

**PRESENT LAW AND BACKGROUND ON THE INCOME TAXATION
OF HIGH INCOME AND HIGH WEALTH TAXPAYERS**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on November 9, 2023

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. DATA ON INCOME, WEALTH, TAX RATES, AND SELECTED TAX EXPENDITURES	3
A. Data on Income	3
B. Data on Wealth	16
II. THE PRESENT LAW INCOME TAXATION OF HIGH INCOME AND HIGH WEALTH TAXPAYERS	22
A. In General.....	22
B. Income Taxation of Individuals, Estates, and Trusts	24
1. Income taxation of individuals.....	24
2. Selected tax rules applicable to certain items of non-wage income	29
3. Income taxation of estates and trusts	34
C. Taxation of Business and Investment Income of Individuals	38
1. Income tax treatment of gains and losses from the disposition of property	38
2. Overview of mark-to-market taxation	43
3. Taxation of domestic business income of individuals	47
4. All-in tax rates on income of individuals.....	53
III. DISCUSSION OF SELECTED ISSUES	57
A. In General.....	57
B. Capital Gains.....	58
1. Mark-to-market.....	59
2. Carried interest.....	61
C. Trusts.....	63
D. Private Placement Life Insurance and Annuity Contracts	67
E. Net Investment Income Tax.....	70
APPENDIX.....	71

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for November 9, 2023, to examine tax planning by wealthy taxpayers. This document,¹ prepared by the staff of the Joint Committee on Taxation, describes empirical information, legal background, and policy considerations related to topics to be considered in the hearing.

The primary purpose of a tax system is to raise revenue to fund government expenditures. Several factors may be used to assess how well a tax system raises revenue, including whether the tax system promotes or hinders economic efficiency and growth, how equitable the tax system is (including considerations of horizontal and vertical equity),² and how simple and administrable the tax system is. One salient question in the policy debate concerning how best to raise revenue is the degree to which the U.S. tax system should impose taxes according to a taxpayer's ability to pay. In other words, what is the appropriate level of progressivity for the overall U.S. tax system?

Part I of this document presents and summarizes background data relating to the sources of income and composition of wealth for U.S. taxpayers. The data show, for example, that higher-income taxpayers receive relatively less income through wages and relatively more income through nonwage sources, such as passthrough business income, corporate income, and interest income. The data also show, for example, that individuals in lower-wealth groups derive the largest share of their financial wealth from assets that are held for a noninvestment consumption purpose, such as owning a home or vehicle. Higher-wealth groups, on the other hand, derive relatively larger shares of their wealth from assets held for investment purposes, such as corporate equities, mutual funds, and private businesses.

Under present law, statutory marginal tax rates on ordinary income are progressive, increasing with a taxpayer's income. A taxpayer's effective marginal income tax rate might differ from her statutory marginal income tax rate because present law provides preferential rules for taxing certain sources of income. Despite these preferential rules, the overall Federal tax system is progressive because average Federal tax rates tend to increase with income. Part II provides a description of present law relating to the income taxation of individuals, estates, and trusts, including the taxation of business and investment income.

Because higher-income taxpayers generally have a higher proportion of income from sources other than wages than do lower-income taxpayers, and because tax rules applicable to nonwage income may be explicitly preferential (in the form of lower statutory tax rates) or, in the case of, as one example, rules for determining the timing of income, preferential in application, higher-income taxpayers may make economic choices or engage in tax planning to

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background on the Income Taxation of High Income and High Wealth Taxpayers* (JCX-51-23), November 7, 2023. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

² The concept of horizontal equity asks whether taxpayers who otherwise are similarly situated bear the same tax burden. The concept of vertical equity asks how the tax burdens of low-ability-to-pay taxpayers compare to tax burdens of high-ability-to-pay taxpayers.

reduce their tax liabilities. Part III describes selected features of present law that facilitate this tax reduction.

I. DATA ON INCOME, WEALTH, TAX RATES, AND SELECTED TAX EXPENDITURES

The following discussion reviews the literature relating to income and income distribution in the United States and analyzes the sources of income and composition of wealth by income and wealth groups, respectively.

A. Data on Income

The economics literature addresses the distribution of national income, which is the total amount of money earned within a country. Specifically, the literature has focused on how best to measure income composition and shares. Income measures used to estimate inequality are critical for estimating average tax rates and tax progressivity. In the early 1900s, researchers first observed that a larger share of national income went to labor than to capital.³ Initial survey data about the distribution of wages, dividends, and interest in different industries revealed that the share of income going to the top one percent of the income distribution was 14 percent and the share going to the top 10 percent was 35 percent.⁴ However, there were disagreements about the assumptions made and data used to measure the distribution of income.⁵ Soon after the introduction of the modern Federal income tax, researchers used the income reported on tax returns to estimate income shares.⁶ In general, revised estimates and trends using tax return information were similar to prior measures, although industry survey data may have underestimated the volatility of national income.⁷ Even after the introduction of tax return reporting, concerns remained as to how to best measure the distribution of national income.⁸

Work on the measurement of income compositions and shares has continued.⁹ The Congressional Budget Office estimated income share using tax return data and found that between 1979 and 2015, the top one percent income group's share of total income before taxes

³ Willford I. King, *The Wealth and Income of the People of the United States*, Macmillan, 1915; Scott Nearing, *Income; an Examination of the Returns for Services Rendered and from Property Owned in the United States*, Macmillan, 1915.

⁴ *Ibid.*

⁵ Arthur L. Bowley, "Income in the United States," *The Quarterly Journal of Economics*, 37(3): 510-517, 1923.

⁶ Wesley C. Mitchell, Willford I. King, Frederick R. Macaulay, and Oswald W. Knauth, "Income in the United States, Its Amount and Distribution, 1909-1919," *General Series National Bureau of Economic Research*, no. 1-2, 1921. For a summary of this early literature, see Hugh Rockoff, "Off to a Good Start: The NBER and the Measurement of National Income," *NBER Working Paper No. 26895*, 2020.

⁷ *Ibid.*

⁸ Joseph Pechman and Benjamin Okner, "Who Bears the Tax Burden?" *Brookings Institution*, 1974. Morgan Reynolds and Eugene Smolensky, *Public Expenditures, Taxes, and the Distribution of Income: The United States, 1959, 1961, 1971*, W. W. Norton & Company, 1977.

⁹ Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *NBER Working Paper No. 8467*, 2001.

and transfers increased by more than seven percentage points.¹⁰ Between 1979 and 2006, Census data show that the top one percent income group's pre-tax/pre-transfer income shares increased by about three percentage points, when corrected for survey changes and top-coding issues.¹¹

Another question that arises is how to measure total income. For example, the Congressional Budget Office estimates above use a narrower income definition than national income.¹² The Census data also consider a narrower definition of income. For example, in 2010 these two measures were about \$8 trillion and \$7 trillion, respectively, but national income was about \$12 trillion. The Census data also look at pre-tax/pre-transfer income shares. Income definitions may also differ because they include or remove taxes (pre-tax or after-tax income) or because they exclude or include certain transfers (pre-transfer or after-transfer income).

Other recent work has indicated that the share of national income (before taxes, but after Social Security and unemployment benefits) earned by the top one percent of American adults rose by eight percentage points from 1979 to 2019.¹³ Subsequent work by other economists has estimated smaller increases in income concentration. Other economists report that the top one percent income group's pre-tax national income rose less than five percentage points from 1979 to 2019.¹⁴ However, pre-tax national income does not account for taxes or government transfers (for example, Medicare, Social Security, and unemployment benefits). When an income measure is computed that includes taxes and transfers, those same economists found that the top one percent income group's share rose by approximately one percentage point from 1979 to 2019.¹⁵ In general, there is uncertainty in how to measure income and in how to interpret available data. There is a range of results due to different data sources, different income definitions, and different assumptions used to allocate missing income.

¹⁰ Congressional Budget Office, *The Distribution of Household Income, 2015*, November 2018 (supplemental data).

¹¹ Top-coding issues include top-coded data observations whose values are above an upper bound and are censored; see Richard V. Burkhauser, Shuaizhang Feng, Stephen P. Jenkins, and Jeff Larrimore, "Recent Trends in Top Income Shares in the United States: Reconciling Estimates from March CPS and IRS Tax Return Data," *Review of Economics and Statistics* 44(2): 371–388, 2012.

¹² Congressional Budget Office estimates do not correct for effects from the Tax Reform Act of 1986, causing an upward bias in the estimated increases. Differences between the Congressional Budget Office income definition and national income are discussed in Gerald Auten and David Splinter, "Top 1% Income Shares: Comparing Estimates Using Tax Data." *AEA Papers & Proceedings* 109, 307–311, 2019.

¹³ Thomas Piketty, Emmanuel Saez, and Gabriel Zucman. "Distributional National Accounts: Methods and Estimates for the United States." *Quarterly Journal of Economics* 133(2): 553–609, 2018.

¹⁴ See Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, September 29, 2023, available at https://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf.

¹⁵ *Ibid.*

In the following tables, the Joint Committee staff has calculated several alternative measures of income categorized by percentiles of the income distribution.¹⁶ The income group thresholds are set such that each percentile has the same number of individual U.S. residents (including adults, dependents, and non-filers). For example, the number of individuals in the bottom 50 percent is the same as the number of individuals in the top 50 percent. The income estimates use Federal tax return data¹⁷ and are ranked using tax-unit size-adjusted incomes if a taxpayer reports a spouse or dependents.¹⁸ The unit of observation for the income estimates is a tax unit.¹⁹ In order to be more consistent with recent income distribution studies, the tables in this subsection (Tables 1 through 4) differ from standard distributional tables produced by the Joint Committee staff.²⁰

In Table 1, the Joint Committee staff ranks tax filing units by the unit's income before taxes and after the receipt of transfers (pre-tax/after-transfer income). Pre-tax income is income before taxes paid, including any indirect taxes paid that are allocable to the group (for example, the employer portion of payroll taxes are added to taxable wages). Pre-tax/after-transfer income also includes government transfers, including government cash and non-cash transfers such as Medicare, Social Security benefits, unemployment benefits, workers' compensation benefits, Medicaid, Supplemental Nutrition Assistance Program ("SNAP"), and Supplemental Security Income ("SSI") benefits. The income groups in Table 1 range from the bottom 50 percent to the top 0.01 percent of the income distribution. Table 1 shows the distribution of pre-tax/after-transfer income amounts (based on national accounts), shares, and averages by income group for the year 2019. For example, the bottom 50 percent had a total combined income amount of \$4.4 trillion, which was 20.7 percent of total income reported in the year 2019. Dividing this total income amount by the number of individuals in the bottom 50 percent (that is, half the

¹⁶ The data on income presented here are compiled by following the methodology described in Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, September 29, 2023, available at <https://davidsplinter.com/AutenSplinter-Tax Data and Inequality.pdf>.

¹⁷ These data are the annual Individual and Sole proprietor ("INSOLE") samples that the IRS Statistics of Income Division produces to be representative of all returns filed each year.

¹⁸ The Joint Committee staff follows the Congressional Budget Office (see Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020) in defining income groups based on all individuals (including primary and secondary taxpayers and dependents). This helps control for the bias introduced from falling marriage rates as compared to groups set by tax units. When ranking tax units, the Joint Committee staff accounts for size differences—which accounts for the costs of supporting dependents and the economies of scale from shared resources—by dividing tax unit income by the square-root of the number of individuals in the unit. This is the same equivalence scale used by the Congressional Budget Office. Income shares are calculated using total tax unit incomes, such that they sum to national income.

¹⁹ Tax units include all individuals claimed on the same tax returns, or who would file together in the case of non-filers. Certain returns are excluded: dependent filers, individuals under the age of 20, non-U.S. residents, and residents of the U.S. territories.

²⁰ For example, in contrast to the standard distributional tables produced by the Joint Committee staff, the income measure used for Tables 1 through 4 accounts for some additional Federal taxes, including the allocation of taxes paid by estates and trusts to beneficiaries and the allocation of estate and gift taxes by decedent income groups. See the Appendix for further comparison of the Joint Committee staff's standard methodology compared to that used for Tables 1 through 4.

population) gives an average per capita income amount of \$27,000. The 50-90 percentile had a total combined income amount of \$9.3 trillion, which was 44.1 percent of total income in the year 2019. The average per capita income amount was \$71,700. In 2019, there are about 16,000 tax units in the top 0.01 percent. The top 0.01 percent had a total income amount of \$420 billion, which was approximately 2.0 percent of total income in the year 2019. The top 0.01 percent average per capita income amount was \$12,973,000.

Table 1.—Distribution of Pre-Tax/After-Transfer National Income Amounts, Shares, and Averages by Income Group for 2019

Income Group (percentile)	Amount (\$ Billions)	Share (percentage)	Average Per Capita (\$)
Bottom 50	4,366	20.7	27,000
50-90	9,288	44.1	71,700
90-95	2,199	10.4	135,800
95-99	2,691	12.8	207,700
99-99.5	630	3.0	388,900
99.5-99.9	916	4.3	707,100
99.9-99.99	572	2.7	1,965,900
Top 0.01	420	2.0	12,973,700

Note: Average incomes are on a per capita basis: total income divided by the number of adults and dependents in each group.

Source: Joint Committee staff calculations.

Table 2 shows the income composition by source of income and by income group of pre-tax/pre-transfer income for the year 2019. In Table 2, the Joint Committee staff measures income on a pre-tax/pre-transfer basis. This is a different measure of income than that used in Table 1. Pre-tax/pre-transfer income is pre-tax income excluding government transfers and equals national income. That is, unlike Table 1, the income measure does not include such items as Social Security, unemployment benefits, and SNAP benefits. The income groups in Table 2 range from the bottom 50 percent to the top 0.01 percent of the income distribution. In the first row, the income share of the bottom 50 percent is largely composed of wage income (65 percent), retirement income (11 percent), and other income (11 percent) and is minimally composed of passthrough business income (nine percent), corporate income (four percent), and interest income (one percent). In other words, this group derives most of its income from employment (that is, wage and retirement income) and other income (that is, imputed rents and property taxes paid that may be attributable to ownership of a primary residence) and a small share of its income from investment (that is, returns on debt and equity, whether in private

businesses or public companies). In general, as one moves up the income distribution, the relative share of income from investment increases, while the relative share of income from employment decreases. For example, in the last row, the income share of the top 0.01 percent is 23 percent wages, 35 percent passthrough business income, 28 percent corporate income, six percent interest, one percent retirement income, and eight percent other income.

Table 2.—Income Composition by Source of Income and by Income Group of Pre-Tax/Pre-Transfer National Income, 2019 (Percent)

Income Group (percentile)	Wage	Passthrough	Corporate	Interest	Retirement	Other	Total
Bottom 50	65	9	4	1	11	11	100
50-90	63	9	5	1	11	11	100
90-95	58	12	7	1	11	11	100
95-99	53	16	8	1	10	11	100
99-99.5	46	25	11	2	6	10	100
99.5-99.9	34	27	24	3	3	9	100
99.9-99.99	31	38	17	5	2	8	100
Top 0.01	23	35	28	6	1	8	100

Notes: Pre-tax/pre-transfer national income is divided into six categories: (1) Wages include employer payroll taxes paid, employer provided health insurance, and underreported wages; (2) passthrough income is gross income net of deductions from partnerships, S corporations, sole proprietorships, farming, and rental activities; (3) corporate income includes taxable dividends (but excludes dividends attributable to retirement accounts, government accounts, and non-profits), retained earnings (taxable income less dividends and corporate taxes paid), and corporate taxes paid; (4) interest income includes taxable interest and tax-exempt interest; (5) private retirement income includes income from tax-exempt retirement accounts, including 401(k)s and IRAs; and (6) other income includes imputed rents (but only from owner-occupied housing) and property and other taxes paid. Mutual fund income is reported in different categories (for example, corporate income or retirement) depending on how it is earned or reported in the tax return data.

Details may not add to total due to rounding.

Source: Joint Committee staff calculations.

Table 3 shows average Federal tax rates by income group for the year 2019. The Joint Committee staff defines average Federal tax rates on a pre-tax/after-transfer income basis.²¹ When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of all applicable Federal taxes increases from 6.8 percent to 34.0 percent. When considering only non-payroll taxes, the average Federal tax rate increases from -0.3 percent to 33.2 percent. This implies a progressive tax system using income as a base (that is, average tax rates increase with income).²² In general, this increasing trend along the income distribution is similar across the following different types of taxes: Federal income tax, Federal corporate tax, and Federal estate and gift tax. The progressivity of the Federal income tax and Federal corporate tax contrasts with the relationship between tax rates and income for other taxes. When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of payroll tax²³ and the average rate of other Federal tax decrease from 7.1 percent to 0.8 percent and 1.2 percent to 0.1 percent, respectively. In other words, these taxes are regressive. Despite this regressivity, the overall Federal tax system, on average, remains progressive. In addition, when excluding payroll taxes or considering the progressive spending that regressive payroll taxes fund (that is, Social Security, Disability, and Medicare benefits), the system becomes more progressive.²⁴ Since 1985, the progressivity of the Federal tax system has increased every decade.²⁵

²¹ For the calculation of average tax rates, the Joint Committee staff assumes the following for incidence: (1) corporate taxes are borne by labor 25 percent, (2) business property taxes are borne by business income, (3) employer payroll taxes are borne by labor, and (4) other taxes are allocated by disposable income less savings. For further information, see the Appendix and Gerald Auten and David Splinter, “Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends,” *Working Paper*, September 29, 2023, available at https://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf.

²² Breaking out the bottom 20 percent also emphasizes this progressivity. For example, the Congressional Budget Office estimates that this bottom income group had a -10.9 Federal income tax rate in 2017, much lower than the bottom 50 percent rates seen in Table 3. Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. For a comparison of recent tax progressivity estimates, see David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4):1005–1024, 2020.

Alternative tax rate estimates appear in other publications. See, e.g., Emmanuel Saez and Gabriel Zucman, *The Triumph of Injustice*, W.W. Norton & Co., Inc., October 15, 2019. However, unlike the average tax rates presented in this pamphlet, these estimates differ because the tax numerator excludes refundable tax credits and the income denominator excludes payroll taxes and all non-Social Security transfers. The estimates therefore use a partial after-tax/pre-transfer income denominator rather than a conventional pre-tax/after-transfer income denominator. Under this approach, the bottom decile has less income than in conventional estimates, causing exaggerated tax rates. For that reason, Saez and Zucman drop the bottom of the distribution from their results.

²³ Three factors lower the average payroll tax rates relative to statutory rates: (1) non-wage income, (2) tax-excluded compensation included in wages, and (3) transfers.

²⁴ The Congressional Budget Office finds that from a lifetime perspective the Social Security system is progressive. They estimate that “for people in the bottom fifth of the earnings distribution, the ratio of benefits to taxes is almost three times as high as it is for those in the top fifth.” Congressional Budget Office, *Is Social Security Progressive?*, December 2006.

²⁵ Congressional Budget Office estimates of average Federal tax rates decreased more for lower-income groups. Between 1985 and 2017, bottom-quintile tax rates decreased 10.5 percentage points, middle-three-quintile

**Table 3.—Average Federal Tax Rates by Income Group, 2019
(Percent)**

Income Group (percentile)	Average Rate of All Federal Taxes	Average Rate of Federal Taxes Excluding Payroll Taxes	Federal Income Tax¹	Federal Corporate Tax	Payroll Tax²	Federal Estate and Gift Tax³	Other Federal Tax⁴
Bottom 50	6.8	-0.3	-2.2	0.6	7.1	*	1.2
50-90	14.6	7.5	5.3	0.8	7.1	*	1.4
90-95	17.6	11.2	9.0	1.0	6.6	*	1.2
95-99	20.7	15.7	13.5	1.1	4.9	0.1	1.0
99-99.5	22.3	18.7	16.4	1.0	3.6	0.3	1.1
99.5-99.9	27.0	24.7	22.5	1.1	2.3	0.5	0.7
99.9-99.99	34.2	32.7	30.0	1.5	1.5	0.8	0.5
Top 0.01	34.0	33.2	30.6	2.1	0.8	0.4	0.1

[1] The Federal income tax rate is negative on average for the bottom 50 percent because of refundable credits.

