THE TAXATION OF INDIVIDUALS AND FAMILIES

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on September 14, 2017

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on September 14, 2017, on the effects of tax reform on individuals and families. This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), includes an overview of the taxation of individuals and families, and data on this topic. The appendix to this document includes reprints of selected tables previously published in the Joint Committee staff's publication of Estimates of Federal Tax Expenditures For Fiscal Years 2016-2020.[2]

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[1] This document may be cited as follows: Joint Committee on Taxation, *The Taxation of Individuals and Families* (JCX-41-17), September 12, 2017. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[2] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020*, (JCX-3-17), Jan. 30, 2017. Appendix Tables A-1 and A-3 report data from that document.

I. GENERAL STRUCTURE OF THE INDIVIDUAL INCOME TAX

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

Adjusted gross income

Under the Internal Revenue Code of 1986 (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute.[4] Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,[5] estates, or trusts.[6] Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, the receipt of property by gift or inheritance, as well as employer-provided health insurance, pension contributions, and certain other benefits.[7]

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[3] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States. A U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion ($102,100 in 2017) for foreign earned income and a limited exclusion of employer-provided housing costs. Sec. 911.

[4] Sec. 61.

[5] In general, partnerships and S corporations (*i.e.*, corporations subject to the provisions of subchapter S of the Code) are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed to the owners at the individual level. A business entity organized as a limited liability company ("LLC") under applicable State law generally is treated as a partnership for Federal income tax purposes if it has two or more members; a single-member LLC generally is disregarded as an entity separate from its owner for Federal income tax purposes.

[6] In general, the accumulated income of estates and trusts is taxed to the entity and the distributed income is taxed to the beneficiaries. A graduated tax rate schedule applies to the taxable income of estates and trusts and the alternative minimum tax may apply. Certain trusts are treated for income tax purposes as if the trust property is owned by grantor; in such cases, the grantor is taxed on the income of the trust.

[7] Appendix Figure A-1 projects the sources of gross income for individual taxpayers in 2017.

An individual's adjusted gross income ("AGI") is determined by subtracting "above-the-line" deductions from gross income.[8] These deductions include certain trade or business expenses, capital losses, contributions to a qualified retirement plan and health insurance premiums of a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), certain moving expenses, certain education-related expenses, and alimony payments.[9]

Taxable income

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions.[10] Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. The amount deductible for each personal exemption is $4,050 in 2017. This amount is indexed annually for inflation. Additionally, the personal exemption phaseout reduces an individual's personal exemptions by two percent for each $2,500 ($1,250 for married filing separately), or fraction thereof, by which the taxpayer's AGI exceeds $261,500 (single), $287,650 (head-of-household), $313,800 (married filing jointly and surviving spouses) and $156,900 (married filing separately).[11] These threshold amounts are indexed for inflation.

An individual also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending on the taxpayer's filing status. Table 1 presents the projected number of returns for tax year 2017, for each filing status. For 2017, the amount of the standard deduction is $6,350 for single individuals and married individuals filing separately, $9,350 for heads of households, and $12,700 for married individuals filing jointly and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) or blind.[12] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

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[8] An "above-the-line" deduction is a deduction from gross income that is taken to arrive at a taxpayer's adjusted gross income. Unlike itemized deductions, above-the-line deductions are available to all taxpayers with gross income, regardless of whether the taxpayer chooses to take the standard deduction.

[9] Sec. 62.

[10] Sec. 63.

[11] Thus, all personal exemptions are completely phased out at incomes of $384,000 (single), $410,150 (head-of-household), $436,300 (married filing jointly) and $218,150 (married filing separately).

[12] For 2017, the additional amount is $1,250 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,550. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2017) of $2,500 or $3,100, as applicable.

Table 1.−Individual Tax Returns by Filing Status, 2017[1]

Category	Returns (millions)
Single	89.0
Married filing Jointly	59.2
Married filing Separately	2.9
Head of Household	23.1
Total	174.2

[1] Includes filing and non-filing units. Filing units include all taxable and nontaxable returns. Non-filing units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Details may not add to total due to rounding.
Source: Joint Committee on Taxation.

The combination of personal exemptions and the standard deduction means that the first several thousand dollars of an individual's income is untaxed by the income tax. For example, a single person whose earnings do not exceed the personal exemption phaseout amount owes no income tax on the first $10,400 of income. This amount would be $20,800 for a married couple filing jointly and $28,900 if that married couple had two dependent children.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes, real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI, or, in the case of tax years ending before 2017, 7.5 percent for taxpayers above age 64), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI).[13] Additionally, the total amount of itemized deductions allowed is reduced by $0.03 for each dollar of AGI in excess of $261,500 (single), $287,650 (head-of-household), $313,800 (married filing jointly and surviving spouses) and $156,900 (married filing separately).[14] These threshold amounts are indexed for inflation. Table 2 presents estimates of the distribution by income class of the three largest itemized deductions,

[13] Sec. 67. Such miscellaneous expenses include, for example, certain nonbusiness investment expenses, expenses incurred in determining or contesting taxes, and employee business expenses that are not deductible under section 62 in determining AGI.

[14] Sec. 68. This rule is sometimes referred to as the "Pease limitation." A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.

as measured by total dollar amount. The text following Table 2 describes these three itemized deductions in detail.

Table 2.─Distribution by Income Class of Selected Itemized Deductions, at 2017 Rates and 2016 Income Levels[1]

[Returns in thousands, money amounts in millions of dollars]

Income Class [2]	State and Local Income, Sales, and Personal Property Tax Deduction		Mortgage Interest Deduction		Charitable Contributions Deduction	
	Returns	*Amount*	*Returns*	*Amount*	*Returns*	*Amount*
Below $10,000	8	[3]	6	$2	2	[3]
$10,000 to $20,000	217	$7	138	$40	107	$9
$20,000 to $30,000	600	$35	350	$132	348	$57
$30,000 to $40,000	1,116	$104	668	$337	710	$155
$40,000 to $50,000	1,793	$241	1,153	$602	1,214	$305
$50,000 to $75,000	6,690	$1,668	4,692	$3,650	4,805	$1,703
$75,000 to $100,000	6,887	$2,935	5,074	$5,538	5,221	$2,662
$100,000 to $200,000	18,136	$15,544	14,597	$24,853	15,180	$11,929
$200,000 and over	7,827	$49,275	7,178	$29,782	8,208	$40,727
Total	**43,274**	**$69,810**	**33,856**	**$64,935**	**35,795**	**$57,547**

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.
[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) excluded income of U.S. citizens living abroad, and (i) individuals' share of business income.
[3] Positive tax expenditure of less than $500,000.

Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

The Joint Committee staff estimates that for the 2017 tax year, approximately 135.0 million taxpayers will claim the standard deduction,[15] while 48.7 million taxpayers will elect to itemize deductions.

Deduction for State and local taxes

Taxpayers are permitted an itemized deduction for State and local real and personal property taxes and State and local income taxes. A deduction may be claimed for State and local sales taxes in lieu of taking a deduction for State and local income taxes. These deductions may be claimed even if such taxes are not incurred in a taxpayer's trade or business.[16] None of these

[15] Includes non-filers.

[16] Sec. 164(a).

deductions is permitted for purposes of determining a taxpayer's alternative minimum taxable income.[17]

Deduction for State and local real property taxes.−For purposes of determining taxable income, taxpayers are permitted an itemized deduction for any State or local real property taxes for the taxable year in which such taxes are paid or accrued. In the event of the sale of real property, the Code and Treasury Regulations provide rules under which the seller and buyer are required to apportion the itemized deductions taken on their respective returns for the real property taxes owed for the tax year.[18]

For Federal income tax purposes, a real property tax is a tax imposed on interests in real property and levied for the general public welfare.[19] Taxes paid for local benefits such as streets, sidewalks, and other similar improvements, imposed because of and measured by some benefit inuring directly to the property against which the tax is levied, are not deductible.[20] A tax is considered assessed for local benefits when the property subject to the tax is limited to property benefited by the proceeds of the assessment. Such taxes are not deductible, even though an incidental benefit may inure to the public welfare.[21]

The IRS has ruled that payments in lieu of taxes ("PILOTs") are deductible when such payments are made pursuant to a State statute, are calculated through a rate based on the valuation of an ownership interest in real property, and are used for public or governmental purposes.[22]

Deduction for State and local personal property taxes.−For purposes of determining taxable income, taxpayers are permitted an itemized deduction for State and local personal property taxes.[23] For a tax to qualify as a personal property tax for Federal income tax purposes, it must meet three criteria.[24] First, the tax must be *ad valorem*, meaning that the tax must be substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as *ad valorem*. For example, a motor vehicle tax based on weight, model year, or horsepower is not an *ad valorem* tax for Federal income tax purposes. However, in the case of a tax which is partially based on value, and partially based on other

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[17] Sec. 56(b)(1)(A)(ii).

[18] Sec. 164(d); Treas. Reg. sec. 1.164-6.

[19] Treas. Reg. sec. 1.164-3(b).

[20] Treas. Reg. sec. 1.164-4. Such taxes are often referred to as "assessments."

[21] *Ibid*.

[22] Private Letter Ruling 8919002. However, only the taxpayer to whom a private letter ruling was issued can rely on it.

[23] Sec. 164(a)(2).

[24] See Treas. Reg. sec. 1.164-3(c).

criteria, that portion of the tax that corresponds to the value-based levy qualifies as an *ad valorem* tax, and the remainder does not.

Second, the tax must be imposed on an annual basis, even if collected more or less frequently.

Third, the tax must be imposed in respect of personal property. A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. For instance, State and local taxes on the registration or licensing of highway motor vehicles are deductible as personal property taxes even if such taxes are denominated as a "registration fee," provided that such fees meet the first and second requirement described above (*i.e.*, they are *ad valorem* in nature and they are imposed on an annual basis).

