

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

Scheduled for a Public Hearing  
Before the  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on May 12, 2021

Prepared by the Staff  
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## INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for May 12, 2021, called, “Funding Our Nation’s Priorities: Reforming the Tax Code’s Advantageous Treatment of the Wealthy.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, describes empirical information, legal background, and policy considerations related to topics to be considered in the hearing.

The primary purpose of a tax system is to raise revenue to fund government expenditures. The economic crisis brought on by the ongoing COVID-19 pandemic has led Congress to respond by passing several bills that will substantially increase the U.S. debt.<sup>2</sup> As the debate over further responses and other priorities continues, several fundamental decisions arise. If Congress desires to increase government expenditures further, funding options include increasing government debt or raising more revenue. If Congress decides to raise more revenue, one of the questions is how.

Several factors may be used to assess how well a tax system raises revenue, including whether the tax system promotes or hinders economic efficiency and growth, how fair the tax system is (including both horizontal and vertical equity),<sup>3</sup> and how simple and administrable the tax system is. The disparate effects of the COVID-19 pandemic across industry,<sup>4</sup> educational attainment,<sup>5</sup> and income group<sup>6</sup> have drawn focus to the continuing debate about the fairness of the U.S. tax system. One salient question in that debate is the degree to which the U.S. tax system should impose taxes according to a taxpayer’s ability to pay; in other words, what is the appropriate level of progressivity for the overall U.S. tax system.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background on the Taxation of High Income and High Wealth Taxpayers* (JCX-24-21), May 10, 2021. This document can be found on the Joint Committee on Taxation website, [www.jct.gov](http://www.jct.gov).

<sup>2</sup> The Congressional Budget Office projects that by 2031, debt as a percent of gross domestic product will exceed the historical highs of Federal spending resulting from World War II. Congressional Budget Office, *The 2021 Long-Term Budget Outlook*, March 2021, Figure 1.

<sup>3</sup> The concept of horizontal equity asks whether taxpayers who otherwise are similarly situated bear the same tax burden. The concept of vertical equity asks how the tax burdens of low-ability-to-pay taxpayers compare to tax burdens of high-ability-to-pay taxpayers.

<sup>4</sup> Michael Dalton, “Geographic Impact of COVID-19 in BLS Surveys by Industry,” *Monthly Labor Review*, U.S. Bureau of Labor Statistics, August 2020, <https://doi.org/10.21916/mlr.2020.17>.

<sup>5</sup> Daly et al., “The Unequal Impact of COVID-19: Why Education Matters,” *FRBSF Economic Letter*, Federal Reserve Board of San Francisco, June 2020.

<sup>6</sup> Juliana Horowitz, Anna Brown, and Rachel Minkin, “A Year Into the Pandemic, Long-Term Financial Impact Weighs Heavily on Many Americans,” Pew Research Center, March 5, 2021 examined survey responses from January 2021 and found that 41 percent of upper-income adults reported that their family’s financial situation had improved since February 2020 compared to 11 percent who reported finances had worsened. In contrast, 22 percent of lower income adults reported financial improvement while 31 percent reported worsening finances.

Answering this question involves considering how ability to pay should be measured. Important concepts for the consideration of this question include income and wealth. A general concept of income is the change in an individual's net wealth plus an individual's consumption over a certain timeframe. Wealth can be defined as an individual's assets minus the individual's debts.<sup>7</sup>

One option for measuring ability to pay is to measure it by income. Income could be argued to be a more appropriate measure of ability to pay than wealth because not all wealth is held in liquid assets. A progressive tax system using income as a base would impose a relatively higher rate of tax on those with more income. However, there are administrability concerns under a broad income tax, including: how should changes in the value of an asset be measured; should income be measured annually;<sup>8</sup> and should certain sources of income be excluded? There are also efficiency concerns: what do high marginal income tax rates do to incentives to work, and compared to other taxes how distortionary is such a tax?

Another possibility is to use a taxpayer's wealth as an indicator of ability to pay. Arguably, a taxpayer with more wealth has more capacity to pay taxes. A progressive tax system using wealth as a base would impose a relatively higher rate of tax on those with more wealth. However, such a tax may treat otherwise similarly situated taxpayers differently depending on saving and consumption patterns. Additionally, the fairness of a tax system is one factor that is balanced against other priorities. If attempting to tax wealth directly, there may be administrability concerns, such as: how should wealth be measured; should certain kinds of assets be excluded; how should nontradable or illiquid assets be valued; and what if any new reporting might be necessary? There are also efficiency concerns: what would a broad tax on wealth do to incentives to save and invest, and compared to other taxes how distortionary is such a tax?

The inquiry is not only how to determine the appropriate base for taxation (wealth, income, some combination, or something else entirely) but also how broad the base should be. Implementing and administering a tax on a broad measure of wealth or income means knowing the relevant composition of wealth and sources of income so that they can be measured. Alternatively, a progressive wealth or income tax could target certain components of wealth or income that are held in higher proportion by high-wealth or high-income taxpayers. Such a tax would also require identifying which components of wealth or income fit these criteria. Section I presents and discusses the available data on sources of income and composition of wealth.

The present U.S. tax system can be viewed as progressively taxing certain components of income and wealth. The individual income tax applies progressive rates to a set of sources of

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<sup>7</sup> This measure would exclude the education or skills of a taxpayer (sometimes referred to as human capital).

<sup>8</sup> Franco Modigliani and Richard H. Brumberg, "Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data," in Kenneth K. Kurihara, (ed.), *Post-Keynesian Economics*, Rutgers University Press, 1954, pp. 388–436.

income.<sup>9</sup> The donor of a gift or decedent making a bequest are subject to the estate and gift tax system, with certain annual and lifetime exemptions which may be present for reasons of administrability (not having to account for relatively small transfers) and fairness (progressivity can be achieved with exemptions for smaller transfers). Section II provides a more detailed description of relevant present law tax provisions that relate to income taxation and wealth transfer taxation.

Given the complexity of the issues and our current system, there are ongoing debates about which components of income and wealth our system should tax and the degree to which such components should be taxed to balance fairness, efficiency, and administrability concerns. Section III concludes with a discussion of some proposals that share an aim to increase the progressivity of the Federal tax system.

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<sup>9</sup> These sources include compensation for services, interest, dividends, capital gains, rents, royalties, 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, income allocated from S corporations and partnerships, and income distributed from estates or trusts.

## I. BACKGROUND DATA

The following discussion reviews data about and provides a summary of analyses of sources of income and composition of wealth by income and wealth groups, respectively.

### A. Data on Income

The economics literature discusses the distribution of national income, the total amount of money earned within a country. Specifically, discussion has focused on how best to measure income composition and shares. Income measures used to estimate inequality are critical for estimating average tax rates and tax progressivity. In the early 1900s, researchers first observed that a larger share of national income went to labor than to capital.<sup>10</sup> Initial survey data about wages, dividends, and interest from different industries revealed that the share of income going to the top one percent of the income distribution was 14 percent and the share going to the top 10 percent was 35 percent.<sup>11</sup> However, there were disagreements about the assumptions made and data used to measure the distribution of income.<sup>12</sup> Soon after the introduction of the modern Federal income tax, researchers used the income reported on tax returns to estimate income shares.<sup>13</sup> In general, revised estimates and trends using tax return information were similar to prior measures, although industry survey data may have underestimated the volatility of national income.<sup>14</sup> Even after the introduction of tax return reporting, concerns remained as to how to best measure the distribution of national income.<sup>15</sup>

Work on the measurement of income compositions and shares has continued.<sup>16</sup> The Congressional Budget Office estimated income share using tax return data and found that between 1979 and 2015, the top one percent's share of income before taxes and transfers increased by more than seven percentage points.<sup>17</sup> Between 1979 and 2006, Census data show

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<sup>10</sup> Willford I. King, *The Wealth and Income of the People of the United States*, Macmillan, 1915; Scott Nearing, *Income; an Examination of the Returns for Services Rendered and from Property Owned in the United States*, Macmillan, 1915.

<sup>11</sup> *Ibid.*

<sup>12</sup> Arthur L. Bowley, "Income in the United States," *The Quarterly Journal of Economics*, 37(3): 510-517, 1923.

<sup>13</sup> Wesley C. Mitchell, Willford I. King, Frederick R. Macaulay, and Oswald W. Knauth, "Income in the United States, Its Amount and Distribution, 1909-1919," *General Series National Bureau of Economic Research*, no. 1-2, 1921. For a summary of this early literature, see Hugh Rockoff, "Off to a Good Start: The NBER and the Measurement of National Income," *NBER Working Paper No. 26895*, 2020.

<sup>14</sup> *Ibid.*

<sup>15</sup> Morgan Reynolds and Eugene Smolensky, *Public Expenditures, Taxes, and the Distribution of Income: The United States, 1959, 1961, 1971*, W. W. Norton & Company, 1977.

<sup>16</sup> Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *NBER Working Paper No. 8467*, 2001.

<sup>17</sup> Congressional Budget Office, *The Distribution of Household Income, 2015*, November 2018 (supplemental data).

that the top one percent's pre-tax/pre-transfer income shares increased by about three percentage points, when corrected for survey changes and top-coding issues.<sup>18</sup>

Another question that arises is how to measure total income. For example, the Congressional Budget Office estimates above use a narrower income definition than national income.<sup>19</sup> The Census data also look at pre-tax/pre-transfer income shares. In general, national income may be measured pre-tax/pre-transfer, pre-tax/after-transfer, or after-tax/after-transfer.

Other recent work shows results that indicate the share of national income (before taxes, but after Social Security and unemployment benefits) earned by the top one percent of American adults rose by eight percentage points from 1979 to 2019.<sup>20</sup> Subsequent work by other economists has estimated smaller increases in income concentration. Other economists report that the top one percent's pre-tax national income rose less than five percentage points from 1979 to 2015.<sup>21</sup> However, pre-tax national income does not account for taxes or government transfers. When an income measure is computed that includes taxes and transfers, those same economists found that the top one percent's share rose by approximately one percentage point from 1979 to 2015.<sup>22</sup> In general, there is uncertainty in how to measure income and interpret available data. There is a range of results due to different data sources, different income definitions, and different assumptions used to allocate missing income.

In the following tables, the Joint Committee staff has calculated several alternative measures of income categorized by percentiles of the income distribution.<sup>23</sup> The income group thresholds are set such that each percentile has the same number of individual U.S. residents (including adults, dependents, and non-filers). For example, the number of individuals in the 27<sup>th</sup> percentile is the same as the number of individuals in the 61<sup>st</sup> percentile. The income

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<sup>18</sup> Richard V. Burkhauser, Shuaizhang Feng, Stephen P. Jenkins, and Jeff Larrimore, "Recent Trends in Top Income Shares in the United States: Reconciling Estimates from March CPS and IRS Tax Return Data," *Review of Economics and Statistics* 44(2): 371–388, 2012.

<sup>19</sup> Congressional Budget Office estimates do not correct for effects from the Tax Reform Act of 1986, causing an upward bias in the estimated increases. Differences between the CBO income definition and national income are discussed in Gerald Auten and David Splinter, "Top 1% Income Shares: Comparing Estimates Using Tax Data." *AEA Papers & Proceedings* 109, 307–311, 2019.

<sup>20</sup> Thomas Piketty, Emmanuel Saez, and Gabriel Zucman. "Distributional National Accounts: Methods and Estimates for the United States." *Quarterly Journal of Economics* 133(2): 553–609, 2018.

<sup>21</sup> See Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, December 20, 2019, available at [http://davidsplinter.com/AutenSplinter-Tax\\_Data\\_and\\_Inequality.pdf](http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf).

<sup>22</sup> *Ibid.*

<sup>23</sup> The data on income presented here are compiled by generally following the methodology described in Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, December 20, 2019, available at [http://davidsplinter.com/AutenSplinter-Tax\\_Data\\_and\\_Inequality.pdf](http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf).

estimates use tax return data<sup>24</sup> and are ranked using tax-unit size-adjusted incomes if a taxpayer reports a spouse and/or dependents.<sup>25</sup> The unit of observation for the income estimates is a tax unit.<sup>26</sup> In order to be more consistent with recent income distribution studies, the tables in this subsection (Tables 1 through 4) differ from standard distributional tables produced by the Joint Committee staff.<sup>27</sup>

In Table 1, the Joint Committee staff ranks tax filing units by the unit's income before taxes and after the receipt of transfers (pre-tax/after-transfer income). Pre-tax income is income before taxes paid, including any indirect taxes paid that are allocable to the group (*e.g.*, the employer portion of payroll taxes are added to taxable wages). Pre-tax/after-transfer income also includes government transfers, including government cash and non-cash transfers such as Medicare, Social Security benefits, unemployment benefits, workers' compensation benefits, Medicaid, Supplemental Nutrition Assistance Program ("SNAP"), and Supplemental Security Income ("SSI") benefits. The income groups in Table 1 range from the bottom 50 percent to the top 0.01 percent of the income distribution. Table 1 shows the distribution of pre-tax/after-transfer national income amounts, shares, and averages by income group for the year 2018. For example, the bottom 50 percent had a total combined income amount of \$4.4 trillion, which was 20.7 percent of total national income reported in the year 2018. The average per capita income amount was \$27,000. The 50-90 percentile had a total combined income amount of \$8.9 trillion, which was 43.4 percent of total national income reported in the year 2018. The average per capita income amount was \$71,000. In 2018, there are about 15,000 tax units in the top 0.01 percent. The top 0.01 percent had a total income amount of \$447 billion, which was approximately 2.2 percent of total national income in the year 2018. The top 0.01 percent average income amount was \$14,259,000.

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<sup>24</sup> These data are the annual Individual and Sole proprietor ("INSOLE") samples that the IRS Statistics of Income Division produces to be representative of all returns filed each year.

<sup>25</sup> The Joint Committee staff follows the Congressional Budget Office (see Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020) in defining income groups based on all individuals (including primary and secondary taxpayers and dependents). This helps control for the bias introduced from falling marriage rates as compared to groups set by tax units. When ranking tax units, the Joint Committee staff accounts for size differences—which accounts for the costs of supporting dependents and the economies of scale from shared resources—by dividing tax unit income by the square-root of the number of individuals in the unit. This is the same equivalence scale used by the Congressional Budget Office. Income shares are calculated using total tax unit incomes, such that they sum to national income.

<sup>26</sup> Tax units include all individuals claimed on the same tax returns, or who would file together in the case of non-filers. Certain returns are excluded: dependent filers, individuals under the age of 20, non-U.S. residents, and residents of the U.S. territories.

<sup>27</sup> See the Appendix for a comparison of the Joint Committee staff's standard methodology compared to that used for Tables 1 through 4.



**Table 1.—Distribution of Pre-Tax/After-Transfer National Income Amounts, Shares, and Averages by Income Group for 2018**

<b>Income Group (Percentile)</b>	<b>Amount (\$ Billions)</b>	<b>Share (Percent)</b>	<b>Average Per Capita (Dollars)</b>
<b>Bottom 50</b>	4,252	20.7	27,000
<b>50-90</b>	8,889	43.4	71,000
<b>90-95</b>	2,106	10.3	134,000
<b>95-99</b>	2,709	13.2	216,000
<b>99-99.5</b>	617	3.0	394,000
<b>99.5-99.9</b>	874	4.3	697,000
<b>99.9-99.99</b>	610	3.0	2,163,000
<b>Top 0.01</b>	447	2.2	14,259,000

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

Source: Joint Committee staff calculations.

In Table 2, the Joint Committee staff measures income on a pre-tax/pre-transfer basis. This is a different measure of income than that used in Table 1. Pre-tax/pre-transfer income is pre-tax income excluding government transfers. That is, unlike Table 1, the income measure does not include such items as Social Security, unemployment benefits, and SNAP benefits. The income groups in Table 2 range from the bottom 50 percent to the top 0.01 percent of the income distribution. Table 2 shows the income composition by source of income and by income group of pre-tax/pre-transfer national income for the year 2018. In the first row, the income share of the bottom 50 percent is largely composed of wage income (67 percent) and retirement income (12 percent) and is minimally composed of passthrough business income (eight percent), corporate income (four percent), interest income (one percent), and other income (seven percent). In other words, this group derives most of its income from employment (*i.e.*, wage and retirement income) and a small share of its income from investment (*i.e.*, returns on debt and equity, whether in private businesses or public companies) and other income (*i.e.*, imputed rents and property taxes paid that may be attributable to ownership of a primary residence). In general, as one moves up the income distribution, the relative share of income from investment increases, while the relative share of income from employment decreases. For example, in the last row, the income share of the top 0.01 percent is 21 percent wages, 28 percent passthrough business income, 28 percent corporate income, six percent interest, two percent retirement income, and 16 percent other income.

**Table 2.—Income Composition by Source of Income and by Income Group of Pre-Tax/Pre-Transfer National Income, 2018 (Percent)**

<b>Income Group (Percentile)</b>	<b>Wage</b>	<b>Passthrough</b>	<b>Corporate</b>	<b>Interest</b>	<b>Retirement</b>	<b>Other</b>	<b>Total</b>
<b>Bottom 50</b>	67	8	4	1	12	7	<b>100</b>
<b>50-90</b>	66	7	5	1	12	10	<b>100</b>
<b>90-95</b>	51	10	6	1	11	21	<b>100</b>
<b>95-99</b>	46	17	8	1	9	19	<b>100</b>
<b>99-99.5</b>	40	26	9	2	6	16	<b>100</b>
<b>99.5-99.9</b>	32	31	12	3	4	18	<b>100</b>
<b>99.9-99.99</b>	28	32	16	4	3	17	<b>100</b>
<b>Top 0.01</b>	21	28	28	6	2	16	<b>100</b>

Notes: Pre-tax/pre-transfer national income is divided into six categories: (1) wages include employer payroll taxes paid, employer provided health insurance, and underreported wages; (2) passthrough income is gross income net of deductions from partnerships, S corporations, sole proprietorships, farming, and rental activities; (3) corporate income includes taxable dividends (but excludes dividends attributable to retirement accounts, government accounts, and non-profits), retained earnings (taxable income less dividends and corporate taxes paid), and corporate taxes paid; (4) interest income includes taxable interest and tax-exempt interest; (5) private retirement income includes income from tax-exempt retirement accounts, including 401(k)s and IRAs; and (6) other income includes imputed rents (but only from owner-occupied housing) and property and other taxes paid. Mutual fund income is reported in different categories (e.g., corporate income or retirement) depending on how it is earned or reported in the tax return data. Details may not add due to rounding.

Source: Joint Committee staff calculations.

In Table 3, the Joint Committee staff measures income on a pre-tax/pre-transfer basis; this is the same measure used in Table 2. The income groups remain the same. Table 3 shows the distribution of different sources of income across income groups for the year 2018. In each column, the denominator changes to reflect the source of income. For example, in the first column, the denominator is all wage income reported in the year 2018. The 50-90 percentile reported more than one-half of wage income (52 percent) and retirement income (51 percent) and between one-quarter and one-third of passthrough business income (25 percent), corporate income (31 percent), interest income (21 percent), and other income (33 percent). In total, the groups representing the top ten percent reported more than half of passthrough business income (61 percent), corporate income (65 percent), interest income (63 percent), and other income (59 percent).

**Table 3.—Shares of Source of Pre-Tax/Pre-Transfer National Income  
By Income Group, 2018 (Percent)**

<b>Income Group (Percentile)</b>	<b>Wage</b>	<b>Passthrough</b>	<b>Corporate</b>	<b>Interest</b>	<b>Retirement</b>	<b>Other</b>
<b>Bottom 50</b>	18	9	10	15	18	9
<b>50-90</b>	52	25	31	21	51	33
<b>90-95</b>	10	9	10	7	12	18
<b>95-99</b>	12	21	17	14	13	22
<b>99-99.5</b>	2	7	5	5	2	4
<b>99.5-99.9</b>	3	13	9	12	2	7
<b>99.9-99.99</b>	2	9	8	12	1	5
<b>Top 0.01</b>	1	6	11	13	0.4	3
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Notes: Pre-tax/pre-transfer national income is divided into six categories: (1) wages include employer payroll taxes paid, employer provided health insurance, and underreported wages; (2) passthrough income is gross income net of deductions from partnerships, S corporations, sole proprietorships, farming, and rental activities; (3) corporate income includes taxable dividends (but excludes dividends attributable to retirement accounts, government accounts, and non-profits), retained earnings (taxable income less dividends and corporate taxes paid), and corporate taxes paid; (4) interest income includes taxable interest and tax-exempt interest; (5) private retirement income includes income from tax-exempt retirement accounts, including 401(k)s and IRAs; and (6) other income includes imputed rents (but only from owner-occupied housing) and property and other taxes paid. Mutual fund income is reported in different categories (*e.g.*, corporate income or retirement) depending on how it is earned or reported in the tax return data. Details may not add due to rounding.

Source: Joint Committee staff calculations.

Table 4 shows average Federal tax rates by income group for the year 2018. The Joint Committee staff defines average Federal tax rates on a pre-tax/after-transfer income basis.<sup>28</sup> When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of all applicable Federal taxes increases from 6.3 percent to 32.9 percent. When excluding payroll taxes, the average Federal tax rate increases from -0.6 percent to 32.1 percent. This implies a progressive tax system using income as a base (*i.e.*, there is a relatively higher

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<sup>28</sup> For the calculation of average tax rates, the Joint Committee staff assumes the following for incidence: (1) corporate taxes are borne by labor 25 percent, (2) business property taxes are borne by business income, (3) employer payroll taxes are borne by labor, and (4) other taxes are allocated by disposable income less savings. For further information, see the Appendix and Gerald Auten and David Splinter, “Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends,” *Working Paper*, December 20, 2019, available at [http://davidsplinter.com/AutenSplinter-Tax\\_Data\\_and\\_Inequality.pdf](http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf).

average rate of tax imposed on taxpayers with more income).<sup>29</sup> In general, this increasing trend along the income distribution is similar across the following different types of taxes: Federal income tax, Federal corporate tax, and Federal estate and gift tax. The progressivity of the Federal income tax and Federal corporate tax are greater than that of the other taxes. When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of payroll tax<sup>30</sup> and the average rate of other Federal tax decrease from 6.8 percent to 0.8 percent and 1.0 percent to 0.2 percent, respectively. In other words, these taxes are regressive. Despite this regressivity, the overall Federal tax system, on average, remains progressive. In addition, when excluding payroll taxes or considering the progressive spending that regressive payroll taxes fund (*i.e.*, Social Security, Disability, and Medicare benefits), the system becomes more progressive.<sup>31</sup> Since 1985, the progressivity of the Federal tax system has increased every decade.<sup>32</sup>

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<sup>29</sup> Breaking out the bottom 20 percent also emphasizes this progressivity. For example, the Congressional Budget Office estimates that this bottom income group had a -10.9 Federal income tax rate in 2017, much lower than the bottom 50 percent rates seen in Table 4. Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. For a comparison of recent tax progressivity estimates, see David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4): 1005–1024, 2020.

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

<sup>30</sup> Three factors lower the average payroll tax rates relative to statutory rates: (1) non-wage income, (2) tax-excluded compensation included in wages, and (3) transfers.

<sup>31</sup> The Congressional Budget Office finds that from a lifetime perspective the Social Security system is progressive. They estimate that “for people in the bottom fifth of the earnings distribution, the ratio of benefits to taxes is almost three times as high as it is for those in the top fifth.” Congressional Budget Office, *Is Social Security Progressive?*, December 2006.

<sup>32</sup> Congressional Budget Office estimates of average Federal tax rates decreased more for lower-income groups. Between 1985 and 2017, bottom-quintile tax rates decreased 10.5 percentage points, middle-three-quintile tax rates decreased 3.7 percentage points, and top one percent rates increased 5.5 percentage points. See Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. Various measures of tax progressivity show similar increases. See, *e.g.*, David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4):1005–1024, 2020.