[2] Payroll tax includes both employer and employee portions as well as all unemployment insurance contributions.

[3] The estate tax is allocated based on the decedent's income in the last ten full years of life.

[4] Other Federal tax is mostly excise taxes and customs duties.

Note: The average rate is the amount of tax for that income group divided by the pre-tax/after-transfer income of that income group, hence, the denominator is the same for all types of taxes. “*” denotes negligible.

Preferential rates

The progressivity of the tax system is affected by special exclusions, deductions, and tax rates—usually referred to as tax expenditures. Table 4 shows the distributions of tax expenditures for the 20-percent qualified business income deduction (a deduction against taxable income that is equivalent to a reduced rate on certain income)²⁶ and preferential capital gains rates by income group for 2019.²⁷ Similar to Tables 1 and 3, the income groups for this table are

tax rates decreased 3.7 percentage points, and top one percent rates increased 5.5 percentage points. See Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. Various measures of tax progressivity show similar increases. See, e.g., David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4):1005–1024, 2020.

²⁶ Sec. 199A.

²⁷ A tax expenditure is measured as the difference between tax liability under present law and the tax liability that would result from a recomputation of tax without benefit of the tax expenditure provision. Taxpayer behavior is assumed to remain unchanged for tax expenditure estimate purposes. This assumption is made to simplify the calculation and conform to the presentation of government outlays. This approach to tax expenditure measurement is in contrast to the approach taken in revenue estimating; all Joint Committee staff revenue estimates

defined on a pre-tax/after-transfer income basis. For the section 199A deduction, the expenditure (that is, the tax loss to the Federal government) for the bottom 50 percent was \$1 billion, which was about three percent of the total share in the year 2019. The deduction allowed for the top 0.01 percent of the income distribution accounted for a total tax loss of \$5 billion, which was approximately 13 percent of the total share of the section 199A tax expenditure in taxable year 2019. The section 199A deduction for taxpayers in the 95-99 and 99.9-99.99 percentiles each accounted for the largest amount of tax loss of \$8 billion, or approximately 18 to 19 percent of the total tax expenditure in tax year 2019.

For preferential capital gains rates, when moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the total amount of tax loss increases from \$5 billion to \$22 billion. The bottom 50 percent represents about five percent of the total share, and the top 0.01 percent represents approximately 21 percent of the total share. Both the 199A deduction and the preferential capital gains deduction generally have a regressive trend, that is, taxpayers at the higher end of the income distribution receive more of the expenditure.

Table 4.—Distributions of Tax Expenditures for the 199A Deduction and Preferential Capital Gains Rates, by Pre-tax/After-transfer National Income, 2019

Income Group (percentile)	20-Percent 199A Deduction		Preferential Capital Gains Rates	
	Tax Loss (\$ Billions)	Share (percentage)	Tax Loss (\$ Billions)	Share (percentage)
Bottom 50	1	3	5	5
50-90	6	15	12	11
90-95	3	8	6	5
95-99	8	19	15	15
99-99.5	4	8	8	8
99.5-99.9	7	16	16	15
99.9-99.99	8	18	22	20
Top 0.01	5	13	22	21

Notes: Unlike revenue estimates, tax expenditure estimates exclude behavioral responses. Therefore, these estimates are only based on tax-rate changes applied to income amounts reported on 2019 tax returns from the specific policies.

Details may not add to total due to rounding.

Source: Joint Committee staff calculations.

reflect anticipated taxpayer behavior. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024* (JCX-23-20), November 5, 2020 for a detailed description of tax expenditures.

Income share trends

The following figures present information about pre-tax/pre-transfer (as with Table 2), pre-tax/after-transfer (as with Table 1), and after-tax/after-transfer national income. After-tax/after-transfer income is income after all taxes (Federal, State, and local) are paid and includes government transfers.²⁸ After-tax/after-transfer income represents the annual amount a tax unit has available to allocate between current consumption and savings. Figure 1 shows the pre-tax/pre-transfer, pre-tax/after-transfer, and after-tax/after-transfer income share trends from 1960 to 2019 for the following income groups: bottom 50 percent (Figure 1a), the 50-90 percentile (Figure 1b), the 90-99 percentile (Figure 1c), and top one percent (Figure 1d). Pre-tax/pre-transfer income and pre-tax/after-transfer income are as described above.²⁹

The shares of the bottom 50 percent increase after transfers and taxes are taken into account. This is the result of the concentration of transfers in the bottom half of the income distribution as well as the effects of refundable tax credits and the lower tax rates imposed on lower-income individuals. In Figure 1b, the tax and transfer system has, on average, little effect on the shares of incomes for the 50-90 percentile. This suggests that the tax and transfer system in the aggregate has little effect on the relative share of income of individuals in the 50-90 percentile relative to its effect on individuals in the bottom 50 percent and top ten percent. Finally, in Figures 1c and 1d, the shares of income for the 90-99 percentile and the top one percent fall when accounting for transfers and taxes. This is the opposite pattern to that seen for the bottom 50 percent and occurs because this higher-income group receives fewer transfers and pays tax at relatively higher rates than lower income groups.

Trends over time are also apparent. In Figure 1a, all three shares of income measures for the bottom 50 percent, after rising in the 1960s, have been declining since the 1970s, although for income after taxes and transfers it has been relatively stable since the mid-1980s. In Figure 1b, all three shares of income measures for the 50-90 percentile have been relatively flat since 1960. In Figure 1c, all three shares of income measures for the 90-99 percentile have also been relatively flat. In Figure 1d, all three shares of income measures for the top one percent declined in the late 1960s, rose between the early 1990s and late 2000s, and have been relatively stable in recent years.³⁰ When accounting for taxes and transfers, however, the increase between the early 1990s and late 2000s is less pronounced.

²⁸ The after-tax/after-transfer income estimates include an allocation for government consumption (*e.g.*, spending on schools) half per capita and half by after-tax income and an allocation of deficits by Federal payroll and income taxes.

²⁹ See descriptions for Tables 1 and 2 for the definitions of pre-tax/pre-transfer income and pre-tax/after-transfer income.

³⁰ The estimated jump in top income shares between 1986 and 1988 is related to the Tax Reform Act of 1986, which changed how income was reported on tax returns. These changes make it difficult to precisely identify when top income shares began increasing. Top income shares generally tend to increase with economic expansions and decrease with recessions.

Figure 1a.—Bottom 50 Percent Income Shares, 1960-2019

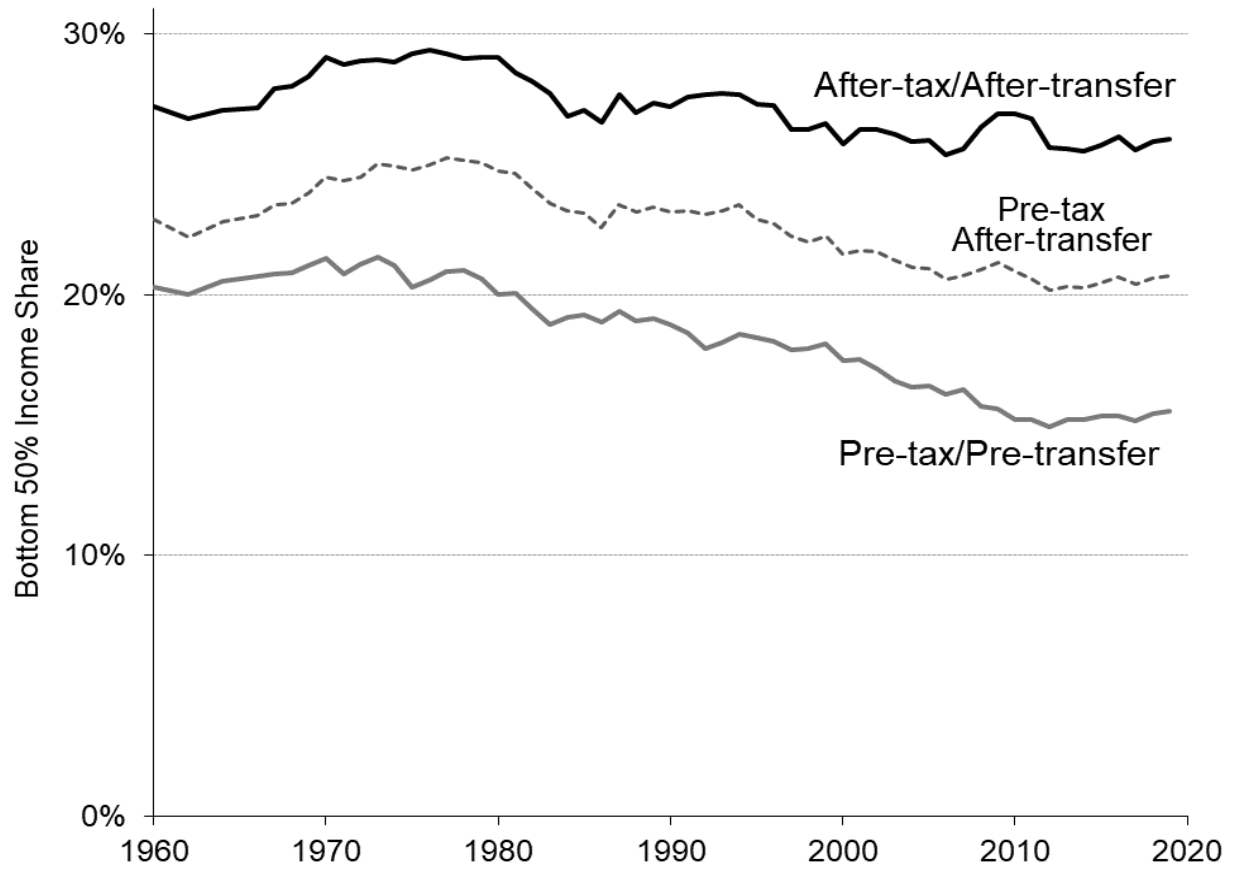


Figure 1b.-50-90 Percentile Income Shares, 1960-2019

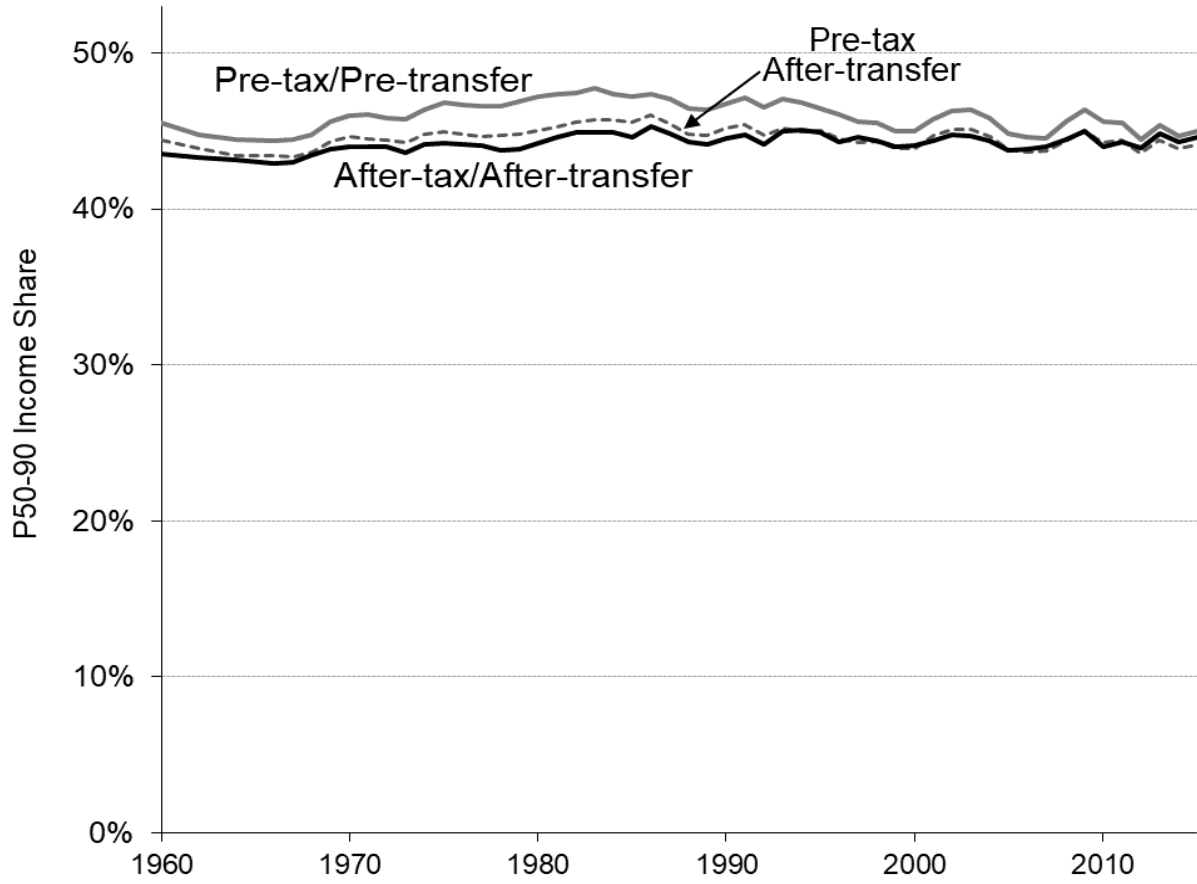


Figure 1c.-90-99 Percentile Income Shares, 1960-2019

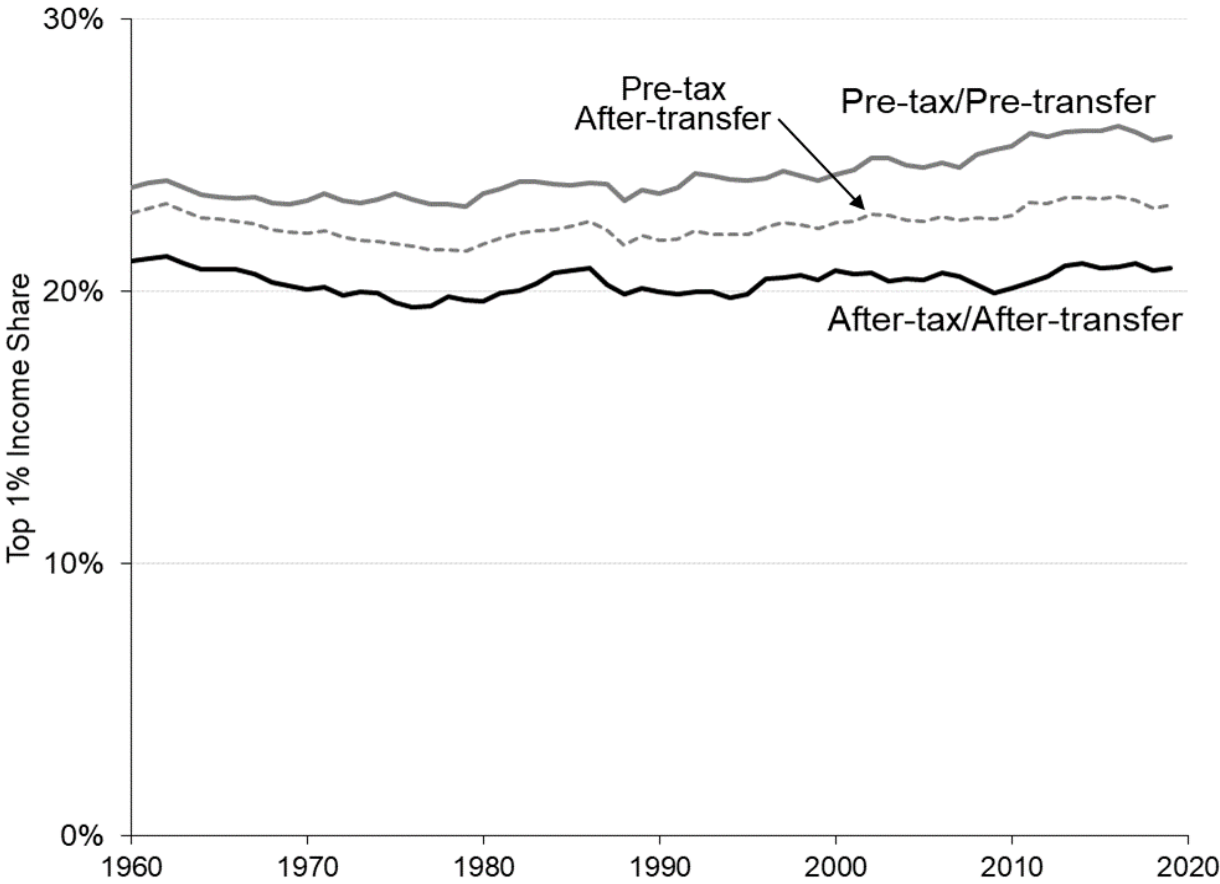
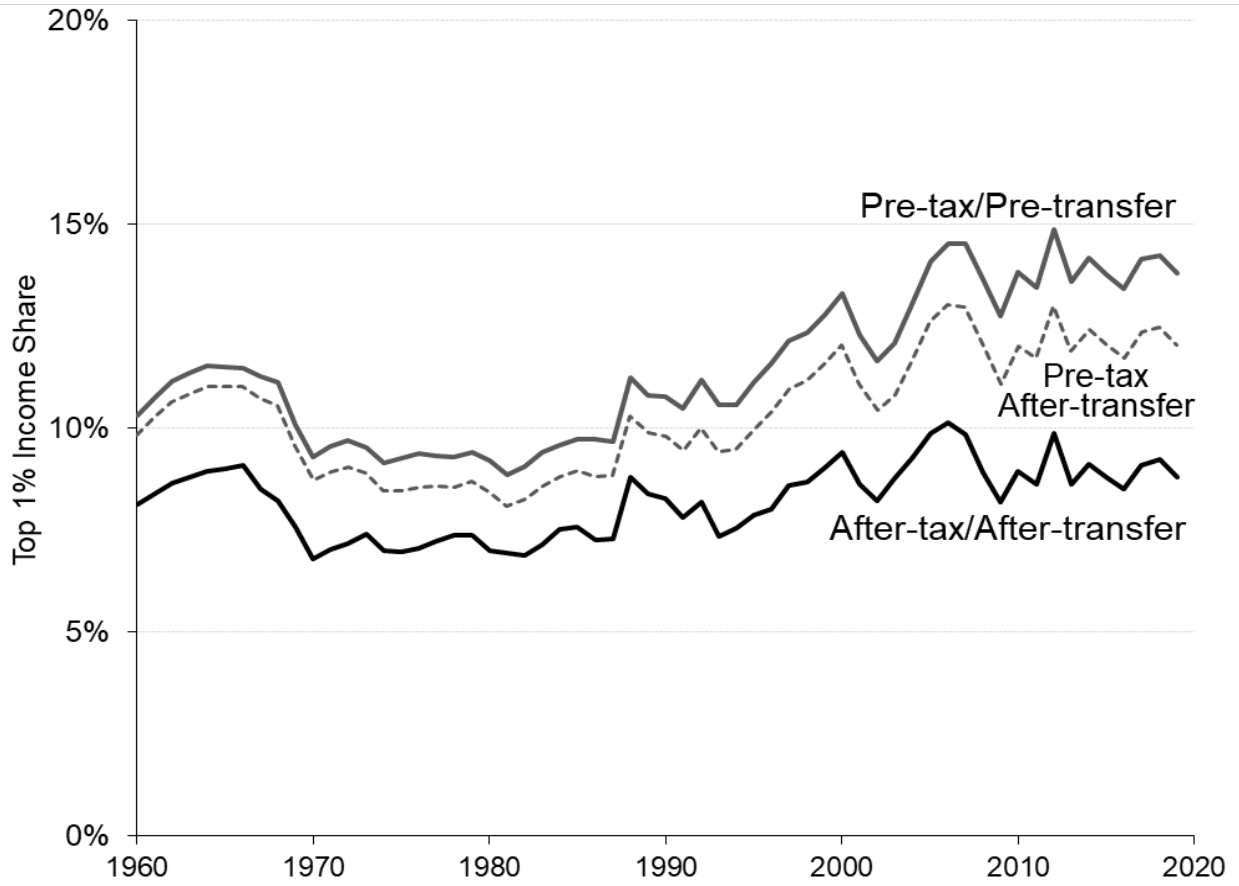


Figure 1d.—Top 1% Income Shares, 1960-2019



B. Data on Wealth

As with income, there are many ways to measure wealth. The following discussion uses a measure of annual net financial wealth, which deducts current private debts from current private financial assets. When using this measure for wealth, the share of wealth held by the top wealth groups has increased over the last three decades; the share of wealth owned by the top one percent has especially increased. However, recent work argues that when also including expected Social Security benefits, the increase in wealth levels held by the top wealth groups is less pronounced, with top wealth shares remaining relatively flat over the last three decades.³¹ Including expected Social Security benefits in a measure of wealth is similar to including government transfers in income measure, as done in Table 1 and Figures 1a to 1d. Because of data limitations, however, the following discussion uses measures of wealth that do not include Social Security benefits.

