OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2013

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee Staff"), provides a summary of the present-law Federal tax system as in effect for 2013.

The current Federal tax system has four main elements: (1) an income tax on individuals and corporations (which consists of both a "regular" income tax and an alternative minimum tax); (2) payroll taxes on wages (and corresponding taxes on self-employment income) to finance certain social insurance programs; (3) estate, gift, and generation-skipping taxes, and (4) excise taxes on selected goods and services. This document provides a broad overview of each of these elements.[2]

A number of aspects of the Federal tax laws are subject to change over time. For example, some dollar amounts and income thresholds are indexed for inflation. The standard deduction, tax rate brackets, and the annual gift tax exclusion are examples of amounts that are indexed for inflation. In general, the Internal Revenue Service adjusts these numbers annually and publishes the inflation-adjusted amounts in effect for a tax year prior to the beginning of that year. Where applicable, this document generally includes dollar amounts in effect for 2013 and notes whether dollar amounts are indexed for inflation. A number of the inflation indexed 2013 values have not yet been published by the Internal Revenue Service. In these cases, the referenced figures were calculated by the Joint Committee Staff in accordance with the governing statute and published Consumer Price Index values.

In addition, a number of the provisions in the Federal tax laws have been enacted on a temporary basis or have parameters that vary by statute from year to year. For simplicity, this document describes the Federal tax laws in effect for 2013 and generally does not include references to provisions as they may be in effect for future years or to termination dates for expiring provisions.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2013* (JCX-2-13R), January 8, 2013.

[2] If certain requirements are met, certain entities or organizations are exempt from Federal income tax. A description of such organizations is beyond the scope of this document.

I. SUMMARY OF PRESENT-LAW FEDERAL TAX SYSTEM

A. Individual Income Tax

In general

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[3] Taxable income equals the taxpayer's total gross income less certain exclusions, exemptions, and deductions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Under the Internal Revenue Code of 1986 (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[4] trusts or estates.[5] Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, certain education-related expenses, and alimony payments.

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[3] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

[4] In general, partnerships and S corporations are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed to the owners at the individual level. A business entity organized as a limited liability company ("LLC") under applicable State law generally is treated as a partnership for Federal income tax purposes.

[5] In general, estates and most trusts pay tax on income at the entity level, unless the income is distributed or required to be distributed under governing law or under the terms of the governing instrument. Such entities determine their tax liability using a special tax rate schedule and are subject to the alternative minimum tax. Certain trusts, however, do not pay Federal income tax at the trust level. For example, certain trusts that distribute all income currently to beneficiaries are treated as pass-through or conduit entities (similar to a partnership). Other trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

Taxable income

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2013, the amount deductible for each personal exemption is $3,900. This amount is indexed annually for inflation. Additionally, the personal exemption phase-out ("PEP") reduces a taxpayer's personal exemptions by two percent for each $2,500 ($1,250 for married filing separately), or fraction thereof, by which the taxpayer's AGI exceeds $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately).[6] These threshold amounts are indexed for inflation.

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2013, the amount of the standard deduction is $6,100 for single individuals and married individuals filing separate returns, $8,950 for heads of households, and $12,200 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[7] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes (or, in lieu of income**,** sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). Additionally, the total amount of itemized deductions allowed is reduced by $0.03 for each dollar of AGI in excess of $250,000 (single), $275,000 (head-of-household), $300,000 (married filing jointly) and $150,000 (married filing separately).[8] These threshold amounts are indexed for inflation.

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[6] A taxpayer thus has all personal exemptions completely phased out at incomes of $372, 501 (single), $397,501 (head-of-household), $422,501 (married filing jointly) and $211,251 (married filing separately).

[7] For 2013, the additional amount is $1,200 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,500. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2013) of $2,400 or $3,000, as applicable.

[8] This rule is sometimes referred to as the "Pease limitation." A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.

Table 1.–2013 Standard Deduction and Personal Exemption Values

Standard Deduction	
Married Filing Jointly	$12,200
Head of Household	$8,950
Single and Married Filing Separately	$6,100
Personal Exemptions	$3,900

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax, or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains; those rates apply for both the regular tax and the alternative minimum tax.

Regular tax liability

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2013, the regular individual income tax rate schedules are as follows:

Table 2.–Federal Individual Income Tax Rates for 2013

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000
Heads of Households	
Not over $12,750	10% of the taxable income
Over $12,750 but not over $48,600	$1,275 plus 15% of the excess over $12,750
Over $48,600 but not over $125,450	$6,652.50 plus 25% of the excess over $48,600
Over $125,450 but not over $203,150	$25,865 plus 28% of the excess over $125,450
Over $203,150 but not over $398,350	$47,621 plus 33% of the excess over $203,150
Over $398,350 but not over $425,000	$112,037 plus 35% of the excess over $398,350
Over $425,000	$121,364.50 plus 39.6% of the excess over $425,000
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $17,850	10% of the taxable income
Over $17,850 but not over $72,500	$1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of the excess over $146,400