<u>Deduction for State and local income taxes</u>.−For purposes of determining taxable income, taxpayers are permitted an itemized deduction for any State or local income taxes for the taxable year in which such taxes are paid or accrued. A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.[25] In determining whether a payment constitutes a tax, the IRS generally takes the position that a tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as payment for some privilege granted or service rendered.[26] The tax must be paid to a government levying the tax, to certain public benefit corporations created by that government for a public purpose, or to their agents.[27]

The IRS has ruled that a tax is considered to be a State or local income tax for purposes of section 164 if that tax is imposed on "net gain."[28] Thus, in the case of a tax imposed upon the transfer of land, if the taxpayer cannot reduce taxable gain from sales or exchanges of land during the taxable year by any losses from other sales or exchanges of land during that year, such a tax is not considered an income tax for purposes of section 164(a).[29]

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[25] Sec. 164(b)(2).

[26] See Rev. Rul. 81-193, 1981-2 C.B. 52.

[27] *Ibid*.

[28] Rev. Rul. 80-121, 1980-1 C.B. 43.

[29] *Ibid*.

Additionally, the IRS has ruled employees may deduct amounts paid to State unemployment compensation funds and disability benefit funds as State income taxes.[30]

Deduction for State and local sales taxes.−At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes.[31] Taxpayers have two options with respect to the determination of the sales tax deduction amount.[32] Taxpayers may deduct the total amount of State and local general sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income, and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats, and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

A general sales tax is a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.[33] No deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the above rules are relaxed in two ways. First, if the tax does not apply with respect to some or all of such items, a tax that applies to other such items can still be considered a general sales tax. Second, the rate of tax applicable with respect to some or all of these items may be lower than the general rate. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess is disregarded and the general rate is treated as the applicable rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the jurisdiction imposing the use tax that are similar to such item.[34]

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[30] See, *e.g.*, Rev. Rul. 81-194, 1981-2 C.B. 54; Rev. Rul. 81-191, 1981-2 C.B. 49; Rev. Rul. 81-193, 1981-2 C.B. 52.

[31] Sec. 164(b)(5).

[32] See Notice 2005-31, 2005-1 C.B. 830.

[33] Sec. 164(b)(5)(B).

[34] Sec. 164(b)(5)(E).

Home mortgage interest deduction

In lieu of taking the standard deduction, a taxpayer may elect to claim an itemized deduction for qualified residence interest, subject to limitations, notwithstanding the general rule that personal interest is nondeductible.[35] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness.−Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer.[36]

Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to improve the residence substantially). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing.

The indebtedness must be secured by the qualified residence and is limited to $1 million ($500,000 for married persons filing a separate return).[37] A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.[38] A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Home equity indebtedness.−Certain home equity indebtedness may give rise to deductible qualified residence interest.[39] Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.[40]

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[35] Sec. 163(h)(2)(D) and (h)(3).

[36] Sec. 163(h)(3)(B).

[37] Sec. 163(h)(3)(B)(ii).

[38] Section 163(h)(4) defines qualified residence to include both a principal residence within the meaning of section 121 (relating to an exclusion of capital gain upon sale of a personal residence) and a second residence that satisfies the terms of section 280A(d)(1) (relating to whether a dwelling unit is used as a residence for purposes of the disallowance of certain deductions).

[39] Sec. 163(h)(3)(A)(ii).

[40] Sec. 163(h)(3)(C)(i).

The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).[41]

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (*e.g.*, a traditional mortgage), a series of payments (*e.g.*, a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (*e.g.*, a home equity line of credit).

The aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

The deduction for interest on home equity indebtedness is not allowed in computing alternative minimum taxable income.[42]

<u>Points</u>.−Points (prepaid interest) paid with respect to a home mortgage (including points on a refinancing of a qualified residence of the taxpayer) are generally capitalized and amortized over the period of the indebtedness.[43] An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

<u>Private mortgage insurance</u>.−Under a recently expired provision, certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer were treated as interest that is qualified residence interest and thus deductible.[44] The amount allowable as a deduction was phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction was not allowed if the taxpayer's adjusted gross

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[41] Sec. 163(h)(3)(C)(ii).

[42] See sections 56(b)(1)(C) and 56(e)(1), providing that for purposes of computing alternative minimum taxable income, the deduction for "qualified housing interest" includes only interest paid with respect to acquisition indebtedness.

[43] Sec. 461(g).

[44] Sec. 163(h)(3)(E).

income exceeds $110,000 ($55,000 in the case of married individual filing a separate return). Reporting rules apply under the provision.

For this purpose, qualified mortgage insurance meant mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision (December 20, 2006)).[45]

Amounts paid for qualified mortgage insurance that were properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction was allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision did not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminated for any amount paid or accrued after December 31, 2016, or properly allocable to any period after that date.[46]

Deduction for charitable contributions

In general.−The Internal Revenue Code allows individual and corporate taxpayers to reduce their income tax liabilities by taking deductions for contributions to certain organizations, including charities, Federal, State, local and Indian tribal governments, and certain other organizations. Although this section primarily discusses the income tax charitable deduction (section 170), contributions to such institutions also may qualify for a gift or estate tax charitable deduction.[47]

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.*, an organization or entity described in section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.*, not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[48] Fourth, the transfer must be of money or property—

[45] Sec. 163(h)(4)(E).

[46] Sec. 163(h)(3)(E)(iv).

[47] Secs. 2522 and 2055.

[48] Sec. 170(a)(1).

contributions of services are not deductible.[49] Finally, the transfer must be substantiated and in the proper form.

As also discussed below, special rules limit a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

Percentage limit on charitable contributions.−Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's adjusted gross income ("AGI") for a taxable year, disregarding any net operating loss carryback to the year under section 172.[50] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, more favorable percentage limits sometimes apply to contributions *to* the donee charity than to contributions that are *for the use of* the donee charity. Contributions of capital

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[49] For example, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

[50] Sec. 170(b)(1)(G).

gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base.[51] In contrast to property contributed directly to a charitable organization, property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[52] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

Table 3.–Charitable Contribution Percentage Limits For Individual Taxpayers[1]

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient[2]	Capital Gain Property for the Use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30%[3]	20%
Nonoperating Private Foundations	30%	20%	20%

[1] Percentages shown are the percentage of an individual's contribution base.

[2] Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

[3] Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[53] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Valuation of charitable contributions.−For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of

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[51] Certain qualified conservation contributions (generally, conservation easements), qualify for more generous contribution limits and carryforward periods.

[52] *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).

[53] Sec. 170(d).

the property, the donor's tax basis in the property, or in different circumstance a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.[54] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;[55] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[56] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[57]

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

Special "enhanced deduction" rules apply for certain contributions an inventory and other property.[58] Certain special rules also apply in the case of contributions of vehicles,[59] patents and other intellectual property,[60] and clothing and household items.[61]

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[54] Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Sec. 170(e)(1)(A).

[55] Sec. 170(e).

[56] Sec. 170(e)(1)(B)(i)(I).

[57] Sec. 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. Sec. 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.

[58] See, *e.g.*, sec. 170(e)(3).

[59] Sec. 170(f)(12).

[60] Sec. 170(m).

[61] Sec. 170(f)(16).

Tax liability

In general

An individual's income tax liability generally is determined by applying a rate schedule to the individual's taxable income. Also, an alternative minimum tax ("AMT") may apply. Lower rates apply to the net capital gain and certain dividends of individuals; these lower rates apply for both the regular tax and the alternative minimum tax. The tax liability is then reduced by credits to the extent allowable against the regular tax and against the alternative minimum tax.

Regular tax liability

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, with the marginal tax rate increasing as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 2017, the regular individual income tax rate schedules are as follows:

Table 4.−Federal Individual Income Tax Rates for 2017

If Taxable Income is:	Then Income Tax Equals:
Single Individuals	
Not over $9,325	10% of the taxable income
Over $9,325 but not over $37,950	$932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $91,900	$5,226.25 plus 25% of the excess over $37,950
Over $91,900 but not over $191,650	$18,713.75 plus 28% of the excess over $91,900
Over $191,650 but not over $416,700	$46,643.75 plus 33% of the excess over $191,650
Over $416,700 but not over $418,400	$120,910.25 plus 35% of the excess over $416,700
Over $418,400	$121,505.25 plus 39.6% of the excess over $418,400
Head of Households	
Not over $13,350	10% of the taxable income
Over $13,350 but not over $50,800	$1,335 plus 15% of the excess over $13,350
Over $50,800 but not over $131,200	$6,952.50 plus 25% of the excess over $50,800
Over $131,200 but not over $212,500	$27,052.50 plus 28% of the excess over $131,200
Over $212,500 but not over $416,700	$49,816.50 plus 33% of the excess over $212,500
Over $416,700 but not over $444,550	$117,202.50 plus 35% of the excess over $416,700
Over $444,550	$126,950 plus 39.6% of the excess over $444,550

If Taxable Income is:	Then Income Tax Equals:
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $18,650	10% of the taxable income
Over $18,650 but not over $75,900	$1,865 plus 15% of the excess over $18,650
Over $75,900 but not over $153,100	$10,452.50 plus 25% of the excess over $75,900
Over $153,100 but not over $233,350	$29,752.50 plus 28% of the excess over $153,100
Over $233,350 but not over $416,700	$52,222.50 plus 33% of the excess over $233,350
Over $416,700 but not over $470,700	$112,728 plus 35% of the excess over $416,700
Over $470,700	$131,628 plus 39.6% of the excess over $470,700

Special capital gains and dividends rates

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

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

A maximum rate applies to certain capital gains and dividends. Any adjusted net capital gain[62] otherwise taxed at 10 or 15 percent is taxed at zero percent. Adjusted net capital gain otherwise taxed at rates greater than 15 percent but less than 39.6 percent is taxed at 15 percent. Finally, adjusted net capital gain otherwise taxed at 39.6 percent is taxed at the maximum tax rate of 20 percent. These rates apply for purposes of both the regular tax and the alternative minimum tax. Qualified dividend income is generally taxed at the same rate as net capital gain.

