dividends and Related Provisions in the President's FY2011 Budget Proposal*, by Maxim Shvedov for further information.

[9] 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).

[10] For the 2008 through 2010 tax years the tax rate on capital gains for individuals in the 10% and 15% tax brackets is 0%.

[11] For more information see CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle.

rate as capital gains.[12] Absent legislative action, dividends income will be subject to ordinary tax rates beginning in 2011.[13]

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, although it is always difficult to measure such income precisely.[14] 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. 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. The most common deductions for taxpayers choosing to itemize were listed above. Personal exemptions and standard deductions from 2004 through 2010 are given in **Table 1**.

Table 1. Statutory Personal Exemptions and Standard Deductions

Filing Status	2004	2005	2006	2007	2008	2009	2010
Personal Exemptions	$3,100	$3,200	$3,300	$3,400	$3,500	$3,650	$3,650
Standard Deductions							
—Married Filing Jointly	$9,700	$10,000	$10,300	$10,700	$10,900	$11,400	$11,400
—Single Individual	$4,850	$5,000	$5,150	$5,350	$5,450	$5,700	$5,700
—Head of Household	$7,150	$7,300	$7,750	$7,850	$8,000	$8,350	$8,400

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.

[12] For more information see CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, by Jane G. Gravelle.

[13] Reduced rates for qualified dividends were introduced under Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27). The reduced rate is set to expire at the end of 2010. For more information, see CRS Report R41394, *Tax Treatment of Long-Term Capital Gains and Dividends and Related Provisions in the President's FY2011 Budget Proposal*, by Maxim Shvedov.

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

Historically, personal exemptions and itemized deductions have been limited for certain high-income taxpayers.[15] 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. President Obama's FY2011 Budget Proposal, if enacted, would reinstate the personal exemption phaseout for high income taxpayers.

Before 2010, itemized deductions were limited above a certain threshold.[16] 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 are scheduled to expire at the end of 2010. President Obama's FY2011 Budget proposes to reinstate the Pease limitations for married couples filing jointly with an AGI of more than $250,000 and single filers with an AGI of more than $200,000. For the 2009 PEP and Pease phaseout limits, see the **Appendix**.

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 2010 are shown in **Table 2**. In the absence of legislative action, the current marginal tax rates will revert back to year 2000 levels after the 2010 tax year.[17]

As was noted above, income earned from long-term capital gains and dividends is taxed at lower rates. For tax years 2008 through 2010, capital gains and dividends are taxed at 15% for most taxpayers. Taxpayers in the 10% and 15% tax brackets have a tax rate of 0% on capital gains and dividends for tax years 2008 through 2010. In the absence of further legislative action, long-term capital gains will be taxed at a rate of 20% (10% for taxpayers in the 15% bracket) and dividends will be taxed as ordinary income after 2010.

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.

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[15] For further discussion see CRS Report R40508, *Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease)*, by Maxim Shvedov.

[16] *Ibid.*

[17] 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).

Table 2. Statutory Marginal Tax Rates, 2010

Tax Schedules by Filing Status

Married Filing Jointly			
If taxable income is:			Then, *tax* is:
$ 0	to	$16,750	10% of the amount over $0
$16,700	to	$68,000	$ 1,675 plus 15% of the amount over $16,700
$68,000	to	$137,300	$ 9,362.50 plus 25% of the amount over $68,000
$137,300	to	$209,250	$26,687.50 plus 28% of the amount over $137,300
$209,250	to	$373,650	$46,833.50 plus 33% of the amount over $209,250
$373,650	plus		$101,085.50 plus 35% of the amount over $373,650
Single Returns			
If taxable income is:			Then, *tax* is:
$0	to	$8,375	10% of the amount over $0
$8,375	to	$34,000	$837.50 plus 15% of the amount over $8,375
$34,000	to	$82,400	$4,681.25 plus 25% of the amount over $34,000
$82,400	to	$171,850	$16,781.25 plus 28% of the amount over $82,400
$171,850	to	$373,650	$41,827.25 plus 33% of the amount over $171,850
$373,650	plus		$108,421.25 plus 35% of the amount over $373,650
Heads of Households			
If taxable income is:			Then, *tax* is:
$0	to	$11,950	10% of the amount over $0
$11,950	to	$45,550	$1,195 plus 15% of the amount over $11,950
$45,550	to	$117,650	$6,235 plus 25% of the amount over $45,550
$117,650	to	$190,550	$24,260 plus 28% of the amount over $117,650
$190,550	to	$373,650	$44,672 plus 33% of the amount over $190,550
$373,650	plus		$105,095 plus 35% of the amount over $373,650

Source: Internal Revenue Code

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. 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 Credit

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 and 2009 temporarily expanded eligibility for the refundable portion of the credit.[18] In 2010, families may qualify for a $1,000 credit per qualifying child. This credit is phased out for higher income families.

