

**OVERVIEW OF THE FEDERAL TAX SYSTEM
AS IN EFFECT FOR 2008**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on April 15, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



April 14, 2008
JCX-32-08

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for April 15, 2008, entitled “Tax: Fundamentals in Advance of Reform.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a summary of the present-law Federal tax system as in effect for 2008.

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); (3) estate, gift, and generation-skipping transfer 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 2008 and notes whether dollar amounts are indexed for inflation.

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 example, the Tax Relief and Health Care Act of 2006 extended a number of expired or soon to expire provisions on a temporary basis. In addition, many of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 initially were to expire at the end of 2010; some provisions of that Act have been modified subsequently or made permanent. For simplicity, this document describes the Federal tax laws in effect in 2008 and generally does not include references to provisions as they may be in effect for future years or to termination dates for expiring provisions. A list of expiring tax provisions may be found in Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2007-2020*, (JCX-1-08), January 11, 2008.

¹ This document may be cited as follows: Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2008* (JCX-32-08), April 14, 2008.

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, among other things, 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, among other things, trade or business expenses, capital losses, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, and alimony payments.

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.

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

In order 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 2008, the amount deductible for each personal exemption is \$3,500. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds, which are indexed annually for inflation. The applicable thresholds for 2008 are \$159,950 for single individuals, \$239,950 for married individuals filing a joint return and surviving spouses, \$199,950 for heads of households, and \$119,975 for married individuals filing separate returns.

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 2008, the amount of the standard deduction is \$5,450 for single individuals and married individuals filing separate returns, \$8,000 for heads of households, and \$10,900 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.⁶ 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), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 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). The total amount of most itemized deductions allowed is reduced for taxpayers with incomes over a certain threshold amount, which is indexed annually for inflation. The threshold amount for 2008 is \$159,950 (\$79,975 for married individuals filing separate returns).

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.

⁶ For 2008, the additional amount is \$1,050 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,350. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2008) of \$2,100 or \$2,700, as applicable.

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 2008, the regular individual income tax rate schedules are as follows:

Table 1.—Federal Individual Income Tax Rates for 2008

If taxable income is:	Then income tax equals:
<i>Single Individuals</i>	
Not over \$8,025	10% of the taxable income
Over \$8,025 but not over \$32,550	\$802.50 plus 15% of the excess over \$8,025
Over \$32,550 but not over \$78,850	\$4,481.25 plus 25% of the excess over \$32,550
Over \$78,850 but not over \$164,550	\$16,056.25 plus 28% of the excess over \$78,850
Over \$164,550 but not over \$357,700	\$40,052.25 plus 33% of the excess over \$164,550
Over \$357,700	\$103,791.75 plus 35% of the excess over \$357,700
<i>Heads of Households</i>	
Not over \$11,450	10% of the taxable income
Over \$11,450 but not over \$43,650	\$1,145 plus 15% of the excess over \$11,450
Over \$43,650 but not over \$112,650	\$5,975 plus 25% of the excess over \$43,650
Over \$112,650 but not over \$182,400	\$23,225 plus 28% of the excess over \$112,650
Over \$182,400 but not over \$357,700	\$42,755 plus 33% of the excess over \$182,400
Over \$357,700	\$100,604 plus 35% of the excess over \$357,700
<i>Married Individuals Filing Joint Returns and Surviving Spouses</i>	
Not over \$16,050	10% of the taxable income
Over \$16,050 but not over \$65,100	\$1,605 plus 15% of the excess over \$16,050
Over \$65,100 but not over \$131,450	\$8,962.50 plus 25% of the excess over \$65,100
Over \$131,450 but not over \$200,300	\$25,550 plus 28% of the excess over \$131,450
Over \$200,300 but not over \$357,700	\$44,828 plus 33% of the excess over \$200,300
Over \$357,700	\$96,770 plus 35% of the excess over \$357,700

Married Individuals Filing Separate Returns

Not over \$8,025	10% of the taxable income
Over \$8,025 but not over \$32,550	\$802.50 plus 15% of the excess over \$8,025
Over \$32,550 but not over \$65,725	\$4,481.25 plus 25% of the excess over \$32,550
Over \$65,725 but not over \$100,150	\$12,775 plus 28% of the excess over \$65,725
Over \$100,150 but not over \$178,850	\$22,414 plus 33% of the excess over \$100,150
Over \$178,850	\$48,385 plus 35% of the excess over \$178,850