[62] Adjusted net capital gain is net capital gain reduced by certain capital gain taxed at higher rates (such as unrecaptured section 1250 gain and gain on the sale of collectibles), plus qualified dividend income. Qualified dividend income generally includes dividends from domestic corporations and certain foreign corporations for which holding period requirements are met. Sec. 1(h).

Table 5.–Individual Tax Rates Applicable to Certain Categories of Income[1]

	Regular Tax Rate Bracket							Minimum Tax Rate Bracket[2]	
Category of income	10%	15%	25%	28%	33%	35%	39.6%	26%	28%
Qualified dividend income	0	0	15	15	15	15	20	same as regular tax	
Short-term capital gain[3]	10	15	25	28	33	35	39.6	26	28
Long-term capital gain[4]	0	0	15	15	15	15	20	same as regular tax	
Section 1250 gain[5]	10	15	25	25	25	25	25	25	25
Collectible gain	10	15	25	28	28	28	28	26	28
Small business stock issued after September 27, 2010[6]	0	0	0	0	0	0	0	0	0

[1] These rates are exclusive of the 3.8-percent tax levied on net investment income for taxpayers with AGI in excess of $250,000 ($200,000 in the case of non-joint filers)

[2] Because of the phase-out of the AMT exemption amount, the effective marginal rate for taxpayers with AMT liability may be 6.5 or 7 percentage points higher than the rates shown in this table.

[3] Gains from assets held not more than one year.

[4] Gain from assets held more than one year not included in another category.

[5] Capital gain attributable to depreciation on section 1250 property (*i.e.*, depreciable real estate).

[6] Must be held five years or longer. Small business stock issued prior to this date is subject to different preferential rates.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.[63] In addition, the net gain from the sale, exchange, or involuntary

[63] Sec. 1221.

conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.[64]

Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.[65] Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.[66]

Table 6 presents the projected distribution of selected sources of income, including capital gains and dividends, across income category for 2017.

Table 6.−Distribution of Selected Sources of Income in 2017 (Projected)

Income Category [1]	Millions of Returns [2]	Long-Term Capital Gains in AGI $ Billions	Dividend Income $ Billions	Wages $ Billions	Interest Income $ Billions	Schedule C Income $ Billions	Schedule E Income $ Billions
Less than $10,000……..............	19.2	0.2	0.6	41.9	0.6	7.0	-0.7
$10,000 to $20,000..................	20.3	0.5	0.9	166.1	0.5	32.2	0.0
$20,000 to $30,000..................	21.1	0.6	1.5	241.3	1.2	17.2	1.2
$30,000 to $40,000..................	16.0	0.9	2.0	269.4	1.8	13.3	1.1
$40,000 to $50,000..................	12.7	1.5	3.2	292.9	1.9	10.2	1.4
$50,000 to $75,000..................	26.9	7.1	11.1	925.2	5.2	20.9	5.5
$75,000 to $100,000................	17.4	11.0	13.4	815.2	5.9	21.6	9.6
$100,000 to $200,000..............	30.0	51.3	47.3	2,475.2	15.6	69.4	53.5
$200,000 to $500,000..............	9.0	91.4	54.4	1,542.5	15.0	83.8	140.8
$500,000 to $1,000,000...........	1.1	69.5	30.5	393.5	8.0	35.6	118.1
$1,000,000 and over.................	0.6	442.8	103.5	546.2	39.1	47.0	464.1
Total, All Taxpayers...............	174.2	676.9	268.5	7,709.5	94.8	358.2	794.7

[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 2017 levels.
[2] Includes nonfilers, excludes dependent filers and returns with negative income.
Source: Joint Committee on Taxation staff estimates.

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[64] Sec. 1231. 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.

[65] Sec. 1245.

[66] Sec. 1250.

Net investment income

An additional tax is imposed on net investment income in the case of an individual, estate, or trust.[67] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[68] over the threshold amount. 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.[69] Thus, the maximum rate on net capital gains and qualified dividends is 23.8 percent, while the maximum rate on other investment income, including interest, annuities, royalties, and rents, is 43.4 percent.

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

The Joint Committee staff estimates that for the 2017 tax year, approximately 4.3 million taxpayers will pay the additional tax on net investment income, representing approximately $26.1 billion in tax revenue.

Credits against tax

An individual may reduce his or her tax liability by any available tax credits.[70] Certain credits are "refundable;" that is, if the amount of these credits exceeds tax liability (net of other

[67] Sec. 1411.

[68] Modified adjusted gross income is adjusted gross income 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).

[69] These thresholds are not indexed for inflation.

[70] These personal credits include the child tax credit, earned income tax credit, child and dependent care credit, adoption credit, premium assistance tax credit, health coverage tax credit, saver's credit, foreign tax credit, lifetime learning credit, American opportunity tax credit, residential energy efficient property credit (for qualifying solar energy property), and credits for the elderly or disabled.

credits), an overpayment is created, which may generate a refund. Two major refundable credits are the child tax credit and the earned income credit ("EIC").[71]

An individual may claim a tax credit for each qualifying child under age 17. The amount of the credit per child is $1,000.[72] Additionally, a refundable earned income tax credit is available to low-income workers who satisfy certain requirements.[73] Both of these credits are described in more detail in Part II of this document.

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

Alternative minimum tax liability

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year.[74] For 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $187,800 ($93,900 in the case of married filing separately) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The breakpoint between the 26-percent and 28-percent bracket is indexed for inflation. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

For tax year 2017, the exemption amount is $84,500 for married individuals filing jointly and surviving spouses, $54,300 for other unmarried individuals, $42,250 for married individuals filing separately, and $24,100 for estates or trusts. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds $160,900 for married individuals filing jointly and surviving spouses, $120,700 for other unmarried individuals, and $80,450 for married individuals filing separately, estates, or trusts. These amounts are indexed annually for inflation.

Among the tax preferences and adjustments included in AMTI are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas, certain

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[71] Other refundable credits include the American opportunity tax credit, the premium tax credit, and the health coverage tax credit.

[72] Sec. 24.

[73] Sec. 32.

[74] Sec. 55.

expenses and allowances related to mining exploration and development, certain tax-exempt interest income, and a portion of the gain excluded with respect to the sale or disposition of certain small business stock. Personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI.

The Joint Committee staff estimates that for the 2017 tax year approximately 4.5 million taxpayers will be subject to the AMT, and $30.2 billion in AMT liability will be collected. Table 7 shows the estimated distribution of AMT filers by income class for 2017.

Table 7.─Distribution by Income Class of Alternative Minimum Tax, Returns and Liability, 2017

Income Class [1]	Returns (Millions)	Liability (Billions)	Percent of All Returns	Average Liability
Below $10,000	[2]	[3]	[4]	[5]
$10,000 to $20,000	[2]	[3]	[4]	[5]
$20,000 to $30,000	[2]	[3]	[4]	[5]
$30,000 to $40,000	[2]	[3]	[4]	[5]
$40,000 to $50,000	[2]	[3]	[4]	[5]
$50,000 to $75,000	[2]	$0.1	[4]	$4,491
$75,000 to $100,000	[2]	$0.1	0.2%	$1,441
$100,000 to $200,000	0.5	$0.9	1.5%	$1,950
$200,000 to $500,000	3.2	$14.1	36.0%	$4,350
$500,000 to $1,000,000	0.6	$6.9	54.6%	$11,228
$1,000,000 and over	0.1	$8.2	19.7%	$74,813
Total	**4.5**	**$30.2**	**2.6%**	**$6,775**

[1] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) excluded income of U.S. citizens living abroad, and (i) individuals' share of business income. Categories are measured at 2017 levels. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

[2] Less than 500,000

[3] Less than $50 million

[4] Less than 0.05%

[5] Not reported because the average would be based on less than 5,000 returns

Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Return filing requirements

An individual is required to file a tax return if the individual has AGI in excess of an exemption amount.[75] The exemption amount is generally equal to the value of the standard deduction plus the personal exemption (for the taxpayer and the taxpayer's spouse, if applicable).

Every citizen, whether residing in or outside the United States, and every resident of the United States within the meaning of section 7701(b) must file an income tax return if the individual has income that equals or exceeds the exemption amount.[76] Treasury regulations require individual taxpayers to make this return using a Form 1040, U.S. Individual Income Tax Return.[77]

The IRS accepts returns that are signed digitally, as well as paper returns.[78] For tax year 2014, of approximately 148.6 million individual tax returns filed, 128.1 million of those returns were filed electronically (roughly 86.2 percent). Additionally, in 2014 approximately 81.8 million taxpayers (roughly 55 percent) filed their returns with the assistance of a paid preparer.[79]

Effective marginal tax rates

In general

The term "marginal tax rate" refers to the additional, or incremental, increase in tax liability that a taxpayer incurs from a $1.00 increase in income.

The effective marginal tax rate may in some situations differ from the statutory marginal tax rate. For the purposes of this document, the term "statutory marginal tax rate" refers to the seven marginal tax rates for individuals as defined in section 1 of the Code and as reported in Table 4. The term "effective marginal tax rate" refers to the marginal tax rate the taxpayer faces after accounting for all provisions of the Code. In general, if an additional $1.00 of income to the taxpayer resulted in the taxpayer's taxable income increasing by $1.00, then there would be no difference between statutory marginal tax rates and effective marginal tax rates. However, due to the design of certain provisions of the Code, an effective marginal tax rate may not always correspond to the statutory marginal tax rate. Generally, credits, deductions, and exemptions cause effective marginal tax rates to differ from statutory marginal tax rates when they have qualifiers that depend on the amount of taxpayer income, such as a floor, phasein, or phaseout. The character of income also affects effective marginal tax rates as the Code provides statutory

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[75] Sec. 6012(a).

[76] Sec. 6012(a)(1).

[77] Treas. Reg. sec. 1.6012-1(a)(6).

[78] Sec. 6061.

[79] This number does not include those taxpayers that filed returns electronically with the use of tax preparation software.

rates for income from the realization of capital gains and qualified dividends that are different, and generally lower, than those of Table 4, and interest paid to a bondholder of qualified State and local debt is excluded from income. Table 8 shows how marginal tax rates for labor income and long-term capital gains income vary across income class.