**Table 4.–Average Federal Tax Rates by Income Group, 2018  
(Percent)**

<b>Income Group (Percentile)</b>	<b>Average Rate of All Federal Taxes</b>	<b>Average Rate of All Federal Taxes Excluding Payroll Taxes</b>	<b>Federal Income Tax<sup>1</sup></b>	<b>Federal Corporate Tax</b>	<b>Payroll Tax<sup>2</sup></b>	<b>Federal Estate and Gift Tax<sup>3</sup></b>	<b>Other Federal Tax<sup>4</sup></b>
<b>Bottom 50</b>	6.3	-0.6	-2.0	0.5	6.8	*	1.0
<b>50-90</b>	14.1	6.9	5.0	0.7	7.2	*	1.2
<b>90-95</b>	17.6	11.1	9.1	0.9	6.5	0.1	1.0
<b>95-99</b>	18.6	13.9	12.0	1.0	4.7	0.1	0.8
<b>99-99.5</b>	22.6	19.4	17.4	1.0	3.2	0.3	0.6
<b>99.5-99.9</b>	26.0	23.8	21.7	1.0	2.3	0.5	0.5
<b>99.9-99.99</b>	30.8	29.5	27.0	1.3	1.4	0.7	0.4
<b>Top 0.01</b>	32.9	32.1	29.5	1.9	0.8	0.5	0.2

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

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

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

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

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

Source: Joint Committee staff calculations.

The following figures present information about pre-tax/pre-transfer (as with Tables 2 and 3), pre-tax/after-transfer (as with Table 1), and after-tax/after-transfer national income. After-tax/after-transfer income is income after all taxes (Federal, State, and, local) are paid and includes government transfers.<sup>33</sup> After-tax/after-transfer income represents the annual amount a tax unit has available to allocate between current consumption and savings. Figure 1 shows the pre-tax/pre-transfer, pre-tax/after-transfer, and after-tax/after-transfer income share trends from 1960 to 2018 for the following income groups: bottom 50 percent (Figure 1a), the 50-90 percentile (Figure 1b), the 90-99 percentile (Figure 1c), and top one percent (Figure 1d). Pre-tax/pre-transfer income and pre-tax/after-transfer income are as described above.<sup>34</sup>

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

Trends over time are also apparent. In Figure 1a, all three share of income measures for the bottom 50 percent, after rising in the 1960s, have been declining since the 1970s. In Figure 1b, all three share of income measures for the 50-90 percentile have been relatively flat since 1960. In Figure 1c, all three of income measures for the 90-99 percentile have also been relatively flat. In Figure 1d, all three share of income measures for the top one percent declined in the late 1960s, rose between the early 1990s and late 2000s, and have been relatively stable in recent years.<sup>35</sup> When accounting for taxes and transfers, however, the increase between the early 1990s and late 2000s is less pronounced.

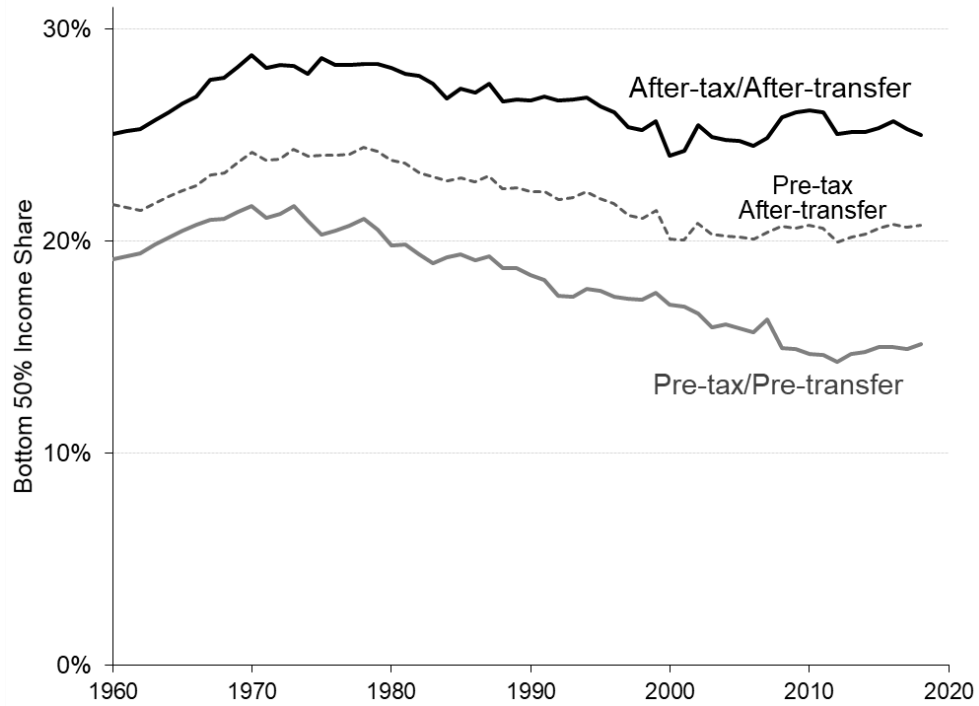
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<sup>33</sup> The after-tax/after-transfer income estimates include an allocation for government consumption (*e.g.*, spending on schools) half per capita and half by after-tax income and an allocation of deficits by Federal payroll and income taxes.

<sup>34</sup> See descriptions for Tables 1 and 2 for the definitions of pre-tax/pre-transfer income and pre-tax/after-transfer income.

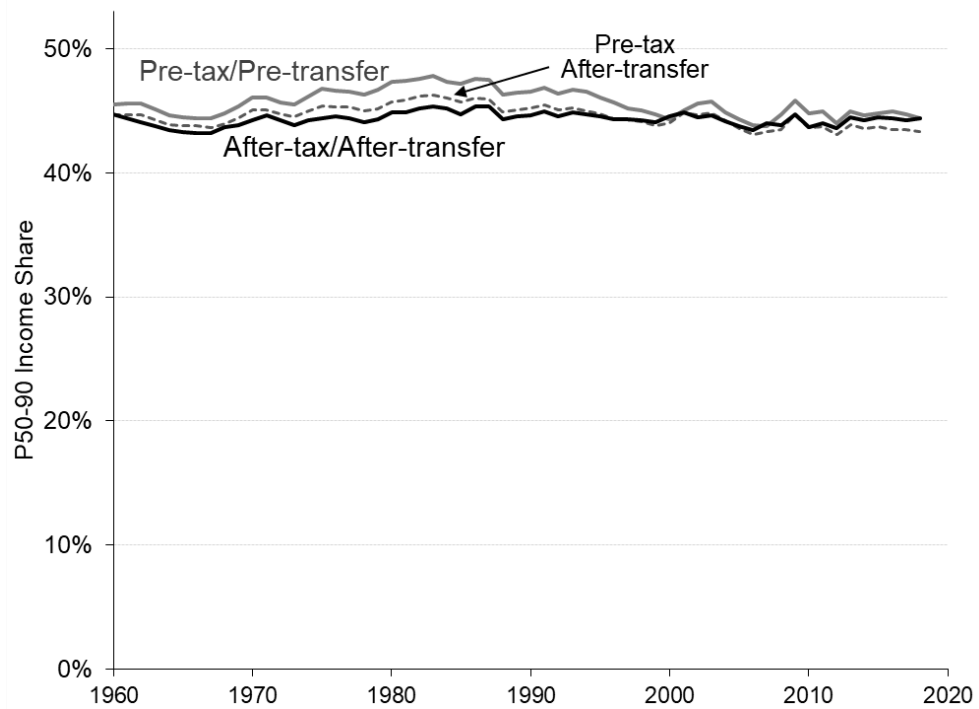
<sup>35</sup> The estimated jump in top income shares between 1986 and 1988 is related to the Tax Reform Act of 1986, which changed how income was reported on tax returns. These changes make it difficult to precisely identify when top income shares began increasing. Top income shares generally tend to increase with economic expansions and decrease with recessions.

**Figure 1a.—Bottom 50 Percent Income Shares, 1960-2018**



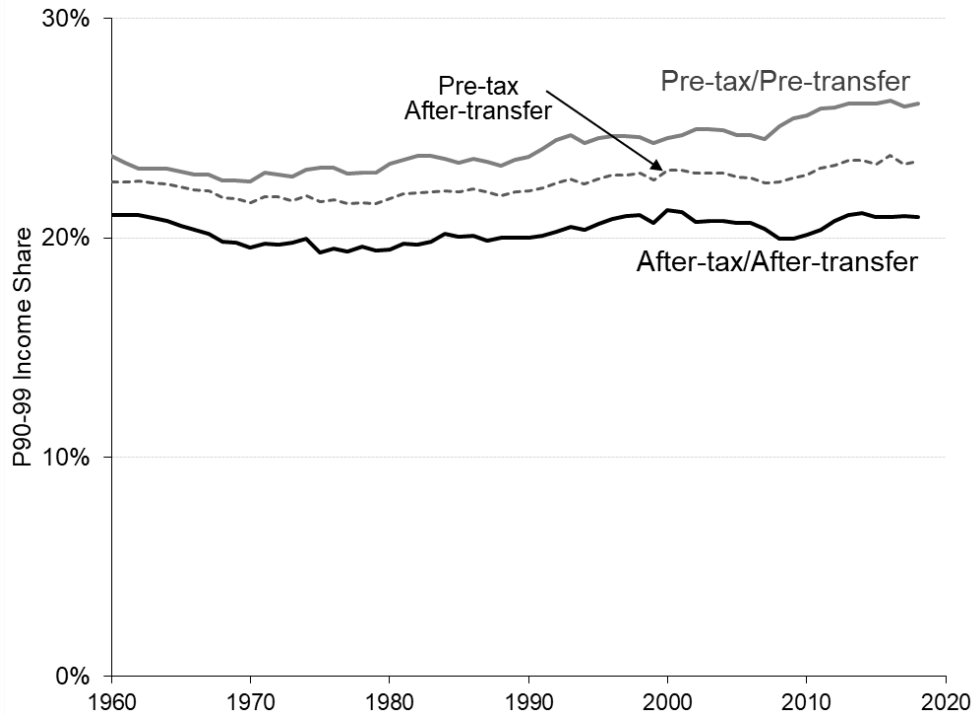
Source: Joint Committee staff calculations.

**Figure 1b.—50-90 Percentile Income Shares, 1960-2018**



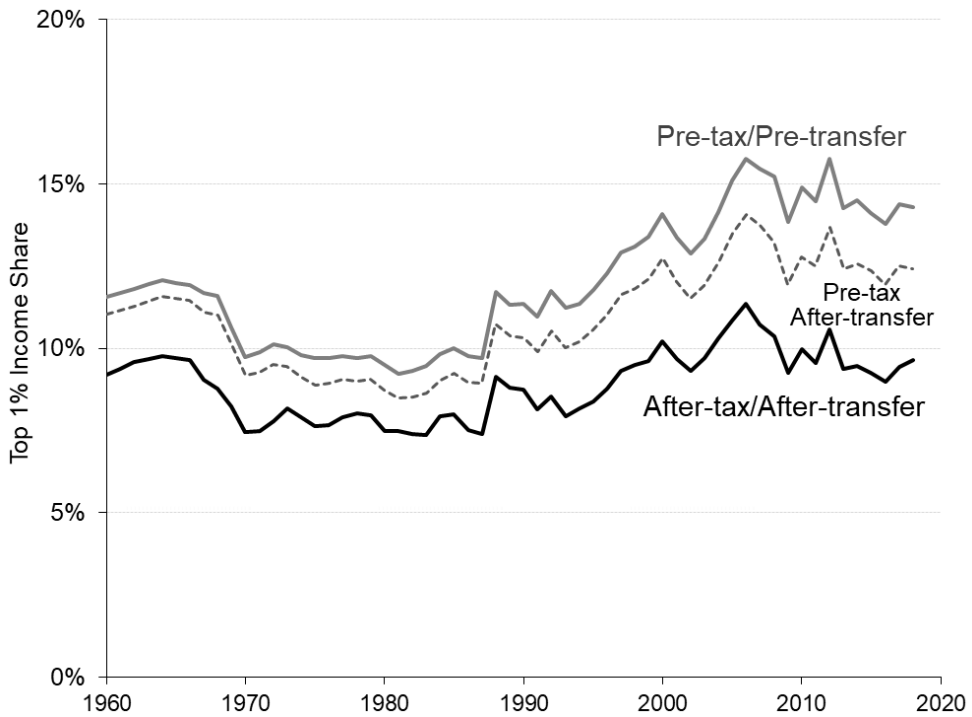
Source: Joint Committee staff calculations.

**Figure 1c.—90-99 Percentile Income Shares, 1960-2018**



Source: Joint Committee staff calculations.

**Figure 1d.—Top 1% Income Shares, 1960-2018**



Source: Joint Committee staff calculations.



## B. Data on the Income Taxation of Estates and Trusts

This section provides income tax data for estates and trusts. Estates and trusts are generally taxed in the same manner as individuals. However, they are allowed a deduction for amounts distributed to beneficiaries. By use of this deduction, estates and trusts may eliminate their income tax liability if they distribute (rather than retain) income; beneficiaries are taxed on distributions. Income distributed by an estate or trust to a beneficiary retains its character.

In 2017, 3.2 million Form 1041 trust and estate income tax returns were filed. In the year 2017, based on income distributions reported on Form K1-1041 by U.S. taxpayers, beneficiaries received on net \$56.0 billion of distributions from estates and trusts. The \$56.0 billion consists of income allocable to estates' and trusts' interest (5.0 percent), dividends (33.7 percent), business income (7.7 percent), short-term capital gains (0.7 percent), long-term capital gains (20.8 percent), rent (17.6 percent), and other/unknown sources (14.7 percent).

Estates and trusts are subject to tax on income that is not distributed but instead retained. For 2017, 1.1 million estate and trust income tax returns reported net taxable income. Total estate and trust income was \$178 billion, and total net taxable income (*i.e.*, income after exemptions and deductions including the deduction for income distributed to beneficiaries) was \$90 billion.

Table 5 provides information about estate and trust distributions for 2017. The Joint Committee staff calculated an income distribution table of total net income from estates and trusts. The income groups are based on beneficiary adjusted gross income ("AGI") exclusive of distributions received from trusts or estates.<sup>36</sup> Because of this, there is a "negative" AGI category of taxpayers who absent distributions do not have positive AGI.

Table 5 shows the number of individual returns that report trust distributions received, the amount of distributions, the group's percentage share of total distributions, the average distribution received, and average AGI excluding distributions. The last six columns, for each income group, represent the percentage of returns for which the distributions are less than a certain percent of total AGI. The \$100,000-\$200,000 income group reported the largest number of returns (318) totaling \$8.3 billion, which represents 14.8 percent of the total amount reported in the year 2017. However, the less than \$0 income group reported the largest amount of \$10.0 billion, which represents 17.9 percent of the total amount reported in the year 2017. The less than \$0 income group had an average distribution of \$129,348 and an average AGI of -\$141,493. The \$1 million and over income group had the largest average distribution and average AGI of \$303,373 and \$4,271,561, respectively. As shown in the table, taxpayers across income groups receive distributions from estates and trusts, as measured by both the total distributions received and the percentage shares. However, individuals in higher income groups receive on average higher distributions, while, at the same time, those distributions are more likely to account for a smaller percentage of AGI.

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<sup>36</sup> The income groups are not subject to the modifications described above for the tables relating to the income taxation of individuals.

**Table 5.—Distribution from Estates and Trusts by Distribution-Exclusive AGI Group, 2017**

Income Group	Number of Returns (Thousands)	Total Distributions Received (\$ Millions)	Share (%)	Average Distribution Received (\$)	Average AGI Excluding Distributions (\$)	Distributions as Percentage of AGI					
						<10% (Percent)	10%-25% (Percent)	25%-50% (Percent)	50%-75% (Percent)	75%-90% (Percent)	>90% (Percent) <sup>1</sup>
Less than \$0	77	10,000	17.9	129,348	-141,493	*	*	*	*	*	*
\$0-\$15,000	231	3,026	5.4	13,075	18,577	24.9	9.5	18.2	21.4	13.7	12.3
\$15,000-\$30,000	139	3,724	6.7	26,875	49,357	35.8	18.0	18.2	16.4	9.9	1.7
\$30,000-\$50,000	144	3,812	6.8	26,391	66,846	40.2	24.4	17.2	14.0	3.8	0.5
\$50,000-\$75,000	180	4,153	7.4	23,070	85,949	50.4	20.7	20.7	6.6	1.4	0.2
\$75,000-\$100,000	147	3,235	5.8	22,056	108,733	59.3	20.3	16.0	3.5	0.9	0.1
\$100,000-\$200,000	318	8,294	14.8	26,101	168,166	65.9	21.0	10.2	2.5	0.3	0.1
\$200,000-\$500,000	174	7,238	12.9	41,553	338,492	73.3	16.4	8.5	1.4	0.3	0.0
\$500,000-\$1,000,000	44	3,604	6.4	82,048	770,709	78.2	13.4	6.4	1.7	0.3	0.0
\$1,000,000 and Over	29	8,899	15.9	303,373	4,271,561	83.6	9.9	4.8	1.5	0.2	0.1
<b>Total</b>	<b>1,484</b>	<b>55,987</b>	<b>100</b>	<b>37,735</b>	<b>210,854</b>	<b>53.3</b>	<b>18.2</b>	<b>14.4</b>	<b>8.2</b>	<b>3.8</b>	<b>2.0</b>

Note: "\*" Distribution as a percentage of AGI is not calculated for returns with negative AGI. Details may not add due to rounding.

[1] "0.0" less than 0.5 percent.

Source: Joint Committee staff calculations.

### C. Data on Wealth Transfer Taxes

In Table 6, below, the Joint Committee staff draws on tax return data to show the burden of the estate tax, a tax on the transfer of wealth, for taxpayers across the income distribution.<sup>37</sup> Table 6 shows estate tax returns and estate tax liability by average real (inflation adjusted) modified adjusted gross income from 2011 to 2015. The estate tax returns and estate tax liability are for 2016 decedents; decedents must generally file estate tax returns with 15 months (including extension) from date of death.<sup>38</sup>

While comparing estate tax liabilities by income group presents conceptual challenges,<sup>39</sup> the following method provides some information on the distribution of the estate tax by the income of the decedent. The Joint Committee staff constructed a dataset consisting of a match of the income tax returns for years 2011 to 2016 to the estate tax returns of decedents dying in calendar year 2016. The Joint Committee staff then computed modified adjusted gross income by adding tax-exempt interest and nontaxable Social Security benefits to those decedents' adjusted gross incomes to produce measures of income for each taxable year from 2011 to 2016. These income values were then adjusted for inflation so that the values represent 2016 dollars. The Joint Committee staff then averaged the 2016 values of the decedents' incomes for the last five full calendar years of the decedents' lives to produce measures of average income. The original sample contained 7,875 estate tax returns representing the 13,429 decedents dying in 2016 with estate tax filing requirements. The Joint Committee staff computed an average real income measure for 7,711 observations representing 13,191 decedents.<sup>40</sup> The matched returns represent more than 93 percent of the total estate tax liability reported on the estate tax returns of 2016 decedents.

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<sup>37</sup> As discussed more below, the income distribution is calculated differently for purposes of Table 6 than for tables in the prior subsections.

<sup>38</sup> Thus, the estate tax returns for 2016 decedents will generally be filed in 2016, 2017, and 2018. Every three years, IRS Statistics of Income ("SOI") compiles for all decedents of the year a file of estate tax returns. This "year of death" file was used to generate Table 6. 2016 is the latest year for which this file is available.

<sup>39</sup> For example, the decedent may not bear the burden of estate tax. If, for example, the decedent did not alter his or her behavior because of the tax, then the burden would be borne by the decedent's heirs. In that case, comparing by the heirs' income may be more appropriate than by the decedent's income.

<sup>40</sup> The Joint Committee staff dropped observations with losses or without reported income.

**Table 6.—All Estate Tax Returns from 2016 Decedents by Average Real Modified Adjusted Gross Income from 2011-2015**

Income Group	Estate				
	Returns	Total Estate Tax Liability <sup>1</sup> (\$ Millions)	Average Estate Tax Liability (\$ Millions)	Percent of Estate Tax Liability (Percent)	Average Estate Tax Rate
<b>Less than \$100,000</b>	591	268	0.5	1.4	5.7
<b>\$100,000 to \$200,000</b>	1,486	463	0.3	2.4	4.4
<b>\$200,000 to \$500,000</b>	5,137	2,910	0.6	15.1	7.1
<b>\$500,000 to \$1,000,000</b>	3,177	3,419	1.1	17.8	9.7
<b>\$1,000,000 and Over</b>	2,800	12,171	4.3	63.3	12.1
<b>Total, All Returns</b>	<b>13,191</b>	<b>19,236</b>	<b>1.5</b>	<b>100.0</b>	<b>10.0</b>

[1] This includes only estate tax liability and excludes generation-skipping transfer tax liability.

Note: Details may not add due to rounding.

Source: Joint Committee staff calculations.

Table 6 shows, by income group for the year 2016, the number of returns filed, the total estate tax liability reported on those returns, the average estate tax liability reported on those returns, income groups' percent share of total estate tax liability reported, and the average estate tax rate. The income groups, which range from less than \$100,000 to \$1,000,000 and over, are based on average real modified adjusted gross income. In general, income groups toward the bottom of the income distribution file fewer estate tax returns, pay less estate tax, and are subject to a lower average estate tax rate. In the first column, the \$200,000 to \$500,000 income group filed the largest number of returns. However, the \$1,000,000 and over income group reported the largest total estate tax liability (\$12,171 million), representing 63.3 percent of estate tax liability reported in 2016, while the \$200,000 to \$500,000 income group reported a total estate tax liability of \$2,910 million (15.1 percent of estate tax). The average estate tax liability paid for the \$1,000,000 and over income group (\$4.3 million) was significantly greater than the average value of lower income groups. Similarly, in the last column, the \$1,000,000 and over income group paid a relatively higher average estate tax rate of 12.1 percent compared to the average estate tax rate of lower income groups.

As shown in Table 6, a decedent with estate tax liability may have relatively low income. This could be for several reasons. In general, wealthy taxpayers have more control over the timing and forms of their incomes. Some taxpayers may have made large lifetime gifts. Because the estate tax takes into account gifts made during life, these taxpayers may finish life with few assets (and income from those assets) relative to other estate tax filers but may have an estate tax

liability.<sup>41</sup> As another example, some taxpayers may have significant assets and income, but also may have large business losses that reduce their income. The years covered by the analysis includes the aftermath of the 2008 financial crisis, which may have generated business losses for some taxpayers. Third, some taxpayers with large estates may hold significant assets that do not produce taxable income, such as cash, a home, or a Roth IRA or other similar retirement account. Alternatively, a thrifty individual may have saved a large portion of modest income over her lifetime and accumulated enough wealth to have estate tax liability. Taxpayers following these (and potentially other) patterns may have low income in the final years of life, but also have (or have gifted) assets worth enough to trigger the estate tax.

Table 7 shows the estate tax returns filed for 2016 decedents, distributed by gross estate size. A decedent's gross estate is reduced by a lifetime exemption and certain deductions to determine estate tax liability. As mentioned above, the estate tax also takes into account gifts during life. The table separately lists taxable and nontaxable returns. Nontaxable returns are largely returns subject to a filing requirement that claimed a deduction for transfers to charity, a deduction for a bequest to a surviving spouse, or both, which reduced the taxable estate below the exemption amount. The gross estate size categories range from less than \$5 million to \$50 million or more. The table shows the number of estate tax returns filed and the total amount of gross estate for each group. It also shows the number of returns claiming a deduction for a bequest to a surviving spouse, and the total amount of that deduction for each group, as well as the number of returns claiming a charitable deduction, and the total amount of the deduction for each group. Finally, for returns subject to tax, the table shows the amount of estate tax. Most returns are filed by taxpayers in the lower end of the gross estate distribution, with the less than \$5 million group and \$5 million to \$10 million group collectively filing 9,036 returns. However, the total gross estate (when grouping taxable and nontaxable returns), marital deduction, charitable deduction, and estate tax are all highest for taxpayers in the highest gross estate group.