The following tables use the Distributional Financial Accounts (“DFA”) dataset to present the distribution and composition trend of financial wealth, as well as trends over time. The DFA, compiled by the Federal Reserve Board, provides quarterly estimates of the distribution of a comprehensive measure of U.S. household³² financial wealth³³ from the third quarter of the year 1989 to the second quarter of the year 2023. The DFA presents data on the level, composition, and share of U.S. household financial wealth held by four percentile groups of financial wealth: the top one percent, the next nine percent (that is, the 90-99 percentile), the next 40 percent (that is, the 50-90 percentile), and the bottom 50 percent.³⁴ The DFA integrates two datasets produced by the Federal Reserve Board: the Financial Accounts of the United States, which provide quarterly data on aggregate balance sheets of various sectors of the U.S. economy, and the Survey of Consumer Finances (“SCF”), which provides comprehensive triennial microdata on the assets and liabilities of a representative sample of U.S. households.³⁵ The DFA is constructed in three steps: (1) a balance sheet from the SCF is generated that is conceptually consistent with the components of aggregate household net worth in the Financial

³¹ See Sylvain Catherine, Max Miller, and Natasha Sarin, “Social Security and Trends in Wealth Inequality,” *Jacobs Levy Equity Management Center for Quantitative Financial Research Paper*, February 29, 2020, available at <https://ssrn.com/abstract=3546668>. The authors also argue that wealth estimated on a lifetime (rather than annual) basis further reduces observed wealth shares by the top wealth groups.

³² The unit of observation is the primary economic unit (“PEU”), which for simplicity is referred to here as “household”. The PEU follows the Survey of Consumer Finance unit of observations and is defined as the “economically dominant single individual or couple (married or living as partners) in a household and all other individuals in the household who are financially interdependent with that individual or couple.”

³³ For the meanings of consumer durable goods and real estate, see the note accompanying Tables 6 and 7.

³⁴ The top 0.1 percent was recently broken out from the top one percent; see Board of Governors of the Federal Reserve System, *DFA: Distributional Financial Accounts*, <https://www.federalreserve.gov/releases/z1/dataviz/dfa/>.

³⁵ Michael Batty, Jess Bricker, Joseph Briggs, Elizabeth Holmquist, Susan McIntosh, Kevin Moore, Eric Nielsen, Sarah Reber, Molly Shatto, Kamila Sommer, Tom Sweeney, and Alice Henriques Volz, “Introducing the Distributional Financial Accounts of the United States,” *Finance and Economics Discussion Series 2019-017*, Washington: Board of Governors of the Federal Reserve System, <https://www.federalreserve.gov/econres/feds/files/2019017pap.pdf>.

Accounts; (2) the reconciled SCF balance sheet is interpolated and forecasted for quarters where the SCF is not observed based on information in the Financial Accounts and other sources; and (3) the distribution observed is applied in the reconciled SCF to the Financial Accounts’ aggregates.

This dataset is different from that used in the prior section to show different measures of income and therefore the results may not be strictly comparable. For example, the income distributions presented in the prior section are determined based on groups of equal number of individuals and tax units, while here wealth groups are determined based on the number of households, which ignores differences in household size.³⁶ The distribution of tax units by income, while positively correlated, is not the same as the distribution of households by wealth because income and wealth are different measures. For example, there may be individuals with income less than \$50,000 and wealth over \$1 million, which would place such an individual in the bottom 90 percent of the income distribution and the top ten percent of the wealth distribution, based on the income measure defined in Table 1.³⁷

Table 5 shows the distribution of net financial wealth levels and shares by wealth group for the second quarter of year 2023. Net financial wealth is gross financial wealth less debt. The wealth groups in Table 5 range from the bottom 50 percent to the top one percent of the financial wealth distribution. The bottom 50 percent has a net financial wealth level of \$4 trillion, which is approximately 2.5 percent of total net financial wealth in the year 2023. The 90-99 percentile has a net financial wealth level of \$55 trillion, which represents 37.5 percent of total net financial wealth in the year 2023. The top one percent has a net financial wealth level of \$46 trillion, which is approximately 31.4 percent of total net financial wealth in the year 2023.

Table 5.—Distribution of Net Financial Wealth Levels and Shares by Wealth Group, 2023

Wealth Group (Percentile)	Level (\$ Trillions)	Share (Percentage)
Bottom 50	4	2.5
50-90	42	28.6
90-99	55	37.5
Top 1	46	31.4

Source: Distributional Financial Accounts data.

³⁶ Tax units and household or PEU units can diverge for several reasons. First, unmarried individuals who are in the same household and classified in the SCF as “living with partner” would file separate tax returns. In addition, there can be other members of a household who would file their own tax returns if their incomes were high enough. In both cases, one household is associated with multiple tax units.

³⁷ Also, wealth share measures may differ not only based on how broadly one defines wealth, but also based on how percentile groups are determined. For example, when using the DFA data and changing from setting percentiles by wealth to setting them by income, the year 2023 second quarter top one percent financial wealth shares fall from 31 percent to 26 percent.

Table 6 shows the financial wealth composition by source of financial wealth and by wealth group for the year 2023. The wealth groups remain the same, ranging from the bottom 50 percent to the top one percent of the financial wealth distribution. Summing across both assets and liabilities, each wealth group's shares of total financial wealth sum to 100 percent. In the first row, for assets, the financial wealth of the bottom 50 percent is largely composed of real estate (54 percent), consumer durable goods (20 percent), pension entitlements (9 percent), and other wealth (12 percent), while the financial wealth share of the bottom 50 percent is minimally composed of corporate equities and mutual fund shares (two percent) and private businesses (two percent). This group derives most of its financial wealth from assets held for a noninvestment consumption purpose (for example, owning a home or a vehicle and owning whole life insurance), while this group derives minimal financial wealth from public companies and private businesses. However, moving up the wealth distribution, the relative share of financial wealth from investment increases, along with an increase in other assets, while the relative share of financial wealth from assets held for a noninvestment consumption purpose decreases. In the last row, the financial wealth share of the top one percent is composed of 14 percent real estate, two percent consumer durable goods, 44 percent corporate equities and mutual fund shares, three percent pension entitlements, 20 percent private businesses, and 18 percent other.

For liabilities, home mortgages represent the largest share of debt for each wealth group. However, consumer credit (for example, credit card debt and student loans) is a much greater share of liabilities for the two groups at the bottom of the financial wealth distribution, especially for the bottom 50 percent, where the share of consumer credit is almost as large as the share of home mortgages. While home mortgages are a way to build financial wealth (in the form of real estate equity), consumer credit is less likely to build financial wealth (although it may when incurred to purchase durable goods). However, that comparison is incomplete because real estate and durable goods are not equal forms of financial wealth: real estate tends to increase in nominal value over time, while durable goods generally depreciate. Among other liabilities are loans against insurance policies and trading on margin, which are debts incurred for specific benefits or for convenience.

**Table 6.—Financial Wealth Composition by Source of Financial Wealth and by Wealth Group, 2023
(Percent)**

Wealth Group (Percentile)	Assets							Liabilities			
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Fund Shares	Pension Entitlements	Private Businesses	Other	Total	Home Mortgages	Consumer Credit	Other	Total
Bottom 50	54	20	2	9	2	12	100	50	45	5	100
50-90	39	7	8	28	4	15	100	73	22	4	100
90-99	23	3	23	25	10	16	100	86	9	6	100
Top 1	14	2	44	3	20	18	100	72	7	21	100

Note: Real estate includes all types of owner-occupied housing including farmhouses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land (at market value). Consumer durable goods includes automobiles, trucks/motor vehicles, furniture, carpets/rugs, light fixtures, household appliances, audio/video/photo equipment, computers, boats, books, jewelry/watches, health and therapeutic equipment, and luggage. Corporate equities and mutual fund shares include directly held stocks and mutual funds, as well as the portion of other investment vehicles that are invested in equities (IRAs, trusts, managed investment accounts, 529 plans, and Health Savings Accounts) and held indirectly through IRAs, trusts, and managed investment accounts (checkable deposits, securities, and bonds). Pension entitlements include the balances of defined contribution pension plans (such as 401(k) and 403(b) plans), accrued benefits to be paid in the future from defined benefit plans (including those for which life insurance companies have assumed the payment obligation), and annuities sold by life insurers directly to individuals, but does not include Social Security. Private businesses include equity in private businesses (including rental real estate). Other assets include receivables due from property-casualty insurance companies, the value of other policies from life insurance companies (excluding reserves for life insurance coverage and annuities), and government-sponsored retiree health care fund reserves. Home mortgages are derived from measures of residential home mortgage loans as reported by lenders and households. Consumer credit includes credit card, student loan, and vehicle loan balances. Other liabilities include margin accounts at broker-dealers, loans taken against the value of life insurance policies, and loans to households from a variety of government programs.

Details may not add to total due to rounding.

Source: Distributional Financial Accounts data.

Table 7 shows the distribution of different sources of financial wealth across wealth groups for the year 2023. The wealth groups remain the same. In each column, the denominator changes to reflect the type of asset or liability. For example, in the first column, the denominator is all real estate owned by U.S. households in the year 2023. In total, groups representing the bottom 90 percent own more than one-half of real estate (56 percent) and about two-thirds of consumer durable goods. In total, groups representing the top ten percent own about one-third (33 percent) of consumer durable goods and less than half (44 percent) of real estate. These groups own more than half (53 percent) of pension entitlements. By contrast, the 50-90 percentile hold roughly their proportionate share of pension entitlements (44 percent), while the bottom 50 percent owns only three percent. The ownership of corporate equities and mutual fund shares and private businesses is even more concentrated: the top one percent owns 54 percent of the former and 53 percent of the latter. Finally, other assets (which is largely rights to insurance) is concentrated at the top, with the 90-99 percentile owning 36 percent and the top one percent owning 31 percent.

For liabilities, home mortgages are disproportionately held by the wealthiest groups. The 50-90 percentile has 46 percent (20 percent more than their proportionate share), while the 90-99 percentile has 25 percent (more than double their proportionate share), and the top one percent has five percent. Consumer credit, however, which generally does not build financial wealth, is disproportionately incurred by the bottom 50 percent.³⁸ Finally, other liabilities, generally business debt, are disproportionately incurred by groups representing the top ten percent, with almost half the total share (37 percent) being incurred by the top one percent.

³⁸ The distributions of home mortgage and consumer credit liabilities cannot be compared to the distributions of real estate and consumer durable goods. Liabilities represent smaller total dollar amounts.

**Table 7.– Shares of Source of Financial Wealth and by Wealth Group, 2023
(Percent)**

Wealth Group (Percentile)	Assets						Liabilities		
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Fund Shares	Pension Entitlements	Private Businesses	Other	Home Mortgages	Consumer Credit	Other
Bottom 50	12	25	1	3	1	4	24	56	29
50-90	44	42	10	44	11	29	46	36	34
90-99	30	21	35	48	34	36	25	7	30
Top 1	14	12	54	5	53	31	5	1	17
TOTAL	100	100	100	100	100	100	100	100	100

Note: Real estate includes all types of owner-occupied housing including farmhouses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land (at market value). Consumer durable goods includes automobiles, trucks/motor vehicles, furniture, carpets/rugs, light fixtures, household appliances, audio/video/photo equipment, computers, boats, books, jewelry/watches, health and therapeutic equipment, and luggage. Corporate equities and mutual fund shares include directly held stocks and mutual funds, as well as the portion of other investment vehicles that are invested in equities (IRAs, trusts, managed investment accounts, 529 plans, and Health Savings Accounts) and held indirectly through IRAs, trusts, and managed investment accounts (checkable deposits, securities, and bonds). Pension entitlements include the balances of defined contribution pension plans (such as 401(k) and 403(b) plans), accrued benefits to be paid in the future from defined benefit plans (including those for which life insurance companies have assumed the payment obligation), and annuities sold by life insurers directly to individuals, but does not include Social Security. Private businesses include equity in private businesses (including rental real estate). Other assets include receivables due from property-casualty insurance companies, the value of other policies from life insurance companies (excluding reserves for life insurance coverage and annuities), and government-sponsored retiree health care fund reserves. Home mortgages are derived from measures of residential home mortgage loans as reported by lenders and households. Consumer credit includes credit card, student loan, and vehicle loan balances. Other liabilities include margin accounts at broker-dealers, loans taken against the value of life insurance policies, and loans to households from a variety of government programs.

Details may not add to total due to rounding.

Source: Distributional Financial Accounts data.

II. THE PRESENT LAW INCOME TAXATION OF HIGH INCOME AND HIGH WEALTH TAXPAYERS

A. In General

There is no Federal tax on wealth or property owned³⁹ by an individual.⁴⁰ However, the income tax imposes tax on income derived from property, such as dividends from stock or gain from the sale of property. The income tax system also, in some cases, taxes estates and trusts as separate taxpayers, capturing income on property held by an estate or in trust on behalf of individual beneficiaries.

In general, individuals and other taxpayers are only subject to tax on property when there has been a disposition of the property, that is, a sale or exchange.⁴¹ However, in certain cases, the taxpayer may be subject to tax on income from property even where a disposition has not occurred.⁴²

Capital gains rules permit owners of capital assets, generally including interests in business entities like partnerships and corporations to claim capital gain treatment on the sale or exchange of such assets. In many cases, there are other rules that affect the tax treatment of income derived through business entities, affecting the tax that is either directly or indirectly borne by the owners.

The income tax system generally does not tax property received by an individual from transfers by gift or at death.⁴³ However, a separate wealth transfer tax system—comprised of the estate tax, gift tax, and generation-skipping transfer (“GST”) tax—may impose tax on the donor who transfers assets by gift or the estate of the decedent who transfers assets at death.⁴⁴ The

³⁹ In contrast, many local and some State governments impose a wealth tax in the form of taxes on the value of real property. See 50-State Property Tax Comparison Study for Taxes Paid in 2021, Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, July 2022, available at <https://www.lincolnst.edu/publications/other/50-state-property-tax-comparison-study-2021> (last visited October 16, 2023).

⁴⁰ The Code generally uses the term “individual” to refer to natural persons.

⁴¹ Sec. 1001. Unless otherwise stated, all references to the Code are to the Internal Revenue Code of 1986, as amended.

⁴² See, e.g., secs. 475, 877A, 1256, 1259, 1272, and 1296.

⁴³ Sec. 102; see also sec. 101.

⁴⁴ Chapters 11-13 of the Internal Revenue Code. The wealth transfer tax system has a large lifetime exemption that excludes most donors and decedents from transfer tax. For gifts made and decedents dying in 2023, the lifetime exemption is \$12.92 million (\$25.84 million for married taxpayers).

Joint Committee staff describes the Federal wealth transfer taxes in *Overview of the Federal Tax System as in Effect for 2023*.⁴⁵

⁴⁵ *Overview of the Federal Tax System as in Effect for 2023* (JCX-9-23), May 11, 2023, pp. 23-24. For a more detailed description of the Federal wealth transfer taxes, see *Present Law and Background on the Taxation of High Income and High Wealth Taxpayers* (JCX-24-21), May 10, 2021, pp. 58-66.

B. Income Taxation of Individuals, Estates, and Trusts

1. Income taxation of individuals

In general

Individual taxpayers are subject to income taxation under the Code.⁴⁶ United States citizens and resident aliens are generally subject to taxation on worldwide income.⁴⁷ A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.⁴⁸

Taxable income equals the taxpayer's gross income less certain exclusions, exemptions, and deductions. Income tax liability is determined by applying graduated tax rates to a taxpayer's taxable income. A taxpayer may face additional liability if the alternative minimum tax applies. Income tax liability may be reduced by applicable tax credits.

The tax rate brackets and amount of certain deductions and limitations vary depending on the individual's filing status.⁴⁹ Filing categories are the following: (1) married filing jointly, (2) surviving spouse,⁵⁰ (3) head of household,⁵¹ (4) married filing separately, and (5) unmarried individual other than a surviving spouse or head of household.

Gross income

Gross income means "income from whatever source derived" except for certain items specifically exempt or excluded.⁵² Sources of income listed in section 61(a) include compensation for services, annuities, income from life insurance and endowment contracts (other

⁴⁶ Sec. 1. For a more detailed overview on the taxation of individuals, see Joint Committee on Taxation, *Overview of the Federal Tax System As In Effect for 2023* (JCX-9-23), May 11, 2023.

⁴⁷ 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 U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion (\$120,000 in 2023) for foreign earned income and a limited exclusion for employer-provided housing. Sec. 911. For a more detailed discussion of international tax rules that affect individual taxpayers, see Joint Committee on Taxation, *Background and Analysis of the Taxation of Income Earned by Multinational Enterprises* (JCX-35R-23), July 17, 2023.

⁴⁸ See sec. 871.

⁴⁹ See sec. 1(a)-(d), (j)(2).

⁵⁰ A surviving spouse is generally a taxpayer whose spouse died in either of the two taxable years preceding the current taxable year who maintains a household with a qualifying child. Sec. 2(a). Surviving spouses are often but not always treated the same as married filing jointly taxpayers.

⁵¹ A head of household taxpayer is generally an unmarried taxpayer (who is not a surviving spouse) who maintains a household with a qualifying child or dependent. Sec. 2(b).

⁵² Sec. 61. Part III of Subchapter B of Chapter 1 of the Code contains provisions excluding certain items from gross income. In addition, exclusions may be a matter of common law. See, e.g., Rev. Proc. 2014-35, 2014-26 I.R.B. 1110 (discussing general welfare doctrine).

than certain death benefits), pensions, gross profits from a trade or business, and income in respect of a decedent. They also include income derived from property such as interest, dividends, capital gains, rents, and royalties.