Dependent Care Credit

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 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 is nonrefundable.[19] The current credit amounts were set under EGTRRA. Absent legislative action, the maximum credit amounts will fall to $2,400 for one child, and $4,800 for two children, beginning after 2010.

Earned Income Tax Credit

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. The EITC is refundable (otherwise, it could not fulfill its function) and is phased out at lower and moderate income levels.[20]

Hope and Lifetime Learning Credits (Education Credits)

The Hope credit is limited to $2,500 per student for 2009 and 2010 for expenditures on tuition (temporarily increased from $1,200 and temporarily allows expenditures related to tuition to qualify), and is available for the first four years of college (temporarily extended from the first two). The Hope credit is temporarily partially refundable for 2009 and 2010 (prior to 2009 the credit was non-refundable) and phases out for higher-income individuals. Presently, the Lifetime

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[18] See CRS Report RL34715, *The Child Tax Credit*, by Maxim Shvedov.

[19] See CRS Report RS21466, *Dependent Care: Current Tax Benefits and Legislative Issues*, by Janemarie Mulvey and Christine Scott.

[20] See CRS Report RL31768, *The Earned Income Tax Credit (EITC): An Overview*, by Christine Scott and CRS Report RS21352, *The Earned Income Tax Credit (EITC): Changes for 2009 and 2010*, by Christine Scott.

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.[21]

Alternative Minimum Tax

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, an exemption of $70,950 for joint returns and $46,700 for single and head of household returns is subtracted from this income base to obtain AMT taxable income. (These exemption levels are temporary levels for 2009, and are scheduled to revert to their prior law levels of $45,000 for joint returns and $35,750 for unmarried taxpayers in 2010.) The basic exemptions are phased out for taxpayers 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.

Even taxpayers that do not actually pay the AMT may see their regular tax liability affected by the AMT. Nonrefundable tax credits under the regular income tax are limited to the excess of regular income tax over AMT liability. Thus, a taxpayer who has a net $4,000 regular income tax liability ($5,000 tax liability less $1,000 in nonrefundable tax credits) but has an AMT liability of $4,300 will, effectively, see his regular income tax credits reduced by $300. Temporary provisions, first enacted in 1998, allow individuals to use all personal tax credits against both their regular and AMT tax liabilities.[22]

Although the AMT was originally designed to prevent high-income taxpayers from escaping what was perceived to be their fair share of the income tax burden, since the exemption amounts are not indexed to inflation, there will be a significant increase in the number of middle- to upper-middle-income taxpayers affected by the AMT in the absence of legislation to increase the exemption amounts or broader reform.[23]

The Corporate Income Tax

Table 3 contains the marginal corporate tax rates faced by U.S. firms. Smaller firms face a progressive tax schedule. 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.

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[21] See CRS Report RL32554, *An Overview of Tax Benefits for Higher Education Expenses*, by Mark P. Keightley and CRS Report RL32507, *Higher Education Tax Credits: An Economic Analysis*, by Mark P. Keightley.

[22] 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 expire after 2010.

[23] See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire, for further information.

Table 3. Corporate Tax Rate Schedule, 2010

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%
$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 the corporate tax to capital in general.

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.[24]

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 paid at a combined rate of 15.3% of wages, with 7.65% being paid by the employee and employer alike. In 2010, the Social Security part of the tax (6.2% for both employees and employers) is only levied on the first $106,800 of wages, with the cap adjusted annually for increases in average wages in the economy. The Medicare portion (2.9%) is applied to all wages.[25]

The other categories of federal payroll taxes are unemployment insurance taxes (FUTA) and employees' contributions to the federal retirement system. The federal portion of the unemployment tax is applied at a 6.2% rate to the first $7,000 of wages. However, the states apply the tax at a 5.4% rate that is credited against the federal tax so that the net federal rate is 0.8%.