Public Law 115-97 generally doubled the estate and gift tax exemption for decedents dying and gifts made during the years 2018 through 2025, with the exemption reverting to the exemption levels that otherwise would have been in effect for decedents dying and gifts made after 2025. This change may affect the number of individuals subject to estate tax. There is currently incomplete information about decedents in years after 2016. However, a look at individuals who filed estate tax returns in 2019 (who may have died in 2017, 2018, 2019, or other years), shows that 6,409 returns were filed, of which 2,570 were taxable.

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<sup>41</sup> The estate tax calculation imposes tax on adjusted taxable gifts previously made by the decedent but provides a reduction based on prior-year gifts. In this way, the estate tax system takes into account prior gifts.

**Table 7.— Estate Tax Returns Filed for 2016 Decedents by Size of Total Gross Estate and Estate Tax Return Status Group**

Size of Total Gross Estate	Gross Estate, Tax Purposes		Bequests to Surviving Spouse		Charitable Deduction		Estate Tax	
	Number	Amount (\$ Millions)	Number	Amount (\$ Millions)	Number	Amount (\$ Millions)	Number	Amount (\$ Millions)
<b><i>All Taxable Returns</i></b>	5,467	105,412	740	13,373	1,550	11,602	5,467	20,485
Less than \$5 Million	568	1,821	57	27	102	36	568	298
\$5 Million to \$10 Million	2,556	18,390	211	390	546	264	2,556	2,021
\$10 Million to \$20 Million	1,446	19,617	211	952	489	789	1,446	4,125
\$20 Million to \$50 Million	614	18,658	144	1,975	261	1,409	614	4,652
\$50 Million or More	282	46,925	116	10,029	152	9,104	282	9,389
<b><i>All Nontaxable Returns</i></b>	7,963	91,682	5,922	51,961	1,495	8,459	--	--
Less than \$5 Million	597	2,142	389	780	80	59	--	--
\$5 Million to \$10 Million	5,315	36,965	3,743	14,393	934	2,268	--	--
\$10 Million to \$20 Million	1,390	18,500	1,202	11,162	308	1,722	--	--
\$20 Million to \$50 Million	502	14,624	444	10,567	130	1,804	--	--
\$50 Million or More	159	19,451	145	15,058	43	2,605	--	--

Note: Details may not add due to rounding.

Source: Joint Committee staff calculations.

## D. Data on Wealth

As with income, there are many ways to measure wealth. The following discussion uses a measure of annual net financial wealth, which deducts current private debts from current private financial assets. When using this measure for wealth, the share of wealth held by the top wealth groups has increased over the last three decades; the share of wealth owned by the top one percent has especially increased. However, recent work argues that when also including expected Social Security benefits, the increase in wealth levels held by the top wealth groups is less pronounced, with top wealth shares remaining relatively flat over the last three decades.<sup>42</sup> Including expected Social Security benefits in a measure of wealth is similar to including government transfers in income measure, as done in Table 1 and Figures 1. Because of data limitations, however, the following discussion uses measures of wealth that do not include Social Security benefits.

The following tables use the Distributional Financial Accounts (“DFA”) dataset to present the distribution and composition trend of financial wealth, as well as trends over time. The DFA, compiled by the Federal Reserve Board, provides quarterly estimates of the distribution of a comprehensive measure of U.S. household<sup>43</sup> financial wealth<sup>44</sup> from the third quarter of the year 1989 to the fourth quarter of the year 2020. The DFA presents data on the level, composition, and share of U.S. household financial wealth held by four percentile groups of financial wealth: the top one percent, the next nine percent (*i.e.*, the 90-99 percentile), the next 40 percent (*i.e.*, the 50-90 percentile), and the bottom 50 percent.<sup>45</sup> The DFA integrates two datasets produced by the Federal Reserve Board: the Financial Accounts of the United States, which provide quarterly data on aggregate balance sheets of various sectors of the U.S. economy, and the Survey of Consumer Finances (“SCF”), which provides comprehensive triennial microdata on the assets and liabilities of a representative sample of U.S. households.<sup>46</sup> The DFA is constructed in three steps: (1) a balance sheet from the SCF is generated that is conceptually consistent with the components of aggregate household net worth in the Financial Accounts; (2) the reconciled SCF balance sheet is interpolated and forecasted for quarters where the SCF is not

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<sup>42</sup> See Sylvia in Catherine, Max Miller, and Natasha Sarin, “Social Security and Trends in Wealth Inequality,” *Jacobs Levy Equity Management Center for Quantitative Financial Research Paper*, February 29, 2020, available at <https://ssrn.com/abstract=3546668>. The authors also argue that wealth estimated on a lifetime (rather than annual) basis further reduces observed wealth shares by the top wealth groups.

<sup>43</sup> The unit of observation is the primary economic unit (“PEU”), which for simplicity is referred to here as “household”. The PEU follows the Survey of Consumer Finance unit of observations and is defined as the “economically dominant single individual or couple (married or living as partners) in a household and all other individuals in the household who are financially interdependent with that individual or couple.”

<sup>44</sup> For the meanings of consumer durable goods and real estate, see the note accompanying the table.

<sup>45</sup> Board of Governors of the Federal Reserve System, *DFA: Distributional Financial Accounts*, <https://www.federalreserve.gov/releases/z1/dataviz/dfa/>.

<sup>46</sup> Michael Batty, Jess Bricker, Joseph Briggs, Elizabeth Holmquist, Susan McIntosh, Kevin Moore, Eric Nielsen, Sarah Reber, Molly Shatto, Kamila Sommer, Tom Sweeney, and Alice Henriques Volz, “Introducing the Distributional Financial Accounts of the United States,” *Finance and Economics Discussion Series 2019-017*, Washington: Board of Governors of the Federal Reserve System, <https://www.federalreserve.gov/econres/feds/files/2019017pap.pdf>.

observed based on information in the Financial Accounts and other sources; and (3) the distribution observed is applied in the reconciled SCF to the Financial Accounts' aggregates.

This dataset is different from that used in the prior section to show different measures of income and therefore the results may not be strictly comparable. For example, the income distributions presented in the prior section are determined based on groups of equal number of individuals and tax units, while here wealth groups are determined based on the number of households, which ignores differences in household size.<sup>47</sup> The distribution of tax units by income, while positively correlated, is not the same as the distribution of households by wealth because income and wealth are different measures. For example, there may be individuals with income less than \$50,000 and wealth over \$1 million, which would place such an individual in the bottom 90 percent of the income distribution and the top ten percent of the wealth distribution, based on measures in Table 1 and Figure 2c.<sup>48</sup>

Table 8 shows the distribution of net financial wealth levels and shares by wealth group for the year 2020. Net financial wealth is gross financial wealth less debt. The wealth groups in Table 8 range from the bottom 50 percent to the top one percent of the financial wealth distribution. The bottom 50 percent has a net financial wealth level of \$2.2 trillion, which was approximately two percent of total net financial wealth in the year 2020. The 90-99 percentile has a net financial wealth level of \$43.8 trillion, which represents 38.4 percent of total net financial wealth in the year 2020. The top one percent has a net financial wealth level of \$35.1 trillion, which was approximately 30.8 percent of total net financial wealth in the year 2020.

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<sup>47</sup> Tax units and household or PEU units can diverge for several reasons. First, unmarried individuals who are in the same household and classified in the SCF as "living with partner" would file separate tax returns. In addition, there can be other members of a household who would file their own tax returns if their incomes were high enough. In both cases, one household is associated with multiple tax units.

<sup>48</sup> Also, wealth share measures may differ not only based on how broadly one defines wealth, but also based on how percentile groups are determined. For example, when using the DFA data and changing from setting percentiles by wealth to setting them by income, the year 2020 fourth quarter top one percent financial wealth shares fall from 31 percent to 26 percent.



**Table 8.—Distribution of Net Financial Wealth Levels and Shares<sup>1</sup>  
by Wealth Group, 2020**

<b>Wealth Group (Percentile)</b>	<b>Level (\$ Trillions)</b>	<b>Share (Percent)</b>
<b>Bottom 50</b>	2.2	2.0
<b>50-90</b>	33.0	29.0
<b>90-99</b>	43.8	38.4
<b>Top 1</b>	35.1	30.8

[1] Net average financial wealth is not shown in Table 8 because of the lack of data on the number of households for the year 2020 from the SCF and Current Population Survey.

Source: Distributional Financial Accounts data.

Table 9 shows the financial wealth composition by source of financial wealth and by wealth group for the year 2020. The wealth groups remain the same, ranging from the bottom 50 percent to the top one percent of the financial wealth distribution. Summing across both assets and liabilities, each wealth group's shares of total financial wealth sum to 100 percent. In the first row, for assets, the financial wealth of the bottom 50 percent is largely composed of real estate (52 percent), consumer durable goods (19 percent), pension entitlements (11 percent), and other wealth (13 percent), while the financial wealth share of the bottom 50 percent is minimally composed of corporate equities and mutual fund shares (two percent) and private businesses (two percent). This group derives most of its financial wealth from assets held for a noninvestment consumption purpose (*e.g.*, owning a home or a vehicle and owning whole life insurance), while this group derives minimal financial wealth from public companies and private businesses. However, moving up the wealth distribution, the relative share of financial wealth from investment increases, along with an increase in other assets, while the relative share of financial wealth from assets held for a noninvestment consumption purpose decreases. In the last row, the financial wealth share of the top one percent is composed of 13 percent real estate, two percent consumer durable goods, 41 percent corporate equities and mutual fund shares, four percent pension entitlements, and 21 percent other.

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

**Table 9.—Financial Wealth Composition by Source of Financial Wealth and by Wealth Group, 2020  
(Percent)**

Wealth Group (Percentile)	Assets							Liabilities			
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Funds	Pension Entitlements	Private Businesses	Other	Total	Home Mortgage	Consumer Credit	Other	Total
<b>Bottom 50</b>	52	19	2	11	2	13	<b>100</b>	48	47	5	<b>100</b>
<b>50-90</b>	34	6	8	30	4	17	<b>100</b>	75	21	4	<b>100</b>
<b>90-99</b>	20	3	21	29	9	18	<b>100</b>	86	9	6	<b>100</b>
<b>Top 1</b>	13	2	41	4	19	21	<b>100</b>	71	9	20	<b>100</b>

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

Source: Distributional Financial Accounts data.

Table 10 shows the distribution of different sources of financial wealth across wealth groups for the year 2020. The wealth groups remain the same. In each column, the denominator changes to reflect the type of asset or liability. For example, in the first column, the denominator is all real estate owned by U.S. households in the year 2020. In total, groups representing the bottom 90 percent own more than one-half of real estate (55 percent) and about two-thirds of consumer durable goods. In total, groups representing the top ten percent own about one-third (35 percent) of consumer durable goods and less than half (44 percent) of real estate, more than four times its proportionate share. These groups own more than half (54 percent) of pension entitlements. By contrast, the 50-90 percentile hold roughly their proportionate share of pension entitlements (43 percent), while the bottom 50 percent owns only three percent. The ownership of corporate equities and mutual fund shares and private businesses is even more concentrated: the top one percent owns 52 percent of the former and 54 percent of the latter. Finally, other income (which is largely rights to insurance) is concentrated at the top, with the 90-99 percentile owning 36 percent and the top one percent owning 31 percent.

For liabilities, home mortgages are disproportionately held by the wealthiest groups. The 50-90 percentile has 48 percent (20 percent more than their proportionate share), while the 90-99 percentile has 25 percent (more than double their proportionate share), and the top one percent has five percent. Consumer credit, however, which generally does not build financial wealth, is disproportionately incurred by the bottom 50 percent.<sup>49</sup> Finally, other liabilities, generally business debt, are disproportionately incurred by groups representing the top ten percent, with almost half the total share (18 percent) being incurred by the top one percent.

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<sup>49</sup> The distributions of home mortgage and consumer credit liabilities cannot be compared to the distributions of real estate and consumer durable goods. Liabilities represent smaller total dollar amounts.

**Table 10.– Shares of Source of Financial Wealth and by Wealth Group, 2020  
(Percent)**

Wealth Group (Percentile)	Assets						Liabilities		
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Funds	Pension Entitlements	Private Businesses	Other	Home Mortgage	Consumer Credit	Other
<b>Bottom 50</b>	12	24	1	3	1	4	22	57	31
<b>50-90</b>	43	42	11	43	13	29	48	35	32
<b>90-99</b>	30	22	36	48	32	36	25	7	20
<b>Top 1</b>	14	13	52	6	54	31	5	2	18
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

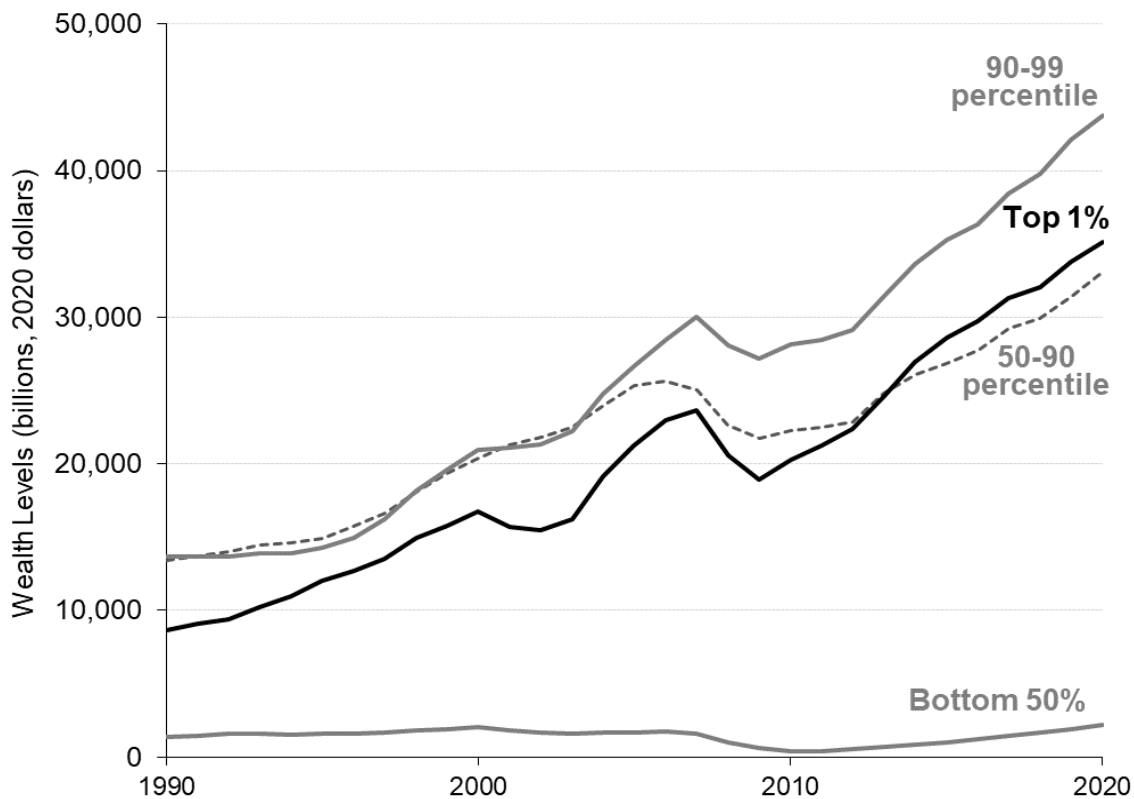
Note: Real estate includes all types of owner-occupied housing including farmhouses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land (at market value). Consumer durable goods includes automobiles, trucks/motor vehicles, furniture, carpets/rugs, light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

Sources: Distributional Financial Accounts data.

The following figures show the trends of net financial wealth levels (Figure 2a) and net financial wealth shares (Figure 2b) by wealth group from 1990 to 2020. These trends do not take into account wealth from Social Security benefits due to data limitations. The wealth groups are the same in each figure, ranging from the bottom 50 percent to the top one percent of the financial wealth distribution.

Figure 2a shows the relative stability of the trends in net financial wealth levels before the financial crisis in 2007. While the net financial wealth level for the top 50 percent steadily increases, the net financial wealth level for the bottom 50 percent is relatively steady. All groups saw a decline in net financial wealth levels during the 2008 financial crisis. While the top 50 percent reached its pre-crisis financial wealth level in a few years, the bottom 50 percent reached its pre-crisis financial wealth level only recently.<sup>50</sup>

**Figure 2a.—Trends in Real Net Financial Wealth Levels by Wealth Group, 1990-2020**



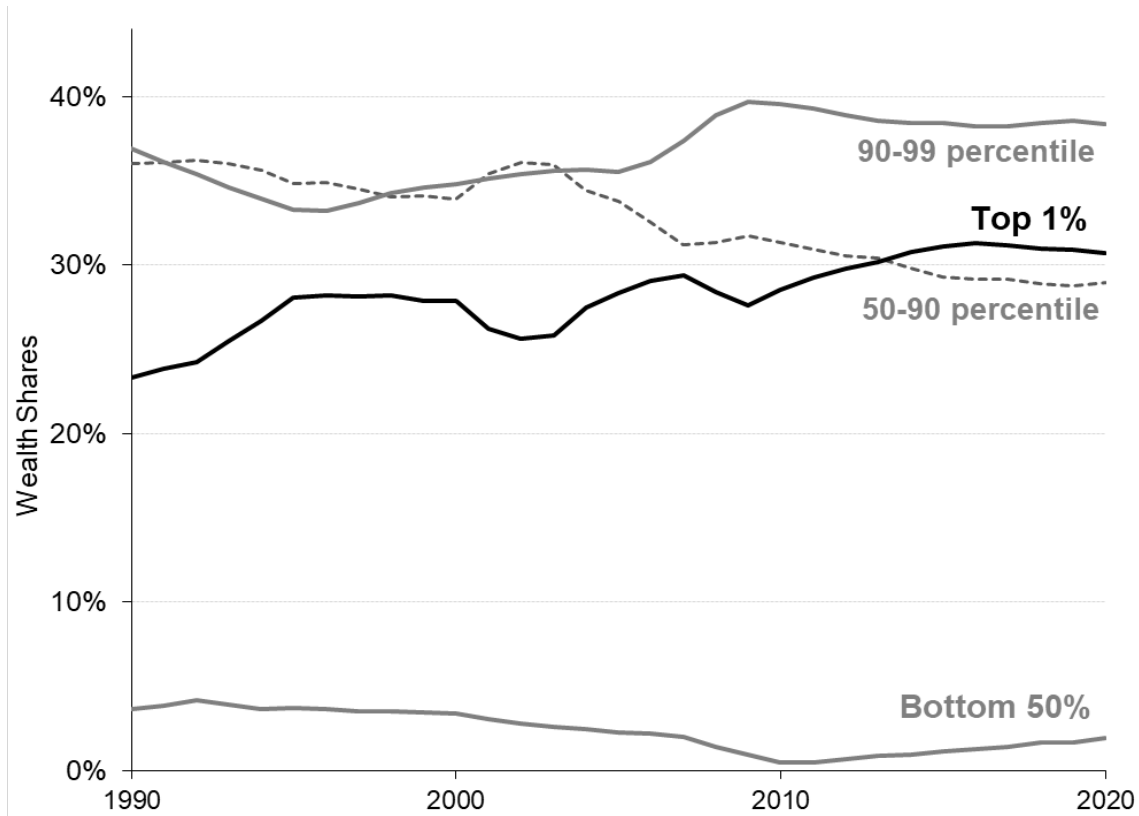
Note: Wealth is indexed for inflation using the PCEPI.

Source: Distributional Financial Accounts data.

<sup>50</sup> When combining the DFA data with the Current Population Survey for the approximate number of households, a average wealth per household by wealth group generally shows the same story: relative to other wealth groups, the bottom 50 percent had a larger proportional shock to their wealth during the financial crisis and only recently returned to their pre-crisis average wealth.

Figure 2b shows divergent trends in net financial wealth shares. While the top ten percentile groups trend upward over time, the bottom 90 percent trends down. Since the financial crisis, the 90-99 percentile has owned a relatively constant share of wealth, and the 50-90 percentile has owned a declining share of wealth. The offsetting increase has gone to the bottom 50 percent and top one percent.

**Figure 2b.—Trends in Net Financial Wealth Shares by Wealth Group, 1990-2020**



Source: Distributional Financial Accounts data.

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

### A. In general

There is no Federal tax on wealth or property owned<sup>51</sup> by an individual.<sup>52</sup> However, the income tax imposes tax on income derived from property, such as dividends from stock or gain from the sale of property. The income tax system also, in some cases, taxes estates and trusts as separate taxpayers, capturing income on property held by an estate or in trust on behalf of individual beneficiaries.

In general, individuals and other taxpayers are only subject to tax on property when there has been a disposition of the property, *i.e.*, a sale or exchange.<sup>53</sup> However, in certain cases, the taxpayer may be subject to tax on income from property even where a disposition has not occurred.<sup>54</sup>

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

The income tax system generally does not tax property received by an individual from transfers by gift or at death.<sup>55</sup> However, a separate wealth transfer tax system—comprised of the

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<sup>51</sup> In contrast, many local and some State governments impose a wealth tax in the form of taxes on the value of real property. See 50-State Property Tax Comparison Study for Taxes Paid in 2019, Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, June 2020, available at [https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019\\_full.pdf](https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019_full.pdf) (last visited April 30, 2021); 2018 State & Local Government Finance Historical Datasets and Tables, United States Census, available at <https://www.census.gov/data/datasets/2018/econ/local/public-use-datasets.html> (last visited April 30, 2021).

Separately, for a short period of time, the Code imposed tax on the acquisition of certain luxury goods including aircrafts, boats, passenger vehicles, furs, and jewelry valued at over a certain threshold, but these laws were repealed within a few years of enactment. See Pub. L. No. 101–508, January 23, 1990 (enacting the luxury excise tax); Pub. L. No. 103–66, August 10, 1993 (repealing the luxury excise tax for all items except passenger vehicles); Pub. L. No. 104–188, August 20, 1996 (repealing the luxury excise tax on passenger vehicles). For a more detailed description of these taxes see Joint Committee on Taxation, *Description Of A Proposal To Extend Certain Expiring Tax Provisions, Repeal The Luxury Excise Tax On Certain Items, And Adopt Revenue-Raising Provisions Scheduled for Markup by the Senate Committee on Finance on June 16, 1992* (JCX-23-92), June 19, 1992.

<sup>52</sup> The Code generally uses the term “individual” to refer to natural persons.

<sup>53</sup> Sec. 1001. Unless otherwise stated, all references to the Code are to the Internal Revenue Code of 1986, as amended.

<sup>54</sup> See, *e.g.*, secs. 475, 877A, 1256, 1259, 1272, and 1296.

<sup>55</sup> Sec. 102; see also sec. 101.

estate tax, gift tax, and generation-skipping transfer tax—may impose tax on the donor who transfers assets by gift or the estate of the decedent who transfers assets at death.<sup>56</sup>

These rules are discussed in more detail in section II.D.

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<sup>56</sup> Chapters 11-13 of the Internal Revenue Code. The wealth transfer tax system has a large lifetime exemption that excludes most donors and decedents from transfer tax.



## **B. Income Taxation of Individuals, Estates, and Trusts**

### **1. Income taxation of individuals**

#### **In general**

Individual taxpayers are subject to income taxation under the Internal Revenue Code (“Code”).<sup>57</sup> United States citizens and resident aliens are generally subject to taxation on worldwide income.<sup>58</sup> A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.<sup>59</sup>

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

The tax rate brackets and amount of certain deductions and limitations vary depending on the individual’s filing status.<sup>60</sup> Individuals may file as (1) married filing jointly, (2) a surviving spouse,<sup>61</sup> (3) a head of household,<sup>62</sup> (4) married filing separately, or (5) an unmarried individual (other than a surviving spouse or head of household).