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.⁷

Alternative minimum tax liability

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. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 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 maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's "tax preference items" and adjusted by redetermining 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 are: (1) \$45,000 (\$66,250 in taxable years beginning in 2007) in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 (\$44,350 in taxable years beginning in 2007) in the case of other unmarried individuals; (3) \$22,500 (\$33,125 in taxable years beginning in 2007) in the case of married individuals filing separate returns; and (4) \$22,500 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) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

⁷ This deduction is described in more detail below in the summary of the tax rules applicable to corporations.

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 items, are not allowed to reduce alternative minimum taxable income.

Special capital gains and dividends rates

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 up to \$3,000 of capital losses from ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A separate rate structure applies to capital gains and dividends. Under present law, for 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Certain qualified dividends generally are taxed at the same rate as capital gains.

Credits against tax

The individual may reduce his or her tax liability by any available tax credits. Tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain education expenditures, certain child care expenditures, and with respect to children under 17 and for certain elderly or disabled individuals. In addition, 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, more than one, or no qualifying children. In 2008, the maximum EITC is \$4,824 for taxpayers with more than one qualifying child, \$2,917 for taxpayers with one qualifying child, and \$438 for taxpayers with no qualifying children. Credits allowed against the regular tax are not uniformly allowed against the alternative minimum tax.

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.⁸

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 typically may be carried back two years or carried forward 20 years and allowed as a deduction in another taxable year. 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 typically may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,⁹ 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, and fines, penalties, bribes, kickbacks and illegal payments.

⁸ 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.

A qualified small business corporation may elect, under subchapter S of the Code, 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. Special rules (not discussed herein) also apply to a corporation that has elected to be taxable as a regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).

⁹ 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 2.—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. For taxable years beginning in 2008 and 2009, the deduction is equal to six percent of the income from manufacturing, construction, and certain other activities specified in the Code. Thereafter, the deduction is increased to nine percent.¹⁰

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include, among other things, credits for producing fuels

¹⁰ At the fully phased-in 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.

from nonconventional sources, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the alcohol fuels credit (applicable to production of certain alcohol fuels), the research credit (which expired on December 31, 2007), the low-income housing credit (applicable to investment in certain low-income housing projects), the enhanced oil recovery credit (applicable to the recovery of certain difficult-to-extract oil reserves), 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). The credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

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. For purposes of calculating tax liability, corporations filing a consolidated return generally are treated as divisions of a single corporation; thus, the losses (and credits) of one corporation generally 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 which 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.¹¹ 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 preference items 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, net operating losses 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" exceeds 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.

¹¹ The exemption amount is phased out for corporations with income above certain thresholds, 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.¹² 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.¹³ 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 15 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 are designed to ensure that both a corporate tax and a shareholder tax are effectively imposed on corporate earnings.

¹² 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 common stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

¹³ This double taxation is mitigated by a reduced maximum tax rate of 15 percent generally applicable to dividend income of individuals.

C. Estate, Gift, and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on transfers 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 \$12,000 (for 2008) or less per donor per donee generally are not subject to tax.

An estate tax 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.¹⁴ 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 began as separate taxes but were partially unified in 1976 so that a single graduated rate schedule and a single exemption applied to an individual's cumulative taxable gifts and bequests. A single, common rate schedule still applies to gifts and bequests, but changes in 2001 partially decoupled the estate and gift taxes, such that the estate and gift tax "unified credit" now results in a smaller exemption for gift tax purposes than for estate tax purposes. For 2008, a unified credit of \$345,800 is available with respect to taxable transfers by gift, and a unified credit of \$780,800 is available with respect to taxable transfers at death. These credits effectively exempt a total of \$1 million in cumulative taxable inter vivos gifts from gift tax and \$2 million in cumulative taxable transfers (by gift or by bequest) from the estate tax. Tax rates on gifts in excess of the \$1 million gift tax effective exemption amount begin at 41 percent. The maximum estate and gift tax rate for 2008 is 45 percent.¹⁵

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

¹⁴ 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 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.