Gross income is not limited to income earned directly by the individual. It also includes income distributed from trusts or estates⁵³ and income allocated from S corporations or partnerships.⁵⁴

Statutory exclusions from gross income include property received by gift or inheritance, for which the transferor may be subject to tax under the wealth transfer tax system.⁵⁵ Other exclusions include death benefits payable under a life insurance contract,⁵⁶ interest on certain State and local bonds,⁵⁷ employer-provided health insurance,⁵⁸ and certain other employer-provided benefits.⁵⁹

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions⁶⁰ include trade or business expenses of trades or businesses that do not consist of the performance of services as an employee, as well as limited trade or business expenses of employees, such as certain moving expenses for members of the Armed Forces and certain expenses of elementary and secondary school teachers.⁶¹ Deductions in determining AGI also include contributions to a qualified retirement plan by a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), losses from the sale or exchange of property, and deductions attributable to rent or royalties.

⁵³ The rules for the income taxation of estates and trusts are discussed at Section II.B.2, below.

⁵⁴ These rules for partnerships and S corporations are discussed at Section II.C.3, below.

⁵⁵ Sec. 102.

⁵⁶ Sec. 101.

⁵⁷ Sec. 103.

⁵⁸ Secs. 105 and 106.

⁵⁹ See, e.g., secs. 119, 127, and 129.

⁶⁰ Sec. 62.

⁶¹ Sec. 62(a)(1).

Taxable income

To determine taxable income, an individual reduces AGI by (1) a standard deduction or itemized deductions⁶² and (2) the deduction for qualified business income.⁶³

The standard deduction is the sum of the basic standard deduction and the additional standard deduction. The amount of the basic standard deduction depends on a taxpayer's filing status.⁶⁴ The additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) and/or blind.⁶⁵ The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

Instead of taking a standard deduction, an individual may elect to itemize deductions. Itemized deductions include⁶⁶ certain State and local income, property, and sales taxes;⁶⁷ home mortgage interest (on mortgages up to certain specified dollar amounts);⁶⁸ charitable contributions;⁶⁹ certain investment interest;⁷⁰ medical expenses (in excess of 7.5 percent of AGI);⁷¹ and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of \$100 per loss).⁷²

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

⁶² Sec. 63.

⁶³ Sec. 199A. The deduction for qualified business income, which has the effect of a tax rate reduction for certain business income, is discussed in more detail at Section II.C.4, below.

⁶⁴ For 2023, the amount of the standard deduction is \$13,850 for a single individual and for a married individual filing separately, \$20,800 for a head of household, and \$27,700 for married individuals filing jointly and for a surviving spouse.

⁶⁵ For 2023, the additional amount is \$1,500 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,850. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2023) of \$3,000 or \$3,700, as applicable.

⁶⁶ See also Part VI and Part VII of Subchapter B of Chapter 1 of the Code.

⁶⁷ Sec. 164. This deduction is limited to \$10,000 annually (\$5,000 for married taxpayers filing separately).

⁶⁸ See sec. 163(h).

⁶⁹ Sec. 170.

⁷⁰ See sec. 163(d).

⁷¹ Sec. 213.

⁷² Sec. 165.

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.

Regular tax liability

To determine regular tax liability, the tax rate schedules (or the tax tables) are applied to a taxpayer's regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, with the marginal tax rate increasing as a taxpayer's income increases.⁷³ Separate rate schedules apply based on an individual's filing status. The current highest statutory marginal tax rate for individuals is 37 percent.⁷⁴

Effective (not statutory) marginal tax rates may be altered by the phase-in and phaseout of certain exemptions or credits.⁷⁵

Credits against tax

An individual's income tax liability may be reduced by tax credits. Some credits, such as the credit for specified child or dependent care expenditures⁷⁶ and the credit for adoption expenses,⁷⁷ are allowed only to individuals.⁷⁸ Individuals may also be allowed other credits that are allowed for legal entities. These credits include the foreign tax credit⁷⁹ and the general business credit.⁸⁰

⁷³ The term "marginal tax rate" generally refers to the additional, or incremental, increase in tax liability from a \$1.00 increase in the taxpayer's income. The marginal tax rates for individuals prescribed in section 1 of the Code are referred to as "statutory marginal tax rates."

⁷⁴ Sec. 1(j).

⁷⁵ The term "effective marginal tax rate" refers to the additional, or incremental, increase in tax liability *under the income tax* from a \$1.00 increase in the taxpayer's income. For example, a credit that is phased out, or incrementally reduced, by \$.05 for every \$1.00 above a certain threshold would cause the effective marginal tax rate to be 5 percentage points higher than the statutory marginal tax rate in the phaseout range. The Code includes many provisions that may cause effective marginal tax rates to differ from statutory marginal rates. For a discussion of such provisions that have an effect on effective marginal tax rates as applied to a prior version of the Code, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

⁷⁶ Sec. 21.

⁷⁷ Sec. 23.

⁷⁸ See Subpart A of Part IV of Chapter 1 of the Code; see also, *e.g.*, secs. 32, 35, and 36B.

⁷⁹ Sec. 901.

⁸⁰ See subpart D of Subchapter A of Chapter 1 of the Code.

Some credits are refundable. Under a refundable credit, a taxpayer is treated as having made an overpayment of tax, and is allowed a refund from the government, if the amount of the credit exceeds the taxpayer's pre-credit tax liability after reduction for nonrefundable credits.

Three significant refundable credits are the child tax credit,⁸¹ the earned income tax credit,⁸² and recent recovery rebate credits.⁸³

Alternative minimum tax liability

To the extent that an individual's tentative minimum tax liability exceeds the individual's regular income tax liability for a taxable year, the individual is liable for alternative minimum tax ("AMT") in that year.⁸⁴ The tentative minimum tax is determined by reference to alternative minimum taxable income ("AMTI"), which is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of specified items in a manner that negates the tax preference resulting from the regular tax treatment of those items.⁸⁵ This amount is compared to an exemption amount that varies by filing status.⁸⁶

Among the tax preferences and adjustments included in AMTI are the inclusion of certain tax-exempt interest⁸⁷ and the disallowance of the deduction for State and local taxes, the standard deduction, and certain itemized deductions.⁸⁸

Certain credits are not allowable against tentative minimum tax liability.⁸⁹

⁸¹ Sec. 24.

⁸² Sec. 32.

⁸³ Secs. 6428, 6428A, and 6428B. Other refundable credits include the American opportunity tax credit, the premium tax credit, and the health coverage tax credit.

⁸⁴ Sec. 55.

⁸⁵ Secs. 56, 57 and 58.

⁸⁶ For taxable years beginning in 2023, the exemption amount is \$126,500 for married individuals filing jointly and surviving spouses for whom the exemption begins to phase out at \$1,156,300, \$81,300 for other unmarried individuals for whom the exemption begins to phase out at \$578,150, and \$63,250 for married individuals filing separately for whom the exemption begins to phase out at \$578,150.

⁸⁷ Sec. 57(a)(5).

⁸⁸ Sec. 56(b).

⁸⁹ See sec. 55(c)(3).

2. Selected tax rules applicable to certain items of non-wage income

Tax rates on capital gains and qualified dividends and the net investment income tax

Individuals are subject to lower rates on certain capital gains and dividends.⁹⁰ These lower rates apply for both the regular tax and the alternative minimum tax.⁹¹

The deduction for qualified business income⁹² is allowed for certain business income. This deduction has the effect of reducing the effective marginal tax rate on the income that qualifies for the deduction.

In addition to the income tax, individuals are subject to a 3.8-percent net investment income tax on certain income.⁹³ The deduction for qualified business income and the net investment income tax are described in more detail in section II.C.4 below.

Carried (profits) interests taxed as short-term capital gain (section 1061 of the Code)

Section 1061 provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest (known as a carried interest) held by the taxpayer.⁹⁴ In general, if the three-year holding period requirement is not satisfied, section 1061 treats gain subject to the provision as short-term capital gain (taxed at ordinary rates). This rule applies notwithstanding the rules of section 83 relating to property transferred in connection with the performance of services or any election in effect under section 83(b) to include amounts in gross income in the year of transfer.

The amounts that are subject to the three-year holding period include gain from, and loss from, the sale or exchange of a capital asset held for more than one year, to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.⁹⁵

An applicable partnership interest is generally an interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business.⁹⁶ The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. An applicable partnership interest does not include a capital interest in a partnership giving the taxpayer a right to share in

⁹⁰ Sec. 1(h), (j)(5).

⁹¹ Sec. 55(b)(3).

⁹² Sec. 199A.

⁹³ Sec. 1411.

⁹⁴ Section 1061 is effective for taxable years beginning after December 31, 2017.

⁹⁵ Sec. 1061(a)(2), referring to secs. 1222(3) and (4).

⁹⁶ Sec. 1061(c).

partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest.

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (ii) developing specified assets. Specified assets mean securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. Reporting requirements and regulatory authority are provided under the provision.

Private placement life insurance and annuity contracts

In general

No provision of present law provides tax treatment specific to private placement life insurance contracts or private placement annuity contracts. A private placement life insurance contract or private placement annuity contract is generally an insurance or annuity contract that would be treated as a security subject to securities laws registration requirements, but that is exempt from registration, that is, the contract can be privately placed. A securities registration exemption is generally permitted if the purchaser is an accredited investor or qualified purchaser within the meaning of securities rules.⁹⁷ Present law does provide for the tax treatment of life insurance contracts and annuity contracts generally.

Tax treatment of a life insurance contract

No Federal income tax for a taxable year generally is imposed on a contract holder with respect to the earnings under a life insurance contract (“inside buildup”).⁹⁸ An exclusion from

⁹⁷ The Securities and Exchange Act of 1934 and the Investment Advisors Act of 1940, and Regulation D (17 CFR Part 230.500).

⁹⁸ This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includable in income, to the extent that the amounts distributed exceed the taxpayer's investment in the contract; such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (that is, income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory “7-pay” test, that is, generally is funded more rapidly than seven annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale

Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.⁹⁹ As a result, inside buildup can be permanently excluded from income to the extent paid out by reason of the death of the insured.

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.¹⁰⁰ Under the limitation, the excludable amount may not exceed the sum of: (1) the actual value of the consideration; and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the amount of the death benefit later received under the contract exceeds the consideration paid for the contract combined with subsequent premium payments on the contract, then the difference is includable in the buyer's income.¹⁰¹

Section 7702 definition of a life insurance contract

A statutory definition of a life insurance contract was enacted in 1984 because of "a general concern with the proliferation of investment-oriented life insurance contracts."¹⁰²

A life insurance contract is defined as any contract that is a life insurance contract under applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement.¹⁰³ In the case of a variable life insurance contract,¹⁰⁴ the

or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured (sec. 101(g)).

⁹⁹ Sec. 101(a)(1).

¹⁰⁰ Sec. 101(a)(2).

¹⁰¹ Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if: (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract (sec. 101(a)(2)(A)); or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer (Sec. 101(a)(2)(B)).

¹⁰² Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, December 31, 1984, page 646. The provision enacted in 1984 is narrower in some respects than 1982 and 1983 temporary guidelines relating to flexible premium life insurance contracts because of Congress' concern about investment oriented life insurance products. *Ibid.*

¹⁰³ Sec. 7702. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes. Because the cash value accumulation test must be met at all times by the terms of the contract, failure of a contract to meet this requirement means that the contract must meet, at all times, the guideline premium/cash value corridor test. Rather than being a requirement of the terms of the contract the guideline premium/cash value corridor test is applied in practice and calls for specific corrective actions if a contract fails to meet it at any time. Although the guideline premium/cash value corridor test does not have to be met by the terms of the contract, the test limitations can be built into a contract to make compliance with the test automatic and to avoid inadvertent violation.

¹⁰⁴ Sec. 817.

determination of whether the contract meets the cash value accumulation test, or meets the guideline premium requirements and falls within the cash value corridor, must be made whenever the amount of the death benefit under the contract changes, but not less frequently than once during each 12-month period.

If a contract does not meet either of the two alternative tests under the definition of a life insurance contract, the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract for a taxable year is the amount by which the sum of the increase in the net surrender value of the contract and the cost of life insurance protection exceeds premiums paid less policyholder dividends paid under the contract during the taxable year.

Tax treatment of an annuity contract

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral period in the hands of the holder of the contract.¹⁰⁵ When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received as an annuity.¹⁰⁶

For amounts received as an annuity by an individual, an exclusion ratio determines the taxable portion of each payment.¹⁰⁷ The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract (tax basis) to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the contract's annuity starting date. Once a taxpayer has recovered the investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date, and are included in income to the extent allocable to income on the contract if received before the annuity starting date (that is, as income first).¹⁰⁸

Definition of an annuity contract

A contract generally is not treated as an annuity contract for Federal tax purposes unless it provides that the entire interest in the contract must be distributed after the death of any holder

¹⁰⁵ If an annuity contract is held by a corporation or by any other person that is not a natural person, the income on the contract is treated as ordinary income accrued by the contract owner and is subject to current taxation. The contract is not treated as an annuity contract (sec. 72(u)).

¹⁰⁶ Sec. 72.

¹⁰⁷ Sec. 72(b).

¹⁰⁸ Sec. 72(e).

over the remaining distribution period, or within five years of death if the death occurs before the annuity starting date.¹⁰⁹

Separate account maintenance and diversification requirements for variable contracts

Life insurance companies generally maintain assets that support liabilities under insurance contracts in a general account, or in separate accounts¹¹⁰ in the case of certain types of contracts such as variable contracts.¹¹¹

A variable life insurance contract is one under which the amount of the death benefit (or period of coverage) is adjusted on the basis of the market value of the separate account. A variable annuity is one under which the amounts paid in, or the amount paid out, reflect the investment return and the market value of the separate account. Present law imposes asset diversification requirements on separate accounts with respect to variable contracts.¹¹² A variable contract that is based on a separate account is not treated as an annuity, endowment or life insurance contract if investments made by the separate account are not adequately diversified (as prescribed in Treasury regulations).

Separate financial reporting to State insurance regulators under statutory accounting rules is generally required for separate accounts, and separate financial statements, registration statements, and other reports may be required under Federal securities laws for separate accounts. For Federal income tax purposes, income, gain and loss of a separate account of a life insurer is reported on the Federal income tax return of the life insurer.

Investor control doctrine

Under the investor control doctrine, the holder of a variable life insurance or annuity contract is treated as the owner of the assets (such as mutual fund shares) underlying the contract if the holder's ability to direct the investment of those assets constitutes sufficient control over individual investment decisions.¹¹³

¹⁰⁹ Sec. 72(s). Exceptions and special rules apply under section 72(s).

¹¹⁰ Sec. 817(c).

¹¹¹ Sec. 817(d).

¹¹² Sec. 817(h). The separate account must satisfy applicable tax requirements.

¹¹³ *Jeffrey T. Webber v. Comm'r*, 144 T.C. No. 17 (2015). See also Rev. Rul. 81-225, 1981-2 C.B. 13; *Christofferson v. U.S.*, 749 F.2d 513 (8th Cir. 1984); Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2007-7, 2007-1 C.B. 468.

3. Income taxation of estates and trusts

Estates and trusts in general

Estates and trusts are legal arrangements that may be created upon the transfer of wealth.¹¹⁴

A trust is a three-party legal arrangement for the ownership of property arranged as follows: (1) A settlor or grantor transfers legal title to the property to (2) one or more trustees, who hold title on behalf of (3) one or more beneficiaries. The trustee has a fiduciary duty to protect the beneficial or equitable rights of the beneficiaries with respect to the property; the trustee may be subject to certain requirements with respect to both the corpus of (that is, the property held by) the trust and the income earned by the trust. The three parties to the trust need not be different; a grantor may also be a trustee or a beneficiary, and a trustee may be a beneficiary. The beneficiaries of a trust are generally individuals but may also include charitable organizations, business entities, or other persons.

An estate is a similar arrangement that may arise upon the death of an individual as follows: (1) A decedent's property is held (2) by an executor who controls the property (3) on behalf of one or more beneficiaries, the heirs of the estate, until the affairs of the estate are wound up and the property is distributed to the heirs.

Trusts are generally governed by a trust agreement. An estate may be governed by a will but may also arise by operation of law even if the decedent does not have a will. Both estates and trusts are also subject to State statutory and common law.

Tax treatment of estates and trusts

Estates and trusts are generally subject to Federal income tax.¹¹⁵ Domestic estates and trusts are generally subject to tax on worldwide income.¹¹⁶

¹¹⁴ See generally Lane and Zaritzky, *Federal Income Taxation of Estates and Trusts*, 3d. edition, Chapter 1; see also Treas. Reg. sec. 301.7701-4(a) (trusts), *Commissioner v. Beebe*, 67 F.2d 662, 664 (1933) (estates).

¹¹⁵ Sec. 1(e), Part 1 of Subchapter J of Chapter 1. The term "trust" may also refer to a number of other types of arrangements or entities. Certain trusts may be classified as business entities. See Treas. Reg. sec. 301.7701-4(a). Trusts may also be pensions, sec. 401, or charitable entities, sec. 501. These types of trusts are all outside the scope of the document.

In addition, many trusts are subject to special rules beyond the ones discussed herein. See, e.g., sec. 641(c) (small business trusts), sec. 642(b) (qualified disability trusts), sec. 644 (charitable remainder trusts), and sec. 646 (Alaska Native Settlement Trusts).

¹¹⁶ Foreign estates and foreign trusts are generally taxed similarly to nonresident aliens. See sec. 7701(a)(31) (definition of foreign estate and foreign trust); see also sec. 7701(a)(30). Taxation will depend on the source of income, whether the income is retained or distributed, the residence of the beneficiaries, and, in the case of trusts, whether the trust is a grantor trust or a nongrantor trust.

The taxable income of estates and trusts is generally computed in the same manner as the taxable income of individuals, with modifications:¹¹⁷ (1) no standard deduction is allowed;¹¹⁸ (2) a small personal exemption is allowed;¹¹⁹ (3) an unlimited charitable deduction is allowed for amounts paid to (or in the case of an estate or certain trusts, amounts permanently set aside for) charity;¹²⁰ and (4) estates and trusts may deduct estate or trust administration costs.¹²¹

Estates and trusts are allowed a deduction for amounts distributed to beneficiaries during the taxable year.¹²² The amount of the deduction is limited by distributable net income, a measure of income to be distributed.¹²³ Because of this deduction, the beneficiary, not the estate or trust, is generally subject to income tax on the distributed amount. By use of this deduction, trusts and estates may eliminate income tax liability to the extent they distribute (rather than retain) income.

If an estate or trust retains income and has taxable income, the rate brackets¹²⁴ that apply are more compressed than the individual tax brackets, meaning that an estate or trust is more quickly subject to tax at the highest marginal rate.¹²⁵ If an estate or trust is subject to tax, it generally pays the tax using income or assets of the estate or trust. Thus, for example, the trust grantor does not pay the tax. This reduces the funds of the estate or trust held for the beneficiaries.

Like individuals, estates and trusts may claim the foreign tax credit¹²⁶ or credits under the general business credit.¹²⁷ However, these credits may in some cases instead be allocated to the beneficiaries of the estate or trust.¹²⁸ Similarly, estates and trusts are subject to the AMT.

¹¹⁷ Sec. 641(b).

¹¹⁸ Sec. 63(c)(6)(D).

¹¹⁹ Sec. 642(b). For estates, the amount of the exemption is \$600. For trusts required to currently distribute all income, the amount is \$300, while for other trusts, the amount is \$100.

¹²⁰ Sec. 642(c).

¹²¹ Sec. 67(e).

¹²² See secs. 651 and 661.

¹²³ Sec. 643(a).

¹²⁴ Sec. 1(e), (j)(2).

¹²⁵ For example, for taxable years beginning in 2023, estates and trusts are subject to the highest marginal rate of 37 percent on taxable income above \$14,450, while married filing separately taxpayers (the next most “compressed” bracket) are subject to the highest marginal rate on taxable income above \$346,875.

¹²⁶ Sec. 642(a).

¹²⁷ Subpart D of Subchapter A of Chapter 1 of the Code.