#### **Gross income**

Under the Code, gross income means “income from whatever source derived” except for certain items specifically exempt or excluded.<sup>63</sup> Sources of income include compensation for services, annuities, income from life insurance and endowment contracts (other than certain

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<sup>57</sup> Sec. 1. For a more detailed overview on the taxation of individuals, see Joint Committee on Taxation, *Overview of the Federal Tax System As In Effect for 2021* (JCX-18-20), April 15, 2021.

<sup>58</sup> Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion (\$108,700 in 2021) for foreign earned income and a limited exclusion for employer-provided housing. Sec. 911. For a more detailed discussion of international tax rules that affect individual taxpayers, see *General Explanation of Public Law 115-97* (JCS-1-18), December 2018, p.331-338.

<sup>59</sup> See sec. 871.

<sup>60</sup> See sec. 1(a)-(d), (j)(2).

<sup>61</sup> A surviving spouse is generally a taxpayer whose spouse died in either of the two taxable years preceding the current taxable year who maintains a household with a qualifying child. Sec. 2(a). Surviving spouses are often but not always treated the same as married filing jointly taxpayers.

<sup>62</sup> A head of household taxpayer is generally an unmarried taxpayer (who is not a surviving spouse) who maintains a household with a qualifying child or dependent. Sec. 2(b).

<sup>63</sup> Sec. 61. Part III of Subchapter B of Chapter 1 of the Code contains provisions excluding certain items from gross income. In addition, exclusions may be a matter of common law. See, e.g., Rev. Rul. 74-74, 1974-1 C.B. 18 (discussing common law general welfare doctrine).

death benefits), pensions, gross profits from a trade or business, and income in respect of a decedent.<sup>64</sup> They also include income derived from property such as interest, dividends, capital gains, rents, and royalties. Contributions to qualified retirement plans, along with any attributable earnings, generally are included in gross income upon distribution.

Gross income is not limited to income earned directly by the individual. It also includes income distributed from trusts or estates<sup>65</sup> and income allocated from S corporations or partnerships.<sup>66</sup>

Statutory exclusions from gross income include property received by gift or inheritance,<sup>67</sup> for which the transferor may be subject to tax under the wealth transfer tax system.<sup>68</sup> Other exclusions include death benefits payable under a life insurance contract,<sup>69</sup> interest on certain State and local bonds,<sup>70</sup> employer-provided health insurance,<sup>71</sup> and certain other employer-provided benefits.<sup>72</sup>

### Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions<sup>73</sup> include trade or business expenses of trades or businesses that do not consist of the performance of services as an employee, as well as limited trade or business expenses of employees such as certain moving expenses for members of the Armed Forces and certain expenses of elementary and secondary school teachers.<sup>74</sup> Such deductions also include contributions to a qualified retirement plan by a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), losses from the sale or exchange of property, and deductions attributable to rent or royalties.

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<sup>64</sup> Alimony and separate maintenance payments received generally are includable as income for divorce or separation instruments executed before January 1, 2019.

<sup>65</sup> The rules for the income taxation of estates and trusts are discussed at Section II.B.2, below.

<sup>66</sup> These rules for partnerships and S corporations are discussed at Section II.C.3, below.

<sup>67</sup> Sec. 102.

<sup>68</sup> The wealth transfer tax rules are discussed at Section II.D, below.

<sup>69</sup> Sec. 101.

<sup>70</sup> Sec. 103.

<sup>71</sup> Secs. 105 and 106.

<sup>72</sup> See, e.g., secs. 119, 127, and 129.

<sup>73</sup> Sec. 62. Alimony and separate maintenance payments generally are deductible by the payor spouse for divorce and separation instruments executed before January 1, 2019.

<sup>74</sup> Sec. 62(a)(1).

## **Taxable income**

To determine taxable income, an individual reduces AGI by (1) the applicable standard deduction<sup>75</sup> or applicable itemized deductions<sup>76</sup> and (2) the deduction for qualified business income.<sup>77</sup>

The standard deduction is the sum of the basic standard deduction and the additional standard deduction. The amount of the basic standard deduction depends on a taxpayer's filing status.<sup>78</sup> The additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) and/or blind.<sup>79</sup> The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include<sup>80</sup> certain State and local income, property, and sales taxes;<sup>81</sup> home mortgage interest (on mortgages up to certain specified dollar amounts);<sup>82</sup> charitable contributions;<sup>83</sup> certain investment interest;<sup>84</sup> medical expenses (in excess of 7.5 percent of AGI);<sup>85</sup> and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of \$100 per loss).<sup>86</sup>

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<sup>75</sup> In the case of any taxable year beginning in 2021, if the taxpayer elects not to itemize, up to \$300 (\$600 in the case of a joint return) in certain charitable contributions may be deducted in addition to the standard deduction. See sec. 170(p).

<sup>76</sup> Sec. 63.

<sup>77</sup> Sec. 199A. The deduction for qualified business income, which has the effect of a tax rate reduction for certain business income, is discussed in more detail at Section II.C.4, below.

<sup>78</sup> For 2021, the amount of the standard deduction is \$12,550 for a single individual and for a married individual filing separately, \$18,800 for a head of household, and \$25,100 for married individuals filing jointly and for a surviving spouse.

<sup>79</sup> For 2021, the additional amount is \$1,350 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,700. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2021) of \$2,700 or \$3,400, as applicable.

<sup>80</sup> See also Part VI and Part VII of Subchapter B of Chapter 1 of the Code.

<sup>81</sup> Sec. 164. This deduction is limited to \$10,000 annually (\$5,000 for married taxpayers filing separately).

<sup>82</sup> See sec. 163(h).

<sup>83</sup> Sec. 170.

<sup>84</sup> See sec. 163(d).

<sup>85</sup> Sec. 213.

<sup>86</sup> Sec. 165.

## Tax liability

### In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply.

### Regular tax liability

To determine regular tax liability, the tax rate schedules (or the tax tables) are applied to a taxpayer's regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, with the marginal tax rate increasing as a taxpayer's income increases.<sup>87</sup> Separate rate schedules apply based on an individual's filing status. The current highest marginal tax rate for individuals is 37 percent.<sup>88</sup>

Effective marginal tax rates may be altered by the phase-in and phaseout of certain exemptions or credits.<sup>89</sup>

### Credits against tax

An individual's income tax liability may be reduced by using available tax credits. Certain credits may only be taken by individuals,<sup>90</sup> such as the credit for certain child or dependent care expenditures<sup>91</sup> or the credit for adoption expenses.<sup>92</sup> Individuals may also be

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<sup>87</sup> The term "marginal tax rate" generally refers to the additional, or incremental, increase in tax liability from a \$1.00 increase in the taxpayer's income. The marginal tax rates for individuals prescribed in section 1 of the Code and described in Table 1 are referred to as "statutory marginal tax rates."

<sup>88</sup> Sec. 1(j).

<sup>89</sup> The term "effective marginal tax rate" refers to the additional, or incremental, increase in tax liability *under the income tax* from a \$1.00 increase in the taxpayer's income. For example, a credit that is phased out, or incrementally reduced, by \$.05 for every \$1.00 above a certain threshold would cause the effective marginal tax rate to be 5 percentage points higher than the statutory marginal tax rate in the phaseout range. The Code contains many provisions that may cause effective marginal tax rates to differ from statutory marginal rates. For a discussion of such provisions that have an effect on effective marginal tax rates as applied to a prior version of the Code, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

<sup>90</sup> See Subpart A of Part IV of Chapter 1 of the Code; see also, *e.g.*, secs. 32, 35, and 36B.

<sup>91</sup> Sec. 21.

<sup>92</sup> Sec. 23.

eligible to claim other credits that are generally applicable to taxpayers such as the foreign tax credit<sup>93</sup> or credits under the general business credit.<sup>94</sup>

In some instances, a credit is wholly or partially “refundable,” that is, if the amount of these credits exceeds tax liability (net of other nonrefundable credits), such credits create an overpayment, which may generate a refund. Three of the largest refundable credits in terms of cost are the child tax credit,<sup>95</sup> the earned income tax credit,<sup>96</sup> and the recovery rebate credits.<sup>97</sup>

#### Alternative minimum tax liability

Individuals may also be subject to the alternative minimum tax (“AMT”), in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year.<sup>98</sup> The tentative minimum tax is determined by reference to an alternative minimum taxable income (“AMTI”), which is the taxpayer’s taxable income increased by the taxpayer’s tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.<sup>99</sup> This amount is compared to an exemption amount that varies by filing status.<sup>100</sup>

Among the tax preferences and adjustments included in AMTI are an inclusion of certain tax-exempt interest<sup>101</sup> and the disallowance of the deduction for State and local taxes, the standard deduction, and certain itemized deductions.<sup>102</sup>

An individual may generally use credits against both regular tax liability and tentative minimum tax liability.<sup>103</sup>

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<sup>93</sup> Sec. 901.

<sup>94</sup> See subpart D of Subchapter A of Chapter 1 of the Code.

<sup>95</sup> Sec. 24.

<sup>96</sup> Sec. 32.

<sup>97</sup> Secs. 6428, 6428A, and 6428B. Other refundable credits include the American opportunity tax credit, the premium tax credit, the health coverage tax credit, and (for 2021) the child and dependent care tax credit.

<sup>98</sup> Sec. 55.

<sup>99</sup> Secs. 56, 57 and 58.

<sup>100</sup> For taxable years beginning in 2021, the exemption amount is \$114,600 for married individuals filing jointly and surviving spouses, \$73,600 for other unmarried individuals, and \$57,300 for married individuals filing separately.

<sup>101</sup> Sec. 57(a)(5).

<sup>102</sup> Sec. 56(b).

<sup>103</sup> See secs. 26(a) and 38(c).

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

Individuals are subject to lower rates on certain capital gains and certain dividends.<sup>104</sup> These lower rates apply for both the regular tax and the alternative minimum tax.<sup>105</sup>

The deduction for qualified business income<sup>106</sup> applies to certain business income. This deduction has the effect of reducing the effective marginal tax rate on such income.

In addition to the income tax, individuals are subject to a 3.8-percent net investment income tax on certain income.<sup>107</sup> The deduction for qualified business income and the net investment income tax are discussed in more detail in section II.C.4, below.

## **2. Income taxation of estates and trusts**

### **Estates and trusts in general**

Estates and trusts are legal arrangements that may be created upon the transfer of wealth.<sup>108</sup>

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

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

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

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<sup>104</sup> Sec. 1(h),(j)(5).

<sup>105</sup> Sec. 55(b)(3).

<sup>106</sup> Sec. 199A.

<sup>107</sup> Sec. 1411.

<sup>108</sup> See generally Lane and Zaritzky, *Federal Income Taxation of Estates and Trusts*, 3d. edition, Chapter 1; see also Treas. Reg. sec. 301.7701-4(a) (trusts), *Commissioner v. Beebe*, 67 F.2d 662, 664 (1933) (estates).

## **Tax treatment of estates and trusts**

Estates and trusts are generally subject to Federal income tax.<sup>109</sup> Domestic estates and trusts are generally subject to tax on worldwide income.<sup>110</sup>

The taxable income of estates and trusts is generally computed in the same manner as the taxable income of individuals, with modifications:<sup>111</sup> (1) no standard deduction is allowed;<sup>112</sup> (2) a small personal exemption is allowed;<sup>113</sup> (3) an unlimited charitable deduction is allowed for amounts paid to (or in the case of an estate or certain trusts, amounts permanently set aside for) charity;<sup>114</sup> and (4) estates and trusts may deduct estate or trust administration costs.<sup>115</sup>

Estates and trusts are allowed a deduction for amounts distributed to beneficiaries during the taxable year.<sup>116</sup> The amount of the deduction is limited by distributable net income, a measure of income to be distributed.<sup>117</sup> Because of this deduction, the beneficiary, not the estate or trust, is generally subject to income tax on the distributed amount. By use of this deduction, trusts and estates may eliminate income tax liability to the extent they distribute (rather than retain) income.

If an estate or trust retains income and has taxable income, the rate brackets<sup>118</sup> that apply are more compressed than the individual tax brackets, meaning that an estate or trust is more

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<sup>109</sup> Sec. 1(e), Part 1 of Subchapter J of Chapter 1. The term “trust” may also refer to a number of other types of arrangements or entities. Certain trusts may be classified as business entities. See Treas. Reg. sec. 301.7701-4(a). Trust may also be pensions, sec. 401, or charitable entities, sec. 501. These types of trusts are all outside the scope of the document.

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

<sup>110</sup> Foreign estates and foreign trusts are generally taxed similarly to nonresident aliens. See sec. 7701(a)(31) (definition of foreign estate and foreign trust); see also sec. 7701(a)(30). Taxation will depend on the source of income, whether the income is retained or distributed, the residence of the beneficiaries, and, in the case of trusts, whether the trust is a grantor trust or a nongrantor trust.

<sup>111</sup> Sec. 641(b).

<sup>112</sup> Sec. 63(c)(6)(D).

<sup>113</sup> Sec. 642(b). For estates, the amount of the exemption is \$600. For trusts required to currently distribute all income, the amount is \$300, while for other trusts, the amount is \$100.

<sup>114</sup> Sec. 642(c).

<sup>115</sup> Sec. 67(e).

<sup>116</sup> See secs. 651 and 661.

<sup>117</sup> Sec. 643(a).

<sup>118</sup> Sec. 1(e), (j)(2).

quickly subject to tax at the highest marginal rate.<sup>119</sup> If an estate or trust is subject to tax, it generally pays the tax using income or assets of the estate or trust. Thus, for example, the trust grantor does not pay the tax. This reduces the funds of the estate or trust held for the beneficiaries.

Like individuals, estates and trusts may claim the foreign tax credit<sup>120</sup> or credits under the general business credit.<sup>121</sup> However, these credits may in some cases instead be allocated to the beneficiaries of the estate or trust.<sup>122</sup> Similarly, estates and trusts are subject to the AMT.

Estates and trusts are subject to lower rates on certain capital gains and certain dividends.<sup>123</sup> Estates and trusts may claim a deduction for qualified business income.<sup>124</sup> Estates and trusts are also subject to a separate net investment income tax on certain income.<sup>125</sup>

## **Tax treatment of beneficiaries and grantors**

### **Beneficiaries**

The transfer of property to an estate or a trust is not a taxable event for the beneficiary or beneficiaries.<sup>126</sup>

If a beneficiary or beneficiaries receives a distribution from an estate or trust, the amount of the distribution, limited by distributable net income, is included in the beneficiary's gross income.<sup>127</sup> An item of income retains its character when received by the beneficiary.

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<sup>119</sup> For example, for taxable years beginning in 2021, estates and trusts are subject to the highest marginal rate of 37 percent on taxable income above \$13,050, while married filing separately taxpayers (the next most "compressed" bracket) are subject to the highest marginal rate on taxable income above \$314,150.

<sup>120</sup> Sec. 642(a).

<sup>121</sup> Subpart D of Subchapter A of Chapter 1 of the Code.

<sup>122</sup> See, e.g., secs. 52(d) and 901(b)(5).

<sup>123</sup> Sec. 1(h),(j)(5). These lower rates apply for both the regular tax and the AMT. Sec. 55(b)(3).

<sup>124</sup> Sec. 199A. This provision is discussed in more detail at Section II.C.4, below.

<sup>125</sup> Sec. 1411. This provision is discussed in more detail at Section II.C.4, below.

<sup>126</sup> The transfer may be a gift or bequest to the beneficiary, excluded from gross income under section 102. Alternatively, if the transfer is to a grantor trust (discussed more below), the Secretary generally has held that the transaction has no effect for income tax purposes.

<sup>127</sup> Secs. 652 and 662.



## Grantors

A grantor or settlor generally cannot take a deduction for a transfer to an estate or a trust. However, a grantor may be able to claim a charitable deduction if the transfer is to a trust with a charitable organization as a beneficiary.<sup>128</sup>

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

## Grantor trusts

Under the grantor trust rules, if the grantor or settlor of a trust retains certain rights or powers with respect to a trust, the grantor of the trust is treated as the owner of the trust.<sup>129</sup> A grantor may own only a portion of a trust. Additionally, these rules may apply to an individual other than the grantor who possesses the requisite rights or powers.

If a trust is a grantor trust, the grantor (and not the trust) is taxed on the income of the trust. The grantor may pay the tax out of funds not owned by the trust. If the grantor does so, the funds of the trust available to the beneficiaries are undiminished by the tax payment. Additionally, IRS guidance provides that transactions between the grantor and the grantor trust are disregarded.<sup>130</sup> Thus, for income tax purposes, a transfer of property to a grantor trust is not a gift, and a sale to a grantor trust is not a sale for tax purposes and does not give rise to gain or loss. The wealth transfer tax consequences of a transfer to a grantor trust may be different.

Just as grantor trusts are not separate income tax taxpayers, they are not separately subject to the net investment income tax.<sup>131</sup>

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<sup>128</sup> Sec. 170(f)(2). The charitable organization, exempt from tax, will not have to pay tax on the income received.

<sup>129</sup> Sec. 671-679. A grantor is treated as the owner of any portion of a trust if: (1) the grantor has a reversionary interest in either the corpus or the income from the corpus, if certain conditions are satisfied; (2) the grantor has a power of disposition without the approval or consent of any adverse party; (3) the grantor can exercise certain administrative powers of over the trust; (4) the grantor or a nonadverse party has the power to revoke, *i.e.*, revert in the grantor title of a portion of the trust; and (5) without prior approval of an adverse party, the income from the trust may be distributed to or for the benefit of the grantor or the grantor's spouse.

<sup>130</sup> Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-71 R.B. 28.

<sup>131</sup> Treas. Reg. sec. 1.1411-3(b)(1)(v).

## C. Taxation of Business and Investment Income of Individuals

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

#### In general

In general, a taxpayer is not required to include the economic appreciation (or depreciation) that has accrued on an asset in gross income before the sale or other disposition of the asset.<sup>132</sup> There are, however, exceptions (discussed below) where the Code either requires or permits taxpayers to include income, gain, or loss that has accrued on an asset before the asset has been disposed of.

A taxpayer's gain or loss on disposition of an asset is generally the difference between the amount realized as a result of the disposition and the taxpayer's adjusted basis in the asset.<sup>133</sup> The amount realized is the sum of any money received plus the fair market value of the property (other than money) received by the taxpayer as a result of the disposition.<sup>134</sup> A taxpayer's basis in property is generally the cost paid in acquiring the property.<sup>135</sup> The taxpayer's adjusted basis is basis subject to certain adjustments.<sup>136</sup> For example, a taxpayer must increase basis by certain capital expenditures made or carrying costs incurred with respect to the asset.<sup>137</sup> If the property is depreciable, basis is reduced by depreciation allowed or allowable.<sup>138</sup> If the property is corporate stock, basis is reduced by the amount of a distribution made by the corporation in excess of corporate earnings and profit.<sup>139</sup>

Among other nonrecognition events, an individual's transfer of property by gift or bequest is not a taxable event under the income tax system.<sup>140</sup> Thus, the donor or decedent does not recognize gain or loss upon these dispositions.

In many cases, gains or losses are subject to the capital gains rules. Under these rules, long-term gains are taxed at reduced rates while losses are subject to certain limitations.<sup>141</sup>

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<sup>132</sup> See secs. 61(a)(3) and 1001(a).

<sup>133</sup> Sec. 1001(a).

<sup>134</sup> Sec. 1001(b).

<sup>135</sup> Sec. 1012.

<sup>136</sup> Secs. 1011 and 1016.

<sup>137</sup> Secs. 265 and 266.

<sup>138</sup> Sec. 1016(a)(2).

<sup>139</sup> Sec. 301(c)(2).

<sup>140</sup> See secs. 1001(c), 1014, and 1015.

<sup>141</sup> Secs. 1(h), (j)(5), and 1211.

## Capital gains rules

### Definition of a capital asset

Capital assets are all property held by the taxpayer other than certain enumerated types of property.<sup>142</sup> The enumerated exceptions are: (1) stock in trade or inventory of a business or property held primarily for sale to customers in the ordinary course of a trade or business; (2) depreciable, amortizable, or real property used in a trade or business; (3) a specified patent, invention, model or design (whether or not patented), and a secret formula or process, copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property;<sup>143</sup> (4) accounts or notes receivable acquired in the ordinary course of business for services or from the sale of property described in the first exception; (5) certain publications of the United States government; (6) certain commodities derivative financial instruments held by commodities dealers; (7) certain business hedging transactions; and (8) business supplies.

In addition, under section 1231, the net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.<sup>144</sup> Under section 1245, gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.<sup>145</sup> If the depreciable asset is sold for more than its adjusted basis, any gain exceeding the total depreciation recapture is generally treated as section 1231 gain.

### Mechanics of capital gains

The capital gains rules look to whether the gain or loss from the sale or exchange of a capital asset is long-term or short-term. Generally, gain or loss is treated as long-term if the asset is held for more than one year and treated as short-term if held for one year or less.<sup>146</sup> Rules apply for the determination of the taxpayer's holding period.<sup>147</sup>

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

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<sup>142</sup> Sec. 1221.

<sup>143</sup> The rule applies to such property held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created).

<sup>144</sup> 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.

<sup>145</sup> Sec. 1245. In certain cases, section 1250 may apply to depreciable real property. For a detailed discussion of the recapture rules under sections 1245 and 1250, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021.

<sup>146</sup> Sec. 1222.

<sup>147</sup> Sec. 1223.

ordinary income in each year.<sup>148</sup> Any remaining unused capital losses may be carried forward indefinitely.<sup>149</sup>

### Tax rates on capital gains

The applicable tax rate for an individual's net capital gain is determined based on a progressive rate structure with thresholds based on taxable income.<sup>150</sup> The thresholds vary depending on filing status. There are three rate brackets: 0 percent, 15 percent, and 20 percent.<sup>151</sup> Qualified dividends are also subject to tax at these rates.<sup>152</sup>

In two cases, there are additional higher rate brackets. A maximum 25 percent rate applies to unrecaptured section 1250 gain. Unrecaptured section 1250 gain arises upon the sale of depreciable real property, gain from which may be treated as long-term gain under section 1231 (for property used in a trade or business). Upon the sale of such property, a portion of the gain attributable to depreciation recapture is treated as capital gain but taxed at a higher rate.<sup>153</sup> A maximum 28 percent rate applies to gain from the sale of collectibles.<sup>154</sup>

### Exclusion and deferral

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

### Income tax treatment of transfers of property by gift or bequest

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

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<sup>148</sup> Sec. 1211(b). The limitation is \$1,500 in the case of married filing separately taxpayers.

<sup>149</sup> Sec. 1212(b).

<sup>150</sup> Sec. 1(h) and (j)(5).

<sup>151</sup> Sec. 1(h)

<sup>152</sup> Sec. 1(h)(11).

<sup>153</sup> Sec. 1(h)(6). This should be compared to the section 1245 recapture for depreciable personal property, which may also give rise to long-term capital gain under section 1231. Under that section, the gain attributable to prior depreciation or a amortization allowances is treated as ordinary income (not capital gain) and taxed at ordinary rates.

<sup>154</sup> The term collectible is defined in section 408(m).

system compromising the estate, gift, and generation-skipping transfer tax. The wealth transfer tax system is discussed in more detail below<sup>155</sup> but mentioned as relevant here.

### Transfers by gift

A transfer by gift is not a taxable event to the donor,<sup>156</sup> while the asset transferred is not included in the gross income of the donee.<sup>157</sup> However, the donor may be subject to gift tax on the transfer. The donee's basis is generally the donor's basis increased by any gift tax paid by the donor.<sup>158</sup> However, if the fair market value at the time of transfer is less than the basis, the donee's basis is limited to the fair market value.<sup>159</sup>

Slightly different rules apply to transfers between spouses. A transfer by gift between spouses is not a taxable event,<sup>160</sup> while the asset transferred is not included in the gross income of the donee.<sup>161</sup> In addition, the transfer is generally not subject to gift tax.<sup>162</sup> The donee spouse's basis is the donor spouse's adjusted basis, and the fair-market-value limitation does not apply.<sup>163</sup>

For purposes of the capital gains rules, a donee's holding period includes the donor's holding period.<sup>164</sup>

### Transfers at death

A transfer at death is also not a taxable event to the decedent,<sup>165</sup> while the asset transferred is not included in the gross income of the heir.<sup>166</sup> However, the decedent's estate

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<sup>155</sup> See section II.D.