¹⁵ The unified credit against estate tax is scheduled to increase to \$1,455,800 in 2009 (which corresponds to an effective estate tax exemption of \$3.5 million). As a result of these changes, in 2008 and 2009 the estate tax exclusion amount equals or exceeds the level at which the highest tax rate begins. Effectively, the highest rate is the only estate tax rate. The unified credit against gift tax will remain at \$345,800 through 2009 (and the effective exemption will therefore remain at \$1 million).

transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. For 2008, the generation-skipping transfer tax is imposed at a flat rate of 45 percent on generation-skipping transfers in excess of \$2 million.

The estate and generation-skipping transfer taxes are scheduled to be repealed in 2010 but reinstated in 2011 (under the rules scheduled to be in effect before the 2001 changes).

D. Employment Taxes

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 (\$102,000 in 2008); and (2) the Medicare hospital insurance (“HI”) tax amount equal to 1.45 percent of covered wages.¹⁶ 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.¹⁷

In addition to FICA taxes, employers are subject to a Federal unemployment insurance payroll tax equal to 6.2 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. The current 0.8 percent effective tax rate is composed of a permanent tax rate of 0.6 percent and a temporary surtax rate of 0.2. The temporary surtax expires on December 31, 2008. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

¹⁶ Since 1994, the HI payroll tax has not been subject to a wage cap.

¹⁷ 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.

E. Major Excise Taxes

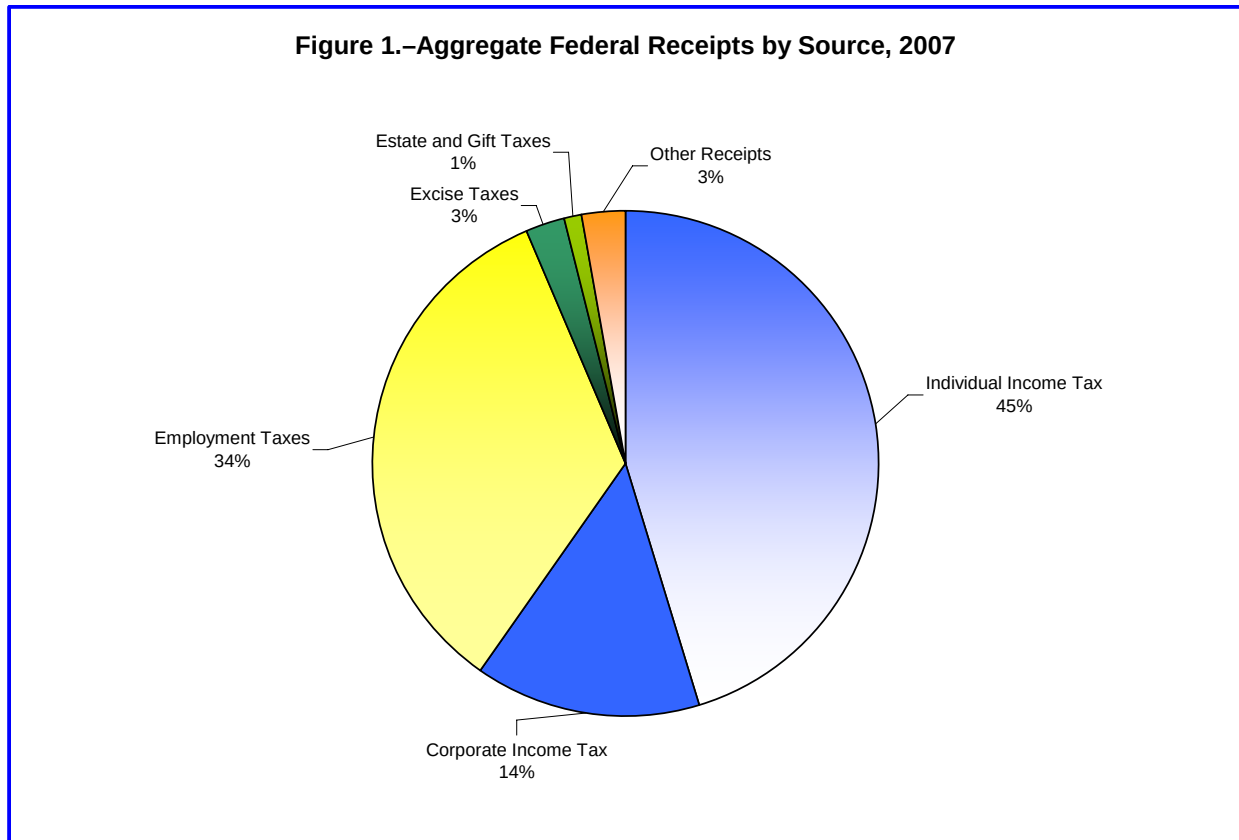
The Federal tax system imposes excise taxes on selected goods and services. Generally, excise taxes are taxes imposed on a per unit or ad valorem (i.e., percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous activities and products, coal, telephone communications, certain wagers, and vehicles lacking in fuel efficiency.¹⁸ The largest excise taxes in terms of revenue (for fiscal year 2006) are those for gasoline motor fuels (\$25.5 billion), diesel motor fuel (\$9.6 billion), domestic air ticket taxes (\$7.7 billion) and domestic cigarettes (\$7.1 billion).