Over $223,050 but not over $398,350	$49,919.50 plus 33% of the excess over $223,050
Over $398,350 but not over $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000
Married Individuals Filing Separate Returns	
Not over $8,925	10% of the taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $73,200	$4,991.25 plus 25% of the excess over $36,250
Over $73,200 but not over $111,525	$14,228.75 plus 28% of the excess over $73,200
Over $111,525 but not over $199,175	$24,959.75 plus 33% of the excess over $111,525
Over $199,175 but not over $225,000	$53,884.25 plus 35% of the excess over $199,175
Over $225,000	$62,923 plus 39.6% of the excess over $225,000

An individual's marginal tax rate may be reduced by the allowance of a deduction equal to a percentage of income from certain domestic manufacturing activities.[9]

<u>Alternative minimum tax liability</u>

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For 2013, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $179,500 ($89,750 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The breakpoint between the 26-percent and 28-percent bracket is indexed for inflation. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts for 2013 are: (1) $80,800 in the case of married individuals filing a joint return and surviving spouses; (2) $51,900 in the case of other unmarried individuals; (3) $40,400 in the case of married individuals filing separate returns; and

[9] This deduction is described in more detail below in the summary of the tax rules applicable to corporations.

(4) $23,100 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $153,900 in the case of married individuals filing a joint return and surviving spouses, (2) $115,400 in the case of other unmarried individuals, and (3) $76,950 in the case of married individuals filing separate returns or an estate or a trust. These amounts are indexed for inflation.

Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI.

<u>Special capital gains and dividends rates</u>

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A maximum rate applies to capital gains and dividends. For 2013, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6 rate. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise taxed at rates greater than 15-percent but less than 39.6 percent is taxed at a 15 percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Dividends are generally taxed at the same rate as capital gains.

<u>Credits against tax</u>

An individual may reduce his or her tax liability by any available tax credits. In some instances, a permissible credit is "refundable", *i.e.*, it may result in a refund in excess of any credits for withheld taxes or estimated tax payments available to the individual. Two major credits are the child tax credit and the earned income credit.

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000.[10] The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[11] (the additional child tax credit) equal to 15 percent of earned income in excess of $3,000.[12]

A refundable earned income tax credit ("EITC") is available to low-income workers who satisfy certain requirements. The amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, two, more than two, or no qualifying children. In 2013, the maximum EITC is $6,044 for taxpayers with more than two qualifying children, $5,372 for taxpayers with two qualifying children, $3,250 for taxpayers with one qualifying child, and $487 for taxpayers with no qualifying children. The credit amount begins to phaseout at an income level of $17,530 ($7,970 for taxpayers with no qualifying children). The phaseout percentages are 15.98 for taxpayers with one qualifying child, 17.68 for two or more qualifying children, and 7.65 for no qualifying children.

Tax credits are also allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain education expenditures, certain child care expenditures, and for certain elderly or disabled individuals. Credits allowed against the regular tax are allowed against the alternative minimum tax.

<u>Tax on net investment income</u>

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.[13] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.[14]

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[10] A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

[11] The refundable credit may not exceed the maximum credit per child of $1,000.

[12] Families with three or more children may determine the additional child tax credit using an alternative formula, if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit.

[13] The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Code (relating to income taxes).

[14] These amounts are not indexed for inflation.

Net investment income is the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities, over (2) deductions properly allocable to such gross income or net gain.

For purposes of this tax, modified adjusted gross income is AGI increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.[15]

[15] The tax does not apply to a nonresident alien or to a trust in which all the unexpired interests are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

B. Corporate Income Tax

Taxable income

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.[16]

The taxable income of a corporation generally is comprised of gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year may be carried back two years or carried forward 20 years. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.

The Code also specifies certain expenditures that may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[17] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, as well as fines, penalties, bribes, kickbacks and illegal payments.

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[16] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

Under subchapter S of the Code, a qualified small business corporation may elect not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders.

[17] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.

Tax liability

A corporation's regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income.

Table 3.–Federal Corporate Income Tax Rates

If taxable income is:	Then the income tax rate is:
$0-$50,000	15 percent of taxable income
$50,001-$75,000	25 percent of taxable income
$75,001-$10,000,000	34 percent of taxable income
Over $10,000,000	35 percent of taxable income

The first two graduated rates described above are phased out for corporations with taxable income between $100,000 and $335,000. As a result, a corporation with taxable income between $335,000 and $10,000,000 effectively is subject to a flat tax rate of 34 percent. Also, the application of the 34-percent rate is gradually phased out for corporations with taxable income between $15,000,000 and $18,333,333, such that a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the Code.[18]

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for biofuels and renewable power, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the research credit, the low-income housing credit

[18] With a nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate of 0.91 * 35, or 31.85 percent. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

(applicable to investment in certain low-income housing projects), the empowerment zone employment credit (applicable to wages paid to certain residents of, or employees in, empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals). Unused credits generally may be carried back one year and carried forward twenty years.