<sup>156</sup> See secs. 1001(c) and 1015.

<sup>157</sup> Sec. 102.

<sup>158</sup> Sec. 1015.

<sup>159</sup> *Ibid.* The increase for gift tax paid also cannot result in basis above fair market value.

<sup>160</sup> Sec. 1041. This rule also applies to transfers incident to divorce.

<sup>161</sup> Sec. 102.

<sup>162</sup> Sec. 2523.

<sup>163</sup> See also sec. 1015(e).

<sup>164</sup> Sec. 1223(2).

<sup>165</sup> See secs. 1001(c) and 1014.

<sup>166</sup> Sec. 102.

may be subject to estate tax on the transfer; transfers to a surviving spouse are generally not subject to estate tax.<sup>167</sup>

The heir's basis in the asset is generally the fair market value of the asset on the date of the decedent's death,<sup>168</sup> despite the fact that untaxed appreciation (or depreciation) is not taken into account by either the decedent or the heir. This "step up" or "step down" in basis removes the built-in gain or loss on the asset at the time of the decedent's death from the income tax system. The income tax system therefore only takes into account gain or loss that arises during the heir's ownership of the asset.

For purposes of the capital gains rules, the heir is treated as holding the inherited asset for more than one year, such that it is eligible for long-term capital gains treatment, regardless of the actual period of ownership.<sup>169</sup>

### Transfers by gift or at death to charitable transferees

Gifts and bequests to charitable organizations, like other gifts and bequests, are not taxable events for income tax purposes and so do not cause the transferor to realize or recognize gain or loss on a transfer of property. The transferor may claim a deduction for income tax purposes, subject to certain limits, generally equally to the fair market value of the property transferred.<sup>170</sup> In the case of appreciated property, this allows the taxpayer to claim a benefit with respect to untaxed appreciation.

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

## **2. Overview of mark-to-market taxation**

In general, a taxpayer is not required to include an item of gain or loss in the calculation of gross income until the gain or loss has been realized. According to the Supreme Court, realization occurs when the taxpayer "obtains the fruition of the economic gain which has already accrued to him."<sup>171</sup> In the context of property (as distinct from services), realization generally occurs when the taxpayer sells, exchanges, or otherwise disposes of the asset on which the gain or loss has accrued.<sup>172</sup>

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<sup>167</sup> Sec. 2056.

<sup>168</sup> Sec. 1014(a). In certain cases, different valuation rules apply.

<sup>169</sup> Sec. 1223(9).

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

<sup>171</sup> *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

<sup>172</sup> See sec. 1001.

In certain circumstances, however, the Code either requires or permits taxpayers to include gain or loss that has accrued on an asset before the asset has been disposed of.<sup>173</sup> Some of these rules employ a concept called “mark to market,” where the taxpayer is treated as if it sold the asset subject to these rules (*i.e.*, the asset being “marked”) for the asset’s fair market value as of the date of the mark prescribed by the statute. In many cases, the date of the mark is the last business day of the taxpayer’s taxable year, but it could also be the date of a particular event (*e.g.*, the day before the taxpayer relinquishes U.S. citizenship).

Any gain or loss included in gross income as a result of an asset being marked to market generally is taken into account in calculating future gain or loss (including gain or loss on a future mark to market) on the asset.<sup>174</sup> So, for example, if a taxpayer purchases a security that is subject to the mark-to-market rules of section 475 for \$20, and at the end of the taxpayer’s taxable year, the security is worth \$40, the taxpayer would be required to include \$20 in income for that year. If at the end of the taxpayer’s next taxable year, the security is worth \$30, the taxpayer would have a \$10 loss. And if, in the middle of the taxable year following the year of the loss, the taxpayer sells the security for \$30, the taxpayer would have no gain on the sale.

As this example demonstrates, the cumulative effect of a mark-to-market regime that applies to an asset over time is for the fluctuation in value of the asset across each relevant period to be included in the taxpayer’s income for each such period. The net amount of the overall inclusions across all periods equals the amount that would have been included if gain or loss were calculated only upon sale or other disposition.<sup>175</sup> But a mark-to-market regime that applies to an asset over time takes account of the gain and loss regularly across the holding period of the asset, rather than merely upon disposition.

What follows is a brief description of four mark-to-market rules in the Code: section 475 (applying mark to market to certain securities and commodities dealers and traders); section 877A (marking to market the assets of individuals who terminate U.S. citizenship or long-term permanent resident status); section 1256 (mark to market of certain financial derivatives); and section 1296 (elective mark to market for marketable stock in a passive foreign investment company).

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<sup>173</sup> See, *e.g.*, secs. 475, 877A, 1256, 1259, 1272, and 1296.

<sup>174</sup> See, *e.g.*, sec. 475(a) (flush language).

<sup>175</sup> In the above example, the net gain or loss is a \$10 gain, which equals the difference between the purchase price of \$20 and the sale price of \$30. This is equal to the gain or loss across all periods of (1) year 1 gain of \$20, (2) year 2 loss of \$10, and (3) year 3 gain or loss of \$0.

## **Mark to market for dealers and traders in securities and commodities**

Section 475(a) generally requires dealers<sup>176</sup> in securities<sup>177</sup> to mark to market securities held by the dealer at the end of each year. That is, the securities are treated as sold on the last business day of the taxable year at their fair market value.<sup>178</sup> The mark-to-market requirement does not apply to securities held for investment, certain debt securities, and certain hedges.<sup>179</sup> Section 475(e) permits dealers in commodities<sup>180</sup> to elect similar treatment with respect to commodities held by the dealer. Section 475(f) permits traders<sup>181</sup> in securities and commodities to elect mark-to-market treatment with respect to securities and commodities held in connection with the trader's trade or business. Such elections, once made, are irrevocable without the consent of the Secretary.

The character of gain or loss from the mark to market or the disposition of a security or commodity under section 475 is ordinary income or loss.<sup>182</sup>

Before the enactment of section 475 in 1993, dealers in securities could elect to account for their inventories according to (1) the lower of cost or market ("LCM"), (2) cost, or (3) fair market value. With section 475, Congress provided a uniform mark-to-market rule for the taxation of securities held by securities dealers of all types. Explaining Congress's reasons for adopting section 475, the House Budget Committee report accompanying the legislation states that "[i]nventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement

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<sup>176</sup> Section 475(c)(1) defines a dealer in securities as a taxpayer who either (1) regularly purchases securities from or sells securities to customers in the ordinary course of business, or (2), regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of business.

<sup>177</sup> Security is defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments. Section 1256 contracts are excluded. See sec. 475(c)(2).

<sup>178</sup> Sec. 475(a).

<sup>179</sup> Sec. 475(b)(1). To meet these exceptions, the eligible securities must be clearly identified as such in the dealer's records. Sec. 475(b)(2).

<sup>180</sup> Commodity is defined to include actively traded commodities within the meaning of section 1092(d)(1), notional principal contracts with respect to actively traded commodities, derivatives on actively traded commodities, and certain hedges with respect to the aforementioned categories of commodity. See sec. 475(e)(2).

<sup>181</sup> The Tax Court has defined a trader as someone that does not provide the services of acting as a middleman (earning compensation from the attendant fees), but rather "depend[s] upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost." See *Kemon v. Commissioner*, 16 T.C. 1026, 1032-33 (1951).

<sup>182</sup> Sec. 475(d)(3) and (f)(1)(D).



purposes.”<sup>183</sup> The report adds, “the cost method and the LCM method generally understate the income of securities dealers and . . . the mark-to-market method most clearly reflects their income.”<sup>184</sup>

### **Mark to market of property of expatriating persons**

Individual taxpayers who expatriate from the United States (*i.e.*, either relinquish U.S. citizenship or cease to be lawful permanent residents of the United States<sup>185</sup>) after June 16, 2008 are subject to tax on the net unrealized gain in their property immediately prior to expatriation under the mark-to-market rules of section 877A.<sup>186</sup> Section 877A treats a taxpayer who expatriates as having sold all of their property on the day before the expatriation date for its fair market value.<sup>187</sup> The taxpayer may elect to defer payment of any additional tax attributable to gain on the deemed sale until the taxpayer actually disposes of property deemed sold, if the taxpayer elects to do so and irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.<sup>188</sup> Nonetheless, the amount of such gain is fixed as of the date of the mark.

### **Mark to market of certain financial derivatives**

Section 1256 was enacted in 1981 as part of a set of rules addressing so-called straddle shelters.<sup>189</sup> A straddle shelter was a transaction whereby a taxpayer could use combinations of financial instruments (potentially including both securities and derivatives) to limit or eliminate risk of loss on an existing financial position while at the same time deferring gain recognition and potentially converting short term capital gain into long term capital gain.<sup>190</sup> Section 1256 applies to certain derivatives that could be used as part of a straddle shelter.

To address the deferral and character conversion opportunities presented by straddle shelters, section 1256 requires derivatives to which it applies (referred to in the statute as “section 1256 contracts”) to be marked to market on the last business day of the taxpayer’s

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<sup>183</sup> Report of the Committee on the Budget, House of Representatives, to accompany H.R. 2264, A Bill to Provide for Reconciliation Pursuant to Section 7 of the Concurrent Resolution on the Budget for Fiscal Year 1994, H.R. Rep. No. 103-111, May 25, 1993, p. 661.

<sup>184</sup> *Ibid.*

<sup>185</sup> Lawful permanent resident is defined in section 7701(b)(6).

<sup>186</sup> See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110<sup>th</sup> Congress* (JCS-1-09), January 2009, p. 197.

<sup>187</sup> Sec. 877A(a)(1). Section 877A provides for a one-time mark, rather than periodic marks as in sections 475, 1256, and 1296.

<sup>188</sup> Sec. 877A(b)(1) and (5).

<sup>189</sup> See generally Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, pp. 279-316.

<sup>190</sup> An example of the mechanics of a straddle shelter is provided by Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, p. 295.

taxable year, and prescribes that any resultant gain or loss is treated as 40 percent short term gain or loss and 60 percent long term gain or loss. Originally, section 1256 applied only to regulated futures contracts, but it has since been expanded to apply to foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts.<sup>191</sup> Any securities futures contract (or option on such a contract) other than a dealer securities futures contract is explicitly excluded from the application of section 1256, as is any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.<sup>192</sup>

### **Mark to market of marketable PFIC stock**

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

A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income or if 50 percent or more of its assets produce, or are held for the production of, passive income.<sup>193</sup> The regime provides three alternative sets of rules for current inclusion of PFIC income, one of which permits a taxpayer holding marketable stock<sup>194</sup> in a PFIC to elect to include (or deduct) income (or loss) each year equal to the difference between the fair market value of the marketable PFIC stock as of the close of the taxable year and the taxpayer’s adjusted basis in such stock (*i.e.*, marking the marketable PFIC stock to market).<sup>195</sup> The resulting gain or loss is treated as ordinary income or loss.<sup>196</sup>

Taxpayers making the election are exempted from a different set of rules under the PFIC regime under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.<sup>197</sup> The same exemption applies to PFIC stock that is required to be marked to market under any other provision of the Code.<sup>198</sup>

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<sup>191</sup> Sec. 1256(b)(1). For definitions of these terms, see section 1256(g).

<sup>192</sup> Sec. 1256(b)(2).

<sup>193</sup> Sec. 1297.

<sup>194</sup> Marketable stock is defined in Treas. Reg. sec. 1.1296-2. Generally, the term comprises stock that is regularly traded on a qualified exchange, certain stock that is redeemable at its net asset value, and options on the previous two categories of marketable stock. Treas. Reg. sec. 1.1296-2(a)(1).

<sup>195</sup> Sec. 1296.

<sup>196</sup> Sec. 1296(c)(1).

<sup>197</sup> Sec. 1291(d)(1).

<sup>198</sup> Sec. 1296(d)(1).

### **3. Taxation of domestic business income of individuals**

#### **Income from a business**

For Federal tax purposes, business income is taxed under rules relating to the form in which the business is conducted. The business may take the form of an entity or may be conducted as a sole proprietorship.<sup>199</sup> The principal business entities for Federal income tax purposes are C corporations, partnerships, and S corporations. Partnerships and S corporations are often referred to as passthrough entities because their income is included in the gross income of the owners of the entities rather than in the income of the entities themselves. In the case of individuals, the tax rate on income from passthrough entities and sole proprietorships depends on the individual's filing status and income. A large portion of business income is derived by C corporations and is taxed under the corporate income tax. Distributed C corporation income (generally, dividend income) is also subject to income tax in the hands of the recipient shareholders.

#### **Choice of business entity**

Taxpayers may choose among forms of doing business. Differences in the way business income is taxed affect this choice.

C corporations are considered to have good access to capital markets, though distributed corporate income is subject to two levels of income tax.<sup>200</sup> As for passthrough entities, partnerships have no limit on the number of partners, whereas S corporations are limited to 100 shareholders.<sup>201</sup> Partnership agreements may provide for allocations of income, gain, deduction, loss and credit to reflect the business arrangement provided the allocations have substantial economic effect, whereas S corporation income, gain, deduction, loss and credit must be allocated to shareholders on a pro rata per share, per day basis.<sup>202</sup> Some differences involve the availability of partnership or S corporation status to existing businesses. For example, a C corporation may convert to an S corporation, but not to a partnership, without immediate recognition of gain at either the corporate or the shareholder level.<sup>203</sup> There are a number of

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<sup>199</sup> A sole proprietorship is generally not treated as an entity separate from its owner, as discussed below. More complex or specialized arrangements involving, for example, affiliated corporations, tiered entities, special purpose entities, real estate investment trusts ("REITs"), regulated investment companies (mutual funds or "RICs") or foreign entities or investments are beyond the scope of this discussion.

<sup>200</sup> Publicly traded partnerships provide access to public capital markets without two levels of income tax, but with additional complexity. Partnerships more commonly are not publicly traded.

<sup>201</sup> Sec. 1361(b). Certain related shareholders are treated as one for this purpose.

<sup>202</sup> Sec. 704(b) and sec. 1366(a).

<sup>203</sup> The liquidation of a C corporation generally requires the corporation to recognize gain on its assets. Secs. 336-338 (providing some exceptions to this treatment). A conversion of a C corporation to a partnership is treated as a liquidation of the C corporation. However, the conversion of a C corporation to an S corporation (achieved through electing S corporation status) is not treated as a liquidation of the C corporation. (Certain built-in gain of a C corporation that elects S corporation status remains subject to C corporation tax if recognized within five years after the conversion.) Thus, if a C corporation can satisfy the limits on the number and types of shareholders,

other differences.<sup>204</sup> In general, a partnership offers more flexibility as well as greater complexity in application, while an S corporation imposes a variety of restrictions but may be simpler to implement in common situations.

In 2018, there were approximately 1.6 million C corporations, 4.0 million partnerships, 4.9 million S corporations, 27.1 million nonfarm sole proprietorships, and 1.8 million farm sole proprietorships. Before 1987, there were more C corporations than S corporations and partnerships combined. In 1987, the number of S corporations and partnerships exceeded the number of C corporations. Since 1987, the combined number of passthrough entities has more than tripled. The growth has been led by large increases in the number of small S corporations (those with less than \$100,000 in assets) and limited liability companies (“LLCs”) taxed as partnerships.<sup>205</sup>

## **Individuals who are shareholders in a C corporation**

### **In general**

An individual who is a shareholder in a C corporation<sup>206</sup> is generally subject to tax on dividends distributed to the individual by the corporation. A distribution by a corporation to its shareholders<sup>207</sup> generally is taxable as a dividend to the extent of the corporation’s current and accumulated earnings and profits.<sup>208</sup> Qualified dividends are subject to tax generally at the same preferential rates that apply to capital gains for individual taxpayers.<sup>209</sup>

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the single class of stock requirement, and other applicable requirements, a conversion of a C corporation to an S corporation is not taxable, and post-conversion income and appreciation of assets in the entity are subject only to shareholder-level tax.

<sup>204</sup> For a chart summarizing tax differences among C corporations, partnerships, S corporations, and sole proprietorships, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, pp. 11-16, at [www.jct.gov](http://www.jct.gov).

<sup>205</sup> Joint Committee on Taxation staff calculations; for more background and data, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, available at [www.jct.gov](http://www.jct.gov).

<sup>206</sup> A C corporation is any corporation that is not an S corporation. The letter “C” appears to reflect that subchapter C of chapter 1 of the Code is entitled “corporate distributions and adjustments.”

<sup>207</sup> A corporate shareholder (*i.e.*, a corporation that owns shares of another corporation) that receives a dividend generally is eligible for a dividends-received deduction that results in the recipient corporation being taxed on at most 30 percent and possibly on none of the dividend received by the shareholder. Sec. 243. Special rules apply in certain cases and with respect to certain amounts received by corporate shareholders. Secs. 245-250.

<sup>208</sup> A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder’s adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. Sec. 301(c). A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property’s fair market value. Sec. 311. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder. Secs. 311(a) and 305.

<sup>209</sup> Sec. 1(h)(11).

In addition, the C corporation is subject to the 21-percent corporate income tax as an entity separate from its shareholders.<sup>210</sup> As a result, a corporation's distributed income generally is taxed once at the corporate level when earned and then again to individual shareholders when distributed as dividends. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed through to shareholders. Corporate income that is not distributed to shareholders generally is subject to tax at the corporate level only. Dividends paid to individuals generally are not deductible by the corporation.<sup>211</sup>

Shareholders in a C corporation are taxed at capital gains rates upon sale or exchange (including certain redemptions<sup>212</sup>) of the stock. Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock.<sup>213</sup>

Income retained at the corporate level (not distributed to shareholders<sup>214</sup>) generally is reflected in an increased stock price, relevant for purposes of determining shareholder-level capital gain on sale or exchange of the stock. If the C corporation distributes property to shareholders, the gain on appreciated corporate property generally is subject to corporate-level tax upon distribution to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders. No separate rate structure exists for corporate capital gains.

In contrast to dividends on stock, some amounts paid as interest to holders of corporate debt may be subject to only one level of tax (at the recipient level) since the corporation is allowed a deduction for part or all of the amount of interest expense paid or accrued.<sup>215</sup>

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<sup>210</sup> Sec. 111. This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.

<sup>211</sup> Foreign investors are subject to withholding tax on dividends paid by domestic corporations, and generally are exempt from U.S. income tax on capital gains from the sale of corporate stock (irrespective of whether the corporation is domestic or foreign). Tax-exempt investors generally are not subject to tax on either dividends or on sales or exchanges of corporate stock.

<sup>212</sup> Sec. 302.

<sup>213</sup> A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the shareholders for its fair market value. Sec. 311. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation. Sec. 332.

<sup>214</sup> The accumulated earnings tax (generally at a 20 percent rate) may be imposed on a corporation if it retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed on the excessive passive income of a closely held corporation. Secs. 531 and 541. These rules, when applicable, in effect impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.

<sup>215</sup> Sec. 163.

## **Individuals who are partners in a partnership**

Partners in a partnership are subject to tax on their distributive shares of partnership income. Partnerships generally are treated for Federal income tax purposes as passthrough entities not subject to tax at the entity level.<sup>216</sup> The character of partnership items, such as ordinary income or loss, capital gain, or capital loss, passes through to partners.<sup>217</sup> Partners must take into account these partnership items based on the partnership's method of accounting and regardless of whether income is distributed to the partners.<sup>218</sup>

A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.<sup>219</sup> Losses not allowed as a result of that limitation generally are carried forward to the next year.

Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.<sup>220</sup>

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.<sup>221</sup> In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.<sup>222</sup>

State laws of every State provide for the establishment of limited liability companies ("LLCs"), which are neither partnerships nor corporations under applicable State law, but which

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<sup>216</sup> Sec. 701.

<sup>217</sup> Sec. 702(b).

<sup>218</sup> Sec. 702(a).

<sup>219</sup> Sec. 704(d). A partner's adjusted basis in a partnership interest generally equals (1) the sum of (a) the amount of money and the adjusted basis of property contributed to the partnership, or the amount paid for the partnership interest, (b) the partner's distributive share of partnership income, and (c) the partner's share of partnership liabilities, reduced by (2) the sum of (a) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any partnership distributions to the partner. Sec. 705. In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by a partner's share of partnership deductions (secs. 469 and 465). These limitations do not apply to corporate partners, except certain closely-held corporations.

<sup>220</sup> Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities in excess of basis, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income). Sec. 751.

<sup>221</sup> Sec. 704(b)(2).

<sup>222</sup> Treas. Reg. sec. 1.704-1(b)(2).

are generally treated as partnerships for Federal tax purposes.<sup>223</sup> An individual who holds an interest in an LLC that is treated as a partnership is a partner for Federal tax purposes.

A partner in a publicly traded partnership that meets the applicable requirements<sup>224</sup> generally is subject to the same tax treatment applicable to a partner in a partnership that is not publicly traded. To meet the applicable requirements, 90 percent or more of a publicly traded partnership's gross income must comprise one or more types of qualifying income.<sup>225</sup>

### **Individuals who are shareholders in an S corporation**

S corporation shareholders are subject to tax on their pro rata shares of S corporation income.<sup>226</sup> An S corporation<sup>227</sup> generally is not subject to Federal income tax at the corporate level.<sup>228</sup> The character of S corporation items, such as ordinary income or loss, capital gain, or capital loss, passes through to S corporation shareholders. The shareholder's pro rata shares are determined based on the S corporation's method of accounting and regardless of whether income is distributed to the shareholders.

A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to the shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year.<sup>229</sup>

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<sup>223</sup> Any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for Federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, treated as not separate from its owner). Treas. Reg. sec. 301.7701-3 (known as the "check-the-box" regulations). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes.

<sup>224</sup> For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof). Sec. 7704(b). If the publicly traded partnership does not meet the applicable requirements, however, it is treated as a corporation for Federal tax purposes. Sec. 7704(a).

<sup>225</sup> Sec. 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and certain other income and gains specified by statute. Sec. 7704(d).

<sup>226</sup> Sec. 1366(b).

<sup>227</sup> An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

<sup>228</sup> Secs. 1363 and 1366.

<sup>229</sup> A shareholder's adjusted basis in the S corporation stock generally equals (1) the sum of (a) the shareholder's capital contributions to the S corporation and (b) the shareholder's pro rata share of S corporation income, reduced by (2) the sum of (a) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any S corporation distributions to the shareholder. Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of

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

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.<sup>230</sup> Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation. Although there are limitations on the types of shareholders and stock structure an S corporation may have, businesses organized as S corporations may be as large as those organized as C corporations or partnerships.

### **Individuals conducting a business as a sole proprietorship**

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

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship generally is not treated as an entity distinct from its owner for Federal income tax purposes.<sup>231</sup> Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,<sup>232</sup> for certain excise taxes,<sup>233</sup> and certain information reporting requirements.<sup>234</sup>

## **4. All-in tax rates on income of individuals**

Tax rates on income of individuals are described in section II.B.1, above, relating to income taxation of individuals. An individual's income from a business may be taxed at ordinary rates up to 37 percent in 2021, or at the rates applicable to capital gains and qualified dividends, generally at a top rate of 20 percent, as described there.

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the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

<sup>230</sup> Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

<sup>231</sup> A single-member unincorporated entity is disregarded for Federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. sec. 301.7701-3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under section 761(f).

<sup>232</sup> Treas. Reg. sec. 301.7701-2(c)(2)(iv).

<sup>233</sup> Treas. Reg. sec. 301.7701-2(c)(2)(v).

<sup>234</sup> Treas. Reg. sec. 301.7701-2(c)(2)(vi).