Table 8.−Marginal Tax Rates on Labor and Long-Term Capital Gains, by Income Category in 2017

Income Category [1]	Labor Income			Long-Term Capital Gains Income
	Average Marginal Income Tax Rate [2]	Average Marginal Employment Tax Rate [2]	Average Combined Marginal Income and Employment Tax Rate [2]	Average Marginal Capital Gains Tax Rate [2]
Less than $10,000....................	-7.2%	14.2%	7.0%	0.4%
$10,000 to $20,000.................	0.5%	14.2%	14.7%	2.5%
$20,000 to $30,000.................	11.4%	14.2%	25.7%	2.1%
$30,000 to $40,000.................	14.0%	14.2%	28.2%	2.9%
$40,000 to $50,000.................	15.4%	14.2%	29.6%	1.7%
$50,000 to $75,000.................	18.3%	14.2%	32.5%	6.9%
$75,000 to $100,000...............	18.2%	14.2%	32.4%	9.2%
$100,000 to $200,000.............	21.0%	13.4%	34.4%	13.1%
$200,000 to $500,000.............	28.5%	9.7%	38.2%	21.0%
$500,000 to $1,000,000..........	34.6%	7.2%	41.8%	23.8%
$1,000,000 and over................	37.7%	6.8%	44.5%	24.1%
Total, All Taxpayers...............	15.6%	13.6%	29.2%	22.0%

[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 2017 levels.

[2] For individual income and employment taxes, the average marginal tax rate is equal to the change in taxes from an additional $100 of wages to each spouse with positive wages. For long-term capital gain, the average marginal tax rate equals the change in taxes from an additional 1% increase in long-term capital gains to each taxpayer with positive long-term capital gains.

Source: Joint Committee on Taxation staff estimates.

The Joint Committee Staff estimates that for the 2017 tax year, of the 128.0 million taxpayers with wage income, 97.9 million will face effective marginal tax rates on wages that differ from statutory marginal tax rates.

Design considerations

While the primary purpose of a tax system is to raise revenue to fund government expenditures, analysts generally judge a tax system−as a way of raising a given amount of revenue−in terms of how the tax system addresses efficiency, equity, and complexity. These considerations can be applied to policies that cause effective marginal tax rates to differ from statutory marginal tax rates.

Economists argue that effective marginal tax rates create incentives, or disincentives, for taxpayers to work, save, donate to charity, and the like. These incentives may distort taxpayer choice. Distorted choice may promote an inefficient allocation of labor and capital resources. The magnitude of the inefficiencies potentially created by deviations of effective marginal tax rates from statutory marginal tax rates depends upon taxpayer responses to effective marginal tax rates. There is not consensus on the extent to which taxpayers alter their labor supply or saving in response to tax changes. Additionally, increased effective marginal tax rates may encourage taxpayers to seek compensation in the form of tax-free fringe benefits rather than taxable compensation. Such distortions in consumption represent an efficiency loss to the economy. Increased effective marginal tax rates also may alter taxpayers' decisions regarding when to recognize income or claim expenses. Any such tax-motivated changes in the timing of income or expense generally require time and expense by the taxpayer. Such time and expense represents an efficiency loss to the economy.

A second question of tax policy is whether aggregate tax liabilities are equitably distributed across taxpayers. Generally, the Federal individual income tax is a progressive tax where tax liability rises as a proportion of income as income rises. The existence of phaseouts and other provisions that create effective marginal tax rates that differ from statutory marginal tax rates do not make the Federal individual income tax a regressive or proportional tax. The phaseouts and other provisions identified here generally operate to increase the overall progressivity of the income tax. The majority of the provisions deny tax benefits to higher-income taxpayers, while preserving tax benefits for low-income and middle-income taxpayers. However, because the phaseouts and other provisions often relate to specific defined economic activities, two different taxpayers may have the same income and one can be subject to a phaseout provision while another is not. That is, these provisions may create horizontal inequities in the Code in addition to intended vertical differences.

The creation of phaseouts adds complexity to the Code. On the other hand, by limiting the number of taxpayers eligible to qualify for certain tax benefits, some of the provisions reduce computations, possibility of error, and record keeping. These provisions also may create a lack of clarity in taxpayers' minds regarding what precisely is the tax base and what sort of preferences exist in the Code. Complexity and lack of clarity may promote taxpayer disillusionment and a sense of unfairness regarding the Code, and may reduce compliance. However, complexity may allow tax benefits to be targeted and therefore come at a lower cost to the government.

The Code contains many provisions that result in differences between effective and statutory marginal tax rates. The discussion below focuses on the effect of phaseouts of some notable provisions mentioned above; the personal exemption phaseout, the limitation on itemized deductions, and the alternative minimum tax.[80] Additionally there are notable credits with phaseins and phaseouts that also change effective marginal tax rates; the earned income tax credit, the child tax credit, and the American opportunity credit. These credits are described in detail in Parts II and III of this document, but the effect on effective marginal tax rates is discussed in this section. Table 9 summarizes the projected number of taxpayers affected by these provisions as well as the number of taxpayers affected by the phaseouts for 2017.

Table 9.−Select Provisions with Phaseouts, 2017

Provision	Returns (millions)	Returns in Phase-out Range (millions)
Personal Exemption[1]	173.2	1.5
Limitation on itemized deductions[2]	49.8	3.1
Alternative Minimum Tax	4.5	3.6
Earned Income Tax Credit[3]	29.0	21.9
Child Tax Credit[4]	35.3	3.5
American Opportunity Credit	10.1	0.4

[1] Returns claiming a personal exemption includes non-filers.

[2] Returns is number of taxpayers itemizing deductions.

[3] Returns in phase-out range includes returns in phase-in range.

[4] The Child Tax Credit includes the Additional Child Tax Credit, the refundable portion of the credit.

Source: Joint Committee on Taxation.

Personal exemption phaseout ("PEP")

Personal exemptions that are allowed are reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. Thus, the personal exemptions claimed are phased out over a $122,500 range beginning at the applicable threshold. The personal exemption phaseout increases the effective marginal rates for those affected taxpayers. For a taxpayer who is subject to the personal exemption phaseout, earning an additional $2,500 will reduce the amount of each personal exemption the taxpayer may claim by two percent, or by $81 in 2017 (0.02 times the $4,050 personal exemption). The taxpayer's

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[80] These and other provisions of the Code alter effective marginal tax rates, many through channels other than phaseins and phaseouts, but which are beyond the scope of this document. For a complete discussion of provisions that have an effect on effective marginal tax rates as applied to a prior iteration 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.

additional taxable income is thus equal to the $2,500 plus the $81 in denied exemption for each personal exemption. For a taxpayer in the 33-percent statutory marginal tax rate bracket, the effective marginal tax rate on the additional $2,500 of income equals the statutory 33 percent plus an additional 1.07 percentage points ($81 divided by the $2,500 in incremental income, times the statutory rate of 0.33) for each personal exemption.[81] Thus if this taxpayer claims four personal exemptions, his or her effective marginal tax rate is 37.3 percent (the statutory 33-percent rate plus four times 1.07 percentage points), or 113 percent of the statutory marginal tax rate.[82]

Alternative minimum tax

If an individual is subject to the AMT, the statutory tax rates one should focus on in determining the effective marginal tax rate generally are the AMT rates. However, if a taxpayer who otherwise would be subject to the AMT generates sufficient additional income, the taxpayer may become subject to the regular tax. In such a case, the regular tax rates would determine the taxpayer's effective marginal rate. In addition, to the extent that an individual's AMT liability gives rise to the AMT credit that may be used by the taxpayer in the future to reduce his or her regular tax liability, the effect of marginal income on the present value of such credit also must be taken into account.[83]

The AMT exemption amount is phased out at a rate of 25 percent as the taxpayer's alternative minimum taxable income increases, causing the effective marginal AMT rates to be

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[81] Mathematically, where Y denotes income, E denotes the number of personal exemptions, I denotes the income threshold, and t denotes the statutory marginal tax rate, the taxpayer's total tax liability, T, in the absence of the phaseout, is given by the following expression:

(1) $T = (Y - 4050 * E) * t = Y * t - 4050 * E * t$

For a taxpayer with income over the threshold amount, I, the taxpayer's tax liability is:

$T = (Y - [\{4050 * E\} * \{1 - (Y-I)/2500\} * 0.2]) * t$
Which simplifies to
(2) $T = Y * t * \{1 + .(0324 * E)\} - (81 * E * t) - (.0324 * I * t)$

Thus the effective marginal tax rate for a taxpayer in the phaseout range is one plus 3.24 percentage points multiplied by the number of personal exemptions claimed, all multiplied by the taxpayer's statutory marginal tax rate.

[82] Technically, the phaseout of the personal exemption operates in steps so that the first dollar of income within each phase-out step of $2,500, decreases the personal exemption two percent, whereas the second dollar of income within each step has no further incremental effect. Thus the additional marginal tax rate on the first dollar of income within each phase-out step is a percent equal to 8,100 times the number of personal exemptions claimed, which is added to the statutory marginal tax rate to calculate the effective marginal tax rate.

[83] The interplay of the alternative minimum tax and regular individual tax as it relates to effective marginal tax rates is explored in detail in Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

higher within the phase-out range. At the start of the phase-out range, an additional $1.00 in income increases taxable income by $1.25 due to the additional 25 cent deduction lost, which results in an effective marginal tax rate of 32.5 percent ($1.25 times the statutory AMT rate of .26). At the end of the phase-out range, the AMT statutory rate is higher, resulting in an effective marginal tax rate of 35 percent ($1.25 times the statutory AMT rate of .28).[84]

Limitation on itemized deductions

The overall limitation on itemized deductions, sometimes referred to as the "Pease limitation," reduces otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) by three percent of the amount of the taxpayer's AGI in excess of certain thresholds, but may not reduce otherwise allowable itemized deductions by more than 80 percent. This limitation increases the effective marginal tax rate for affected taxpayers. If a taxpayer who is above the threshold earns an additional $1.00 of income, the taxpayer's taxable income increases by $1.03 because the taxpayer's income goes up by $1.00 and the itemized deductions must be reduced by three cents. The statutory tax rates apply to taxable income. Thus, if the taxpayer is in the 33 percent bracket, the increase in tax liability resulting from the $1.00 increase in income will be $0.34 (the $1.03 in additional taxable income multiplied by 0.33). Generally, the effective marginal tax rate for taxpayers subject to the limitation on itemized deductions is three percent higher than the statutory tax rate. That is, the taxpayer's effective marginal tax rate equals 103 percent of the statutory marginal tax rate.[85] Once the taxpayer's itemized deductions are reduced by 80 percent, the taxpayer's effective marginal tax rate again equals his or her statutory marginal tax rate.