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. The base is subject to graduated rates that rise from 18% to 45% as estate size increases. An unlimited marital deduction

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[24] For more information, see CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, by Jane G. Gravelle and CRS Report R41394, *Tax Treatment of Long-Term Capital Gains and Dividends and Related Provisions in the President's FY2011 Budget Proposal*, by Maxim Shvedov. For a discussion of who bears the burden of corporate (and other capital) income taxes, see CRS Report RL32517, *Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates*, by Jane G. Gravelle.

[25] See CRS Report RL32552, *Social Security: Calculation and History of Taxing Benefits*, by Christine Scott and Janemarie Mulvey. For information on policy options involving increasing the payroll tax cap see CRS Report RL33943, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, by Thomas L. Hungerford.

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 $3.5 million of an estate from tax in 2009. Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16), the estate tax is repealed in 2010. Since the provisions of EGTRRA sunset after 2010, in 2011 the estate tax is 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%).

The federal gift tax operates alongside the estate tax to prevent individuals from avoiding the estate tax by transferring property to heirs before dying. (Note that the first $13,000 of gifts from one individual to another is excluded from taxation in 2009. Thus, a married couple could each give a child $13,000 for a total gift of $26,000.) 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. 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. EGTRRA gradually reduces the top rate of the gift tax parallel to the estate tax reductions. The gift tax will remain in place after 2010; its top rate will be the top individual income tax rate applicable under EGTRRA.

The estate and gift tax occupies a minor role in the federal fiscal structure, accounting for 1.1% of gross federal tax collections in FY2008.[26] Further, because of the exemption (the unified credit) and deductions, few estates pay the tax. In 2007, 0.6% of deaths resulted in any estate tax liability. Since the exemption is higher in 2009 than in 2007, it is expected that even fewer deaths, approximately 0.2%, will result in estate tax liability in 2009.[27]

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. Some have argued, for example, that the tax inhibits the transfer of farms and small 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.[28]

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[26] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010, Analytical Perspectives* (Washington: GPO, 2009), p. 279.

[27] Urban Institute and Brookings Institute, Tax Policy Center, *Tax Topics: Estate and Gift Taxes. A*vailable at http://www.taxpolicycenter.org/taxtopics/estatetax.cfm.

[28] For more information, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Donald J. Marples and Jane G. Gravelle; CRS Report RL31061, *Estate and Gift Tax Law: Changes Under the Economic Growth and Tax Relief Reconciliation Act of 2001*, by Nonna A. Noto; and CRS Report RL33070, *Estate Taxes and Family Businesses: Economic Issues*, by Jane G. Gravelle and Steven Maguire.

Excise Taxes

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.[29] Federal excise tax revenues are small compared to other federal taxes. In FY2009, $62.5 billion in excise taxes were collected, amounting to 3% of total federal receipts.[30]

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, which made up 36.3% of all excise tax receipts in FY2008.[31] Other prominent excise taxes are those on diesel fuel, domestic air passengers, distilled spirits, beer, 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. In FY2009, 78% of excise tax receipts went into trust funds.[32] The largest amount went 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 fuel taxes were enacted for deficit reduction). 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.

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

[29] 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 Maxim Shvedov.

[30] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011, Analytical Perspectives* (Washington: GPO, 2009), p. 159. Available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/receipts.pdf.

[31] U.S. Internal Revenue Service, *Statistics of Income*, Tax Stats – Historical Table 20. Available at http://www.irs.gov/taxstats/article/0,,id=175900,00.html

[32] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011, Analytical Perspectives* (Washington: GPO, 2009), p. 191. Available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/receipts.pdf.

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.[33]

Tax Statistics

Composition and Size of the Federal Tax System

The federal tax system is composed of five major sources of tax revenue. In FY2009 the individual income tax accounted for 44% of total federal revenue, the Social Security tax for 42% of total revenue, the corporate income tax for 7% of the total, and excise taxes for approximately 3% of the total.[34] The remaining 5% was collected through the estate and gift tax, customs duties, and other taxes.

Figure 2 displays federal tax revenues as a percentage of gross domestic product (GDP). Since the 1960s, total federal revenues have fluctuated between 16% 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 FY2000, federal receipts measured as a percentage of GDP declined to a 53-year low of 16% of GDP in FY2004. Revenues as a percent of GDP were relatively low, less than 15% in FY2009, as compared to the historical average. Revenues as a percentage of GDP are expected to remain at this level in FY2010 before increasing toward the historical average.