Income received by individuals from a corporation is subject to two levels of tax, that is, both the 21-percent corporate income tax and the income tax imposed on the shareholder (generally, at a 20-percent rate for qualified dividends).<sup>235</sup> Income received by individuals through a passthrough entity (a partnership or an S corporation) or a sole proprietorship may have a reduced effective rate of tax due to the qualified business income deduction of up to 20 percent. Some business income of an individual is subject to the net investment income tax (“NIIT”) or the tax on net earnings from self-employment (“SECA”) as well as to the income tax. Taking these other tax rates and the qualified business income deduction into account as well as the individual’s income tax rate gives the “all-in” tax rate.

### **Deduction for qualified business income**

An individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified real estate investment trust (“REIT”) dividends and qualified publicly traded partnership income.<sup>236</sup> A specified agricultural or horticulture cooperative generally may deduct nine percent of qualified production activities income.<sup>237</sup>

For taxpayers with taxable income<sup>238</sup> in excess of the threshold amount (for 2021, \$329,800 for married taxpayers filing jointly, \$164,925 for married taxpayers filing separately, and \$164,900 for all other taxpayers),<sup>239</sup> the deduction with respect to qualified business income is limited based on (1) the taxpayer’s allocable share of W-2 wages paid by the trade or business and the taxpayer’s allocable share of capital investment with respect to the trade or business<sup>240</sup> and (2) the type of trade or business in which the income is earned.<sup>241</sup> These limitations begin to

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<sup>235</sup> Mitigating factors with respect to the two-level taxation of distributed corporate income include the availability of corporate-level deductions and credits that may lower the overall rate of the corporation’s tax; use of corporate debt, payments of interest on which are deductible by the corporation; and retention rather than distribution of corporate income, among other factors.

<sup>236</sup> Sec. 199A.

<sup>237</sup> The deduction is limited by the cooperative’s taxable income for the year (computed without regard to the 199A deduction and reduced by certain payments or allocations to patrons). The deduction may instead be allocated to and deducted by the cooperative’s patrons, limited to each patron’s taxable income for the year (computed without regard to any section 199A deduction under the general rule and after taking into account the cooperative’s section 199A deduction).

<sup>238</sup> Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

<sup>239</sup> These threshold amounts are indexed for inflation.

<sup>240</sup> The deduction is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. Sec. 199A(b)(2)(B).

<sup>241</sup> Qualified business income generally excludes income from a specified service trade or business when taxable income is in excess of the threshold amount and always excludes income from the trade or business of performing services as an employee. A specified service trade or business means any trade or business involving the

phase in above the threshold amount of taxable income.<sup>242</sup> In addition, the deduction calculated with respect to qualified business income, qualified REIT dividends, and qualified publicly traded partnership income may not exceed 20 percent of the taxpayer's taxable income for the tax year.<sup>243</sup>

## **NIIT**

The net investment income tax applies at a 3.8 percent rate to certain investment income of individuals.<sup>244</sup> The tax is imposed in addition to the income tax. Thus, for taxpayers subject to the NIIT, the maximum rate on certain capital gains and dividends is 23.8 percent (that is, 20 percent plus 3.8 percent), while the maximum rate on other investment income that is subject to ordinary rates, including interest, annuities, royalties, and rents, is 40.8 percent (that is, 37 percent plus 3.8 percent). The NIIT generally applies to certain capital gains and dividends, partnership income of a partner that is not subject to SECA tax, and income of an S corporation shareholder not active in the S corporation business.

## **SECA**

SECA tax is imposed generally at a 3.8 percent rate on amounts above \$142,800 for 2021. (For amounts below or equal to \$142,800, the SECA tax rate is generally 3.8 percent plus 12.4 percent, or 16.2 percent<sup>245</sup>). The SECA tax applies to net earnings from self-employment,

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performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Sec. 199A(d).

<sup>242</sup> Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

<sup>243</sup> Taxable income is computed without regard to the deduction allowable under section 199A and is reduced by net capital gain with respect to this limitation.

<sup>244</sup> Sec. 1411. The NIIT generally applies to an individual partner's distributive share of partnership income and gains to which SECA does not apply (see sec. 1402(a)(1)-(17)) and to S corporation shareholders who are not active in the S corporation's business (as well as to certain other investment income). For individuals, the tax is imposed on the lesser of (i) net investment income or (ii) the excess of modified adjusted gross income ("AGI") over a threshold amount. Modified AGI is AGI increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). The threshold amount is \$250,000 in the case of a joint return or surviving spouse, \$125,000 in the case of a married individual filing a separate return, and \$200,000 in any other case. Net investment income is the excess of (i) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the ordinary course of any inapplicable trade or business), (b) other gross income derived from any applicable trade or business, and (c) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in an inapplicable trade or business over (2) deductions properly allocable to such gross income or net gain. The tax also applies to estates and certain trusts.

<sup>245</sup> Sec. 1401. The SECA tax applies at a rate of 12.4 percent on net earnings from self-employment up to the FICA wage base (\$142,800 for 2021), plus an additional hospital insurance "(HI)" tax at 3.8 percent (*i.e.*, the sum of 2.9 percent plus 0.9 percent). The HI tax is not limited to the FICA wage base, but applies to any amount of

taking into account allowable deductions, derived from any trade or business carried on by an individual, including as a sole proprietor.<sup>246</sup> A partner in a partnership is subject to SECA tax on the distributive share of income or loss from the partnership's trade or business, subject to enumerated exceptions.<sup>247</sup> The SECA tax generally does not apply to an S corporation's pro rata share of S corporation income.<sup>248</sup>

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

The all-in rate on distributed corporate income can be higher than the 20-percent top marginal income tax rate applicable to the individual shareholder receiving a qualified dividend, due to the imposition of the 21-percent corporate income tax in addition to shareholder-level tax. The all-in rate on passthrough income taxed to an individual can be lower than the 37-percent top marginal income tax rate on ordinary income of individuals, due to the 20-percent deduction for qualified business income. For distributed corporate income and for passthrough income, the NIIT or the SECA tax, generally at a 3.8 percent rate, may also apply to increase the all-in Federal tax rate.

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net earnings from self-employment. Secs. 1401 and 1402(b). For purposes of calculating an all-in rate for income subject to SECA, it is assumed that the relevant income exceeds \$142,800, and therefore the rate of 3.8 percent is used in this discussion.

<sup>246</sup> Sec. 1402(a).

<sup>247</sup> Sec. 1402(a)(1)-(5), (10), and (13). The SECA exceptions for partners generally relate to certain rent, dividends, interest, gain from the sale or exchange of a capital asset or other property that is not stock in trade nor held for sale to customers, certain retirement income of a partner, and the distributive share of a limited partner that is not a guaranteed payment for services.

<sup>248</sup> An S corporation shareholder is, however, subject to employment tax on wages received from the S corporation. Secs. 3101, 3102, and 3121.

## D. The Estate, Gift, and Generation-Skipping Transfer Taxes

This section describes the Federal wealth transfer taxes, which include the gift tax, the estate tax and the generation-skipping transfer tax. These taxes are imposed on individual taxpayers.<sup>249</sup> A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or through similar arrangement, to a “skip person” (*i.e.*, a beneficiary in a generation more than one generation younger than that of the transferor).

The first subsection below describes several common features of the estate, gift, and generation-skipping transfer taxes. The subsections that follow describe each of the three taxes in greater detail.

### 1. Common features of the estate, gift and generation-skipping transfer taxes

#### Unified credit (exemption) and tax rates

The gift and estate taxes are unified such that a single graduated rate schedule and exemption apply to an individual’s cumulative taxable gifts and bequests. The unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 40 percent on cumulative taxable transfers over \$1,000,000. A unified credit of \$4,625,800 (for 2021) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of \$11.7 million (for 2021)<sup>250</sup> in cumulative taxable transfers from the gift tax or the estate tax. The unified credit thus also has the effect of rendering the marginal rates below 40 percent inapplicable. Any unused exemption amount 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. Table 11, below, summarizes the estate and gift tax rates and exemption amounts in effect for 1977 through 2021.<sup>251</sup>

The generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption is equal to the estate tax exemption amount in effect for the year (currently \$11.7 million).

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<sup>249</sup> A transfer to a corporation is sometimes treated as a gift to the shareholders of the corporation. A transfer from a corporation is sometimes treated as a gift made by the shareholders of the corporation. Treas. Reg. sec. 25.2511-1(h)(1).

<sup>250</sup> Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. Section 2010(c)(3) sets the basic exclusion amount at \$5 million and indexes this amount for inflation for calendar years after 2011. For decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the \$5 million base-year figure is temporarily increased to \$10 million. For decedents dying and gifts made in 2021, the inflation-indexed exemption is \$11.7 million.

<sup>251</sup> In 2004 through 2009, although the estate tax exemption exceeded \$1 million, the gift tax exemption remained at \$1 million.

**Table 11.—Estate and Gift Tax Rates and Exemption Amounts, 1977-2021**

Year	Annual gift exclusion per donee single/joint	Exemption value of unified credit	Threshold of highest statutory tax rate <sup>1</sup>	Highest statutory tax rate (percent)
1977	\$3,000/\$6,000	\$120,667	\$5 million	70
1982	\$10,000/\$20,000	\$225,000	\$4 million	65
1983	\$10,000/\$20,000	\$275,000	\$3.5 million	60
1984	\$10,000/\$20,000	\$325,000	\$3 million	55
1985	\$10,000/\$20,000	\$400,000	\$3 million	55
1986	\$10,000/\$20,000	\$500,000	\$3 million	55
1987	\$10,000/\$20,000	\$600,000	\$3 million	55 <sup>2</sup>
1998	\$10,000/\$20,000	\$625,000	\$3 million	55 <sup>2</sup>
1999	\$10,000/\$20,000	\$650,000	\$3 million	55 <sup>2</sup>
2000	\$10,000/\$20,000	\$675,000	\$3 million	55 <sup>2</sup>
2002	\$11,000/\$22,000	\$1 million	\$2.5 million	50
2003	\$11,000/\$22,000	\$1 million	\$2 million	49
2004	\$11,000/\$22,000	\$1.5 million	\$2 million	48
2005	\$11,000/\$22,000	\$1.5 million	\$2 million	47
2006	\$12,000/\$24,000	\$2 million	\$2 million <sup>1</sup>	46
2007	\$12,000/\$24,000	\$2 million	\$1.5 million <sup>1</sup>	45
2009	\$13,000/\$26,000	\$3.5 million	\$1.5 million <sup>1</sup>	45
2010	\$13,000/\$26,000	\$5 million	\$500,000 <sup>1</sup>	35 <sup>3</sup>
2012	\$13,000/\$26,000	\$5.12 million	\$500,000 <sup>1</sup>	35
2013	\$14,000/\$28,000	\$5.25 million	\$1 million <sup>1</sup>	40
2014	\$14,000/\$28,000	\$5.34 million	\$1 million <sup>1</sup>	40
2015	\$14,000/\$28,000	\$5.43 million	\$1 million <sup>1</sup>	40
2016	\$14,000/\$28,000	\$5.45 million	\$1 million <sup>1</sup>	40
2017	\$14,000/\$28,000	\$5.49 million	\$1 million <sup>1</sup>	40
2018	\$15,000/\$30,000	\$11.18 million	\$1 million <sup>1</sup>	40
2019	\$15,000/\$30,000	\$11.4 million	\$1 million <sup>1</sup>	40
2020	\$15,000/\$30,000	\$11.58 million	\$1 million <sup>1</sup>	40
2021	\$15,000/\$30,000	\$11.7 million	\$1 million <sup>1</sup>	40

<sup>1</sup> Because the exemption amount in later years equals or exceeds the threshold for the highest tax rate, transfers that equal or are in excess of the exemption amount generally are subject to a flat tax at the highest marginal rate.

<sup>2</sup> From 1987 through 1997, the benefits of the graduated rate structure and unified credit were phased out at a 5-percent rate for estates between \$10,000,000 and \$21,040,000, creating an effective marginal tax rate of 60 percent for affected estates (with a \$600,000 unified credit). The Taxpayer Relief Act of 1997 provided for gradual increases in the unified credit from \$625,000 in 1998 to \$1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continued to phase out the benefit of the graduated rates, but the benefit of the unified credit was no longer phased out.

<sup>3</sup> For decedents dying in 2010, executors were permitted to elect not to have the estate subject to estate tax. Heirs who acquire assets from an electing decedent's estate, however, took a modified carryover basis determined under then-section 1022 of the Code, instead of a stepped-up basis determined under section 1014 of the Code.

## **Transfers between spouses**

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.<sup>252</sup> In addition, transfers of “qualified terminable interest property” are eligible for the marital deduction. Qualified terminable interest property is property: (1) that passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A qualifying income interest for life exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

## **Transfers to charity**

Contributions to charitable and certain other organizations may be deducted from the value of a gift or from the value of the assets in an estate for Federal gift or estate tax purposes.<sup>253</sup> For estate tax purposes, the charitable deduction is limited to the value of the transferred property that is required to be included in the gross estate.<sup>254</sup> A charitable contribution of a partial interest in property, such as a remainder or future interest, generally is not deductible for gift or estate tax purposes.<sup>255</sup> Unlike the income tax charitable deduction, there are no percentage limits on deductible charitable contributions for gift or estate tax purposes.<sup>256</sup>

## **2. The estate tax**

### **Overview**

The Code imposes a tax on the transfer of the taxable estate of a decedent who is 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.<sup>257</sup> The taxable estate is determined by deducting from the value of the decedent’s gross estate any

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<sup>252</sup> Secs. 2056 and 2523. A marital deduction generally is denied for property passing to a surviving spouse who is not a U.S. citizen. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution. Tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

<sup>253</sup> Secs. 2055 and 2522.

<sup>254</sup> Sec. 2055(d).

<sup>255</sup> Secs. 2055(e)(2) and 2522(c)(2).

<sup>256</sup> Sec. 170(b).

<sup>257</sup> Secs. 2001(a) and 2101(a).

deductions provided for in the Code. After applying tax rates to determine a tentative amount of estate tax, certain credits are subtracted to determine the final estate tax liability.

### **Gross estate**

A decedent's gross estate includes, to the extent provided for in the Code, the date-of-death value of all of a decedent's property, real or personal, tangible or intangible, wherever the property is situated.<sup>258</sup> In general, the value of property for this purpose is the fair market value of the property as of the date of the decedent's death, although an executor may elect to value certain property as of an alternate valuation date.<sup>259</sup>

The gross estate includes property directly owned by the decedent and other property in which the decedent had a beneficial interest at the time of his or her death.<sup>260</sup> The gross estate also includes certain property transferred by the decedent prior to his or her death, including: (1) certain gifts made within three years prior to the decedent's death;<sup>261</sup> (2) certain transfers of property in which the decedent retained a life estate;<sup>262</sup> (3) certain transfers taking effect at death;<sup>263</sup> and (4) revocable transfers.<sup>264</sup> In addition, the gross estate includes property with respect to which the decedent had, at the time of death, a general power of appointment (generally, the right to determine who will have beneficial ownership).<sup>265</sup> The value of a life insurance policy on the decedent's life is included in the gross estate if the proceeds are payable to the decedent's estate or if the decedent had incidents of ownership with respect to the policy at the time of his or her death.<sup>266</sup>

The rules for determining whether an asset is included in a taxpayer's gross estate differ in some respects from the rules for determining whether a taxpayer is treated as the owner of an asset for income tax purposes. Thus, for example, a taxpayer may be treated as owning an asset for income tax purposes that is not included in the grantor's gross estate for estate tax purposes.

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<sup>258</sup> Sec. 2031(a).

<sup>259</sup> Sec. 2032. In general, the alternate valuation date is the date that is six months after the decedent's death, except that property distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death is valued as of the date of the distribution, sale, exchange, or other disposition.

<sup>260</sup> Sec. 2033.

<sup>261</sup> Sec. 2035.

<sup>262</sup> Sec. 2036.

<sup>263</sup> Sec. 2037.

<sup>264</sup> Sec. 2038.

<sup>265</sup> Sec. 2041.

<sup>266</sup> Sec. 2042.

## **Deductions from the gross estate**

A decedent's taxable estate is determined by subtracting from the value of the gross estate any deductions provided for in the Code. As described above, the value of property transferred to a surviving spouse or to charity generally is deducted from the gross estate in arriving at the taxable estate; as a result, bequests to a surviving spouse or to charity generally are permitted without imposition of an estate tax. An estate tax deduction also is permitted for death taxes (*e.g.*, any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.<sup>267</sup> A deduction is available for any funeral expenses, estate administration expenses, and claims against the estate, including certain taxes.<sup>268</sup> Finally, a deduction is available for uninsured casualty and theft losses incurred during the settlement of the estate.<sup>269</sup>

## **Credits against tax**

After accounting for allowable deductions, a gross amount of estate tax is computed. Estate tax liability is then determined by subtracting allowable credits from the gross estate tax.

The most significant credit allowed for estate tax purposes is the unified credit, which is discussed in greater detail above.<sup>270</sup> For 2021, the value of the unified credit is \$4,625,800, which has the effect of exempting \$11.7 million in transfers from tax. The unified credit available at death is reduced by the amount of unified credit used to offset gift tax on gifts made during the decedent's life.

Estate tax credits also are allowed for: (1) gift tax paid on certain pre-1977 gifts (before the estate and gift tax computations were integrated);<sup>271</sup> (2) estate tax paid on certain prior transfers (to limit the estate tax burden when estate tax is imposed on transfers of the same property in two estates by reason of deaths in rapid succession);<sup>272</sup> and (3) certain foreign death taxes paid (generally, where the property is situated in a foreign country but included in the decedent's U.S. gross estate).<sup>273</sup>

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<sup>267</sup> Sec. 2058. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

<sup>268</sup> Sec. 2053.

<sup>269</sup> Sec. 2054.

<sup>270</sup> Sec. 2010.

<sup>271</sup> Sec. 2012.

<sup>272</sup> Sec. 2013.

<sup>273</sup> Sec. 2014. In certain cases, an election may be made to deduct foreign death taxes. See sec. 2053(d).



## **Rules for small and family-owned businesses and farms**

### **Special-use valuation**

An executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value rather than its fair market value.<sup>274</sup> The maximum reduction in value for such real property is \$750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2021 is \$1,190,000<sup>275</sup>). In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent’s gross estate (including both real and personal property) consists of a farm or closely-held business property in the decedent’s estate and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or closely held business real property. In addition, the property must be used in a qualified use (*e.g.*, farming) by the decedent or a member of the decedent’s family for five of the eight years before the decedent’s death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent’s death, an additional estate tax is imposed to recapture the entire estate-tax benefit of the special-use valuation.

### **Installment payment of estate tax for closely held businesses**

Under present law, the estate tax generally is due within nine months of a decedent’s death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).<sup>276</sup> An estate is eligible for payment of estate tax in installments if the value of the decedent’s interest in a closely held business exceeds 35 percent of the decedent’s adjusted gross estate (*i.e.*, the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.<sup>277</sup>

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<sup>274</sup> Sec. 2032A.

<sup>275</sup> Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024.

<sup>276</sup> Sec. 6166.

<sup>277</sup> A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2021 is \$1,590,000) in taxable value of a closely held business. Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (*i.e.*, 45 percent of the Federal short-term rate plus three percentage points). The interest rate on this portion adjusts with the Federal short-term rate. Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

### 3. The gift tax

#### Overview

The Code imposes a tax for each calendar year on the transfer of property by gift during such year by any individual, whether a resident or nonresident of the United States.<sup>278</sup> The gift tax is imposed on the donor. As with the estate tax, the gift tax generally applies to citizens and residents of the United States and applies to nonresident aliens in certain limited cases.

The amount of an individual's taxable gifts for a calendar year is determined by subtracting from the total amount of gifts made during the year: (1) the gift tax annual exclusion (described below); and (2) allowable deductions. The gift tax for the current taxable year is then determined by: (1) computing a tentative tax on the combined amount of all taxable gifts for the current and all prior calendar years using the common gift tax and estate tax rate table; (2) computing a tentative tax only on all prior-year gifts; (3) subtracting the tentative tax on prior-year gifts from the tentative tax computed for all years to arrive at the portion of the total tentative tax attributable to current-year gifts; and (4) subtracting the amount of unified credit not consumed by prior-year gifts.

#### Transfers by gift

The gift tax applies to a transfer by gift regardless of whether: (1) the transfer is made outright or in trust; (2) the gift is direct or indirect; or (3) the property is real or personal, tangible or intangible.<sup>279</sup> For gift tax purposes, the value of a gift of property is the fair market value of the property at the time of the gift.<sup>280</sup> Where property is transferred for less than full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and is included in computing the total amount of a taxpayer's gifts for a calendar year.<sup>281</sup>

For a gift to occur, a donor generally must relinquish dominion and control over donated property. For example, if a taxpayer transfers assets to a trust established for the benefit of his or her children, but retains the right to revoke the trust, the taxpayer may not have made a completed gift, because the taxpayer has retained dominion and control over the transferred assets. A completed gift made in trust generally is treated as a gift to the trust beneficiaries.

Certain transfers for medical and education purposes are not treated as transfers by gift for gift tax purposes.<sup>282</sup> In addition, the gift tax does not apply transfers to section 527 political

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<sup>278</sup> Sec. 2501(a). Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property if the property is located in the United States at the time of the gift.

<sup>279</sup> Sec. 2511(a).

<sup>280</sup> Sec. 2512(a).

<sup>281</sup> Sec. 2512(b); Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024.

<sup>282</sup> Sec. 2503(e).

organizations or to tax-exempt organizations described in section 501(c)(4), (5), or (6) of the Code.<sup>283</sup>

### **Taxable gifts**

As stated above, the amount of a taxpayer's taxable gifts for the year is determined by subtracting from the total amount of the taxpayer's gifts for the year the gift tax annual exclusion and any available deductions.

#### **Gift tax annual exclusion**

Under present law, donors of lifetime gifts are provided an annual exclusion of \$15,000 per donee in 2021 (indexed for inflation from the 1997 annual exclusion amount of \$10,000) for gifts of present interests in property during the taxable year.<sup>284</sup> If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$30,000 per donee in 2021.

#### **Marital and charitable deductions**

As described above, transfers to a spouse or to charity generally are deductible for gift tax purposes. As a result, transfers between spouses or to charity generally are permitted without imposition of a gift tax.

### **4. The generation-skipping transfer tax**

A generation-skipping transfer tax generally is imposed (in addition to the gift tax or the estate tax) on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (*e.g.*, a beneficiary in a generation more than one generation below that of the transferor).<sup>285</sup> As with the estate and gift taxes, it generally applies to citizens and residents of the United States and may apply to nonresident aliens in certain limited cases.

### **Exemption and tax rate**

A lifetime exemption generally equal to the estate tax exemption (\$11.7 million for 2021) is provided for each person making generation-skipping transfers.<sup>286</sup> The exemption may be allocated by the taxpayer (or his or her executor) to transferred property, and in some cases is automatically allocated. Allocation of the generation-skipping transfer tax exemption effectively reduces the tax rate on a generation-skipping transfer.

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate tax rate (40 percent) multiplied by the "inclusion ratio." The inclusion ratio is one minus

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<sup>283</sup> Sec. 2501(a)(4) & (6).

<sup>284</sup> Sec. 2503(b).

<sup>285</sup> Sec. 2601, *et seq.*

<sup>286</sup> Sec. 2631.

the applicable fraction. The applicable fraction is the amount of exemption allocated to a trust (or to a direct skip) divided by the value of assets transferred.<sup>287</sup>

If, for example, a taxpayer transfers \$5 million in property to a trust and allocates \$5 million of exemption to the transfer, the inclusion ratio is zero (1 minus (\$5 million/\$5 million)), and the applicable tax rate on any subsequent generation-skipping transfers from the trust is zero percent (40 percent multiplied by the inclusion ratio of zero). If the taxpayer instead allocates \$2.5 million of exemption to the \$5 million transfer, the inclusion ratio is 0.5 (1 minus (\$2.5 million/\$5 million)), and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 20 percent (40 percent multiplied by the inclusion ratio of 0.5). If the taxpayer allocates no exemption to a transfer in trust, the inclusion ratio is one, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 40 percent (40 percent multiplied by the inclusion ratio of one).