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.

¹⁸ See, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, (JCS-3-01), April 2001, pp. 478-516 for a detailed description of the various Federal excise taxes.

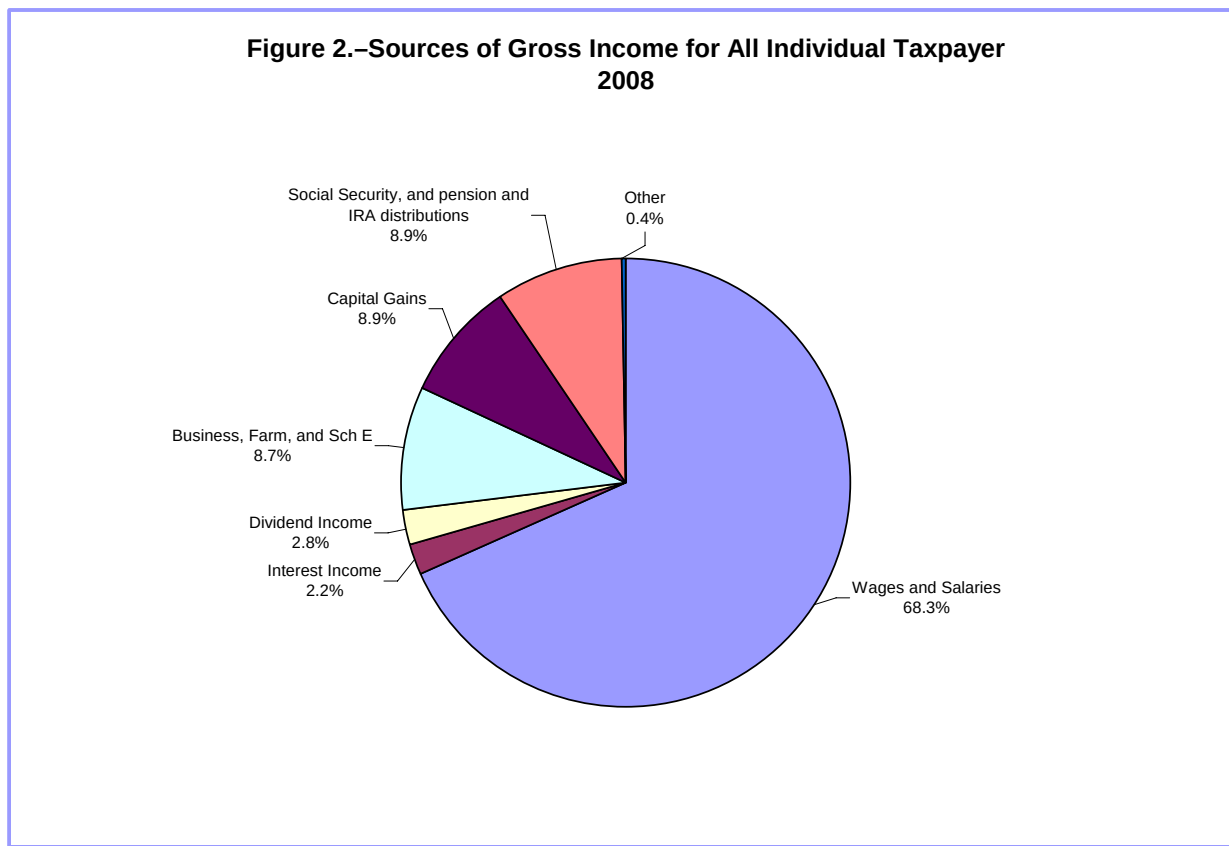
II. RECEIPTS DATA

This section provides recent data on characteristics of the Federal tax system. Figure 1 is a pie chart showing the distribution of Federal tax receipts by source for 2007. The individual income tax represents nearly half of all Federal receipts, while employment taxes are the next largest component at more than one-third. The corporate income tax yields approximately 14 percent of aggregate receipts. Excise taxes, estate and gift taxes, and other receipts represent the balance, with relatively small shares of total receipts.



The individual income tax

Figure 2 shows the JCT staff's estimated 2008 distribution of gross income by source for all individual taxpayers (includes data from taxable returns and those with no tax liability).¹⁹ The largest category by far is wage and salary income (68.3 percent of gross income) followed by Social Security, and or change chart pension and IRA distributions (8.9 percent), income from realized capital gains (8.9 percent), and business, farm and schedule E income (8.7 percent).



¹⁹ Figure 2 shows gross income as reported on tax returns. For example, only the portion of Social Security earnings includable in gross income for tax purposes and not the full amount of benefits is represented here.

Not all of a taxpayer's income is subject to tax. Certain items are excluded from the determination of a taxpayer's gross income, such as pension contributions. Other items are deductible from a taxpayer's gross income to determine taxable income, such as mortgage interest payments. After determining taxable income and tax liability, a taxpayer may be allowed a credit based on certain characteristics, such as having a child under age 17, to offset this tax liability. Such exclusions, deductions, and credits are termed "tax expenditures."