A foreign tax credit is available, subject to limitations, for certain foreign income taxes paid or accrued. Foreign income taxes limited in a tax year may be carried back one year or forward ten years.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Minimum tax

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[19] Credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

[19] The exemption amount is phased out for corporations with income above certain threshold, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accumulated earnings and profits.[20] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[21] Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income.

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[20] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

[21] This double taxation is mitigated by a reduced tax rate generally applicable to dividend income of individuals.

C. Estate, Gift and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $14,000 (for 2013) or less per donor and per donee generally are not subject to tax.

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[22] The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and effective exemption amount apply to an individual's cumulative taxable gifts and bequests. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 40 percent on cumulative taxable transfers over $1,000,000. A unified credit of $2,045,800 (for 2013) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of $5.25 million[23] (for 2013) in cumulative taxable transfers from the gift tax or the estate tax. The unified credit thus generally also has the effect of rendering the marginal rates below 40 percent inapplicable. Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is normally imposed on such transfers. This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than

[22] In addition to interests in property owned by the decedent at the time of death, the Federal estate tax also is imposed on (1) life insurance that was either payable to the decedent's estate or in which the decedent had an incident of ownership at death, (2) property over which the decedent had a general power of appointment at death, (3) annuities purchased by the decedent or his employer that were payable to the decedent before death, (4) property held by the decedents as joint tenants, (5) property transferred by the decedent before death in which the decedent retained a life estate or over which the decedent had the power to designate who will possess or enjoy the property, (6) property revocably transferred by the decedent before death, and (7) certain transfers taking effect at the death of the decedent.

[23] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, establishes an exemption amount of $5 million for 2010 and 2011 and indexes this amount for inflation for years after 2011. The American Taxpayer Relief Act of 2012 makes permanent the exemption provisions of the 2010 Act.

one generation below that of the transferor. For 2013, the generation-skipping transfer tax is imposed at a flat rate of 40 percent on generation-skipping transfers in excess of $5.25 million.

D. Social Insurance Taxes

In general

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($113,700 in 2013); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages.[24] In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer.

As a parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.[25]

In addition to FICA taxes, employers are subject to a Federal unemployment insurance payroll tax equal to 6 percent of the total wages of each employee (up to $7,000) on covered employment. Employers are eligible for a Federal credit equal to 5.4 percent for State unemployment taxes, yielding a 0.6 percent effective tax rate. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

Additional hospital insurance tax on certain high-income individuals

For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a specific threshold amount.[26] However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return,

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[24] Since 1994, the HI payroll tax has not been subject to a wage cap.

[25] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

[26] Sec. 3101(b), as amended by the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148.

$125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual, head of household or surviving spouse).[27]

The same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount.[28]

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[27] These threshold amounts are not indexed for inflation.

[28] Sec. 1402(b).

E. Major Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services. Generally, excise taxes are taxes imposed on a per unit or ad valorem (*i.e.*, percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous products (*e.g.*, the tax on ozone depleting chemicals, and a tax on crude oil and certain petroleum products to fund the Oil Spill Liability Trust Fund), coal, certain telephone communications (*e.g.* local service), certain wagers, certain medical devices, indoor tanning services, and vehicles lacking in fuel efficiency.[29] Additionally, an annual fee is imposed on certain manufacturers and importers of branded prescription drugs pursuant to specified government programs. The largest excise taxes in terms of revenue (for fiscal year 2010) are those for gasoline motor fuel ($25.1 billion), domestic cigarettes ($14.9 billion), diesel motor fuel ($8.6 billion), and domestic air tickets ($7.6 billion).[30]

Revenues from certain Federal excise taxes are dedicated to trust funds (*e.g.*, the Highway Trust Fund) for designated expenditure programs, and revenues from other excise taxes (*e.g.*, alcoholic beverages) go to the General Fund for general purpose expenditures.

Table 4.–2013 Federal Excise Tax Rates for Selected Taxed Products or Services

Gasoline Motor Fuel	18.3 cents per gallon
Diesel Motor Fuel	24.3 cents per gallon
Domestic Cigarettes	$50.33 per thousand small cigarettes; $105.69 per thousand large cigarettes.
Domestic Air Tickets	7.5 percent of fare, plus $3.90 (2013) per domestic flight segment generally.

[29] See Joint Committee on Taxation, *Present Law and Background Information on Federal Excise Taxes* (JCX-1-11), January 2011, for a description the various Federal excise taxes.

[30] Internal Revenue Service, *Statistics of Income Bulletin*, Historical Table 20, "Federal Excise Taxes Reported to or Collected By the Internal Revenue Service, Alcohol and Tobacco Tax and Trade Bureau, and Customs Service, By Type of Excise Tax, Fiscal Years 1999-2010," http://www.irs.gov/pub/irs-soi/histab20.xls (2011).