Earned income tax credit

The earned income tax credit ("EIC") reduces effective marginal rates in the phase-in range and increases effective marginal rates in the phase-out range from applicable statutory rates. In the phase-in range of the credit, effective marginal tax rates are reduced by the phase-in rate of the credit which is 7.65, 34, 40, or 45 percent depending on the number of qualifying children the taxpayer has, since earning an additional dollar will provide 7.65, 34, 40, or 45 cents in additional tax credit respectively. The phase-in range of the EIC also occurs at low levels of income so that a taxpayer's standard deduction and personal exemptions alone provide that taxpayer with a zero marginal rate at these income levels. This means that the EIC results in a negative effective marginal tax rate in the phase-in range as earning an extra dollar results in no increase in tax liability but rather an additional credit amount.

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[84] The AMT phaseout may also affect marginal tax rates on capital gains, leading to effective marginal tax rates on adjusted net capital gain that are higher than the statutory 23.8 percent maximum rate. The Joint Committee Staff estimates that for the 2017 tax year, there will be approximately 2.2 million taxpayers in the AMT phase-out region with AMT liability and adjusted net capital gain.

[85] Even with the limitation on itemized deductions, the statutory marginal tax rate still determines the value of itemized deductions to the taxpayer. These deductions reduce taxable income while the limitation on overall itemized deductions depends on AGI, not taxable income.

Once the maximum amount of the credit is fully phased in, there is a range of additional earnings where the credit will remain unchanged before the start of the phase-out range. Within this range the taxpayer's marginal tax rate is unaffected by the earned income credit and effective marginal tax rates equal statutory marginal tax rates.

For taxpayers in the phase-out ranges, effective marginal tax rates are increased by the phase-out rate of the credit which is 7.65, 15.98, or 21.06 depending on the number of qualifying children the taxpayer has, as earning an additional dollar reduces the earned income credit by 7.65, 15.98, or 21.06 cents respectively. Towards the end of the phase-out range, taxpayers may have statutory marginal rates of 15 percent, so these individuals could have effective marginal tax rates of 22.65, 30.98, or 37.65, depending on the number of qualifying children.

<u>Child tax credit</u>

For taxpayers with modified AGI in excess of certain thresholds, the otherwise allowable child credit is reduced by $50 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold. This phaseout increases the effective marginal tax rates by five percentage points ($50/$1,000) over the statutory marginal tax rate for taxpayers within this phase-out range.[86] Thus a taxpayer in the 25 percent bracket who is in the phase-out range faces an average effective marginal tax rate of 30 percent. Since the phase-out range is flexible, only the starting threshold is specified, the total size of the child credit does not affect the rate at which the credit is phased out, but only affects the length of the phase-out range.[87] For example, a head of household filer with one qualifying child faces a 25-percent statutory marginal rate and a 30-percent average effective marginal tax rate over a $20,000 phase-out range, whereas a head of household filer with two qualifying children would face the same marginal tax rates but over a $40,000 phase-out range.

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[86] Technically, the phaseout of the child tax credit operates in steps, and the first dollar of income over the threshold will cause the credit to decline by $50, for an additional marginal tax rate of 5,000 percent in addition to the statutory marginal tax rate. The next $999 in income would have no further effect on the credit for an effective marginal rate equal to the statutory marginal rate, but the dollar following would again cause the credit to fall by another $50. Thus, per $1,000 of additional income, the effective marginal tax rate averages an additional five percentage points over the statutory marginal tax rate.

[87] Mathematically, where Y denotes income, C denotes the size of the child credit (assumed to be $1,000 in this example), I denotes the beginning of the phase-out range, and t denotes the statutory marginal tax rate, the taxpayer's total tax liability, T, is given by the following expression:

(3) $T = Y * t - C$, where $C = \text{Max}(0, 1000 - 50 * (Y-I)/1000)$

Substituting the expression for C into (1) for taxpayers in the phase-out range yields:

(4) $T = Y * t - 1000 + 0.05 * (Y-I)$

Hence, if Y goes up by $1, T rises by $t + .05$.

American opportunity tax credit

The American opportunity credit increases effective marginal tax rates for taxpayers claiming the credit within the phase-out ranges. The credit is up to $2,500 per eligible student and phases out ratably over a range of $10,000, or $20,000 for married taxpayers filing jointly. A head of household filer with one eligible student, maximum credit eligibility, and income in the phase-out range, therefore may face an effective marginal tax rate equal to 50 percent (the 25-percent statutory marginal rate plus 25 percentage points from the loss in the $2,500 credit over a $10,000 range). However, a married taxpayer with one eligible student, maximum credit eligibility, and income in the phase-out range, may face an effective marginal tax rate of 37.5 percent (the 25-percent statutory marginal rate plus 12.5 percentage points from the loss in the $2,500 over a $20,000 range). Generally, since the phase-out range is twice the size for married individuals filing jointly compared to other taxpayers, the proportional phaseout of this credit increases effective marginal tax rates half as much for married individuals filing jointly compared to other taxpayers.[88]

The effect of the American opportunity tax credit on effective marginal tax rates increases with number of eligible students and the amount of qualified tuition and related expenses. For example, a head of household filer with two eligible students, maximum credit eligibility for each, and income in the phase-out range, may face an effective marginal tax rate equal to 75 percent. The credit is now $5,000 which is phased out over the same $10,000 range, but this means an extra $1 in income results in a loss of $0.50 in credit, increasing marginal tax rates by 50 percentage points in addition to the statutory 25-percent rate.

The American opportunity credit phases out over a fixed range that does not depend on the size of credit claimed. This means that as the claimed credit increases, the effective marginal tax rates within this fixed range increase. The personal exemption phaseout also occurs over a fixed range, so that again, as the number of personal exemptions increases, the effective marginal tax rates within the fixed phase-out range also increase. Generally, for credits that are phased out over a fixed range, the effective marginal tax rate increases in the phase-out range with the size of the credit. This contrasts with provisions that phase out over variable ranges such as the child tax credit and the overall limitation on itemized deductions. For these provisions, even as the

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[88] Mathematically, where Y denotes income, C denotes the full potential size of the American opportunity credit, A denotes the actual credit, I denotes the beginning of the phase-out range, L denotes the length of the phase-out range, and t denotes the statutory marginal tax rate, the taxpayer's total tax liability, T, is given by the following expression:

(1) $T = Y * t - A$, where $A = \mathrm{Max}\ (0, C - \{(Y-I)/L\} * C)$

Substituting the expression for A into (1) for taxpayers in the phase-out range yields:

(2) $T = Y * t - C + (C * Y/L) - (C * I/L)$

Hence, if Y goes up by $1, T rises by $t + C/L$. Thus, because the phase-out length L for single taxpayers is half of that for married taxpayers, the same potential credit C will result in an increase in the effective tax rate that is twice as large for single taxpayers as for married taxpayers.

size of the tax benefit and the length of the phase-out range grow, the change in the effective marginal tax rate due to the phaseout stays fixed over the phase-out range.

II. INCOME TAX PROVISIONS RELATING TO CHILDREN

In general

The Code contains five benefits to taxpayers that use a common definition of qualifying child: (1) the child credit; (2) the earned income credit; (3) the dependent care credit; (4) head of household filing status; and (5) the dependency exemption. Prior to the enactment of the Working Families Tax Relief Act of 2004,[89] each provision had separate criteria for determining whether the taxpayer qualified for the applicable tax benefit with respect to a particular child.[90] That Act modified the Code so as to provide for a uniform definition of a child for all of those provisions.

Under the uniform definition, in general, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: (1) the child has the same principal place of abode as the taxpayer for more than one half the taxable year; (2) the child has a specified relationship to the taxpayer; and (3) the child has not yet attained a specified age. A tie-breaking rule applies if more than one taxpayer may otherwise claim a child as a qualifying child.

Residency test

Under the residency test, a child must have the same principal place of abode as the taxpayer for more than one half of the taxable year. Special rules apply in the case of divorced or separated parents (discussed below).

Relationship test

The relationship test requires that the individual is the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (for example, the taxpayer's grandchild). Additionally, the child can be the taxpayer's brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, the taxpayer's niece or nephew). An adopted child satisfies this relationship test if he or she is an individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer. A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer's child.

Age test

The age test varies depending upon the tax benefit involved. In general, a child must be under age 19 (or under age 24 in the case of a full-time student) to be a qualifying child. In general, no age limit applies with respect to individuals who are totally and permanently disabled

[89] Pub. L. No. 108-311.

[90] Appendix Table A-4. summarizes select differences between definitions of a qualifying child for these provisions.

at any time during the calendar year. Important exceptions to this general rule are: (1) a child must be under age 13 (if he or she is not disabled) for purposes of the dependent care credit and (2) a child must be under age 17 (whether or not disabled) for purposes of the child credit.

Children who support themselves

A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. An exception applies for purposes of the EIC. In that context, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer.

Citizenship and residency

A child who is neither a citizen nor a national of the United States cannot qualify as a qualifying child, unless such child is resident in the United States, Canada or Mexico. However, for purposes of both the child tax credit and the EIC, the child may be a resident only of the United States. A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a qualifying child (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States.