²⁰ Table 3 provides estimates of some of the larger tax expenditures applicable to individuals for the fiscal years 2007-2011.

**Table 3.—Selected Tax Expenditure Estimates for Individuals,
Fiscal Years 2007-2011**

[Billions of Dollars]

	2007	2008	2009	2010	2011	2007-11
Net exclusion of pension contributions and earnings (employer plans, individual retirement accounts, and Keogh plans)	132.9	140.6	149.5	158.2	174.8	755.9
Reduced rates of tax on dividends and long-term capital gains	127.1	127.9	131.0	146.6	99.3	631.9
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums ¹	105.7	116.5	126.0	135.6	144.7	628.5
Deduction for mortgage interest on owner-occupied residences	73.7	79.9	85.2	90.5	101.0	430.2
Exclusion of capital gains at death	51.9	53.7	57.5	60.1	56.7	279.9
Earned income credit (EIC) ²	44.7	46.5	47.9	48.9	46.9	234.9
Tax credit for children under age 17 ²	45.0	44.8	44.8	44.8	21.9	201.3
Exclusion of benefits provided under cafeteria plans ³	30.0	33.6	36.8	40.3	44.8	185.5
Deduction for charitable contributions, other than for education and health	32.0	33.6	35.3	37.1	39.6	177.6
Deduction of nonbusiness State and local government income, sales taxes and personal property taxes ⁴	33.9	29.6	29.6	30.0	52.0	175.1

¹ Estimate includes employer-provided health insurance purchased through cafeteria plans.

² Tax expenditure estimate includes refundable amounts, amounts used to offset income taxes, and amounts used to offset other taxes. The amount of refundable child tax credit and earned income tax credit used to offset taxes other than income tax or paid out as refunds is :\$58.1 billion in 2007, \$59.6 billion in 2008, \$61.0 billion in 2009, \$62.0 billion in 2010, and \$48.9 billion in 2011.