¹²⁸ See, e.g., secs. 52(d) and 901(b)(5).

Estates and trusts are subject to lower rates on certain capital gains and certain dividends.¹²⁹ Estates and trusts may claim a deduction for qualified business income.¹³⁰ Estates and trusts are also subject to a separate net investment income tax on certain income.¹³¹

Tax treatment of beneficiaries and grantors

Beneficiaries

The transfer of property to an estate or a trust is not a taxable event for the beneficiary or beneficiaries.¹³²

If a beneficiary or beneficiaries receives a distribution from an estate or trust, the amount of the distribution, limited by distributable net income, is included in the beneficiary's gross income.¹³³ An item of income retains its character when received by the beneficiary.

Grantors

A grantor or settlor generally cannot take a deduction for a transfer to an estate or a trust. However, a grantor may be able to claim a charitable deduction if the transfer is to a trust with a charitable organization as a beneficiary.¹³⁴

Different rules (discussed below) apply to transactions between grantors and grantor trusts.

Grantor trusts

Under the grantor trust rules, if the grantor or settlor of a trust retains certain rights or powers with respect to a trust, the grantor of the trust is treated as the owner of the trust.¹³⁵ A

¹²⁹ Sec. 1(h), (j)(5). These lower rates apply for both the regular tax and the AMT. Sec. 55(b)(3).

¹³⁰ Sec. 199A.

¹³¹ Sec. 1411.

¹³² The transfer may be a gift or bequest to the beneficiary, excluded from gross income under section 102. Alternatively, if the transfer is to a grantor trust (discussed more below), the Secretary generally has held that the transaction has no effect for income tax purposes.

¹³³ Secs. 652 and 662.

¹³⁴ Sec. 170(f)(2). The charitable organization, exempt from tax, will not have to pay tax on the income received.

¹³⁵ Sec. 671-679. A grantor is treated as the owner of any portion of a trust if: (1) the grantor has a reversionary interest in either the corpus or the income from the corpus, if certain conditions are satisfied; (2) the grantor has a power of disposition without the approval or consent of any adverse party; (3) the grantor can exercise certain administrative powers with respect to the trust; (4) the grantor or a nonadverse party has the power to revoke, *i.e.*, revest in the grantor, title to a portion of the trust; and (5) without prior approval of an adverse party, the income from the trust may be distributed to or for the benefit of the grantor or the grantor's spouse.

grantor may own only a portion of a trust. Additionally, these rules may apply to an individual other than the grantor who possesses the requisite rights or powers.

If a trust is a grantor trust, the grantor (and not the trust) is taxed on the income of the trust. The grantor may pay the tax out of funds not owned by the trust. If the grantor does so, the funds of the trust available to the beneficiaries are undiminished by the tax payment. Additionally, IRS guidance provides that transactions between the grantor and the grantor trust are disregarded.¹³⁶ Thus, for income tax purposes, a transfer of property to a grantor trust is not a gift, and a sale to a grantor trust is not a sale for tax purposes and does not give rise to gain or loss. The wealth transfer tax consequences of a transfer to a grantor trust may be different.

Just as grantor trusts are not separate income tax taxpayers, they are not separately subject to the net investment income tax.¹³⁷

¹³⁶ Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-7 I.R.B. 28.

¹³⁷ Treas. Reg. sec. 1.1411-3(b)(1)(v). For a more detailed discussion of the net investment income tax, see Part II.C.4 below.

C. Taxation of Business and Investment Income of Individuals

1. Income tax treatment of gains and losses from the disposition of property

In general

In general, a taxpayer is not required to include the economic appreciation (or depreciation) that has accrued on an asset in gross income before the sale or other disposition of the asset.¹³⁸ There are, however, exceptions (discussed below) where the Code either requires or permits taxpayers to include income, gain, or loss that has accrued on an asset before the asset has been disposed.

A taxpayer's gain or loss on disposition of an asset is generally the difference between the amount realized as a result of the disposition and the taxpayer's adjusted basis in the asset.¹³⁹ The amount realized is the sum of any money received plus the fair market value of the property (other than money) received by the taxpayer as a result of the disposition.¹⁴⁰ A taxpayer's basis in property is generally the cost paid in acquiring the property.¹⁴¹ The taxpayer's adjusted basis is basis subject to certain adjustments.¹⁴² For example, a taxpayer must increase basis by certain capital expenditures made or carrying costs incurred with respect to the asset.¹⁴³ If the property is depreciable, basis is reduced by depreciation allowed or allowable.¹⁴⁴ If the property is corporate stock, basis is reduced by the amount of a distribution made by the corporation in excess of corporate earnings and profit.¹⁴⁵

Among other nonrecognition events, an individual's transfer of property by gift or bequest is not a taxable event under the income tax system.¹⁴⁶ Thus, the donor or decedent does not recognize gain or loss upon these dispositions.

In many cases, gains or losses are subject to the capital gains rules. Under these rules, long-term gains are taxed at reduced rates while losses are subject to certain limitations.¹⁴⁷

¹³⁸ Secs. 61(a)(3) and 1001(a).

¹³⁹ Sec. 1001(a).

¹⁴⁰ Sec. 1001(b).

¹⁴¹ Sec. 1012.

¹⁴² Secs. 1011 and 1016.

¹⁴³ Secs. 263 and 266.

¹⁴⁴ Sec. 1016(a)(2).

¹⁴⁵ Sec. 301(c)(2).

¹⁴⁶ Secs. 1001(c), 1014, and 1015.

¹⁴⁷ Secs. 1(h), (j)(5), and 1211.

Capital gains rules

Definition of a capital asset

Capital assets are all property held by the taxpayer other than certain enumerated types of property.¹⁴⁸ The enumerated exceptions are: (1) stock in trade or inventory of a business or property held primarily for sale to customers in the ordinary course of a trade or business; (2) depreciable, amortizable, or real property used in a trade or business; (3) a specified patent, invention, model or design (whether or not patented), and a secret formula or process, copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property;¹⁴⁹ (4) accounts or notes receivable acquired in the ordinary course of business for services or from the sale of property described in the first exception; (5) certain publications of the U.S. government; (6) certain commodities derivative financial instruments held by commodities dealers; (7) certain business hedging transactions; and (8) business supplies.

Under section 1231, the net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.¹⁵⁰ Under section 1245, gain from the disposition of depreciable personal property is treated as ordinary income to the extent of previous depreciation allowances.¹⁵¹ If the depreciable asset is sold for more than its adjusted basis, any gain exceeding the total depreciation recapture is generally treated as section 1231 gain (that is, subject to long-term capital gain rates).

Mechanics of capital gains

The capital gains rules look to whether the gain or loss from the sale or exchange of a capital asset is long-term or short-term. Generally, gain or loss is treated as long-term if the asset is held for more than one year and treated as short-term if held for one year or less.¹⁵² Rules apply to determine the taxpayer's holding period.¹⁵³

Capital losses whether short-term or long-term are generally deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of

¹⁴⁸ Sec. 1221.

¹⁴⁹ The rule applies to such property held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created). Sec. 1221(a)(3).

¹⁵⁰ However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses.

¹⁵¹ Sec. 1245. In certain cases, section 1250 may apply to depreciable real property. For a detailed discussion of the recapture rules under sections 1245 and 1250, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021, pp. 15-17, available at www.jct.gov.

¹⁵² Sec. 1222. Section 1061 imposes a three-year holding period requirement for a certain partnership interests transferred to, or held by, a taxpayer in exchange for the performance of services (*i.e.*, a carried interest) to be eligible for long-term capital gain treatment.

¹⁵³ Sec. 1223.

ordinary income in each year.¹⁵⁴ Any remaining unused capital losses may be carried forward indefinitely.¹⁵⁵

Tax rates on capital gains

The applicable tax rate for an individual's net capital gain is determined based on a progressive rate structure with thresholds based on taxable income.¹⁵⁶ The thresholds vary depending on filing status. There are three rate brackets: 0 percent, 15 percent, and 20 percent.¹⁵⁷ Qualified dividends are also subject to tax at these rates.¹⁵⁸

In two cases, there are additional higher rate brackets. A maximum 25 percent rate applies to unrecaptured section 1250 gain. Unrecaptured section 1250 gain arises upon the sale of depreciable real property, gain from which may be treated as long-term gain under section 1231 (for property used in a trade or business). Upon the sale of such property, a portion of the gain attributable to depreciation recapture is treated as capital gain but taxed at a higher rate.¹⁵⁹ A maximum 28 percent rate applies to gain from the sale of collectibles.¹⁶⁰

Exclusion and deferral

Several rules apply to capital gains that allow taxpayers to exclude or defer gain from income. For example, under section 1202, a taxpayer generally may exclude 100 percent of the gain from the sale of certain small business stock. Under section 1031, a taxpayer who realizes gain from the sale of certain real property may defer recognition by reinvesting the proceeds in another real property investment. Under the qualified opportunity zone rules, a taxpayer who realizes capital gain may defer recognition by reinvesting the gain in a qualified opportunity fund that, in turn, makes certain investments in low-income areas.¹⁶¹

¹⁵⁴ Sec. 1211(b). The limitation is \$1,500 in the case of married filing separately taxpayers. An individual may take a limited ordinary loss deduction (\$50,000 or \$100,000 if the taxpayer files a joint return) for a loss sustained on the sale, exchange, or worthlessness of certain small business stock (referred to as "section 1244 stock"). Sec. 1244.

¹⁵⁵ Sec. 1212(b).

¹⁵⁶ Sec. 1(h) and (j)(5).

¹⁵⁷ Sec. 1(h)

¹⁵⁸ Sec. 1(h)(11).

¹⁵⁹ Sec. 1(h)(6). This should be compared to the section 1245 recapture for depreciable personal property, which may also give rise to long-term capital gain under section 1231. Under that section, the gain attributable to prior depreciation or amortization allowances is treated as ordinary income (not capital gain) and taxed at ordinary rates.

¹⁶⁰ Sec. 1(h)(4). The term collectible is defined in section 408(m).

¹⁶¹ Secs. 1400Z-1 and 1400Z-2.

Income tax treatment of transfers of property by gift or bequest

Transfers by a donor by gift or by a decedent at death are treated differently than sales or other dispositions of property. These transfers are generally not taxable events for either the transferor or transferee under the income tax system, and basis rules specific to the transactions apply. In addition, these transfers may give rise to consequences under the wealth transfer tax system compromising the estate, gift, and generation-skipping transfer tax.

Transfers by gift

A transfer by gift is not a taxable event to the donor,¹⁶² while the asset transferred is not included in the gross income of the donee.¹⁶³ However, the donor may be subject to gift tax on the transfer if, for example, the gift exceeds the annual gift tax exclusion amount. The donee's basis is generally the donor's basis increased by any gift tax paid by the donor.¹⁶⁴ However, if the fair market value at the time of transfer is less than the donor's basis, the donee's basis is limited to the fair market value.¹⁶⁵

Slightly different rules apply to transfers between spouses. A transfer by gift between spouses is not a taxable event,¹⁶⁶ while the asset transferred is not included in the gross income of the donee.¹⁶⁷ In addition, the transfer is generally not subject to gift tax.¹⁶⁸ The donee spouse's basis is the donor spouse's adjusted basis, and the fair-market-value limitation does not apply.¹⁶⁹

For purposes of the capital gains rules, a donee's holding period includes the donor's holding period.¹⁷⁰

¹⁶² Secs. 1001(c) and 1015.

¹⁶³ Sec. 102.

¹⁶⁴ Sec. 1015.

¹⁶⁵ *Ibid.* The increase for gift tax paid also cannot result in basis above fair market value.

¹⁶⁶ Sec. 1041. This rule also applies to transfers incident to divorce.

¹⁶⁷ Sec. 102.

¹⁶⁸ Sec. 2523.

¹⁶⁹ See also sec. 1015(e).

¹⁷⁰ Sec. 1223(2).

Transfers at death

A transfer at death is also not a taxable event to the decedent,¹⁷¹ while the asset transferred is not included in the gross income of the heir.¹⁷² However, the decedent's estate may be subject to estate tax on the transfer; transfers to a surviving spouse are generally not subject to estate tax.¹⁷³

The heir's basis in the asset is generally the fair market value of the asset on the date of the decedent's death,¹⁷⁴ even though untaxed appreciation (or depreciation) is not taken into account by either the decedent or the heir.¹⁷⁵ This "step up" or "step down" in basis removes the built-in gain or loss on the asset at the time of the decedent's death from the income tax system. The income tax system therefore only takes into account gain or loss that arises during the heir's ownership of the asset.

For purposes of the capital gains rules, the heir is treated as holding the inherited asset for more than one year, such that it is eligible for long-term capital gains treatment, regardless of the actual period of ownership.¹⁷⁶

Transfers by gift or at death to charitable transferees

Gifts and bequests to charitable organizations, like other gifts and bequests, are not taxable events for income tax purposes and so do not cause the transferor to realize or recognize gain or loss on a transfer of property. The transferor may claim a deduction for income tax purposes, subject to certain limits, generally equally to the fair market value of the property transferred.¹⁷⁷ In the case of appreciated property, this allows the taxpayer to claim a benefit with respect to untaxed appreciation.

Transfers by gift or at death are also generally not subject to tax under the transfer tax system.

¹⁷¹ See secs. 1001(c) and 1014.

¹⁷² Sec. 102.

¹⁷³ Sec. 2056.

¹⁷⁴ Sec. 1014(a). In certain cases, different valuation rules apply. The heir's basis generally cannot exceed the value of the property as finally determined for purposes of imposing estate tax on the decedent's estate. See sec. 1014(f).

¹⁷⁵ In Rev. Rul. 2023-2, 2023-16 I.R.B. 658, the IRS held that assets the decedent transferred to an irrevocable grantor trust (commonly referred to as an "intentionally defective grantor trust") by means of a completed gift do not receive a basis step up at death because those assets are not included in the decedent's gross estate.

¹⁷⁶ Sec. 1223(9).

¹⁷⁷ Sec. 170. In certain cases, the deduction is limited to a lower amount, such as the taxpayer's basis in the contributed property. Sec. 170(e).

2. Overview of mark-to-market taxation

In general, a taxpayer is not required to include an item of gain or loss in the calculation of gross income until the taxpayer realizes the gain or loss.¹⁷⁸ Realization generally occurs when the taxpayer receives cash or property or otherwise “obtains the fruition of the economic gain which has already accrued to him.”¹⁷⁹ In the context of property (as distinct from services), realization generally occurs when the taxpayer sells, exchanges, or otherwise disposes of the asset on which the gain or loss has accrued.¹⁸⁰

In certain circumstances, however, the Code either requires or permits taxpayers to include gain or loss that has accrued on an asset before the asset has been disposed of.¹⁸¹ These rules employ a concept called “mark to market,” where the taxpayer is treated as if it sold the asset subject to these rules (that is, the asset being “marked”) for the asset’s fair market value as of the date of the mark prescribed by the statute. In many cases, the date of the mark is the last business day of the taxpayer’s taxable year, but it could also be the date of a particular event (for example, the day before the taxpayer relinquishes U.S. citizenship).

Any gain or loss included in gross income as a result of an asset being marked to market generally is taken into account in calculating future gain or loss (including gain or loss on a future mark to market) on the asset.¹⁸² For example, if a taxpayer purchases a security that is subject to the mark-to-market rules of section 475 for \$20, and at the end of the taxpayer’s taxable year, the security is worth \$40, the taxpayer is required to include \$20 in income for that year. If at the end of the taxpayer’s next taxable year, the security is worth \$30, the taxpayer has a \$10 loss. And if, in the middle of the taxable year following the year of the loss, the taxpayer sells the security for \$30, the taxpayer has no gain on the sale.

The cumulative effect of a mark-to-market regime is to include in the taxpayer’s income the fluctuation in value of the asset in each tax year. The net amount of the overall inclusions across all tax years equals the amount that would have been included if gain or loss were calculated only upon sale or other disposition.¹⁸³

What follows is a brief description of four mark-to-market rules in the Code: section 475 (applying mark to market to certain securities and commodities dealers and traders); section

¹⁷⁸ While the Code does not explicitly define the realization principle, the reference to gain or loss “from the sale or other disposition of property” in section 1001(a) implies that the change in an asset’s fair market value is generally not considered for tax purposes until the gain or loss is ‘realized’ by a taxable event.

¹⁷⁹ *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

¹⁸⁰ Sec. 1001.

¹⁸¹ See, e.g., secs. 475, 877A, 1256, 1259, 1272, and 1296.

¹⁸² See, e.g., sec. 475(a) (flush language).

¹⁸³ In the above example, the net gain or loss is a \$10 gain, which equals the difference between the purchase price of \$20 and the sale price of \$30. This is equal to the gain or loss across all periods of (1) year 1 gain of \$20, (2) year 2 loss of \$10, and (3) year 3 gain or loss of \$0.

877A (marking to market the assets of individuals who terminate U.S. citizenship or long-term permanent resident status); section 1256 (mark to market of certain financial derivatives); and section 1296 (elective mark to market for marketable stock in a passive foreign investment company).

Mark to market for dealers and traders in securities and commodities

Section 475(a) generally requires dealers¹⁸⁴ in securities¹⁸⁵ to mark to market securities they hold at the end of each tax year. The securities are treated as sold on the last business day of the taxable year at their fair market value.¹⁸⁶ The mark-to-market requirement does not apply to securities held for investment, certain debt securities, and certain hedges.¹⁸⁷ Dealers in commodities¹⁸⁸ and traders¹⁸⁹ in securities and commodities may also elect mark-to-market treatment.¹⁹⁰ The dealer and trader elections, once made, are irrevocable without the consent of the Secretary.¹⁹¹

The character of gain or loss from the mark to market or the disposition of a security or commodity under section 475 is ordinary income or loss.¹⁹²

Before the enactment of section 475 in 1993, dealers in securities could elect to account for their inventories according to (1) the lower of cost or market (“LCM”), (2) cost, or (3) fair market value. With section 475, Congress provided a uniform mark-to-market rule for the

¹⁸⁴ Section 475(c)(1) defines a dealer in securities as a taxpayer who either (1) regularly purchases securities from or sells securities to customers in the ordinary course of business, or (2), regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of business.

¹⁸⁵ A security is broadly defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments. Section 1256 contracts are excluded. See sec. 475(c)(2).

¹⁸⁶ Sec. 475(a).

¹⁸⁷ Sec. 475(b)(1). To meet these exceptions, the eligible securities must be clearly identified as such in the dealer’s records. Sec. 475(b)(2).

¹⁸⁸ Sec. 475(e). Commodity is defined to include actively traded commodities within the meaning of section 1092(d)(1), notional principal contracts with respect to actively traded commodities, derivatives on actively traded commodities, and certain hedges with respect to the aforementioned categories of commodity. See sec. 475(e)(2).

¹⁸⁹ The Tax Court defines a trader as someone that does not provide the services of acting as a middleman (earning compensation from the attendant fees), but rather “depend[s] upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost.” See *Kemon v. Commissioner*, 16 T.C. 1026, 1032-33 (1951).

¹⁹⁰ Sec. 475(f).

¹⁹¹ Secs. 475(e)(3) and (f)(3).

¹⁹² Secs. 475(d)(3) and (f)(1)(D).

taxation of securities held by securities dealers of all types. Explaining Congress's reasons for adopting section 475, the House Budget Committee report accompanying the legislation states that "[i]nventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes."¹⁹³ The report adds, "the cost method and the LCM method generally understate the income of securities dealers and . . . the mark-to-market method most clearly reflects their income."¹⁹⁴

Mark to market of property of expatriating persons

An individual taxpayer who expatriates from the United States (that is, either relinquishes U.S. citizenship or ceases to be a lawful permanent resident of the United States¹⁹⁵) after June 16, 2008 and who satisfies a net income tax liability test or a net worth test or who fails a tax compliance test is subject to tax on the net unrealized gain in the individual's property immediately before expatriation under the mark-to-market rules of section 877A.¹⁹⁶ Section 877A treats a taxpayer who expatriates as having sold all of their property on the day before the expatriation date for its fair market value.¹⁹⁷ The individual may elect to defer payment of any additional tax attributable to gain on the deemed sale until the taxpayer actually disposes of property deemed sold, if the taxpayer elects to do so and irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.¹⁹⁸ The amount of gain is fixed as of the date of the mark.