### **Generation-skipping transfers**

The generation-skipping transfer tax generally is imposed at the time of a generation-skipping transfer – a direct skip, a taxable termination, or a taxable distribution.<sup>288</sup>

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.<sup>289</sup> A skip person may be a natural person or may be certain trusts. All persons assigned to the second or more remote generation below the transferor's generation are skip persons (*e.g.*, grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.<sup>290</sup>

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.<sup>291</sup>

A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable distribution, generation-skipping transfer tax may be avoided.<sup>292</sup>

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<sup>287</sup> Sec. 2642(a).

<sup>288</sup> Sec. 2611.

<sup>289</sup> Sec. 2612(c).

<sup>290</sup> Sec. 2613.

<sup>291</sup> Sec. 2612(a).

<sup>292</sup> Sec. 2612(b).

### III. DISCUSSION

Potential changes to the taxation of individuals' income or wealth could range from changes to rates and rules within the current system to broader overhauls that fundamentally change how certain activities are taxed or introduce a new base on which to impose a tax. Consistent with this document's focus on taxation of high income and high wealth taxpayers, this discussion describes and analyzes proposals that may affect the progressivity of the Code. This section organizes these proposals into three broad categories of the types of taxes they propose, (1) income tax, (2) wealth tax, and (3) wealth transfer tax, and describes the proposals, explores the various trade-offs between them, and discusses their potential efficiency and administrative consequences.

#### A. Income Tax Proposals

##### Individual income tax rates

The individual income tax system can be made more progressive by making changes to the tax rates and the rate brackets.<sup>293</sup> Under present law, the highest marginal tax rate is 37 percent, which for 2021 applies to income above a range for individuals from \$314,150 (for married filing separately taxpayers) to \$628,300 (for married filing jointly taxpayers), and for income above \$13,050 for trusts and estates. Some have proposed to increase the highest marginal rate, either at the same income thresholds or for specified higher thresholds to increase progressivity. Alternatively, or in conjunction, rate thresholds could be lowered so that more income is subject to tax at the highest rates.

Administratively, these changes are relatively straightforward and would mostly require changes in forms and calculations of income tax (using the same base). An issue with this approach is that not everything included in a broad income measure is subject to income taxation and certain categories of income may be subject to preferential rates as under present law.<sup>294</sup>

Increasing tax on income may also affect labor supply and growth in the economy by reducing the after-tax return to labor. A reduction in the after-tax return to labor may reduce the incentive for individuals to work. Partially offsetting this effect, increases in taxes reduce after-tax income and provide an incentive to work more to replace the lost income. This can have two effects on economic output. First, reductions in labor supply lead to reductions in economic output (holding average labor productivity constant). Second, a tax on labor may reduce economic output indirectly by distorting work effort and occupational choice (lowering average

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<sup>293</sup> Expansions in refundable credits also increase progressivity as they function as negative income tax rates. David Splinter, "Who Pays No Tax? The Declining Fraction Paying Income Taxes and Increasing Tax Progressivity," *Contemporary Economic Policy*, vol. 37, July 2019, pp. 413-426.

<sup>294</sup> For example, for discussion of whether carried interests are a form of compensation for services or income or gain from capital see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests* (JCX-41-07), July 10, 2007 or Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. For some other deviations from a broad concept of income in present law see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024* (JCX-23-20), November 5, 2020.

labor productivity). A large economics literature has studied the effect of taxes on hours worked,<sup>295</sup> while fewer studies have been conducted on the effect of taxes on work effort and occupational choice.<sup>296</sup> A number of studies separately identify the effect of taxes on the hours worked by those individuals who are already employed (the “intensive margin” or “hours margin”), and the effect of taxes on the decision to work or not (the “extensive margin” or “participation margin”). Responses on both the intensive and extensive margins affect the amount of labor supplied in the economy.

Most empirical studies find that the labor supply decisions of low-income individuals are generally more responsive to taxes than the labor supply decisions of high-income individuals.<sup>297</sup> Additionally, as tax rates vary across geographic location, individuals may decide not to alter the amount of labor supplied, but rather may alter the location of that labor. Some research has empirically explored migration, both within and across countries, as another response of high-income individuals to individual taxation.<sup>298</sup>

### **Taxation of capital income**

Under present law, the corporate income tax rate is a 21 percent flat rate. Some have proposed to raise this rate, either for all income or income above a certain threshold using a progressive rate structure.

As shown in the data section above, a large share of corporate ownership and income from corporate stock accrues to those with high wealth and high income respectively. If a

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<sup>295</sup> See Joint Committee on Taxation, *Economic Growth and Tax Policy* (JCX-19-17), May 16, 2017 for a summary.

<sup>296</sup> Research on the responsiveness of taxable income to changes in tax rates partly accounts for the possible distortions of tax on work effort and occupational choice, to the extent that taxable income is determined by work effort and occupational choice. For example, if individual income tax rates are lowered, and work effort increases without any change in hours worked, that may increase the amount of income a worker receives (e.g., bonuses) but does not affect hours worked (i.e., labor supply). However, observed changes in taxable income as a result of changes in tax rates are not solely attributable to changes in work effort. An additional behavioral response is often for taxpayers to shift income into a form that is taxed more favorably. For a discussion of the literature on responsiveness of taxable income to change in tax rates, as well as the limitations in this line of research, see Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, “The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review,” *Journal of Economic Literature*, vol. 50, March 2012, pp. 3-50, and Gerald Auten, David Splinter, and Susan Nelson, “Reactions of High-Income Taxpayers to Major Tax Legislation,” *National Tax Journal*, vol. 69, December 2016, pp. 935-964.

<sup>297</sup> Robert McClelland and Shannon Mok, “A Review of Recent Research on Labor Supply Elasticities,” *Congressional Budget Office Working Paper* 2012-12, October 2012.

<sup>298</sup> These studies generally pertain to specific groups, such as inventors or football (soccer) players, where detailed migration data is available, but often find a sizeable response, at least among foreigners, to personal income taxes. See Ufuk Akcigit, Salome Baslandze, and Stephanie Stantcheva, “Taxation and the International Mobility of Inventors,” *American Economic Review*, vol. 106, October 2017, pp. 2930-2981 and Henrik Kleven, Camille Landais, and Emmanuel Saez, “Taxation and International Migration of Superstars: Evidence from the European Football Market,” *American Economic Review*, vol. 103, August 2013, pp. 1892-1924. For an overview of recent work see Henrik Kleven, Camille Landais, Mathilde Munoz, and Stefanie Stantcheva, “Taxation and Migration: Evidence and Policy Implications,” *Journal of Economic Perspectives*, vol. 34, Spring 2020, pp. 119-142.

substantial portion of the burden of the corporate income tax is borne by the owners of capital, then increasing the corporate income tax would raise taxes relatively more from taxpayers with high wealth and high income, thus potentially serving a purpose to increase the progressivity of the U.S. tax system. Although the corporate rate has interactions with many corporate tax provisions (for example modifying the economic value of deductions and accelerated depreciation), such a change could be viewed as relatively simple administratively as it does not fundamentally alter the U.S. corporate income tax system.

Increasing the tax on capital presents certain economic issues related to both fairness and efficiency. In particular, while economic analysis concludes that in the long run owners of domestic capital are more easily able to escape some of the burden of the tax such that a tax on capital is at least partially passed on to labor, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns, or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run.<sup>299</sup> The degree to which incidence of a tax on capital is borne by workers may alter the progressivity of such a tax. In other words, although the owners of capital and recipients of capital income may be the wealthy or high income, some of the burden of an increased tax on capital may be borne by workers lower in the income distribution.

The extent to which individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their savings also relates to the efficiency of a tax on capital. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment. However, the savings response matters in considering what effect an increase in tax on capital might have on the growth of the economy.

For noncorporate business income, modifying the qualified business income deduction has also been considered. A reduction in the generosity of the deduction, or its repeal, may be a relatively progressive change to the U.S. tax system. Recent distributional estimates suggest that much of the benefit of the deduction accrues to high-income households.<sup>300</sup>

In general, the deduction for qualified business income reduces effective tax rates on passthrough business income relative to other forms of income. This may create some horizontal inequity, as the deduction creates a preference for passthrough business income relative to wage income. This may also create a preference for income that is from passthrough businesses other than ineligible service businesses or other ineligible businesses.

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<sup>299</sup> For a discussion of economic incidence of capital taxes in the context of taxes on business income, see Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013. The Joint Committee staff assumes that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital.

<sup>300</sup> While some restrictions apply for qualified business income of taxpayers with prededuction taxable income in excess of certain thresholds, the Joint Committee staff estimates that taxpayers with economic income of \$500,000 or above will claim nearly 50 percent of the dollar amount of the deduction for tax year 2021.

Proponents of the deduction argue that, as with the corporate rate and other deductions on business income, the deduction for qualified business income reduces the user cost of capital and thus may increase investment. Limited empirical research exists on the effect of preferential rates for passthrough business income.<sup>301</sup> Some preliminary work on the qualified business income deduction does not find much evidence of short-run responses.<sup>302</sup>

Some suggest that the complexity of the current rule may make compliance and administration difficult. Complicated rules about what income does and does not qualify and about limitations on the amount of the deduction may increase compliance costs for both the taxpayer and government.<sup>303</sup>

### **Taxation of capital gains**

Other possible changes relate to the rules governing the taxation of capital gains or investment income. For example, some have proposed raising the highest marginal rate – currently 20 percent – imposed on long-term capital gains. Some have also considered changes to the treatment of collectible gains or unrecaptured section 1250 gain or increasing the rate of the NIIT, currently set at 3.8 percent.

Under the present-law system where capital gains are generally taxed upon disposition, there is a benefit to the taxpayer from deferral due to the time value of money. The nominal taxes paid at a later date are lower in real terms than those same amounts paid today. Some claim that the taxation of nominal gains ignores inflation and suggest that real gains should be taxed. In cases where the benefit from deferral outweighs the penalty of inflation, the disposition-based system for taxing capital gains can create a “lock-in” effect where taxpayers choose to hold property with built-in capital gain in response to the present-law rules permitting interest-free deferral of tax on gains.<sup>304</sup> This effect may create inefficiencies if less productive investments are held rather than disposed of as a means of delaying tax consequences. This effect may also be exacerbated by step-up basis, which can allow the gains from assets held until death to escape tax entirely.

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<sup>301</sup> Jason DeBacker, Lucas Goodman, Bradley T. Heim, Shanthi P. Ramnath, and Justin M. Ross, “Pass-Through Entity Responses to Preferential Tax Rates: Evidence on Economic Activity and Owner Compensation in Kansas,” *National Tax Journal*, vol. 71, December 2018, pp. 687-706, examine a 2012 income tax reform in Kansas affecting preferential rates on passthrough business income and find some effect on guaranteed payments to partners, but none on gross receipts, capital investment, or employment.

<sup>302</sup> Lucas Goodman, Katherine Lime, Bruce Sacerdote, and Andrew Whitten, “How Do Business Owners Respond to a Tax cut? Examining the 199A Deduction for Pass-through Firms,” *NBER Working Paper* No. 28680, April 2021.

<sup>303</sup> U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, Results of the 2019 Filing Season, ref. no. 2020-44-07, January 22, 2020, p. 14 find a sizable number of 2018 returns that appear to qualify for but did not claim the deduction.

<sup>304</sup> Analogously, losses may be accelerated as the real tax savings from losses diminish over time.



Within a system for taxation of capital gains where realization is largely defined as disposition, research finds that the sensitivity to changes in the capital gains rates is high.<sup>305</sup> Typically the behavioral response to capital gains taxation is split into two categories: permanent responses to the change in the tax rate, and immediate, temporary responses to anticipated tax rate changes. Recent estimates suggest the permanent elasticity of capital gains is approximately -0.7, meaning a 10-percent increase in rates leads to a seven-percent reduction in capital gains income. The transitory elasticity is estimated to be in excess of -1.0, meaning a 10-percent increase in rates leads to a more than 10-percent reduction in capital gains income.<sup>306</sup> Some have proposed increasing the tax rate on long-term net capital gains. These results suggest that absent other changes to the tax treatment of capital gain, the behavioral responses to an increase in the tax rate on capital gains may significantly lessen the revenue that would be raised if dispositions were held constant.

### **Mark-to-market taxation**

As discussed above in section II.C.2, the Code currently contains provisions that calculate income using a mark-to-market approach. Those provisions target specific fact patterns: dealers and traders in securities and commodities, expatriating persons, certain derivatives, and marketable PFIC stock. Proposals to expand mark-to-market taxation may identify other specific fact patterns where mark-to-market rules solve a narrow policy problem, or may apply mark-to-market rules to capital assets broadly as a way to address distortions caused by the present-law system where realization is largely defined as disposition.

In terms of proposals to solve narrow policy problems, some have proposed replacing the Code's current patchwork approach to the taxation of derivatives<sup>307</sup> with a single set of mark-to-market rules that apply to all derivatives.<sup>308</sup> These proposals seek to address the fact that, under

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<sup>305</sup> See Tim Dowd, Robert McClelland, and Athiphat Muthitacharoen, "New Evidence on the Tax Elasticity of Capital Gains," *National Tax Journal*, vol. 68, no. 3, September, 2015, pp. 511-544; Saez, Emanuel, "Taxing the Rich More: Preliminary Evidence from the 2013 Tax Increase," *Tax Policy and the Economy*, vol. 31, no. 1, 2017, pp.71-120; and Gerald Auten, David Splinter, and Susan Nelson, "Reactions of High-Income Taxpayers to Major Tax Legislation," *National Tax Journal*, vol. 69, no. 4, December, 2016, pp. 935-964.

<sup>306</sup> For a discussion recent research on taxpayer responses to capital gains tax rates and implications for Joint Committee staff revenue estimates, see Joint Committee on Taxation, *Estimating Taxpayer Bunching Responses to the Preferential Capital Gains Tax Rate Threshold* (JCX-42-19), September 10, 2019.

<sup>307</sup> A derivative is a contract in which the amount of at least one contractual payment is calculated by reference to a later change in the value of something (or a combination of things), and includes options, forwards, futures, and swaps.

<sup>308</sup> The Federal income tax laws governing taxation of derivatives are complex and inconsistent with one another. Timing and character rules with respect to various derivatives may differ depending on the type of derivative, (e.g., an option), the type of taxpayer entering into the derivative (e.g., a dealer in securities), the use of the derivative (e.g., as a hedge), the type of underlying (e.g., a foreign currency), how the derivative is traded (e.g., on a U.S. exchange), or the application of other overriding rules (e.g., the straddle rules). Further, derivatives or combinations of derivatives that are similar economically may be subject to different tax rules. For a more extensive discussion of issues raised by the present-law taxation of derivatives, see Joint Committee on Taxation, *Description of the Modernization of Derivatives Tax Act of 2017*, pp. 1-18, available at <https://www.finance.senate.gov/imo/media/doc/JCT%20Memo%20on%20MODA%202017.pdf>.

present law, economically similar but formally different derivatives and combinations of derivatives may be taxed differently, both in terms of the timing of inclusions of income on such derivatives and the character of such income. These differences may give sophisticated taxpayers some flexibility to elect the timing and character of income on their economic positions.

To address this issue, there have been proposals to provide a single timing rule – mark to market – and a single character rule – ordinary income – for all derivatives. These proposals grapple with several policy considerations, the foremost of which is defining the scope of financial contracts that should be subject to such a rule.<sup>309</sup> On one hand, it may be preferable to cast a broad net if the goal is to avoid giving taxpayers the ability to design financial instruments that skirt the definition and allow a continuation of the issues that exist under present law. But on the other hand, it may be desirable to avoid a definition that is so broad that some taxpayers may hold derivatives subject to the rule without realizing it. Another consideration is whether to reform the straddle rules discussed above as part of the exercise, given that those rules have been criticized for being ambiguous in their application and would continue to be relevant in a world where derivatives are marked to market.<sup>310</sup>

Other proposals would expand mark-to-market taxation to cover a significant subset of capital assets in the economy as part of an attempt to address distortions related to taxpayers' strategic timing of realizations of gains and losses caused by the present-law system where realization is largely defined as disposition.

Proposals in this area draw on commentary over the past few decades proposing taxation of some or all capital gains on a mark-to-market or accrual basis.<sup>311</sup> Both the commentary and the proposals grapple with a number of policy issues.

One issue is which assets should be required to be marked to market, and what (if anything) should be done about assets that are not marked to market. Generally, the proposals limit mark-to-market treatment to assets that have publicly-ascertainable values; as one commentator notes, "it is widely agreed that mark-to-market taxation is impractical for assets that are not publicly traded because their market values cannot be accurately measured."<sup>312</sup> For these assets, gains and losses would both be taken into account on an annual basis, as they

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<sup>309</sup> Section 59A(h)(4) provides the Code's only definition of "derivative." This definition could be maintained, expanded, or restricted in the context of a mark-to-market rule.

<sup>310</sup> In particular, there has been uncertainty around the "substantial diminution of loss" standard in section 1092(c)(2) for determining whether a taxpayer holds offsetting positions that would be subject to the timing rules of section 1092(a). To date, little guidance has been provided.

<sup>311</sup> See, e.g., Alan Auerbach, "Reforming Capital Gains Taxation," *Tax Notes*, vol. 95, no. 112, June 11, 2012, p. 1400; Samuel D. Brunson, "Taxing Investors on a Mark-to-Market Basis," *Loyola University Law Review*, Vol. 43, 2010, pp. 507-550; David S. Miller, "A Progressive System of Mark-to-Market Taxation," *Tax Notes*, vol. 121, Oct. 13, 2008, pp. 213-218; Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

<sup>312</sup> Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

accrue. For assets that are not marked to market because they are not easily valued (*e.g.*, stock in a closely-held corporation and non-publicly-traded partnership interests), some proposals impose an additional tax on disposition that is intended to account for the value of deferral as a way of reducing the economic difference between the taxation of marked and non-marked assets.<sup>313</sup> The design of such a “deferral charge” creates its own set of issues, including what interest rate to use and the proper treatment of losses.<sup>314</sup> With regard to the latter issue, one approach could be for the government to pay a deferral charge on losses that mimics the deferral charge paid by taxpayers on gains, but concerns about timing and valuation could support other approaches.

Another issue in the design of such a system is which taxpayers should be subject to the mark-to-market or accrual regime. Some proposals would apply mark to market to all taxpayers on the premise that mark to market provides a more accurate measure of income than disposition-based realization and reduces distortions associated therewith, and therefore should be applied to all taxpayers. Other proposals limit application to high-income or high-wealth taxpayers, leaving the present-law disposition-based system in place for taxpayers not meeting those standards, perhaps on the theory that a hybrid system is more progressive than requiring all taxpayers to mark. Taking that approach raises two sets of additional related issues: (1) how to manage taxpayers’ inevitable movement across any threshold for application of the regime; and (2) what (if anything) to do about potential distortions related to taxpayers’ desire not to be subject to the regime.

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

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

Mark-to-market taxation may be viewed as complimentary to proposals that raise capital gains rates. As discussed above, increasing capital gains rates under the present-law tax system may lead to timing responses that could greatly lower the revenue from implementing such a rate change. However, mark-to-market taxation would largely eliminate the effectiveness of timing

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<sup>313</sup> See, *e.g.*, Alan Auerbach, “Retrospective Capital Gains Taxation” *American Economic Review*, vol. 81, March 1991, pp. 167-178. For an example of how such a system might be designed to eliminate the lock-in effect, see, *e.g.*, James Kwak, “Reducing Inequality with a Retrospective Tax on Capital,” *Cornell Journal of Law and Public Policy*, vol. 25, Fall 2015, pp. 191-244.

<sup>314</sup> Under present law, where gain and loss are calculated on disposition, use of losses is restricted in various ways to address concerns about improper acceleration of losses. See, *e.g.*, secs. 267, 1091, and 1211. Depending on the design of a deferral charge system, these same concerns may or may not continue to be present with regard to non-marked assets, albeit likely to a lesser degree than under present law.

responses with respect to assets to which it applies, since tax would be owed even without disposition.

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

### **Implement a deemed realization system for gifts and bequests**

Some have proposed a “deemed realization” system under which a transfer of property at death and/or by gift is treated as a sale of the property.<sup>315</sup> Under such proposals, the donor of a lifetime gift realizes and recognizes gain at the time of a gift, the deceased owner of an asset realizes and recognizes gain at the time an asset is bequeathed to an heir or to another beneficiary, or both. The gain is the excess of the fair market value of the asset on the date of the gift or bequest over the donor or decedent’s adjusted basis in the asset. The gain is taxable to a donor of a lifetime gift in the year the gift is made and to a decedent on the decedent’s final individual income tax return. The rules may also allow for realization and recognition of losses.

A deemed realization system might exempt or include preferential rules for gifts or bequests to a spouse or to charity. The system might also provide exemptions for a limited dollar amount of gain or for certain lower-value items of tangible personal property. Finally, the system might include special rules to address concerns about liquidity for gain realized on a deemed sale of a business interest or other illiquid asset.

Certain other countries, including Canada and Australia, tax gains on transfers at death or by gift. These countries employ a deemed realization approach as a primary method of taxing transfers of wealth; they do not impose separate, additional taxes on transfers of wealth, such as estate or inheritance taxes.

Some argue that enacting a deemed realization system is necessary to restore fairness to the U.S. tax system. Whereas wealthier individuals often permanently avoid tax on gains by holding assets until death, less-wealthy individuals often must spend down their assets during retirement and pay income tax on realized gains. This difference, some argue, increases the inequity in the tax system. A tax on deemed realizations attempts to address this perceived

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<sup>315</sup> See, e.g., Harry L. Gutman, “Taxing Gains at Death,” *Tax Notes Federal*, vol. 170, January 11, 2021, pp. 215-227. See also The American College of Trust and Estate Counsel, *Report on Proposals to Tax the Deemed Realization of Gain on Gratuitous Transfers of Appreciated Property*, October 15, 2019, available at [https://www.actec.org/assets/1/6/Submission-ACTEC\\_Deemed\\_Realization\\_Report\\_-10-15-19.pdf](https://www.actec.org/assets/1/6/Submission-ACTEC_Deemed_Realization_Report_-10-15-19.pdf); Committee Print, Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance, *Tax Reform Studies and Proposals*, U.S. Treasury Department, February 5, 1969, Part 1, pp. 28-29; Department of the Treasury, *Blueprints for Basic Tax Reform*, January 17, 1977; Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals*, February 2015, pp. 156-157; Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 155-156.

inequity by treating a taxpayer who gratuitously transfers an asset by gift or at death the same as a taxpayer who sells or exchanges the asset.<sup>316</sup>

Some might argue that imposing income tax on gains on a transfer by gift or at death is overly burdensome, particularly when combined with a separate, additional estate and gift tax. If, for example, an estate has limited liquidity to pay the estate tax – such as where much of the value of the estate is in a family business or farm – an additional tax on capital gains could exacerbate the estate’s cash flow burden and harm the business. A deemed realization proposal might seek to mitigate this liquidity concern by providing special rules under which payment of tax is deferred for deemed sales of business interests and certain other illiquid assets.

The prospect of eliminating gains entirely at death through a step-up in basis might exacerbate the lock-in effect of the present-law disposition-based realization system for taxing capital gains by influencing economic decisions regarding whether to hold or transfer assets during life. Implementing a deemed realization system arguably would reduce this lock-in effect of present law.

As one commentator notes, “[a]lthough the existing law which provides a step-up in basis without tax on unrealized gains is inequitable, it is quite simple.”<sup>317</sup> Because present law imposes no income tax on gains at death, the enactment of a deemed realization system likely would add complexity to the Code. Deemed realization generally will require valuation of gain assets as of the decedent’s death (or at the time of a gift). This process might in some cases require costly appraisals and lead to valuation disputes, increasing compliance costs for taxpayers and the Internal Revenue Service.

Deemed realization is also an increase in taxation on capital, so considerations relating to incidence and savings behavior, as discussed above, would also apply to these changes.