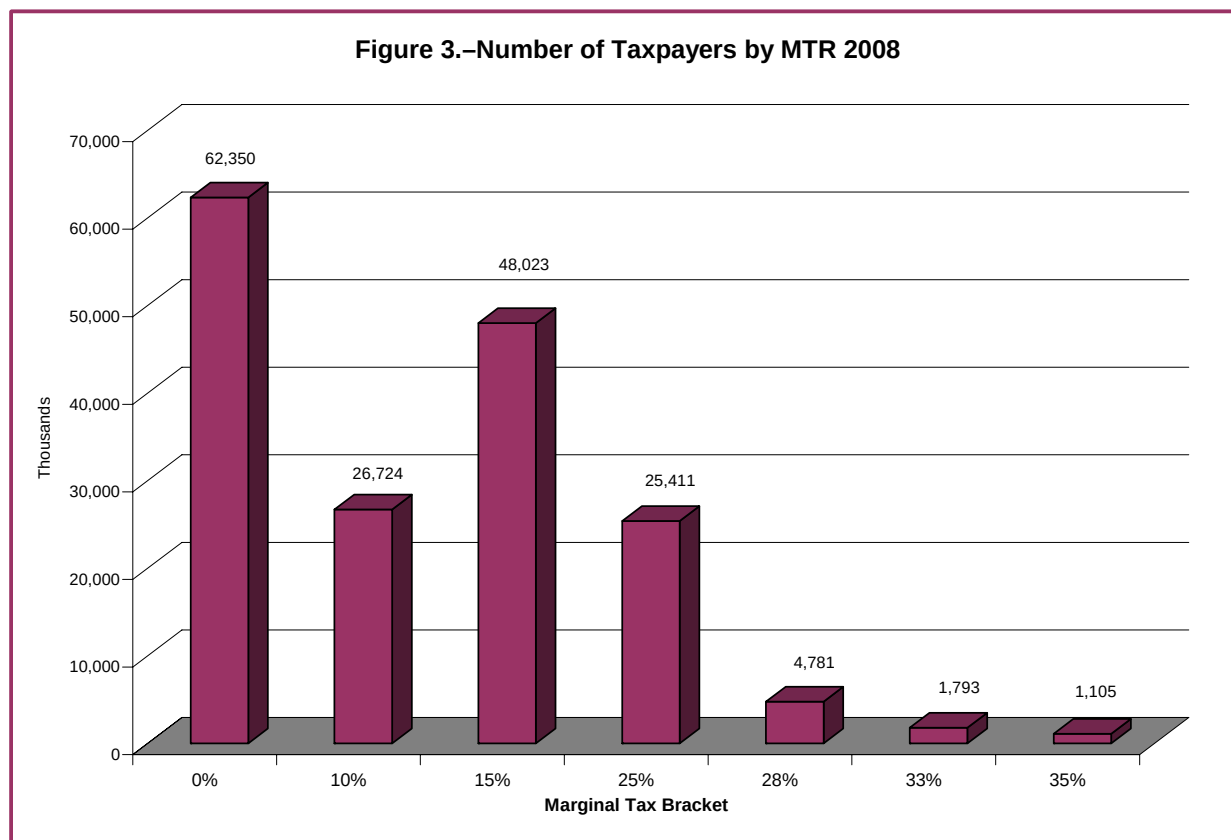
³ Estimate includes amounts of employer-provided health insurance purchased through cafeteria plans and employer-provided child care purchased through dependent care flexible spending accounts. These amounts are also included in other line items in this table.

⁴ Deduction for state and local sales taxes expired after December 31, 2007.

Source: Joint Committee on Taxation.

²⁰ "Tax expenditures" are defined under the Congressional Budget and Impoundment Control Act of 1974 (Pub. L. No. 93-344, sec. 3(3)), as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

Figures 3 and 4 report the JCT staff's estimates for 2008 of the distribution of taxpayers (including nonfilers and dependent filers) and total taxable income by marginal Federal income tax bracket. The JCT staff estimates that approximately 62 million taxpayers will have no tax liability and generally have a marginal tax rate of zero.²¹ Figure 3 shows that, for taxpayers with a positive tax liability, taxpayers with a 15 percent marginal income tax bracket are the largest group (48 million taxpayers), and Figure 4 shows that they report the most taxable income at their marginal rate \$807.2 billion. However, Figure 4 also shows that most taxable income overall (that is, including taxable income that falls in brackets below the taxpayer's marginal rate bracket) is reported by taxpayers with a marginal rate of 25 percent (\$1,759.0 billion).



²¹ Figure 3 does not calculate “effective marginal tax rates resulting from the earned income tax credit and other provisions subject to a phaseout or phase-in.”

**Figure 4.—Total Taxable Income of Taxpayers in Each Marginal Rate Bracket
2008**