Mark to market of certain financial derivatives

Section 1256 was enacted in 1981 as part of a set of rules addressing so-called straddle shelters.¹⁹⁹ A straddle shelter was a transaction whereby a taxpayer could use combinations of financial instruments (potentially including both securities and derivatives) to limit or eliminate risk of loss on an existing financial position while at the same time deferring gain recognition

¹⁹³ Report of the Committee on the Budget, House of Representatives, to accompany H.R. 2264, A Bill to Provide for Reconciliation Pursuant to Section 7 of the Concurrent Resolution on the Budget for Fiscal Year 1994, H.R. Rep. No. 103-111, May 25, 1993, p. 661.

¹⁹⁴ *Ibid.*

¹⁹⁵ Lawful permanent resident is defined in section 7701(b)(6).

¹⁹⁶ Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09), March 2009, pp. 174-185, available at www.jct.gov.

¹⁹⁷ Sec. 877A(a)(1). Section 877A provides for a one-time mark, rather than periodic marks as in sections 475, 1256, and 1296.

¹⁹⁸ Sec. 877A(b)(1) and (5). A tax deferred under these rules bears interest from the due date of the taxpayer's return for the expatriation year (determined without extensions). Sec. 877A(b)(7).

¹⁹⁹ Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, pp. 279-316, available at www.jct.gov.

and potentially converting short term capital gain into long term capital gain.²⁰⁰ Section 1256 applies to certain derivatives that could be used as part of a straddle shelter.

Section 1256 requires certain derivatives (referred to in the statute as “section 1256 contracts”) to be marked to market on the last business day of the taxpayer’s taxable year and prescribes that any resultant gain or loss is treated as 40 percent short term gain or loss and 60 percent long term gain or loss. Section 1256 contracts include regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts.²⁰¹ Any securities futures contract (or option on such a contract) other than a dealer securities futures contract is explicitly excluded from the application of section 1256, as is any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.²⁰²

Mark to market of marketable PFIC stock

The passive foreign investment company (“PFIC”) regime of sections 1291 through 1298 addresses the use of foreign companies to defer U.S. tax on passive income in part by permitting taxpayers to elect to mark certain PFIC stock to market.

A PFIC is any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income or if 50 percent or more of its assets produce, or are held to produce, passive income.²⁰³ The PFIC regime provides three alternative sets of rules for current inclusion of PFIC income, one of which permits a taxpayer holding marketable stock²⁰⁴ in a PFIC to elect to include (or deduct) income (or loss) each year equal to the difference between the fair market value of the marketable PFIC stock as of the close of the taxable year and the taxpayer’s adjusted basis in such stock (that is, marking the marketable PFIC stock to market).²⁰⁵ The resulting gain or loss is treated as ordinary income or loss.²⁰⁶

Taxpayers making the election are exempt from a different set of rules under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest

²⁰⁰ An example of the mechanics of a straddle shelter is provided by Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, p. 295, available at www.jct.gov.

²⁰¹ Sec. 1256(b)(1). For definitions of these terms, see section 1256(g).

²⁰² Sec. 1256(b)(2).

²⁰³ Sec. 1297.

²⁰⁴ Marketable stock is defined in Treas. Reg. sec. 1.1296-2. Generally, the term comprises stock that is regularly traded on a qualified exchange, certain stock that is redeemable at its net asset value, and options on the previous two categories of marketable stock. Treas. Reg. sec. 1.1296-2(a)(1).

²⁰⁵ Sec. 1296.

²⁰⁶ Sec. 1296(c)(1).

charge on the deferral value.²⁰⁷ The same exemption applies to PFIC stock that is required to be marked to market under any other provision of the Code.²⁰⁸

3. Taxation of domestic business income of individuals

Income from a business

Business income is taxed under rules relating to the form in which the business is conducted. The business may take the form of an entity or may be conducted as a sole proprietorship.²⁰⁹ The principal business entities for Federal income tax purposes are C corporations, partnerships, and S corporations. Partnerships and S corporations are often referred to as passthrough entities because their income is included in the gross income of the owners of the entities rather than in the income of the entities themselves. In the case of individuals, the tax rate on income from passthrough entities and sole proprietorships depends on the individual's filing status and income. A large portion of business income is derived by C corporations and is taxed under the corporate income tax. Distributed C corporation income (generally, dividend income) is also subject to income tax in the hands of the recipient shareholders.

Choice of business entity

Taxpayers may choose among forms of doing business. Their choice impacts how the business may be organized and taxed. C corporations have no restrictions on who can hold shares or the number of shareholders, but distributed corporate income is subject to two levels of income tax.²¹⁰ Partnerships have no limit on the number of partners and may allocate income, gain, deduction, loss and credit to reflect the business arrangement provided the allocations have substantial economic effect.²¹¹ In contrast, S corporations are limited to 100 shareholders²¹² and must allocate income, gain, deduction, loss and credit to shareholders on a pro rata per share, per day basis.²¹³ Some differences involve the availability of partnership or S corporation status to

²⁰⁷ Sec. 1291.

²⁰⁸ Sec. 1296(d)(1).

²⁰⁹ A sole proprietorship is generally not treated as an entity separate from its owner, as discussed below. More complex or specialized arrangements involving, for example, affiliated corporations, tiered entities, special purpose entities, real estate investment trusts ("REITs"), regulated investment companies (mutual funds or "RICs") or foreign entities or investments are beyond the scope of this discussion.

²¹⁰ Publicly traded partnerships provide access to public capital markets without two levels of income tax, but with additional complexity. Partnerships more commonly are not publicly traded.

²¹¹ Sec. 704(b).

²¹² Sec. 1361(b). Certain related shareholders are treated as one for this purpose.

²¹³ Sec. 1366(a).

existing businesses.²¹⁴ For example, a C corporation may convert to an S corporation, but not to a partnership, without immediate recognition of gain at either the corporate or the shareholder level.²¹⁵ In general, a partnership offers more flexibility but greater complexity, while an S corporation imposes more restrictions but may be simpler to implement.

In 2020, there were approximately 1.5 million C corporations, 4.3 million partnerships, 4.9 million S corporations, 28.4 million nonfarm sole proprietorships, and 1.8 million farm sole proprietorships.²¹⁶ Before 1987, there were more C corporations than S corporations and partnerships combined. In 1987, the number of S corporations and partnerships exceeded the number of C corporations. Since 1987, the combined number of passthrough entities has more than tripled. The growth has been led by large increases in the number of small S corporations (those with less than \$100,000 in assets) and limited liability companies (“LLCs”) taxed as partnerships.²¹⁷

Individuals who are shareholders in a C corporation

In general

An individual shareholder of a C corporation²¹⁸ is generally subject to tax on dividends distributed to the individual by the corporation. A distribution by a corporation to its shareholders²¹⁹ generally is taxable as a dividend to the extent of the corporation’s current and

²¹⁴ For a chart summarizing tax differences among C corporations, partnerships, S corporations, and sole proprietorships, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, pp. 11-16, available at www.jct.gov.

²¹⁵ The liquidation of a C corporation generally requires the corporation to recognize gain on its assets. Secs. 336-338 (providing some exceptions to this treatment). Converting a C corporation to a partnership is treated as a liquidation of the C corporation. However, converting a C corporation to an S corporation (achieved by electing S corporation status) is not treated as a liquidation of the C corporation. Certain built-in gain of a C corporation that elects S corporation status remains subject to C corporation tax if recognized within five years after the conversion. Thus, if a C corporation satisfies the limits on the number and types of shareholders, the single class of stock requirement, and other applicable requirements, a conversion of a C corporation to an S corporation is not taxable, and post-conversion income and appreciation of assets in the entity are subject only to shareholder-level tax.

²¹⁶ Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2023* (JCX-9R-23), May 11, 2023, p.37, available at www.jct.gov.

²¹⁷ Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, p. 2, available at www.jct.gov.

²¹⁸ A C corporation is any corporation that is not an S corporation. The letter “C” appears to reflect that subchapter C of chapter 1 of the Code is entitled “corporate distributions and adjustments.”

²¹⁹ A corporate shareholder (*i.e.*, a corporation that owns shares of another corporation) that receives a dividend generally is eligible for a dividends-received deduction that results in the recipient corporation being taxed on at most 50 percent and possibly on none of the dividend received by the shareholder. Sec. 243. Special rules apply in certain cases and with respect to certain amounts received by corporate shareholders. Secs. 245, 245A, 246, and 246A.

accumulated earnings and profits.²²⁰ Qualified dividends are subject to tax at the same preferential rates that apply to capital gains for individual taxpayers.²²¹

In addition, the C corporation is subject to the 21-percent corporate income tax as an entity separate from its shareholders, with the same rate applying to short-term and long-term capital gains.²²² As a result, a corporation's distributed income generally is taxed once at the corporate level when earned and then again to individual shareholders when distributed as dividends. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed through to shareholders. Corporate income that is not distributed to shareholders generally is subject to tax at the corporate level only. Dividends paid to individuals generally are not deductible by the corporation.²²³

Shareholders of a C corporation are taxed at capital gains rates upon sale or exchange (including certain redemptions²²⁴) of the stock. Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock.²²⁵

Excess income retained by a C corporation may result in additional corporate-level tax regardless of whether the amounts are distributed to shareholders.²²⁶ If the C corporation distributes property to shareholders, the gain on appreciated corporate property is subject to corporate-level tax upon distribution to the shareholders, yielding the same tax result as if the

²²⁰ A distribution that exceeds the earnings and profits of a corporation 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 that exceeds basis. Sec. 301(c). A distribution of property other than cash is treated as a taxable sale of the property by the corporation and is taken into account by the shareholder at the property's fair market value. Sec. 311. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder. Secs. 311(a) and 305.

²²¹ Sec. 1(h)(11).

²²² Sec. 11. This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.

²²³ Foreign investors are subject to withholding tax on dividends paid by domestic corporations, and generally are exempt from U.S. income tax on capital gains from the sale of corporate stock (irrespective of whether the corporation is domestic or foreign). Tax-exempt investors generally are not subject to tax on either dividends or on sales or exchanges of corporate stock.

²²⁴ Sec. 302.

²²⁵ A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the shareholders for its fair market value. Sec. 311. 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. Sec. 332.

²²⁶ The accumulated earnings tax may be imposed (generally at a 20 percent rate) on a corporation if it retains earnings that exceed reasonable business needs. The personal holding company tax may be imposed on the excess passive income of a closely held corporation. Secs. 531 and 541. These rules impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.

assets had been sold by the corporation and the proceeds distributed to the shareholders.²²⁷ No separate rate structure exists for corporate capital gains.

In contrast to dividends on stock, some amounts paid as interest to holders of corporate debt may be subject to only one level of tax (at the recipient level) since the corporation is allowed a deduction for part or all the interest expense paid or accrued.²²⁸

Individuals who are partners in a partnership

Partners in a partnership are subject to tax on their distributive shares of partnership income. Partnerships generally are treated for Federal income tax purposes as passthrough entities not subject to tax at the entity level.²²⁹ The character of partnership items, such as ordinary income or loss, capital gain, or capital loss, passes through to partners.²³⁰ Partners must take into account these partnership items based on the partnership's method of accounting and regardless of whether income is distributed to the partners.²³¹

A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.²³² Disallowed losses are carried forward to the next year.

Partners may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.²³³

²²⁷ Sec. 311(b).

²²⁸ Sec. 163. Section 163(j) limits the interest deduction of C corporations to the sum of business interest income, floor plan financing interest, and 30 percent of adjusted taxable income. Adjusted taxable income for purposes of the interest deduction limit is the taxpayer's tentative taxable income with certain adjustments to add or subtract business interest income, business interest expense, net operating losses, qualified business income under section 199A, capital loss carryback or carryover deductions, certain inclusions from controlled foreign corporations, and amounts not allocable to the trade or business.

²²⁹ Sec. 701.

²³⁰ Sec. 702(b).

²³¹ Sec. 702(a).

²³² Sec. 704(d). A partner's adjusted basis in a partnership interest generally equals (1) the sum of (a) the amount of money and the adjusted basis of property contributed to the partnership, or the amount paid for the partnership interest, (b) the partner's distributive share of partnership income, and (c) the partner's share of partnership liabilities, reduced by (2) the sum of (a) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any partnership distributions to the partner. Sec. 705. In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by a partner's share of partnership deductions (secs. 469 and 465). These limitations do not apply to corporate partners, except certain closely-held corporations.

²³³ Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities that exceeds basis, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income). Sec. 751.

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.²³⁴ An allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.²³⁵

State laws of every State provide for the establishment of LLCs, which are neither partnerships nor corporations under applicable State law, but which are treated as partnerships for Federal tax purposes.²³⁶ An individual who holds an interest in an LLC that is treated as a partnership is a partner for Federal tax purposes.

A partner in a publicly traded partnership that meets the applicable requirements²³⁷ is subject to the same tax treatment applicable to a partner in a partnership that is not publicly traded. To meet the applicable requirements, 90 percent or more of a publicly traded partnership's gross income must comprise one or more types of qualifying income.²³⁸

Individuals who are shareholders in an S corporation

S corporation shareholders are subject to tax on their pro rata shares of S corporation income.²³⁹ An S corporation²⁴⁰ generally is not subject to Federal income tax at the corporate level.²⁴¹ The character of S corporation items, such as ordinary income or loss, capital gain, or capital loss, passes through to S corporation shareholders.²⁴² The shareholder's pro rata shares

²³⁴ Sec. 704(b)(2).

²³⁵ Treas. Reg. sec. 1.704-1(b)(2).

²³⁶ Any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for Federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, not treated as separate from its owner). Treas. Reg. sec. 301.7701-3 (known as the "check-the-box" regulations). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes.

²³⁷ For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof). Sec. 7704(b). If the publicly traded partnership does not meet the applicable requirements, however, it is treated as a corporation for Federal tax purposes. Sec. 7704(a).

²³⁸ Sec. 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held to produce qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and certain other income and gains specified by statute. Sec. 7704(d).

²³⁹ Secs. 1366(a) and 1377(a).

²⁴⁰ An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

²⁴¹ Secs. 1363 and 1366.

²⁴² Sec. 1366(b).

are determined based on the S corporation's method of accounting and regardless of whether income is distributed to the shareholders.

A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to the shareholder.²⁴³ Disallowed losses are carried forward to the next year.²⁴⁴

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.²⁴⁵

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.²⁴⁶ Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation. Although there are limitations on the types of shareholders and stock structure an S corporation may have, businesses organized as S corporations may be as large as those organized as C corporations or partnerships.

Individuals conducting a business as a sole proprietorship

An individual who conducts a business in the form of a sole proprietorship is taxed directly on business income. The individual files Schedule C (sole proprietorships), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. The transfer of a business conducted as a sole proprietorship is treated as a transfer of each individual asset of the business.²⁴⁷

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship generally is not treated as an entity distinct from its owner for Federal income tax

²⁴³ A shareholder's adjusted basis in the S corporation stock generally equals (1) the sum of (a) the shareholder's capital contributions to the S corporation and (b) the shareholder's pro rata share of S corporation income, reduced by (2) the sum of (a) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any S corporation distributions to the shareholder. Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

²⁴⁴ Sec. 1366(d)(2).

²⁴⁵ Sec. 1368.

²⁴⁶ Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

²⁴⁷ Rev. Rul. 55-79, 1955-1 C.B. 370.

purposes.²⁴⁸ A sole proprietorship is treated as an entity separate from its owner for employment tax purposes,²⁴⁹ for certain excise taxes,²⁵⁰ and certain information reporting requirements.²⁵¹

4. All-in tax rates on income of individuals

Tax rates on income of individuals are described in section II.B.1, above, relating to income taxation of individuals. An individual's income from a business may be taxed at ordinary rates up to 37 percent in 2023, or at the rates applicable to capital gains and qualified dividends, generally at a top rate of 20 percent.

Income received by individuals from a C corporation is subject to two levels of tax: a 21-percent corporate income tax and a shareholder income tax (generally, 20 percent for qualified dividends).²⁵² Income received by individuals through a passthrough entity (a partnership or an S corporation) or a sole proprietorship may have a smaller effective tax rate due to no entity level tax and the qualified business income deduction of up to 20 percent. Some business income of an individual is also subject to the net investment income tax ("NIIT") or the tax on net earnings from self-employment ("SECA"). Adding these other tax rates and the qualified business income deduction to an individual's income tax rate gives the "all-in" tax rate.

Deduction for qualified business income

An individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income.²⁵³ Certain specified agricultural or horticulture cooperative may deduct nine percent of qualified production activities income.²⁵⁴

²⁴⁸ A single-member unincorporated entity is disregarded for Federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. sec. 301.7701-3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under section 761(f).

²⁴⁹ Treas. Reg. sec. 301.7701-2(c)(2)(iv).

²⁵⁰ Treas. Reg. sec. 301.7701-2(c)(2)(v).

²⁵¹ Treas. Reg. sec. 301.7701-2(c)(2)(vi).

²⁵² Mitigating factors of the two-level taxation of distributed corporate income include the availability of corporate deductions and credits that may lower the effective tax; use of corporate debt, payments of interest on which are deductible by the corporation; retention of corporate income as retained earnings; and share buybacks.

²⁵³ Sec. 199A lets individuals, trusts and estates deduct up to 20 percent of their qualified business income for tax years beginning after December 31, 2017, and before January 1, 2026.

²⁵⁴ Sec. 199A(g). The deduction is limited by the cooperative's taxable income for the year (computed without regard to the 199A deduction and reduced by certain payments or allocations to patrons). The deduction may instead be allocated to and deducted by the cooperative's patrons, limited to each patron's taxable income for

For taxpayers with taxable income²⁵⁵ in excess of the threshold amount (for 2023, \$364,200 for married taxpayers filing jointly, \$182,100 for married taxpayers filing separately, and \$182,100 for all other taxpayers),²⁵⁶ the deduction for qualified business income is limited based on (1) the taxpayer's allocable share of W-2 wages paid by the trade or business and the taxpayer's allocable share of capital investment with respect to the trade or business²⁵⁷ and (2) the type of trade or business in which the income is earned.²⁵⁸ These limitations phase in when the threshold amount exceeds taxable income.²⁵⁹ The deduction for qualified business income, qualified REIT dividends, and qualified publicly traded partnership income may not exceed 20 percent of the taxpayer's taxable income for the tax year.²⁶⁰

NIIT

The net investment income tax applies at a 3.8 percent rate to certain investment income of individuals.²⁶¹ Thus, for taxpayers subject to the NIIT, the maximum rate on certain capital

the year (computed without regard to any section 199A deduction under the general rule and after accounting for the cooperative's section 199A deduction).

²⁵⁵ Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

²⁵⁶ Rev. Proc. 2022-38, 2022-45 I.R.B. 445. These threshold amounts are indexed for inflation.

²⁵⁷ The deduction is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. Sec. 199A(b)(2)(B).

²⁵⁸ Qualified business income excludes income from a specified service trade or business when taxable income exceeds the threshold amount and excludes income from the trade or business of performing services as an employee. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Sec. 199A(d).

²⁵⁹ Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

²⁶⁰ Taxable income is computed without regard to the deduction allowable under section 199A and is reduced by net capital gain with respect to this limitation.