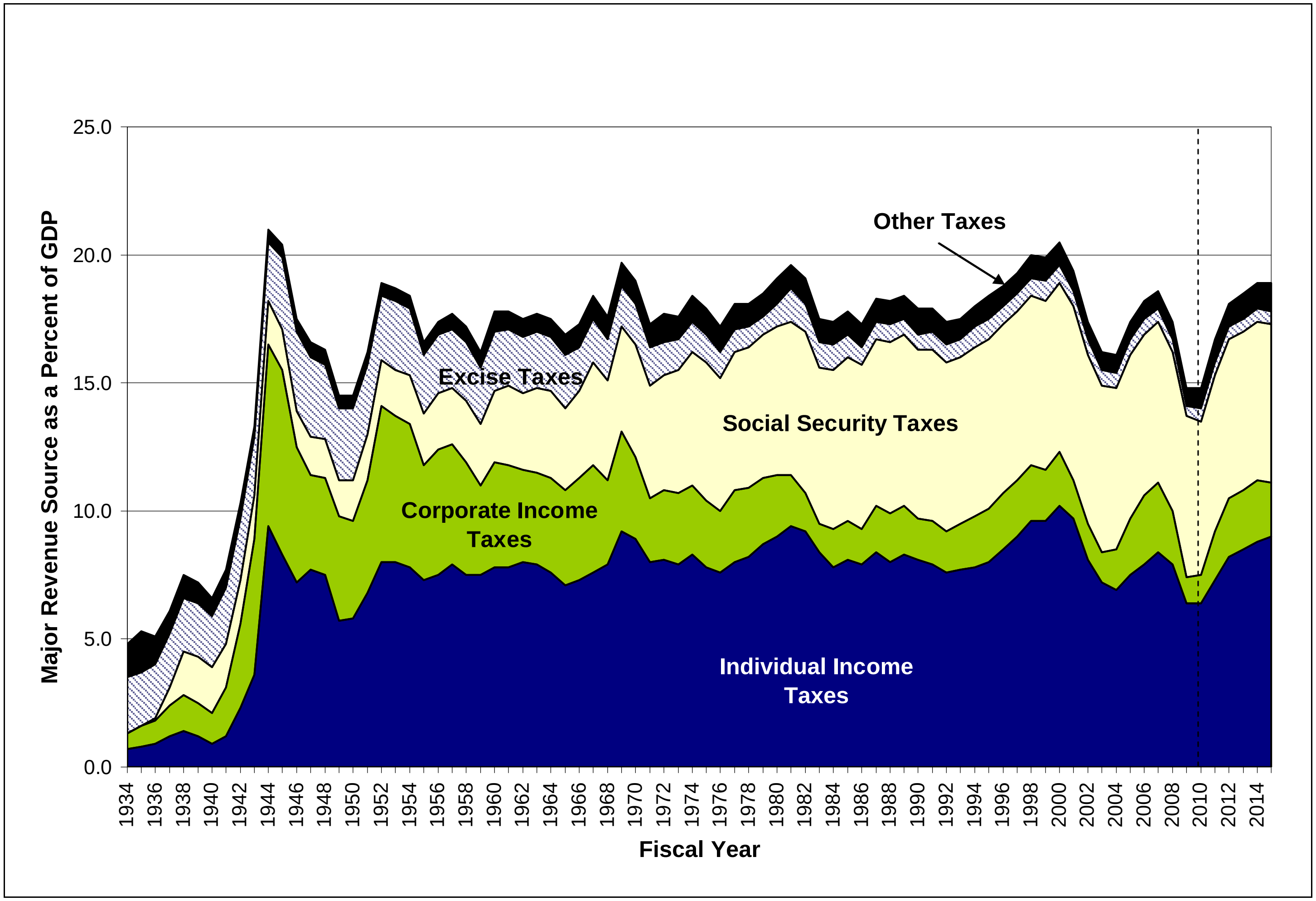
Since the mid-1940s, the individual income tax has been the most important source of federal revenue. Since 2000, however, the individual income tax receipts have decreased from more than 10% of GDP to just over 6% in 2009. Over time, the corporate income tax has fallen from the second to the third most important source of revenue. In the late 1960s, corporate taxes were replaced by Social Security taxes as the second leading revenue source. Excise taxes have also decreased in relative importance over time.