Children of divorced or legally separated parents

Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year) who provide over one half the child's support during the calendar year.[91] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year is deemed to satisfy the support test; however, the custodial parent may release the claim to a dependency exemption (and, therefore, the child credit) to a noncustodial parent. There is an additional custodial waiver rule for purposes of the dependency exemption (and, therefore, the child credit) for decrees of divorce or separate maintenance or written separation agreements. The custodial waiver rules do not affect eligibility with respect to a child of divorced or legally separated parents for purposes of the earned income credit, the dependent care credit, and head of household filing status.

Identification requirements

An individual claiming a benefit with respect to a qualifying child must provide that child's taxpayer identification number on the individual's tax return. For purposes of the EIC, a qualifying child is required to have a Social Security number other than one issued to an individual for the sole purpose of allowing such individual to claim benefits under any program financed in whole or in part from Federal funds (that is, the child must be a U.S. citizen,

[91] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption).

permanent resident, or have a type of temporary visa that permits the child to obtain a Social Security number).

Tie-breaking rules

If a child would be a qualifying child with respect to more than one individual (*e.g.*, a child lives with his or her mother and grandmother in the same residence) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules apply. First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent. Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child of the parent with whom the child resides for the longest period of time, but, if the child resides with both parents for the same amount of time, then the child is deemed the qualifying child of the parent with the highest adjusted gross income. Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

As mentioned above, taxpayers with children that satisfy these requirements may benefit from several tax credits. Table 10 presents a summary of the projected number of returns and total dollar amounts of these credits for 2017. These credits are described in more detail below.

Table 10.−Select Credits Related to Children, 2017

Credit	Returns (millions)	Dollars (billions)
Child Tax Credit[1]	35.3	$54.0
Additional Child Tax Credit	20.0	$27.0
Earned Income Credit	29.0	$71.1
Child and Dependent Care Credit	6.1	$3.3

[1] The Child Tax Credit includes the Additional Child Tax Credit, the refundable portion of the credit.

Source: Joint Committee on Taxation.

Child tax credit

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child tax credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified adjusted gross income includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against both the regular tax and the AMT. To the extent the child tax credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[92] (the additional child tax credit) equal to 15 percent of earned income in excess of $3,000. A refundable credit is a credit which, if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's EIC.

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based on earned income only to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and shall not be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds.

Earned income credit

In general

Low- and moderate-income workers may be eligible for the refundable EIC. Eligibility for the EIC is based on earned income, AGI, investment income, filing status, number of children, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on AGI and earned income.

The EIC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the

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

beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $3,450 (for 2017). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income that is not self-employment income (if greater than zero).

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Filing status

An unmarried individual may claim the EIC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EIC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EIC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter, stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

Presence of qualifying children and amount of the earned income credit

Four separate credit schedules apply: one schedule for taxpayers with no qualifying children, one schedule for taxpayers with one qualifying child, one schedule for taxpayers with two qualifying children, and one schedule for taxpayers with three or more qualifying children.[93] The values below are for 2017.

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to $6,670, resulting in a maximum credit of $510. The maximum is available for those with incomes between $6,670 and $8,340 ($13,930 if married filing jointly). At that point, the credit begins to phase out at a rate of 7.65 percent of earnings above that threshold, resulting in a $0 credit at $15,010 of earnings ($20,600 if married filing jointly).

Taxpayers with one qualifying child may claim a credit of 34 percent of their earnings up to $10,000, resulting in a maximum credit of $3,400. The maximum credit is available for those with earnings between $10,000 and $18,340 ($23,930 if married filing jointly). At that point, the

[93] All income thresholds are indexed for inflation annually.

credit begins to phase out at a rate of 15.98 percent of earnings above this threshold, phasing out completely at $39,617 of earnings ($45,207 if married filing jointly).

Taxpayers with two qualifying children may claim a credit of 40 percent of earnings up to $14,040, resulting in a maximum credit of $5,616. The maximum credit is available for those with earnings between $14,040 and $18,340 ($23,930 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and is completely phased out at $45,007 of earnings ($50,597 if married filing jointly).

Taxpayers with three or more qualifying children may claim a credit of 45 percent of earnings up to $14,040, resulting in a maximum credit of $6,318. The maximum credit is available for those with earnings between $14,040 and $18,340 ($23,930 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings above that threshold, and are completely phased out at $48,340 of earnings ($53,930 if married filing jointly).

Dependent care

Dependent care credit

An individual who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 35 percent of a limited amount of employment-related dependent care expenses. Generally, a qualifying individual is: (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption; or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit.

Eligible child and dependent care expenses related to employment are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of AGI above $15,000. Thus, for taxpayers with adjusted gross income above $43,000, the credit rate is 20 percent. The phase-out point and the amount of expenses eligible for the credit are not indexed for inflation.

Exclusion of employer-provided child or dependent care services

Up to $5,000 annually of employer-provided dependent care assistance is excludable from gross income and wages if the assistance is provided pursuant to a separate written plan of an employer that does not discriminate in favor of highly compensated employees and meets certain other requirements. The amount excludable cannot exceed the earned income of the employee or, if the employee is married, the lesser of the earned income of the employee or the earned income of the employee’s spouse.

Head of household filing status

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half the year of (1) a qualifying child, or (2) an individual for whom the taxpayer may claim a dependency exemption. A taxpayer may claim head of household status with respect to a parent for whom the taxpayer may claim a dependency exemption and who does not live with the taxpayer, if certain requirements are satisfied.

Taxpayers who file as heads of household compute their tax under the same rate structure as all other taxpayers, however the bracket breakpoints for heads of household are higher than those for other unmarried taxpayers and lower than those for married taxpayers filing jointly (other than the beginning of the 35-percent bracket breakpoint, which is the same for all filing statuses, other than married-filing-separate).

Dependent exemption

Individuals are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. Table 11 presents the projected number of dependent exemptions that will be claimed for tax year 2017. The deduction for personal exemptions is phased out for taxpayers with AGI above $261,500 ($313,800 in the case of joint-filers). For 2017, the dependent exemption is $4,050 per dependent.

Table 11.−Dependent Exemptions, 2017

Category	Exemptions (millions)[1]
Children at home	85.1
Children away from home	0.6
Parents	3.6
Other dependents	10.0
Total exemptions	99.2

[1] A return may have multiple dependent exemptions.

Details may not add to total due to rounding.
Source: Joint Committee on Taxation.

III. OTHER TAX PROVISIONS RELATED TO FAMILIES

Tax benefits related to adoption

Adoption credit

A tax credit is allowed for qualified adoption expenses paid or incurred by an individual subject to a maximum credit amount per eligible child.[94] An eligible child is an individual who: (1) has not attained age 18; or (2) is physically or mentally incapable of caring for himself or herself. The maximum credit is applied per child rather than per year. Therefore, while qualified adoption expenses may be incurred in one or more taxable years, the tax credit per adoption of an eligible child may not exceed the maximum credit.

For taxable years beginning in 2017, the maximum credit amount is $13,570, and the credit is phased out ratably for taxpayers with modified AGI above a certain amount. In 2017, the phase out range begins at modified adjusted gross income of $203,540, with no credit allowed for taxpayers with a modified adjusted gross income of $243,540. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands and residents of Puerto Rico, respectively).

In the case of a special needs adoption finalized during a taxable year, the taxpayer may claim as an adoption credit the amount of the maximum credit minus the aggregate qualified adoption expenses with respect to that adoption for all prior taxable years. A special needs child is an eligible child who is a citizen or resident of the United States whom a State has determined: (1) cannot or should not be returned to the home of the birth parents; and (2) has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group, or the presence of factors such as medical conditions, or physical, mental, or emotional handicaps) because of which the child cannot be placed with adoptive parents without adoption assistance.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are: (1) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (2) not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement; (3) not for the adoption of the child of the taxpayer's spouse; and (4) not reimbursed (*e.g.*, by an employer).

IRS published data for tax year 2014 reports that roughly 74,000 taxpayers claimed the adoption credit, representing approximately $355 million in reduced tax liability.

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[94] Sec. 36C.

Exclusion for employer-provided adoption assistance

An exclusion from the gross income of an employee is allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For 2017, the maximum exclusion is $13,570. Also for 2017, the exclusion is phased out ratably for taxpayers with modified adjusted gross income between $203,540 and $243,540. Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under Code sections 911, 931, and 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively). For purposes of this exclusion, modified adjusted gross income also includes all employer payments and reimbursements for adoption expenses whether or not they are taxable to the employee.

Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

Benefits related to health care and dependent care

Dependent care flexible spending arrangements

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee receives certain nontaxable employer-provided benefits, including dependent care assistance. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction.[95] FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (*e.g.*, the exclusion for dependent care assistance). If the applicable requirements are satisfied, contributions to the FSA and all distributions to pay dependent care expenses are excludable from income and from wages for FICA tax purposes.

Credit for coverage under a qualified health plan

Certain taxpayers may claim a refundable tax credit (the "premium assistance credit") for eligible individuals and families who purchase health insurance through an exchange.[96] The

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[95] Sec. 125. Under section 125, a cafeteria plan is an arrangement under which employees may choose to receive certain nontaxable employer-provided benefits, such as dependent care assistance or health benefits, rather than cash compensation.

[96] Sec 36B. Under section 1311 of the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, an American Health Benefit Exchange (or "exchange") is a source through which individuals can purchase health insurance coverage.

premium assistance credit, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an exchange.

The premium assistance credit is available for individuals (single or joint filers) with household incomes between 100 and 400 percent of the Federal poverty level ("FPL") for the family size involved who do not received health insurance through an employer or a spouse's employer. Household income is defined as the sum of: (1) the taxpayer's modified adjusted gross income, plus (2) the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer's family size (but only if such individuals are required to file a tax return for the taxable year). Modified adjusted gross income is defined as adjusted gross income increased by: (1) any amount excluded from gross income for citizens or residents living abroad, (2) any tax-exempt interest received or accrued during the tax year, and (3) the portion of the individual's social security benefits not included in gross income. To be eligible for the premium assistance credit, taxpayers who are married (within the meaning of section 7703) must file a joint return. Individuals who are listed as dependents on a return are ineligible for the premium assistance credit.