²⁶¹ Sec. 1411. The NIIT generally applies to an individual partner's distributive share of partnership income (if the income is from a passive activity with respect to the individual partner), certain gains to which SECA does not apply (see secs. 1402(a)(1)-(17)), and to S corporation shareholders who are not active in the S corporation's business (as well as to certain other investment income). For individuals, the tax is imposed on the lesser of (i) net investment income or (ii) the excess of modified adjusted gross income ("AGI") over a threshold amount. Modified AGI 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). 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. Net investment income is the excess of (i) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the

gains and dividends is 23.8 percent (20 percent income tax plus 3.8 percent NIIT), while the maximum rate on other investment income that is subject to ordinary rates, including interest, annuities, royalties, and rents, is 40.8 percent (37 percent income tax plus 3.8 percent NIIT). The NIIT generally applies to certain capital gains and dividends, net gain (that is not subject to SECA tax) of a partner that is not active in the partnership's business,²⁶² income of a partner not active in the partnership, and income of an S corporation shareholder not active in the S corporation.

SECA

Individuals with self-employment income are subject to the SECA tax in lieu of the Federal Insurance Contributions Act ("FICA") taxes required to be paid by employees and their employer. The SECA tax is imposed at (1) a 15.3 percent rate for amounts below or equal to \$160,200 (the 12.4 percent old-age, survivors, and disability insurance ("OASDI") tax plus 2.9 percent hospital insurance ("HI") tax), (2) a 2.9 percent rate for the HI tax on amounts above \$160,200 for 2023, and (3) a 0.9 percent rate for the additional HI tax on amounts that exceed the applicable HI threshold (\$250,000 for a joint return or surviving spouse, \$125,000 for a married individual filing a separate return, and \$200,000 in any other case).²⁶³ The SECA tax applies to net earnings from self-employment, taking into account allowable deductions, derived from any trade or business carried on by an individual, including as a sole proprietor.²⁶⁴ A partner in a partnership is subject to SECA tax on the distributive share of income or loss from the partnership's trade or business, subject to enumerated exceptions.²⁶⁵ The SECA tax generally does not apply to an S corporation's pro rata share of S corporation income.²⁶⁶

All-in rates on distributed corporate income and on passthrough income

The all-in rate on distributed corporate income can be higher than the 20-percent top marginal income tax rate applicable to the individual shareholder receiving a qualified dividend,

ordinary course of any inapplicable trade or business), (b) other gross income derived from any applicable trade or business, and (c) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in an inapplicable trade or business over (2) deductions properly allocable to such gross income or net gain. The tax also applies to estates and certain trusts.

²⁶² In certain case a partner may not be subject to either SECA or NITT if the partner satisfies one of the exceptions from SECA enumerated in sections 1402(a)(1)-(17) and the material participation test of section 469 with respect to the partnership.

²⁶³ Sec. 1401. The HI tax applies to any amount of net earnings from self-employment. Secs. 1401 and 1402(b).

²⁶⁴ Sec. 1402(a).

²⁶⁵ Sec. 1402(a)(1)-(5), (10), and (13). The SECA exceptions for partners generally relate to certain rent, dividends, interest, gain from the sale or exchange of a capital asset or other property that is not stock in trade nor held for sale to customers, certain retirement income of a partner, and the distributive share of a limited partner that is not a guaranteed payment for services.

²⁶⁶ An S corporation shareholder is, however, subject to employment tax on wages received from the S corporation. Secs. 3101, 3102, and 3121.

due to the imposition of the 21-percent corporate income tax in addition to shareholder-level tax. The all-in rate on passthrough income taxed to an individual can be lower than the 37-percent top marginal income tax rate on ordinary income of individuals, due to no entity tax and the 20-percent deduction for qualified business income. For distributed corporate income and for passthrough income, the NIIT or the SECA tax may also apply to increase the all-in Federal tax rate.

III. DISCUSSION OF SELECTED ISSUES

A. In General

As described in Part II, present law ordinary income marginal tax rates increase with income. However, statutory tax rates on ordinary income do not necessarily match with the effective marginal tax rates taxpayers face due to various provisions of present law which provide preferential treatment for certain sources of income. Additionally, as described in Part I.A, sources of income differ across income group, with higher-income groups receiving relatively less income through wages and more income through nonwage sources. With more non-wage sources of income, higher-income taxpayers have more flexibility to take advantage of the preferential treatment provided to certain sources of income by modifying choices of economic substance or with tax planning.

While these tax preferences for certain sources of income may reduce tax revenues, they may serve other policy considerations such as promoting saving or investment or allowing for timed bequests. The tradeoffs for policymakers are then how to balance the benefits of preferential treatment for certain sources of income without unintended reductions in tax revenue, and how to reduce incentives for behavior that may be considered abusive.

This section describes selected aspects of the present law tax system that higher-income taxpayers may use to reduce tax liability.

B. Capital Gains

One source of non-wage income which is more prevalent for higher-income taxpayers, as shown in Table 4 above, is income from selling capital assets. The highest marginal rate imposed on long-term capital gains is 20 percent in contrast to the 37-percent highest marginal rate currently imposed on ordinary income.

Proponents of preferential rates for capital gains argue that increasing the after-tax return to investment stimulates saving and economic growth. Another argument is that providing preferential rates for long-term capital gains reduces the taxation of income earned in corporate form which is taxable at two levels - first at the corporate level, when earned, and subsequently at the shareholder level, when distributed as a dividend, or when stock is sold, compared to pass-through income subject to one level of tax at ordinary rates.

The extent to which individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their savings relates to the efficiency of a tax on capital. There is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment. Additionally, the shareholder-level tax for C corporate income may already be eliminated for tax-exempt shareholders (such as charitable organizations), shareholders with taxable income in the 0-percent capital gains bracket, and certain foreign shareholders.²⁶⁷ However, the savings response of taxpayers matters in considering what effect tax rates on investment might have on the growth of the economy.

Under the present-law system where capital gains are generally taxed upon disposition, there is a benefit to the taxpayer from deferral due to the time value of money. The nominal taxes paid at a later date are lower in real terms than those same amounts paid today. Some claim that the taxation of nominal gains ignores inflation and suggest that real gains should be taxed. In cases where the benefit from deferral outweighs the penalty of inflation, the disposition-based system for taxing capital gains can create a “lock-in” effect where taxpayers choose to hold property with built-in capital gain in response to the present-law rules permitting interest-free deferral of tax on gains.²⁶⁸ This effect may create inefficiencies if less productive investments are held rather than disposed of as a means of delaying tax consequences. This effect may also be exacerbated by stepped-up basis, which can allow the gains from assets held until death to escape tax entirely.

Within a system for taxation of capital gains where realization is largely defined as disposition, research finds that the sensitivity to changes in the capital gains rates is high.²⁶⁹

²⁶⁷ Dividends of U.S. corporations received by foreign persons are generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. The 30-percent withholding tax may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to withholding is resident.

²⁶⁸ Analogously, losses may be accelerated as the real tax savings from losses diminish over time.

²⁶⁹ See Tim Dowd, Robert McClelland, and Athiphat Muthitacharoen, “New Evidence on the Tax Elasticity of Capital Gains,” *National Tax Journal*, vol. 68, no. 3, September, 2015, pp. 511-544; Saez, Emanuel,

Typically the behavioral response to capital gains taxation is split into two categories: permanent responses to the change in the tax rate, and immediate, temporary responses to anticipated tax rate changes. Recent estimates suggest the permanent elasticity of capital gains is approximately -0.7, meaning a 10-percent increase in rates leads to a seven-percent reduction in capital gains income. The transitory elasticity is estimated to be in excess of -1.0, meaning a 10-percent increase in rates leads to a more than 10-percent reduction in capital gains income.²⁷⁰ These results suggest that absent other changes to the tax treatment of capital gains, the behavioral responses to an increase in the tax rate on capital gains may significantly lessen the revenue that would be raised under the assumption that dispositions were held constant.

1. Mark-to-market

While, as discussed above in part II.B, the Code currently contains provisions that calculate income using a mark-to-market approach those provisions target specific fact patterns: dealers and traders in securities and commodities, expatriating persons, certain derivatives, and marketable PFIC stock. Application of mark-to-market rules to capital assets broadly may be a way to address distortions related to taxpayers' strategic timing of realizations of gains and losses caused by the present-law system where realization is largely defined as disposition.²⁷¹ Some policy issues with a broader mark-to-market approach are discussed here.

One issue is which assets should be required to be marked to market, and what (if anything) should be done about assets that are not marked to market. Some have argued to limit mark-to-market treatment to assets that have publicly-ascertainable values; as one commentator notes, "it is widely agreed that mark-to-market taxation is impractical for assets that are not publicly traded because their market values cannot be accurately measured."²⁷² For assets with publicly-ascertainable values, gains and losses could both be taken into account on an annual basis, as they accrue. For assets that are not marked to market because they are not easily valued (for example, stock in a closely-held corporation and non-publicly-traded partnership interests), one approach would be to impose an additional tax on disposition that is intended to account for the value of deferral as a way of reducing the economic difference between the taxation of

"Taxing the Rich More: Preliminary Evidence from the 2013 Tax Increase," *Tax Policy and the Economy*, vol. 31, no. 1, 2017, pp.71–120; and Gerald Auten, David Splinter, and Susan Nelson, "Reactions of High-Income Taxpayers to Major Tax Legislation," *National Tax Journal*, vol. 69, no. 4, December, 2016, pp. 935–964.

²⁷⁰ For a discussion recent of research on taxpayer responses to capital gains tax rates and implications for Joint Committee staff revenue estimates, see Joint Committee on Taxation, *Estimating Taxpayer Bunching Responses to the Preferential Capital Gains Tax Rate Threshold* (JCX-42-19), September 10, 2019.

²⁷¹ For examples of commentary proposing taxation on some or all capital gains on a mark-to-market or accrual basis see, Alan Auerbach, "Reforming Capital Gains Taxation," *Tax Notes*, vol. 95, no. 112, June 11, 2012, p. 1400; Samuel D. Brunson, "Taxing Investors on a Mark-to-Market Basis," *Loyola University Law Review*, Vol. 43, 2010, pp. 507-550; David S. Miller, "A Progressive System of Mark-to-Market Taxation," *Tax Notes*, vol 121, Oct. 13, 2008, pp. 213-218; Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

²⁷² Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

marked and non-marked assets.²⁷³ The design of such a “deferral charge” creates its own set of issues, including what interest rate to use and the proper treatment of losses.²⁷⁴ With regard to the latter issue, one approach could be for the government to pay a deferral charge on losses that mimics the deferral charge paid by taxpayers on gains, but concerns about timing and valuation could support other approaches.

Another issue in the design of such a system is which taxpayers should be subject to the mark-to-market or accrual regime. Arguably, mark to market should apply to all taxpayers on the premise that mark to market provides a more accurate measure of income than disposition-based realization and reduces distortions associated therewith. On the other hand, limiting application to high-income or high-wealth taxpayers, leaving the present-law disposition-based system in place for taxpayers not meeting those standards, in a hybrid system may be viewed as more progressive than requiring all taxpayers to mark and may moderate the aggregate compliance burden of the system. Taking a hybrid approach raises two additional issues: (1) how to manage taxpayers’ movement across any income or wealth thresholds; and (2) what (if anything) to do about potential distortions related to taxpayers’ tax avoidance.

A further question is what to do about capital assets held by entities – for example, by C corporations, S corporations, and partnerships. While ownership interests in entities may be subject to mark to market or a deferral charge on disposition, those entities themselves may hold capital assets, and any mark-to-market regime should address the extent to which such holdings are also subject to the regime. This issue may be particularly significant with regard to passthrough entities, where the income of the entity passes through to the owners, and some owners may be subject to the regime while others are not.

Another issue is how to transition from present law to the mark-to-market or accrual regime. Taxpayers subject to the regime may hold assets with built-in gain or loss at the time the regime goes into effect, which raises the question of how (for example, when, over what time period, and at what rate) such pre-regime built-in gain or loss is taxed.

Mark-to-market taxation may be viewed as complementary to raising capital gains rates. As discussed above, increasing capital gains rates under the present-law tax system may lead to timing responses that could greatly lower the revenue from implementing such a rate change. However, mark-to-market taxation would largely eliminate the effectiveness of timing responses with respect to assets to which it applies, since tax would be owed even without disposition.

²⁷³ See, e.g., Alan Auerbach, “Retrospective Capital Gains Taxation” *American Economic Review*, vol. 81, March 1991, pp. 167-178. For an example of how such a system might be designed to eliminate the lock-in effect, see, e.g., James Kwak, “Reducing Inequality with a Retrospective Tax on Capital,” *Cornell Journal of Law and Public Policy*, vol. 25, Fall 2015, pp. 191-244.

²⁷⁴ Under present law, where gain and loss are calculated on disposition, use of losses is restricted in various ways to address concerns about improper acceleration of losses. See, e.g., secs. 267, 1091, and 1211. Depending on the design of a deferral charge system, these same concerns may or may not continue to be present with regard to non-marked assets, albeit likely to a lesser degree than under present law.

An increase in tax on capital gains, whether through a rate increase, mark-to-market regime, or both, is also an increase in taxation on capital, so considerations relating to incidence and savings behavior, as discussed above, would also apply to these changes.

2. Carried interest

The rate differential between the ordinary rates on labor income of individuals and the preferential rates of certain capital income may be a motivating factor in taxpayers' choice to structure income as a carried interest that can give rise to capital gain rather than as fees or other ordinary compensation income. Carried interests may also be structured to achieve deferral of income compared to alternative structures.

Capital income or compensation

The central question for the tax treatment of carried interest is whether the carried interest is a form of compensation for services, or whether it is more similar to a right to income or gain from capital. In many cases, it is fairly clear whether money is paid for services rendered, on the one hand, or for the use of capital as equity or debt, on the other hand. This distinction may be more difficult, however, in a business activity involving capital assets and individuals' services with respect to the capital assets. Issues relating to the distinction between gains and earnings from investment in property, on the one hand, and income from the performance of services or from other types of businesses, on the other hand, can be found in many areas. The distinction has been a general source of complexity.²⁷⁵ Distinctions have been established legislatively for tax purposes in some instances, for example, a self-created copyright, which is treated as property that is not a capital asset.²⁷⁶

If the service provider does not contribute capital to the business, but only their labor, the carried interest arrangement involves the performance of services by the individual whose work gives rise to capital income for owners who have contributed capital. While the individual's economic interests are aligned with those of capital investors in the business to the extent that his compensation is based on the positive investment yield of the business, the individual is nevertheless performing services, not receiving a return on contributed capital. Therefore, it is argued that the income should be taxed as ordinary compensation income.

²⁷⁵ See, e.g., *Commissioner v. Jose Ferrer*, 304 F.2d 125 (2d Cir. 1962), rev'g 35 T.C. 617 (1961), involving a disputed distinction between compensation for acting services, on the one hand, and capital gain from the disposition of property rights in the resulting productions, on the other.

²⁷⁶ See, e.g., section 1221(a)(3)(A), providing that certain copyrights and other property in the hands of a taxpayer whose personal efforts created the property are not a capital asset and thus are not eligible for capital gain treatment; section 751 (gain on sale of a partnership interest is not capital gain to extent it reflects certain unrealized receivables, including certain rights to payment for services); section 7701(e)(1) (providing for recharacterization of a services contract as a lease in certain situations).

A variety of arguments that such income should not be treated as ordinary compensation have been advanced, principally in the context of the investment management business.²⁷⁷ For example, it is argued that the service provider with a carried interest is taking economic risk by working in the business and should therefore not be treated as having ordinary compensation income if the income that would flow through the partnership is eligible for capital gains rates. The notion is that capital gains rates can apply when risk is taken. The risk argument can be criticized, however, in that the capital gains rates apply to the disposition of capital assets, not to risk-taking in general that does not involve capital assets. Moreover, the capital gains tax rates do not apply to many types of income related to risk-taking. For example, capital gains rates do not apply to employee compensation that is performance-based, contingent on meeting sales targets or other performance measures. To the extent that the service provider is risking time and effort, but not money, it is argued that the risk rationale for capital gains treatment does not apply. Additionally, the risk involved with carried interest is generally upside risk as the carried interest does not share in the loss of the investments, only in the gain.

Another argument in opposition to treating income from a carried interest as ordinary income is that the carried interest gives rise to equity, or capital, termed “sweat equity” or “founder’s equity.” Present law generally treats gain or loss on sale or exchange of an interest in a business in which the seller worked as from the sale or exchange of a capital asset. This is conceptually correct in that a capital asset has been created, it is argued, and by analogy to present-law treatment, income from a carried interest should not be recharacterized as ordinary income. Nevertheless, present law does not treat operating income from a business (for example, from a barber shop, or a widget manufacturing operation) as capital gain to the extent labor contributed to the business creates capital.

Employment (and self-employment) taxes

A corollary issue relates to the employment tax treatment of income received under a carried interest. Because dividends and capital gain are not subject to employment taxes under present law, the desire to avoid employment or self-employment tax may motivate taxpayers to structure payments through carried interests. However, to the extent income from carried interests is viewed as labor income, failing to subject these amounts to employment or self-employment tax, while other labor income is subject to such taxes, can lead to economic inefficiency and to distortion.²⁷⁸

²⁷⁷ A discussion of this issue in the context of fund managers and fund investors, with references to related articles, appears in Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. See also the related document, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), September 4, 2007. These documents are available at www.jct.gov.

²⁷⁸ The inefficiency arises because the taxpayer is motivated to choose the form of business with the highest after-tax return, potentially foregoing the activity or structure with the highest pre-tax return. The activity with the highest pre-tax return maximizes the societal benefit (economic efficiency), and any other choice reduces economic efficiency. In addition, the cost of tax planning to achieve the highest after-tax return can be viewed as distortive, diverting resources away from other productive business activities.

C. Trusts

Trusts originated to serve a nontax purpose²⁷⁹ and today allow predecessors to provide bequests to heirs at specific times and manners which are chosen by the predecessor. However, taxpayers may also use trusts to avoid taxes.

Tax policy issues relating to transfer taxes

Some economists assert that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If transfer taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and their heirs.²⁸⁰ It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.²⁸¹ Others believe the bequest motive is not important in national capital formation,²⁸² and empirical analysis of the existence of a bequest motive has not led to a consensus.²⁸³ Theoretically, it is an open question whether estate and gift taxes encourage or

²⁷⁹ Hansmann, Henry, and Ugo Mattei. "The functions of trust law: A comparative legal and economic analysis." *NYU Rev.* 73 (1998): 434.

²⁸⁰ A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod (eds.), *Rethinking the Estate Tax*, The Brookings Institution, 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, vol. 15, Winter 2001, pp. 205-218.

²⁸¹ See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, vol. 89, August 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, vol. 2, Spring 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, vol. 45, June 1992. For attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Krueger (eds.), *The Political Economy of Tax Reform*, The University of Chicago Press, 1992; and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

²⁸² Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 2, Spring 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

²⁸³ See B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, vol. 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, vol. 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings...."

discourage saving, and there has been limited empirical analysis of this specific issue.²⁸⁴ By raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. Alternatively, estate and gift taxes may have only a moderate behavioral effect on savings and may instead encourage potential transferors to engage in aggressive estate tax planning.²⁸⁵

Some argue that a rationale for a wealth transfer tax system is to break up excessive concentrations of wealth across generations.²⁸⁶ One avenue by which taxes on the transfer of wealth may affect the concentration of wealth is by creating incentives to distribute accumulated wealth more widely or less widely. Some argue, for example, that because the current U.S. estate tax system is focused solely on the circumstances of the transferor, it does little to break up concentrations of wealth or to promote equality of opportunity.²⁸⁷ Such commentators argue that

Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities.” *Ibid.*, p. 308.