[33] 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.

[34] U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011, Historical Tables* Table 2.2 (Washington: GPO, 2010). Available at http://www.whitehouse.gov/omb/budget/Historicals.

Figure 2. Federal Revenue as a Percentage of GDP

1934 - 2015



Source: CRS calculations using data from U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2011, Historical Tables* (Washington: GPO, 2010). Table 2.3. http://www.whitehouse.gov/omb/budget/Historicals.

Notes: Revenues for 2010-2015 are projections. FY2010 is noted with the vertical dotted line.

The U.S. Fiscal Position Compared to Other Nations

The U.S. budget deficit as a percentage of GDP has increased in recent years. Budget deficits averaged 1.5% of GDP between 2000 and 2008. These deficits began increasing in 2008, reaching nearly 10% of GDP in 2009.[35]

Given congressional interest in the fiscal position of the federal government, the question of how the U.S. public sector compares to other nations often arises. Using aggregate budget data for all levels of government relative to economic output (budget aggregates as a percentage of gross domestic product, 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, Japan and the U.S. public sectors collect the least amount of revenue relative to their 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 the seven major industrialized countries in 2009. Like the U.S., other industrialized countries have experienced rising budget deficits as a result of the recent economic downturn.

Table 4. U.S. Fiscal Position Compared to Other Industrialized Nations, 2009

	Government Revenues as a % of GDP	Government Expenditures as a % of GDP	Surplus/Deficit as a % of GDP
Japan	34.4%	41.5%	-7.2%
United States	30.5	41.5	-11.0
Canada	38.7	43.8	-5.1
United Kingdom	40.2	51.4	-11.3
Germany	44.3	47.6	-3.3
Italy	46.7	51.9	-5.2
France	48.1	55.7	-7.6

Source: OECD Economic Outlook 2010, No. 87 Annex Tables. Available at http://www.oecd.org/document/61/0,3343,en_2649_34573_2483901_1_1_1_1,00.html.

Notes: U.S. data exclude the operating surplus of public enterprises.

[35] These figures are those reported in the President's FY2011 Budget, Historical Tables. These figures may differ from those reported by the OECD.

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 1997 and 2007. In relative terms, effective tax rates declined more for the lowest income quintile (effective tax rate fell by 31%) than for the highest income quintile (effective tax rate fell by 10%). As a result, higher income groups paid a larger share of federal tax liabilities in 2007 than in 1997. The positive effective tax rates for those in the lowest income quintile are driven by payroll taxes.[36]

Table 5. Average Federal Tax Rates for All Households: 1997 and 2007

Income category	Effective Tax Rate 1997	Share of Tax Liabilities 1997	Effective Tax Rate 2007	Share of Tax Liabilities 2007
Lowest quintile	5.8%	1.1%	4.0%	0.8%
Second quintile	13.6	5.4	10.6	4.4
Middle quintile	17.4	10.8	14.3	9.2
Fourth quintile	20.5	18.3	17.4	16.5
Highest quintile	28.0	64.2	25.1	68.9
Top 10%	29.9	49.3	26.7	55.0
Top 5%	31.6	38.3	27.9	44.3
Top 1%	34.9	22.7	29.5	28.1
All quintiles	22.9	100.0	20.4	100.0

Source: U.S. Congress, Congressional Budget Office, *Average Federal Taxes by Income Group* (June 2010). Available at http://www.cbo.gov/publications/collections/collections.cfm?collect=13.

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,

[36] For further analysis see CRS Report RL32693, *Distribution of the Tax Burden Across Individuals: An Overview*, by Jane G. Gravelle and Maxim Shvedov.

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 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 10 individual tax expenditures. These 10 expenditure categories account for 70% of total tax expenditures on individuals. The largest tax expenditure is allowing dividends and long-term capital gains to be taxed at reduced rates, resulting in a loss of revenue of $150.2 billion for 2008. Excluding employer-provided health care from tax results in a loss of tax revenue of $116.8 billion for 2008.