Benefits for education saving and expenses

The Code provides individuals with numerous tax benefits for certain expenditures on education. The provisions listed below are generally those provisions most relevant to families saving for, and paying for, expenses related to elementary, secondary and post-secondary education for their children.[97] Information relating to the income distribution of claimants of the credits for tuition and related expenses is available in the appendix at table A-3.[98]

The American Opportunity credit

The American Opportunity credit provides individuals with a tax credit of up to $2,500 per eligible student per year for qualified tuition and related expenses (including course materials) paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses.

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[97] A complete discussion of this topic can be found in Joint Committee on Taxation, *Background and Present Law Related to Tax Benefits for Education* (JCX-70-14), June, 2014, available at www.jct.gov.

[98] The data on this table includes the Lifetime Learning credit, a credit generally claimed with respect to tuition paid after the first four years of post-secondary education, as well as the deduction for student loan interest. For more detail on these topics, see Joint Committee on Taxation, *Background and Present Law Related to Tax Benefits for Education* (JCX-70-14), June, 2014.

The American Opportunity credit is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. A refundable credit is a credit which, if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Deduction for tuition

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[99] The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose AGI for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose AGI does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2016.

Gift tax exclusion for education expenses

Gift tax is imposed on transfers of property by gift, subject to several exceptions. One exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to $14,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.[100]

In addition to the gift tax annual exclusion, the Code provides that certain tuition payments are not considered transfers of property by gift for gift tax purposes.[101] This exclusion covers amounts paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(A)(ii) (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on) for the education or training of such individual. No unlimited exclusion is permitted for books, supplies, dormitory fees, board, or

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[99] Sec. 222.

[100] The Code provides an amount of $10,000, adjusted in $1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2017 is $14,000.

[101] Sec. 2503(e).

other similar expenses that do not constitute direct tuition costs.[102] The exclusion applies only to direct transfers to the educational institution, not to reimbursements to donees for amounts paid by them for otherwise qualifying services, or to trusts to provide for the education of designated beneficiaries.[103] This exclusion applies without regard to the relationship of the donor and donee.

Section 529 qualified tuition programs

Section 529 of the Code provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[104] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time, as well as computers and Internet access.

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax).

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[102] Treas. Reg. sec. 25.2503-6(b)(2).

[103] Treas. Reg. sec. 25.2503-6(c), ex. 2.

[104] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over without income tax liability to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

Coverdell Education Savings Accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[105] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn. However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (*i.e.*, the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[106]

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. The term qualified elementary and secondary school expenses, means expenses for: (1) tuition, fees, academic tutoring, special needs services, books,

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[105] Sec. 530.

[106] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature

Benefits related to the gift tax

Annual gift tax exclusion

A gift tax is generally imposed on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities.

Annual gifts of $14,000 (for 2017) or less per donor and per donee generally are not subject to tax. The amount of the annual gift tax exclusion is indexed for inflation.

Gift tax exclusion for medical expenses

A gift tax is imposed on transfers of property by gift, subject to several exceptions. One exception is the gift tax annual exclusion of section 2503(b), described above. In addition to the gift tax annual exclusion, the Code provides that payments of medical expenses are not considered transfers of property by gift for gift tax purposes.[107] This exclusion covers amounts paid: (a) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purposes of affecting any structure or function of the body; (b) for transportation primarily for and essential in medical care referred to in (a); (c) for qualified long-term care services; or (d) for insurance (including amounts paid as premiums under Part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in (a) and (b) or for any qualified long-term care insurance contract.

Gift tax deduction for spousal gifts

The value of a gift made from one spouse to another is deductible in computing the donor's taxable gifts. This deduction effectively exempts such gift from the gift tax.

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[107] Sec. 2503(e).

IV. TAXATION OF WEALTH TRANSFERS

Estate, Gift, and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $14,000 (for 2017) or less per donor and donee pair are not treated as taxable gifts and thus are not subject to tax.

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[108] The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and effective exemption amount apply to an individual's cumulative taxable gifts and bequests. Under present law, this results in an estate and gift tax rate of 40 percent and a total amount exempted from gift and estate taxation for an individual of $5.49 million (for 2017).[109] Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is normally imposed on such transfers. This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. For 2017, the generation-skipping transfer tax is

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

[109] The $5.49 million value for 2017 is the result of inflation indexing required by section 2010(c)(3)(B) of the $5 million exemption amount set forth in section 2010(c)(3)(A) for years after 2011.

imposed at a flat rate of 40 percent on generation-skipping transfers in excess of $5.49 million.[110]

Income Tax Basis in Property Received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (*i.e*., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

A gift or bequest of appreciated (or loss) property is not an income tax realization event for the transferor. The Code provides special rules for determining a recipient's basis in assets received by lifetime gift or from a decedent.

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

Basis in property acquired from a decedent

Property acquired from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" means that the basis of property acquired from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). Providing a fair market value basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Thus, both the decedent's one-half share and the surviving

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[110] For a more detailed description of present law, see Joint Committee on Taxation, *History, Present Law, and Analysis of the federal Wealth Transfer Tax System* (JCX-52-15), March 16, 2015, pp. 13-23.

spouse's one-half share are stepped up to fair market value. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that stock of a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (*i.e.*, generally the date of the decedent's death unless an alternate valuation date is elected).

Data about the Federal estate and gift taxes

Revenues generated by the estate and gift tax are a small portion of overall Federal tax revenues. In fiscal year 2016, the IRS collected $21.4 billion in net estate and gift tax revenues. This amount represented 0.7 percent of total net Federal tax collections in fiscal year 2016. By comparison, the highest post-World War II share of total Federal revenues represented by the estate and gift tax was 2.6 percent in fiscal year 1972.[111]

Relatively few taxpayers are directly affected by the Federal estate and gift tax. In 2013, the most recent year for which final numbers are available, there were 2.6 million deaths in the United States, and 4,700 estate tax returns reporting some tax liability were filed. Thus, taxable estate tax returns represented approximately one-fifth of one percent of deaths in 2013. By comparison, in the mid-1970s taxable estate tax returns exceeded six percent of all deaths.

Economic ramifications of estate taxation

Although the Federal estate and gift tax accounts for a small share of total Federal revenues and directly affects a small percentage of taxpayers, it may have broad economic effects. First, the estate tax might affect aggregate capital formation, but there is not consensus among economists on this issue. Some economists believe that individuals' attitudes toward leaving bequests have a significant effect on overall capital accumulation. The existence of an estate tax may influence these attitudes.

Second, the estate tax may affect individuals' saving behavior. Because the estate tax increases the after-tax cost of leaving a bequest, the existence of the tax may discourage some individuals from saving for a bequest. On the other hand, individuals who want to give a bequest of a certain amount may increase their savings to account for the potential estate tax burden.

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[111] Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, "The Estate Tax: Ninety Years and Counting," in Internal Revenue Service, *Statistics of Income Bulletin* (Summer 2007), p. 125.

There has been limited empirical analysis to determine the effect, if any, of the estate tax on individual saving.

Third, the estate tax may have an impact on the amount of investment in small businesses. An estate tax might create cash flow difficulties for small businesses and thereby may cause small business owners to borrow money or to sell or otherwise liquidate businesses to pay estate tax liability. If small businesses are sold, there may be a shift toward less overall investment in small business. If small business owners borrow funds to pay the estate tax, they may reduce their investment in the businesses, and this reduced investment could have deleterious effects on the larger economy. Some observers argue, however, that the present estate tax imposes a limited burden on small business owners because the exemption level has risen to $5.49 million for estates of individuals dying in 2017 and because special rules allow installment payment of tax liability for estates consisting largely of closely-held business assets.

Another way in which the estate tax may affect the economy is through planning strategies to avoid the tax. To the extent that resources are shifted towards tax avoidance activities and away from more productive endeavors, the overall economy may be smaller as a result.[112]

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[112] For additional data and a more detailed discussion of economic issues, see Joint Committee on Taxation, *History, Present Law, and Analysis of the federal Wealth Transfer Tax System* (JCX-52-15), March 16, 2015, pp. 24-46.

APPENDIX

Table A-1.−Distribution by Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability, at 2017 Rates and 2016 Income Levels[1]

[Returns in thousands, money amounts in millions of dollars]

Income Class [2]	All Returns [3]	Taxable Returns	Itemized Returns	Tax Liability [4]
Below $10,000	19,513	8,149	315	-$6,117
$10,000 to $20,000	21,662	6,654	639	-$41,588
$20,000 to $30,000	21,408	8,883	1,109	-$26,471
$30,000 to $40,000	15,891	9,791	1,644	-$4,434
$40,000 to $50,000	13,391	9,665	2,257	$11,818
$50,000 to $75,000	26,646	22,924	7,113	$90,638
$75,000 to $100,000	17,351	16,743	6,837	$123,490
$100,000 to $200,000	28,548	28,481	17,844	$454,895
$200,000 and over	9,942	9,941	8,974	$1,173,096
Total	**174,352**	**121,230**	**46,732**	**$1,775,326**

[1] Tax law as in effect on December 31, 2016, is applied to the 2016 level and sources of income and their distribution among taxpayers.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) excluded income of U.S. citizens living abroad,

[3] Includes filing and non-filing units. Filing units include all taxable and nontaxable returns. Non-filing units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

[4] Individual income tax and individuals' share of business taxes.

Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Table A-2.−Distribution by Income Class and Tax Filing Status, 2017

Income Class [1]	All Returns			Single Returns			Married Filing Jointly			Married Filing Separately			Head of Household		
	Returns [2]	*Individual Income Taxes*	*Employ ment Taxes*	*Returns* [2]	*Individual Income Taxes*	*Employ ment Taxes*	*Returns* [2]	*Individual Income Taxes*	*Employ ment Taxes*	*Returns* [2]	*Individual Income Taxes*	*Employ ment Taxes*	*Returns* [2]	*Individual Income Taxes*	*Employ ment Taxes*
Below $10,000	19,174	-$6.2	$7.6	16,672	-$28.8	$6.0	858	-$0.5	$0.5	137	[3]	$0.1	1,507	-$2.8	$1.0
$10,000 to $20,000	20,306	-$41.0	$31.0	13,905	-$109.7	$18.2	1,406	-$4.0	$2.4	201	-$0.1	$0.4	4,796	-$25.9	$10.1
$20,000 to $30,000	21,107	-$31.9	$41.3	14,756	-$29.8	$23.0	2,301	-$7.3	$5.6	283	-$0.1	$0.7	3,767	-$21.5	$12.0
$30,000 to $40,000	15,965	-$12.5	$45.5	10,193	$58.8	$25.9	2,610	-$6.9	$7.3	304	$0.2	$1.1	2,857	-$11.7	$11.2
$40,000 to $50,000	12,680	$2.3	$48.8	7,086	$122.3	$26.4	3,020	-$5.9	$10.0	296	$0.6	$1.3	2,278	-$4.7	$11.1
$50,000 to $75,000	26,945	$60.6	$148.3	13,276	$564.6	$75.4	8,773	-$2.7	$41.2	736	$3.1	$4.7	4,160	$3.8	$27.0
$75,000 to $100,000	17,417	$91.9	$130.1	6,176	$545.2	$51.0	8,979	$25.4	$58.6	411	$3.3	$3.6	1,851	$8.7	$16.9
$100,000 to $200,000	29,971	$368.9	$387.9	5,777	$986.3	$71.6	22,082	$241.1	$286.7	431	$7.5	$6.0	1,682	$21.7	$23.6
$200,000 to $500,000	8,975	$386.8	$203.4	988	$503.7	$15.9	7,712	$322.2	$182.0	73	$3.9	$1.4	202	$10.4	$4.2
$500,000 to $1,000,000	1,121	$172.9	$35.7	128	$196.1	$2.7	954	$147.0	$32.0	13	$2.2	$0.3	25	$4.1	$0.8
$1,000,000 and over	560	$484.8	$34.9	70	$590.8	$3.2	466	$399.3	$30.2	11	$16.1	$0.7	12	$10.4	$0.7
Total	**174,220**	**$1,476.6**	**$1,114.6**	**89,027**	**$3,399.6**	**$319.3**	**59,160**	**$1,107.7**	**$656.3**	**2,896**	**$36.6**	**$20.4**	**23,137**	**-$7.7**	**$118.6**

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) worker's compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) individual share of business taxes, and (i) excluded income of U.S. citizens living abroad. Categories are measured at 2017 levels.

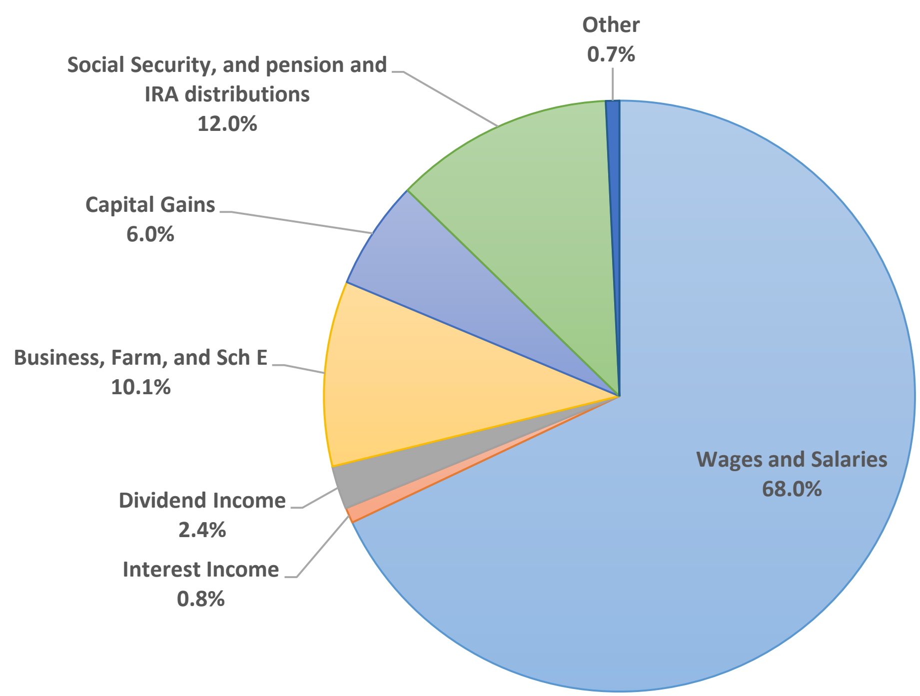
[2] Includes nonfilers, excludes dependent filers and returns with negative income.

[3] Less than $50 million

Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Figure A-1.−Sources of Gross Income for Individual Taxpayers, 2017 (Projected)



Source: Joint Committe on Taxation staff estimates

Table A-3.−Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2017 Rates and 2016 Income Levels[1]

[Returns in thousands, money amounts in millions of dollars]

Income Class [2]	Untaxed Social Security and Railroad Retirement Benefits		Medical Deduction		Real Estate Tax Deduction	
	Returns	*Amount*	*Returns*	*Amount*	*Returns*	*Amount*
Below $10,000	2	[3]	2	$9	2	[3]
$10,000 to $20,000	737	$234	92	$18	117	$19
$20,000 to $30,000	6,231	$2,640	211	$65	333	$76
$30,000 to $40,000	4,514	$5,113	380	$162	668	$180
$40,000 to $50,000	3,349	$4,985	661	$321	1,197	$335
$50,000 to $75,000	7,237	$10,437	1,830	$1,418	5,045	$2,098
$75,000 to $100,000	5,385	$7,409	1,580	$1,831	5,552	$3,194
$100,000 to $200,000	7,431	$6,395	2,308	$4,226	15,775	$14,042
$200,000 and over	2,075	$3,113	296	$1,967	6,124	$13,439
Total	**36,961**	**$40,327**	**7,360**	**$10,016**	**34,814**	**$33,382**

Footnotes appear at the end of the table.

Table A-3 Cont.−Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2017 Rates and 2016 Income Levels[1]

[Returns in thousands, money amounts in millions of dollars]

Income Class [2]	Child Tax Credit [4]		Earned Income Credit [4]	
	Returns	*Amount*	*Returns*	*Amount*
Below $10,000	1,465	$873	5,105	$5,218
$10,000 to $20,000	6,094	$8,211	9,062	$28,389
$20,000 to $30,000	4,738	$7,716	5,240	$17,896
$30,000 to $40,000	3,379	$5,567	3,856	$10,409
$40,000 to $50,000	3,212	$5,453	3,010	$6,405
$50,000 to $75,000	5,967	$9,934	2,922	$4,641
$75,000 to $100,000	3,988	$6,689	236	$311
$100,000 to $200,000	6,593	$9,696	8	$20
$200,000 and over	34	$21	---	---
Total	**35,470**	**$54,161**	**29,439**	**$73,290**

Income Class [2]	Education Credits		Student Loan Interest Deduction	
	Returns	*Amount*	*Returns*	*Amount*
Below $10,000	1,059	$917	13	$1
$10,000 to $20,000	2,012	$1,863	431	$43
$20,000 to $30,000	1,552	$1,839	884	$140
$30,000 to $40,000	1,187	$1,576	952	$176
$40,000 to $50,000	1,020	$1,510	1,077	$178
$50,000 to $75,000	2,260	$3,652	2,711	$588
$75,000 to $100,000	1,355	$2,408	1,851	$322
$100,000 to $200,000	2,999	$6,020	3,519	$859
$200,000 and over	158	$195	15	$1
Total	**13,602**	**$19,980**	**11,453**	**$2,306**

Footnotes appear at the end of the table.

Table A-3 Cont.−Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2017 Rates and 2016 Income Levels[1]

[Returns in thousands, money amounts in millions of dollars]

Income Class [2]	**Child Care Credit**		**Phase out of Personal Exemption for Regular Income Tax, and Denial of Personal Exemption and the Standard Deduction for AMT**	
	Returns	***Amount***	***Returns***	***Amount***
Below $10,000	1	[3]	1	-$2
$10,000 to $20,000	50	$11	1	-$1
$20,000 to $30,000	318	$131	1	-$4
$30,000 to $40,000	379	$215	1	-$3
$40,000 to $50,000	454	$267	2	-$4
$50,000 to $75,000	1,000	$574	16	-$22
$75,000 to $100,000	801	$454	42	-$39
$100,000 to $200,000	2,365	$1,647	498	-$697
$200,000 and over	1,061	$990	5,254	-$16,852
Total	**6,429**	**$4,289**	**5,816**	**-$17,625**

[1] Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, (h) excluded income of U.S. citizens living abroad, and (i) individuals' share of business income.

[3] Positive tax expenditure of less than $500,000.

[4] Includes the refundable portion.

Details may not add to totals due to rounding.
Source: Joint Committee on Taxation.

Table A-4.−Qualifying Child Comparison

Benefit	Age of child	Support Test	Citizenship/Residency of Child	Identification of Requirement for Child	Divorced or Separated Filers Living Apart
Personal Exemption/Section 152 Qualifying Child	Under age 19, or full-time student under age 24	Child provides less than one-half of own support	U.S. Citizen or Resident of U.S., Canada, or Mexico	Taxpayer Identification Number	Noncustodial parent if custodial parent releases exemption
Child Tax Credit	Under age 17	*	U.S. Citizen or Resident of U.S.	*	*
Earned Income Credit	*	Child allowed to provide more than one-half of own support	Principal place of abode in U.S. for more than one-half of taxable year	Social Security Number+	Custodial parent only
Child and Dependent Care Credit	Under age 13	*	*	*	Custodial parent only
Head of Household	*	*	*	Name (if not dependent)	Custodial parent only

* Rule for personal exemption applies.

+ Section 32(m) requires that for purposes of the EIC, a taxpayer's identifying number must be an SSN other than a SSN issued to an individual for the sole purpose of allowing such individual to claim benefits under any program financed in whole or in part from Federal funds.