²⁸⁴ Wojciech Kopczuk and Joel Slemrod, “The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors,” in William G. Gale and Joel B. Slemrod (eds.), *Rethinking Estate and Gift Taxation*, The Brookings Institution, 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. The authors find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

David Joulfaian, “The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence,” *National Tax Journal*, vol. 59, June 2006, pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While the author emphasizes the sensitivity of the analysis to how individuals’ expectations about future taxes are modeled he concludes that “taxable estates are ten percent smaller because of the estate tax.”

²⁸⁵ Wojciech Kopczuk, “Bequest and Tax Planning: Evidence from Estate Tax Returns,” *Quarterly Journal of Economics*, vol. 122, November 2007, pp. 1801-1854, finds that the onset of a terminal illness leads to a significant reduction in the value of estate reported on tax returns and provides evidence of estate planning rather than real reductions in net worth. Jonathan Goupille-Lebre and Jose Infante, “Behavioral Responses to Inheritance Tax: Evidence from Notches in France,” *Journal of Public Economics*, vol. 168, December 2018, pp. 21-34, use French data from a period in which there was a significant policy change to the French inheritance tax and find evidence of real and shifting responses by decedents to the tax, particularly late in life. The evidence suggests myopia as a reason for late-life rather than throughout-life responses.

²⁸⁶ Commentators have articulated various rationales for taxing transfers of wealth, including breaking up dynastic concentrations of wealth, maximizing equality of opportunity, and contributing to progressivity in the Federal tax system. The articulated rationales themselves are controversial. Moreover, the extent to which the various alternative means of taxing transfers of wealth, such as an inheritance tax, further these policy goals has been a subject of vigorous debate.

²⁸⁷ Joseph M. Dodge, “Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax,” *SMU Law Review*, vol. 56, Winter 2003, pp. 551, 553 (The author notes, “any transferee-oriented tax should possess greater appeal than a transferor-oriented tax with respect to achieving such goals as curbing undue accumulations of wealth or improving equality of opportunity.”). See also Lily L. Batchelder, “Estate Tax Reform: Issues and Options,” *Tax Notes*, vol. 122, February 2, 2009, pp. 633, 640-641 and Lily L. Batchelder, “What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax,” *Tax Law Review*, vol. 63, 2009, pp. 1, 53-56.

systems that impose a tax based on the circumstances of the transferee – such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries.²⁸⁸

Different types of wealth transfer tax systems raise different administrative and compliance issues, including filing or tax planning burdens, opportunities for aggressive planning, and opportunities for abuse. If, for example, migrating from an estate tax to an inheritance tax would in fact lead to wider dispersal of gifts and bequests, such a migration also might be expected to increase compliance costs, because a greater number of taxpayers would need to file returns or reports with the IRS. Even where no tax is due in a particular year because receipts fall below an annual or lifetime exemption amount, such taxpayers still would need to track and likely report on such receipts to keep track of the amount of exemption used.

Use of trusts for tax avoidance

Taxpayers can use trust arrangements to avoid transfer tax. First, grantors sometimes structure estate “freeze” transactions that leverage the ability to create a trust that is treated as separate from the grantor for transfer tax purposes but not for income tax purposes, sometimes referred to as an “intentionally defective grantor trust,” (“IDGT”). In a simple estate freeze transaction, a grantor might transfer assets to an IDGT by way of a taxable gift during his or her lifetime. The gift tax value is measured (“frozen”) at the time of the transfer, and any subsequent appreciation accrues to the trust (and ultimately the trust beneficiaries) without further gift or estate tax consequences, provided the trust is structured to avoid inclusion in the grantor’s gross estate.

Some argue that the original concerns that gave rise to the grantor trust rules have diminished and the rules instead are used primarily for transfer tax avoidance, such that some or all of the grantor trust rules should be repealed.²⁸⁹ Other commentators seek to address the use of IDGTs for transfer tax avoidance by harmonizing or coordinating the income and transfer tax rules governing grantor trusts. For example, one academic recommends repealing most of the grantor trust rules and replacing them with a single rule based on the standards for determining whether a transfer is a completed gift for gift tax purposes.²⁹⁰ Alternatively, the Treasury Department has proposed harmonizing the income and transfer tax rules by imposing certain transfer tax consequences on a grantor trust.²⁹¹

²⁸⁸ *Ibid.* at 560-61.

²⁸⁹ Leo L. Schmolka, “FLPs and GRATs: What to Do?,” *Tax Notes*, March 13, 2000 (special supplement), p. 1473; Jay A. Soled and Mitchell Gans, “Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques,” *Tennessee Law Review*, vol. 78, Summer 2011, pp. 973, 1005.

²⁹⁰ See Robert T. Danforth, “A Proposal for Integrating the Income and Transfer Taxation of Trusts,” *Virginia Tax Review*, vol. 18, Winter 1999, pp. 545, 611-615.

²⁹¹ See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

Second, taxpayers sometimes use grantor retained annuity trusts (“GRATs”), to avoid gift or estate tax. A GRAT is an irrevocable grantor trust in which the grantor retains an annuity interest, with the remainder passing to other trust beneficiaries, such as the grantor’s children, in a taxable gift. Because the interests are valued using rules that often overstate the value of the retained annuity and understate the value of the remainder interest, the grantor often is able to value the taxable gift at an amount far below the real economic value of the remainder interest.²⁹² Some have proposed additional requirements for GRATs, including a minimum 10-year term, that likely would sharply limit their utility as tools to avoid gift or estate tax.²⁹³

Third, taxpayers sometimes avoid GST tax by allocating GST exemption to a “perpetual dynasty trust.” Once a taxpayer allocates GST exemption to a trust, the trust assets often may grow indefinitely, benefiting beneficiaries in multiple successive generations without further GST tax consequences. Some have argued that this result is inconsistent with one of the principal purposes of the GST tax: to impose transfer tax at each generational level.²⁹⁴

²⁹² The annuity is valued under tables prescribed by section 7520 of the Code, which requires use of an interest rate equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1). Sec. 2702(a). The remainder interest is valued by subtracting the value of the annuity interest (as derived from the annuity tables) from the value of assets transferred to the trust. If returns on trust assets exceed the rate of return assumed under the annuity tables, any excess appreciation may pass to the remainder beneficiaries and escape gift or estate taxation.

²⁹³ See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

²⁹⁴ Since the original enactment of the GST tax, many States have repealed or sharply limited application of their rules against perpetuities, which limited the maximum duration of a trust.

D. Private Placement Life Insurance and Annuity Contracts

Life insurance is often thought of as a way for an individual to provide financial security to their family in the event of the individual's death. For a simple life insurance contract with level annual premiums, a fixed death benefit, and no cash value ("term" life insurance), the contract holder and beneficiaries receive the greatest financial benefit for their premiums if the insured person dies earlier in the contract term, with less financial benefit for each additional year of paying premiums while the insured remains alive. For any given insured individual, the expected value of the total premiums paid may exceed the expected value of the payout, both factoring in the probability of the individual's death. The reason an individual may be willing to purchase life insurance with a higher monetary cost than benefit is that the security of knowing the family will receive a payout on death exceeds the difference between the expected monetary cost and benefit. In other words, term life insurance may reduce the negative financial effect on an individual's family in the case of the individual's death and loss of wage or other income that individual may have generated for the family.

On the insurer side, the mortality risks of insured individuals are pooled, with the expectation that the sum of premiums and investment income received generally exceeds the payout of death benefits annually. However, the possibility of asymmetric information (where the individual knows more about the probability of death in any particular year than the insurer) may cause an insurance market to fail because of adverse selection (where only higher risk individuals buy insurance). An argument for Federal tax subsidies for life insurance is then to help ensure a life insurance market can exist in spite of problems with asymmetric information. In addition, externalities in the market for commercial life insurance products may mean there is a social benefit beyond the private benefit (such as reducing the burden on social insurance programs).

Life insurance contracts with a cash value, however, are more complex than term life insurance and combine features of insurance and tax-favored savings accounts. Variable contracts, whether variable life insurance or variable annuity contracts, reflect the underlying returns on assets in the insurer's separate account with respect to the contract. The rate of return generally is taken into account by adjusting the amount paid into, or as a benefit paid from, a variable annuity contract, or by adjusting the period of coverage or the amount of death benefit under a variable life insurance contract.

A specialized form of insurance product with tax-favored investment features is private placement life insurance contracts and private placement annuity contracts. These contracts are advertised to have a wider range of investment options including hedge funds and private equity, real-estate, commodity, and currency investments through separately managed accounts and insurance-dedicated funds. They tend to be larger dollar-amount contracts with customized terms that are sold to accredited investors and qualified purchasers so that the contracts are not required to be registered as securities under applicable U.S. securities laws and regulations. These contracts allow investments to be acquired inside a life insurance or annuity contract to defer or exclude the investment earnings under the U.S. income tax and estate tax. Taxpayers that seek to minimize U.S. income tax or plan to pass to heirs a large amount of investments may prefer to use a private placement life insurance or annuity contract as an investment vehicle rather than directly holding the same type of investment.

Additionally, off-shore private placement contracts are generally not subject to regulation by States or the SEC and may have an even larger set of permissible investments, although taxpayers may view the loss of U.S. regulation of these contracts as a negative.

These contracts have tax advantages that can be viewed as similar to those of other tax-favored savings vehicles allowed by the Code (that is, retirement plans, such as 401(k)s, and 529 qualified tuition programs) as investment growth is not taxed as it accrues²⁹⁵ and assets held until death may escape income tax entirely. Additionally, loans under the contract and withdrawals of cash value up to an owner's tax basis may not be subject to income tax.

Research has found that rates of life insurance ownership overall have declined, with rates of ownership of cash value life insurance declining more rapidly than rates of ownership of term life insurance.²⁹⁶ Various explanations have been provided for these declining rates including increases in life expectancy, declining fees and expenses for mutual funds (a substitute for the investment component of cash value life insurance), and the enactment and expansion of other tax-advantaged savings vehicles. Of note, households with a net worth at least 10 times their income are less likely to own term life insurance, but are just as likely to hold a cash value contract.²⁹⁷ This suggests that wealthy individuals are more likely to self-insure against the income loss to their family at death rather than use term life insurance, and that cash value contracts may serve a different purpose than insuring against income loss.

While life insurance contracts with cash value are provided similar treatment for tax-advantaged savings to some other programs, the goals and therefore the structure of benefits are arguably different. 529 qualified tuition programs and retirement accounts provide tax-advantages for saving for specific purposes (education and retirement) and have limitations on contributions.²⁹⁸ The introduction and expansion of these tax-advantaged accounts is thought to

²⁹⁵ Earnings inside a life insurance contract may never be taxed to the contract holder or beneficiary if paid out by reason of the insured person's death. Annuities provide deferral of taxation of earnings inside the contract, generally until the amounts are paid out after the annuity starting date. See Part II.B of this document, above, for a description of the present-law tax treatment of life insurance and annuity contracts.

²⁹⁶ Hartley, Daniel, Anna Paulson, and Katerina Powers. "What explains the decline in life insurance ownership." *Economic Perspectives* 41, no. 8 (2017): 1-20.

²⁹⁷ *Ibid.*

²⁹⁸ Generally, contributions to a 529 plan are considered completed gifts (potentially subject to gift tax) and retirement accounts have annual contribution limits.

There is generally no cap that restricts the amount that an individual can contribute each year to a life insurance or annuity contract. However, if premiums on a life insurance contract are too heavily front-loaded, the contract is treated as a MEC, which generally results in income taxation of withdrawals and loans from the contract. Sec. 72(e) and 7702A, described above in Part II.B.

have contributed to the decline in cash value life insurance ownership, as taxpayers can now save with other tax-advantaged accounts.²⁹⁹

The policy benefits of the life insurance market could be considered closer to those of the health insurance market. Proponents of tax subsidies for health insurance argue that subsidies are needed exist to ensure the market will not fail due to asymmetric information and to encourage takeup due to positive externalities. However, health insurance policies do not have a cash value and are not provided the same uncapped tax advantage for savings that life insurance contracts with a cash value provide.

Taxpayers that plan to pass on large amount of investments may prefer to use a tax-favored private placement life insurance or annuity contract rather than traditional investment holdings such as cash, stocks, bonds, or mutual funds because of tax advantages described above. Providing preferential tax treatment to investments held inside such contracts may increase the return to capital investment. However, if increasing the return to capital investment is the goal, a policy that provides the same preferential tax treatment for all investments, rather than just those held in life insurance and annuity contracts, may be appropriate.

²⁹⁹ Mulholland, Barry, Michael Finke, and Sandra Huston. "Understanding the shift in demand for cash value life insurance." *Risk Management and Insurance Review* 19, no. 1 (2016): 7-36.

E. Net Investment Income Tax

As described above, the FICA HI tax, the SECA HI tax, and the NII tax each apply up to a 3.8 percent tax rate,³⁰⁰ but they apply to different categories of taxpayers and to different tax bases. The differences in the application of these taxes have the consequence that some income derived from passthrough businesses is not subject to a 3.8-percent tax rate under any of the three regimes. For example, S corporation owner-employees may pay employment taxes only on “reasonable compensation,” but generally do not have their share of net profits subject to the additional Medicare tax or the NII tax.

Proponents of the scope of the present law NII tax argue that its exceptions appropriately promote small businesses that are structured in passthrough form. On the other hand, the current structure of the FICA HI tax, the SECA HI tax, and the NII tax means the 3.8-percent tax rate (on top of regular income tax) does not apply similarly across all passthrough businesses. The inconsistent treatment of passthrough business income may encourage tax planning and distort taxpayers’ choice of organizational form for businesses.³⁰¹

³⁰⁰ For FICA and SECA, the HI tax rate is 2.9 percent, plus an additional 0.9 percent rate on wages and self-employment income above the threshold amounts (\$250,000 in the case of a joint return, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case).

³⁰¹ For some evidence of this shifting occurring, at least in the short term, see Gerald Auten, David Splinter, and Susan Nelson, “Reactions of high-income taxpayers to major tax legislation,” *National Tax Journal*, vol. 69, no. 4, 2016, pp. 935-964.

APPENDIX

In order to be more consistent with recent income distribution studies, Tables 1 through 4 in this pamphlet differ from standard distributional tables produced by the Joint Committee staff. This appendix describes differences in income measures and incidence assumptions between the methodology used in this pamphlet for Tables 1 through 4 and the Joint Committee staff's standard methodology.

While both Tables 1 through 4 in this pamphlet and Joint Committee staff standard distributional tables use tax units as the unit of observation to rank by income category, the tables here group tax units into percentiles of the population ranked highest to lowest with a tax-unit size-adjustment, rather than according to dollar-based thresholds without any tax-unit size-adjustment. The tax-unit size-adjustment used for ranking tax units in Tables 1 through 4 is intended to account for the costs of supporting dependents and the economies of scale from shared resources. The adjustment is made by dividing tax unit income by the square-root of the number of individuals in the unit.³⁰²

The income definition used for Tables 1 through 4 differs from the definition of “expanded income” generally used by the Joint Committee staff. Expanded income is AGI plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker’s compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad.³⁰³

Pre-tax/pre-transfer income (used for Table 2) excludes transfers that are included in expanded income—the insurance value of Medicare, Social Security benefits, unemployment benefits, and workers’ compensation benefits—and includes all additional sources included in national income, such as imputed rents from owner-occupied housing and undistributed retirement account income. This income measure also accounts for some additional Federal taxes, including the allocation of taxes paid by estates and trusts to beneficiaries and the allocation of estate and gift taxes by decedent income groups.

Pre-tax/after-transfer income (used for Tables 1, 3, and 4) includes all the transfers in expanded income, as well as additional transfers in national income, such as Medicaid, SNAP, and SSI benefits.

To distribute Federal taxes, the Joint Committee staff assigns the individual income tax (including the outlay portion of refundable credits) to taxpayers, payroll taxes (both the employer’s and the employee’s share) are attributed to employees, corporate income taxes (and

³⁰² This is the same equivalence scale used by the Congressional Budget Office.

³⁰³ See Joint Committee on Taxation, *Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses* (JCX-15-12), February 8, 2012 for a detailed description of expanded income.

taxes on business income of passthroughs) are attributed to labor and capital owners,³⁰⁴ and excise taxes are attributed to consumers. The approach used for Table 3 follows the Joint Committee staff's standard methodology to distribute individual income and payroll taxes but differs in how corporate and excise taxes are distributed. For corporate taxes, calculations in Table 3 use the same assumption for the labor share but a different approach to allocate the non-labor share among capital owners, for example, ownership by non-profits is allocated more evenly over the income distribution. Excise taxes and custom duties are allocated by after-tax cash income less savings.

Under the approach used in Table 3 and the Joint Committee staff's standard methodology, Federal average tax rates follow roughly the same pattern in a given year; Federal average tax rates increase as income increases. Table A.1 presents the distribution of average tax rates in 2019³⁰⁵ under the standard methodology.³⁰⁶ For corresponding income groups, these are generally a few percentage points above the average tax rates calculated in Table 3 of this pamphlet.³⁰⁷

³⁰⁴ The Joint Committee staff assumes that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital, and five percent of taxes on business income of passthroughs is borne by domestic labor and 95 percent is borne by owners of domestic capital. See Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013.

³⁰⁵ Average tax rates derived from Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2018* (JCX-3-18), February 7, 2018.

³⁰⁶ The 50th percentile of tax-unit income by tax filing unit is approximately \$50,000. The 90th percentile of tax-unit income by tax filing unit is approximately \$169,000. The \$1,000,000 and over category corresponds to the top 0.3 percent of tax filing units.

³⁰⁷ The income definition used in this pamphlet is broader than the Joint Committee staff's measure of expanded income leading to lower average tax rates.

Table A.1–Distribution of Average Tax Rates in 2019

Income Category ¹	Combined Income, Excise, and Corporate Taxes ²	Individual Income Taxes	Payroll Taxes	Excise Taxes	Corporate Taxes
	Average Tax Rate %	Average Tax Rate %	Average Tax Rate %	Average Tax Rate %	Average Tax Rate %
Less than \$15,000	2.0	-12.9	10.8	3.4	0.6
\$15,000 to \$30,000	3.5	-7.3	9.1	1.3	0.5
\$30,000 to \$40,000	8.3	-2.4	9.1	1.0	0.6
\$40,000 to \$50,000	10.8	0.2	9.1	0.9	0.6
\$50,000 to \$60,000	12.2	1.9	8.9	0.8	0.7
\$60,000 to \$80,000	14.0	3.5	8.9	0.8	0.8
\$80,000 to \$100,000	15.5	5.1	8.8	0.6	0.9
\$100,000 to \$150,000	17.7	6.8	9.2	0.6	1.1
\$150,000 to \$200,000	20.5	9.2	9.5	0.5	1.3
\$200,000 to \$500,000	23.8	13.5	8.3	0.4	1.6
\$500,000 to \$1,000,000	28.0	20.7	5.0	0.2	2.0
\$1,000,000 and over	29.3	24.9	1.9	0.1	2.4
Total, All Taxpayers	19.0	9.3	7.8	0.6	1.3

Note: Includes nonfilers, excludes dependent filers and returns with negative income. The average tax rate is equal to Federal taxes described in footnote (2) divided by income described in footnote (1).

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus:

- [1] tax-exempt interest,
- [2] employer contributions for health plans and life insurance,
- [3] employer share of FICA tax,
- [4] worker's compensation,
- [5] nontaxable Social Security benefits,
- [6] insurance value of Medicare benefits,
- [7] alternative minimum tax preference items,
- [8] individual share of business taxes, and
- [9] excluded income of U.S. citizens living abroad. Categories are measured at 2019 levels.

[2] Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

Does not include indirect effects.