Table 6. 10 Largest Tax Expenditures for Individuals, 2008

Billions of Dollars

Tax Expenditure	Amount
Reduced rates of tax on dividends and long-term capital gains	150.2
Exclusion of contributions and earnings to retirement plans	119.2
Exclusion of employer contributions for health care	116.8
Recovery rebate	95.0
Deduction for mortgage interest	67.0
Earned income tax credit	48.6
Deduction of state and local taxes	48.0
Tax credit for children under age 17	47.6
Deduction for charitable contributions	44.3
Exclusion of Medicare benefits	41.0

Source: U.S. Congress, Senate, Committee on the Budget, *Tax Expenditures – Compendium of Background Material on Individual Provisions,* December 2008, p.7; updated biennially by CRS with revenue data provided by the Joint Committee on Taxation.

Table 7 reports estimated total tax expenditures for individuals and corporations for FY2008 through FY2012. While it is not precisely correct to add up all tax expenditures, which are estimated individually and have some interactive effects, these totals provide some notion of the magnitude of these provisions. In FY2008, individual income taxes yielded $1,145.7 billion.[37] Thus, tax expenditures are large relative to total receipts.

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[37] Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010, Analytical Perspectives* (continued...)

Table 7. Sum of Tax Expenditures: FY2008-FY2012

Billions of Dollars

Fiscal Year	Individuals	Corporations	Total
2008	1,014.6	118.1	1,222.7
2009	1,047.3	117.0	1,164.3
2010	1,060.6	99.4	1,160.0
2011	1,106.0	105.9	1,211.9
2012	1,166.2	116.0	1,282.2

Source: U.S. Congress, Senate, Committee on the Budget, *Tax Expenditures – Compendium of Background Material on Individual Provisions,* December 2008, p.13; updated biennially by CRS with revenue data provided by the Joint Committee on Taxation.

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.

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. The tax rate on capital gains taxes was reduced in 1997. 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 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) 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.

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.

(...continued)

(Washington: GPO, 2009), p. 241.

Arguments have also been made that cutting capital gains taxes could increase savings and stimulate 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.

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.[38]

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). This can be viewed as a 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 tax rate schedules.[39] 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 $16,181.25 each (or $32,362.50 jointly). 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 $33,043.50. The marriage tax penalty for this couple would be $681.

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

[38] 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.

[39] 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.

a federal income tax liability of $21,709.25. If that individual took a spouse who had no earnings, the tax liability for a couple with $100,000 in taxable income is $17,362.50. Hence, this couple would have a marriage tax bonus of $4,346.75.

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). 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.[40]

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 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 right or wrong 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% (the top marginal tax rate on long-term capital gains), 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

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

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.[41] 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.*

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.

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.[42]

[41] The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) contains provisions extending bonus depreciation allowances for certain property. ARRA also contains provisions allowing taxpayers with relatively small levels of investment to expense qualified property. See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle and CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther, for more information.

[42] For more information see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to* (continued...)

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

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(...continued)

Legislative Changes, by Mark P. Keightley.

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.[43]

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

Appendix. 2009 PEP and Pease Phaseout Limits

While PEP and Pease limits do not apply for 2010, limits were in place in 2009 and are expected to return again in 2011. **Table A-1** shows the personal exemption phaseout range for 2009. For married couples filing jointly, the personal exemption amount is reduced starting for individuals with an AGI of $250,000. By the time the married couple filing jointly earns $372,000 the value of the personal exemption is zero.

Table A-1. Phase Out of Personal Exemption

2009

Filing Status	Phase Out Starts	Phase Out Ends
Married Filing Jointly	$250,000	$372,700
Single Individual	$166,800	$289,300
Head of Household	$208,500	$331,000

Source: Internal Revenue Code

Notes: For married couples filing separately the phase out range is half the value listed for married couples filing jointly.

In 2009, itemized deductions began to phase out for taxpayers with a filing status of married filing jointly, single individuals, and heads of household at $166,800 and $83,400 for married individuals filing separately. Calculating the reduction is a three-step process. First, the reduction is calculated as the lesser of (1) 3% of AGI in excess of the threshold amount, or (2) 80% of the total amount of otherwise allowable itemized deductions.[44] Second, the amount of the reduction is reduced by two-thirds. Third, the amount from the second step is subtracted from the individual's otherwise allowable itemized deductions to calculate actual allowable itemized deductions.

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[44] For the purposes of calculating 80% of itemized deductions, deductions for medical expenses, investment interest, casualty and theft losses, and wagering losses are excluded.