### **Require carryover basis for assets acquired from a decedent**

An alternative to a deemed-realization system would be to require that the basis of an asset owned by a decedent at the time of her death be carried over to the decedent’s heir. Capital gains tax on any appreciation that accrued before the decedent died would be deferred and paid

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<sup>316</sup> See American Bar Association, Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 2004, p. 183. Others might argue that, under present law, unrealized gain does not escape taxation, because the estate tax applies to the entire value of an asset included in the decedent’s estate. Adding a new tax on gains to the existing wealth transfer taxes, they might argue, is unnecessary and will result in double taxation of wealth transfers. The two taxes, however, arguably serve different purposes and apply to different tax bases: the estate and gift taxes impose a tax on transfers across generations, whereas the capital gains tax on deemed realizations taxes accrued gain that has been deferred under rules regarding realizations.<sup>316</sup> See David Kamin, “How to Tax the Rich,” *Tax Notes* (January 5, 2015), p. 126. Furthermore, the concern about double taxation could be mitigated by allowing tax on deemed realizations resulting from death to be deducted for estate tax purposes, thereby removing the assets used to pay the capital gains tax from the estate tax base.

<sup>317</sup> Michael J. Graetz, “Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals,” *Virginia Law Review*, vol. 59, 1973, p. 838.

when the heir sells or disposes of the asset. This approach generally would align the basis rules for assets acquired from a decedent with the rules for assets acquired by gift.

On two prior occasions, the Code has been modified to provide for a carryover basis for certain assets acquired from a decedent. First, the Tax Reform Act of 1976<sup>318</sup> replaced the section 1014 basis step-up rules with rules that generally provided for the decedent's basis to be carried over to the heir. The rules were short lived; under the weight of heavy criticism, they were repealed only four years later, in 1980.<sup>319</sup> Second, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")<sup>320</sup> provided for the phase-out and eventual temporary repeal of the estate tax. For decedents dying in 2010, the one year in which the estate tax was to be repealed, a new basis regime was to take effect. Specifically, taxpayers who acquired assets from a decedent who died during 2010 would take a modified carryover basis under which only a limited, specified amount of "step up" would be allowed for assets in the estate (generally, \$1.3 million plus an additional \$3 million for assets transferred to a spouse); other assets generally would take a carryover basis. In December 2010, however, the estate tax and step-up in basis rules were restored retroactively for decedents dying during 2010, although an executor was permitted to elect to have the EGTRRA rules apply to the estate and to the decedent's heirs, *i.e.*, no estate tax would apply, but heirs would take a modified carryover basis rather than a stepped-up basis.<sup>321</sup>

A carryover basis regime, like a deemed-realization proposal, seeks to address concerns about equity by limiting opportunities to avoid permanently the tax on gains that accrue prior to death.<sup>322</sup> A carryover basis regime would not, however, place bequests completely on par with a sale of an asset during life, because gain still could be deferred indefinitely from one generation to the next. In this respect, bequests would be treated more like gifts, which take a carryover basis under present law.<sup>323</sup>

Furthermore, a carryover basis regime for assets acquired from a decedent may not fully address the lock-in concern that arises under the present-law step-up in basis regime. While decedents will have a lesser incentive to hold until death, some argue that a carryover basis requirement might exacerbate the lock-in effect for heirs, as heirs in subsequent generations could face an ever increasing tax burden in the event of a sale, as values continue to rise over time, increasing the gap between fair market value and the initial decedent's tax basis.<sup>324</sup>

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<sup>318</sup> Pub. L. No. 94-455 (Oct. 4, 1976), sec. 2005.

<sup>319</sup> Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223 (April 2, 1980), sec. 401(a).

<sup>320</sup> Pub. L. No. 107-16 (June 7, 2001), secs. 541 and 542.

<sup>321</sup> Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (December 17, 2010), sec. 301.

<sup>322</sup> See Lawrence Zelenak, "Taxing Gains at Death," *Vanderbilt Law Review*, vol. 46, 1993, p. 361, 367.

<sup>323</sup> See Graetz, *supra*, p. 833.

<sup>324</sup> See *ibid*, p. 837.

A carryover basis regime also might increase taxpayers' compliance burdens and the costs to the IRS of administering the law. Executors, for example, would need to consider not only the equitable allocation of asset values across a decedent's heirs, but also the allocation of basis across heirs. In addition, basis would in some cases have to be tracked across multiple generations, raising compliance concerns.<sup>325</sup>

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<sup>325</sup> Zelenak, *supra*, p. 368.

## B. Wealth Taxation

Under present law, there is no Federal tax imposed directly on an individual's wealth or assets or property held.<sup>326</sup> The closest analogue may be the combined estate, gift, and generation-skipping transfer tax system, which impose tax on the transfer of wealth. The concepts of gross estate<sup>327</sup> and taxable estate<sup>328</sup> are measures of the wealth transferred by a decedent.

Implementing a wealth tax raises many design considerations. First, which taxpayers will be subject to the wealth tax? Will the tax only apply to individuals, or will it also apply to trusts that own assets? With respect to individuals, is each individual separately subject to tax, or are married couples treated as one unit (as in the case of the income tax)?

A second consideration is determining the base of the wealth tax. Starting with a basic definition of wealth as the fair market value of a taxpayer's assets less liabilities, many questions arise, including: (1) should all assets be included in the tax base, or should certain assets, such as personal effects or hard-to-value assets, be excluded;<sup>329</sup> (2) what amount of wealth, if any, should be exempt from tax; and (3) should wealth include worldwide wealth (like the income and estate tax for citizens and residents) or only domestic wealth?

A third consideration is what tax rate should apply. The wealth tax could have one flat tax rate or have a graduated rate structure with different marginal rates for different levels of wealth.

As shown in section I above, the wealth distribution is highly concentrated. Thus, a direct tax on wealth would be relatively progressive. Proponents argue that such a tax will generate a high proportion of revenue from those with the most ability to pay. Some go beyond standard economic considerations of fairness and efficiency and argue that the wealth tax has broader societal benefits.<sup>330</sup> Opponents of a wealth tax argue that the European experience with wealth taxes shows that efficiency concerns and administrative issues raised by a wealth tax

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<sup>326</sup> In contrast, many local governments impose a wealth tax in the form of taxes on the value of real property. See Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, "50-State Property Tax Comparison Study for Taxes Paid in 2019," June 2020, available at [https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019\\_full.pdf](https://www.lincolninst.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019_full.pdf).

<sup>327</sup> Sec. 2031.

<sup>328</sup> Sec. 2051.

<sup>329</sup> A similar question applies to related liabilities.

<sup>330</sup> Some argue excessive inequality leads to either concentration of political power among the rich or perhaps even political instability. For a discussion of such concerns and also a general overview of economic considerations relating to a wealth tax see Florian Scheuer and Joel Slemrod, "Taxing our wealth," *Journal of Economic Perspectives*, vol. 35, Winter 2021, pp. 207-230. An opposing view is that a wealth tax may increase the influence of the wealthy, as they may decide to donate to political causes (which would also reduce wealth tax liability). See Lawrence Summers, "Would a Wealth Tax Help Combat Inequality?" in Olivier Blanchard and Dani Rodrick (eds.), *Combating Inequality: Rethinking Government's Role*, MIT Press, 2021, pp. 141-152.



outweigh the benefits of such a tax.<sup>331</sup> Some also argue that a broad wealth tax as generally proposed is unconstitutional.<sup>332</sup>

Income taxes, payroll taxes, and excise and other consumption taxes generally tax economic activity as it occurs. Income and consumption represent ongoing, current economic activity by the taxpayer.<sup>333</sup> Accumulated wealth does not result from any ongoing, current economic activity.<sup>334</sup> Wealth depends upon previous economic activity either by the current wealth holder or other individuals. For example, current wealth can result from accumulated saving from income or from received bequests.

These differences in the base between an income tax and wealth tax mean that a low rate of tax on wealth can be equivalent to a relatively high rate of tax on capital income. For example, a wealth tax with a two-percent rate applied to an asset with a four-percent rate of return would be equivalent to a tax rate of 52 percent on the income from the asset.<sup>335</sup> Mechanically, a wealth tax is less burdensome on wealth holders with high rates of return, as the rate of tax on capital income that is needed to produce the same amount of revenue as a wealth tax at a particular rate decreases as the rate of return on the asset increases.<sup>336</sup> Some argue that a wealth tax may thus encourage the reallocation of capital to more productive uses.<sup>337</sup> However, if differences in rates of return are due to excess profits such as monopoly rents, then a wealth tax places a higher relative burden on normal rates of return. Consequently, a wealth tax with an

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<sup>331</sup> See Organisation for Economic Co-operation and Development (OECD), “The Role and Design of Net Wealth Taxes in the OECD,” 2018 for a summary the experience of OECD countries with wealth taxes. The report describes that of 12 OECD countries with net wealth taxes in the 1990s, only four had such regimes as of 2017.

<sup>332</sup> Erik Jensen, “Is a Tax on Wealth Constitutional?” *Journal of Taxation of Investments*, vol. 36, Spring 2019, pp.79-86. For some proposed alternatives to avoid constitutionality issues see Ari Glogower, “A Constitutional Wealth Tax” *Michigan Law Review*, vol. 118, 2020, pp. 717-784.

<sup>333</sup> Economists call income and consumption “flow” concepts. In simple terms, a flow can only be measured by reference to a unit of time. Thus, one refers to a taxpayer’s annual income or monthly consumption expenditures.

<sup>334</sup> Economists call wealth a “stock” concept. A stock of wealth, such as a bank account, may generate a flow of income, such as an annual interest income.

<sup>335</sup> The tax from a two-percent rate on wealth applied to an asset of value  $A$  with a return of four-percent is  $.02 * A * (1 + .04) = .0208 * A$ . Income from that asset is  $.04 * A$ . Thus, a 52-percent rate of tax on capital income is  $.52 * .04 * A = .0208 * A$ .

<sup>336</sup> For example, consider two taxpayers, one with an asset achieving a four-percent rate of return and one with an asset achieving an eight-percent rate of return. The two-percent rate wealth tax is equivalent to a 52-percent rate on capital income for the first taxpayer, but only a 27-percent rate on capital income for the second taxpayer.

<sup>337</sup> In Faith Guvenen, Gueorgui Kambourov, Burhan Kuruscu, Sergio Ocampo, and Daphne Chen, “Use It or Lose It: Efficiency Gains from Wealth Taxation,” *NBER Working Paper 26284*, September 2019, the authors argue that if differences in these rates of return are the result of productivity differences, there are efficiency gains from implementing a wealth tax relative to a capital income tax. They simulate a model to attempt to quantify these gains.

increasing burden on normal rates of return, would be less efficient than a tax on capital income.<sup>338</sup>

As with a tax on capital income, a natural question with a tax on wealth is how it will affect the amount of taxed wealth, that is, how sensitive is wealth to wealth taxation. Taxpayers may respond to a wealth tax by changing real savings behavior, avoiding the tax (*e.g.*, shifting wealth into exempt assets), evading the tax (*e.g.*, undervaluing assets), or some combination of the three. Empirical studies are generally based on the experiences of European countries that have implemented wealth taxes, and are therefore relatively limited in number.<sup>339</sup> Additionally some studies use differences in subnational rates to estimate this sensitivity, and results may not generalize to behavioral responses to a national wealth tax.<sup>340</sup> In general, these studies find that taxable wealth is quite sensitive to taxation, but that the degree to which that sensitivity may be attributable to savings changes, avoidance, or evasion varies as wealth tax regimes vary in design.<sup>341</sup>

As people become wealthier, they have an incentive to consume more of everything, including leisure time. Theory therefore suggests that, by reducing the amount of wealth transferrable to heirs, transfer taxes may reduce labor supply of the parent,<sup>342</sup> although it may increase labor supply of the heir.<sup>343</sup> Over 120 years ago, Andrew Carnegie opined that “the parent who leaves his son enormous wealth generally deadens the talents and energies of the son,

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<sup>338</sup> Keeping with the example in the footnote above, with one taxpayer achieving a four-percent rate of return and one taxpayer achieving an eight-percent rate of return, if the normal rate of return is four percent and the second taxpayer achieves excess profit of an additional four percent, then a two-percent rate on wealth could be viewed as falling on the normal rate of return. In other words, the wealth tax applies to the normal rate of return for both taxpayers, but does not apply to the excess profit of the second taxpayer.

<sup>339</sup> For some recent examples see Floris Zoutman, “The Elasticity of Taxable Wealth: Evidence from the Netherlands,” *Working Paper*, 2018, and Katrine Jakobsen, Kristian Jakobsen, Henrik Kleven, and Gabriel Zucman, “Wealth Taxation and Wealth Accumulation: Theory and Evidence from Denmark,” *Quarterly Journal of Economics*, vol. 135, February 2020, pp. 329-388.

<sup>340</sup> For a within country example, see Marius Brühlhart, Jonathan Gruber, Matthias Krapf, and Kurt Schmidheiny, “Behavioral Responses to Wealth Taxes: Evidence from Switzerland,” *Working Paper*, 2021.

<sup>341</sup> For a review of this literature, see Arun Advani and Hannah Tarrant, “Behavioural Responses to a Wealth Tax,” *Wealth Tax Commission Evidence Paper no. 5*, October 2020.

<sup>342</sup> For a review of this issue, see John Pencavel, “Labor Supply of Men: A Survey,” in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. I, North-Holland Publishing Co., 1986.

<sup>343</sup> In recent work, Fabian Kindermann, Lukas Mayr, and Dominik Sachs, “Inheritance taxation and wealth effects on the labor supply of heirs,” *Journal of Public Economics*, vol. 191, November 2020, calibrate a model to estimate how bequest taxes can generate additional labor income tax revenue from changing the labor supply of heirs.

and tempts him to lead a less useful and less worthy life than he otherwise would . . . .”<sup>344</sup> Some empirical economic studies have found evidence of this effect.<sup>345</sup>

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. The incidence and efficiency effects of a tax on capital are discussed above.

A wealth tax may share certain administrative issues with mark-to-market taxation (discussed above). In order to tax the change in the value of assets, assets need to be identified and valued. More information reporting may be needed in order to identify sources of wealth and ownership. Even if all assets and ownership can be identified the question remains how certain assets should be valued. If an asset is freely traded in the market (*e.g.*, a stock or security), this valuation is not difficult to do. Certain other assets may be more difficult to value (*e.g.* closely-held business interests, vested pensions, and life insurance policies).

Additional administrative considerations include those relating to timing. The wealth tax could be imposed annually or in shorter or longer intervals. A date or period on or over which the value is measure also needs to be chosen. For example, the policy could be to impose an annual wealth tax based on wealth as measured on the last day of the calendar year. However, such a system may lead to inaccurate measures of wealth, if, for example, asset prices are volatile on that date. It may, instead, be preferable to have a system for the measurement of wealth that takes an average of asset values over a fixed time period; however, this may be a greater administrative burden for the taxpayer.

An effective wealth tax system may require new and substantial administrative costs on the government and compliance costs on the taxpayer.

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<sup>344</sup> Andrew Carnegie, “The Advantages of Poverty,” in *The Gospel of Wealth and Other Timely Essays*, Edward C. Kirkland (ed.), The Belknap Press of Harvard University Press, 1962, reprint of Carnegie from 1891.

<sup>345</sup> Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, “The Carnegie Conjecture: Some Empirical Evidence,” *Quarterly Journal of Economics*, vol. 108, May 1993, pp. 413-435 and Erlend E. Bø, Elin Halvorsen, and Thor O. Thoresen, “Heterogeneity of the Carnegie Effect,” *Journal of Human Resources*, vol. 54, July 2019, pp. 726-759.

### C. Wealth Transfer Tax Proposals

Federal wealth transfer taxes are levied on the transfer of accumulated wealth. As taxes on transfers of wealth, much of the discussion above on the economic effects of wealth taxes applies to estate and gift taxes as well.

Proposals to strengthen the present-law wealth transfer taxes range from (1) expanding the existing estate and gift taxes by lowering exemptions and increasing tax rates, to (2) enacting more targeted proposals designed to plug perceived holes in the estate, gift, and GST tax bases, to (3) replacing the existing system, which imposes tax on the transferor, with an inheritance tax or income inclusion system that would instead tax the recipient. These proposals are discussed in greater detail, below.

Some economists assert that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.<sup>346</sup> It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.<sup>347</sup> Others believe the bequest motive is not important in national capital formation,<sup>348</sup> and empirical analysis of the existence of a bequest motive has not led to a consensus.<sup>349</sup> Theoretically, it is an open question whether estate and gift taxes

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<sup>346</sup> A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod (eds.), *Rethinking the Estate Tax*, The Brookings Institution, 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, vol. 15, Winter 2001, pp. 205-218.

<sup>347</sup> See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, vol. 89, August 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, vol. 2, Spring 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, vol. 45, June 1992. For attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Krueger (eds.), *The Political Economy of Tax Reform*, The University of Chicago Press, 1992; and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

<sup>348</sup> Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 2, Spring 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

<sup>349</sup> See B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, vol. 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a

encourage or discourage saving, and there has been limited empirical analysis of this specific issue.<sup>350</sup> By raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. Alternatively, estate and gift taxes may have only a moderate behavioral effect on savings and may instead encourage potential transferors to engage in aggressive estate tax planning.<sup>351</sup> For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Some argue that a rationale for a wealth transfer tax system is to break up excessive concentrations of wealth across generations.<sup>352</sup> One avenue by which taxes on the transfer of wealth may affect the concentration of wealth is by creating incentives to distribute accumulated wealth more widely or less widely. Some argue, for example, that because the current U.S. estate tax system is focused solely on the circumstances of the transferor, it does little to break up

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positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, “Savings of the Elderly and Desired Bequests,” *American Economic Review*, vol. 77, June 1987, pp. 298-312. Hurd concludes that “any bequest motive is not an important determinant of consumption decisions and wealth holdings... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities.” *Ibid.*, p. 308.

<sup>350</sup> Wojciech Kopczuk and Joel Slemrod, “The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors,” in William G. Gale and Joel B. Slemrod (eds.), *Rethinking Estate and Gift Taxation*, The Brookings Institution, 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging successful avoidance activity.

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

<sup>351</sup> Wojciech Kopczuk, “Bequest and Tax Planning: Evidence from Estate Tax Returns,” *Quarterly Journal of Economics*, vol. 122, November 2007, pp. 1801-1854, finds that the onset of a terminal illness leads to a significant reduction in the value of estate reported on tax returns and provides evidence of estate planning rather than real reductions in net worth. Jonathan Goupille-Lebre and Jose Infante, “Behavioral Responses to Inheritance Tax: Evidence from Notches in France,” *Journal of Public Economics*, vol. 168, December 2018, pp. 21-34, use French data from a period in which there was a significant policy change to the French inheritance tax and find evidence of real and shifting responses by decedents to the tax, particularly late in life. Their evidence suggests myopia as a reason for late-life rather than throughout-life responses.

<sup>352</sup> Commentators have articulated various rationales for taxing transfers of wealth, including breaking up dynastic concentrations of wealth, maximizing equality of opportunity, and contributing to progressivity in the Federal tax system. The articulated rationales themselves are controversial. Moreover, the extent to which the various alternative means of taxing transfers of wealth, such as an inheritance tax, further these policy goals has been a subject of vigorous debate.

concentrations of wealth or to promote equality of opportunity.<sup>353</sup> Such commentators argue that systems that impose a tax based on the circumstances of the transferee – such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries.<sup>354</sup>

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

### **Lower exemptions and increase tax rates**

Some have proposed expanding application of the present-law wealth transfer taxes by reducing exemption levels, increasing tax rates, or both. Public Law 115-97 generally doubled the estate and gift tax exemption for decedents dying and gifts made during the years 2018 through 2025, with the exemption reverting to the exemptions levels that otherwise would have been in effect for decedents dying and gifts made after 2025.<sup>355</sup> The exemption in effect for 2021 is \$11.7 million per person. Some have proposed accelerating the expiration of the increased exemption amount. Others have proposed returning to the exemptions and rates in effect in 2009 – a \$3.5 million estate tax exemption, a \$1 million gift tax exemption, and a top tax rate of 45 percent (as compared to the present-law 40-percent rate).

Administratively, these changes are relatively straightforward and would mostly require changes in forms and calculations of wealth transfer tax. These changes are subject to the general considerations described above.

### **Reform the present-law estate and gift tax system**

Taxpayers sometimes avoid estate or gift tax through planning that artificially reduces the taxable value of property or places wealth beyond the reach of the tax system. Commentators have proposed various reforms designed to prevent such avoidance.

*Valuation discounts.*—Taxpayers sometimes use valuation discounts to reduce the estate and gift tax values of transferred property. Courts and the IRS have recognized that for various

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<sup>353</sup> Joseph M. Dodge, “Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax,” *SMU Law Review*, vol. 56, Winter 2003, pp. 551, 553 (“[A]ny transferee-oriented tax should possess greater appeal than a transferor-oriented tax with respect to achieving such goals as curbing undue accumulations of wealth or improving equality of opportunity.”).

<sup>354</sup> *Ibid.* at 560-61.

<sup>355</sup> The Joint Committee staff projects that the exemption for decedents dying and gifts made in 2026 will be \$6.44 million per person.

reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. In some cases, however, these reductions in value for estate and gift tax purposes do not accurately reflect economic value. This is particularly true in situations where family members together control property in which interests are transferred. Various reforms have been proposed to curb the use of valuation discounts in situations where the discounted value of a transferred asset might be lower than the true economic value.<sup>356</sup>

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

Some argue that the original concerns that gave rise to the grantor trust rules have diminished and the rules instead are used primarily for transfer tax avoidance, such that some or all of the grantor trust rules should be repealed.<sup>357</sup> Other commentators seek to address the use of IDGTs for transfer tax avoidance by harmonizing or coordinating the income and transfer tax rules governing grantor trusts. For example, one academic would repeal most of the grantor trust rules and replace them with a single rule based on the standards for determining whether a transfer is a completed gift for gift tax purposes.<sup>358</sup> Alternatively, the Treasury Department has proposed harmonizing the income and transfer tax rules by imposing certain transfer tax consequences on a grantor trust.<sup>359</sup>

Second, taxpayers sometimes use grantor retained annuity trusts, or GRATs, to avoid gift or estate tax. A GRAT is an irrevocable grantor trust in which the grantor retains an annuity interest, with the remainder passing to other trust beneficiaries, such as the grantor's children, in a taxable gift. Because the interests are valued using rules that often overstate the value of the

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<sup>356</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, p. 79; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 260; Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 396-405.

<sup>357</sup> Leo L. Schmolka, “FLPs and GRATs: What to Do?,” *Tax Notes*, March 13, 2000 (special supplement), p. 1473; Jay A. Soled and Mitchell Gans, “Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques,” *Tennessee Law Review*, vol. 78, Summer 2011, pp. 973, 1005.

<sup>358</sup> See Robert T. Danforth, “A Proposal for Integrating the Income and Transfer Taxation of Trusts,” *Virginia Tax Review*, vol. 18, Winter 1999, pp. 545, 611-615.

<sup>359</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

retained annuity and understate the value of the remainder interest, the grantor often is able to value the taxable gift at an amount far below the real economic value of the remainder interest.<sup>360</sup> Some have proposed additional requirements for GRATs, including a minimum 10-year term, that likely would sharply limit their utility as tools to avoid gift or estate tax.<sup>361</sup>

Third, taxpayers sometimes avoid GST tax by allocating GST exemption to a “perpetual dynasty trust.” Once a taxpayer allocates GST exemption to a trust, the trust assets often may grow indefinitely, benefiting beneficiaries in multiple successive generations without further GST tax consequences. Some have argued that this result is inconsistent with one of the principal purposes of the GST tax: to impose transfer tax at each generational level.<sup>362</sup>

Policymakers could address the use of perpetual dynasty trusts by prohibiting any allocation of generation skipping tax exemption to a trust that could benefit generations other than the transferor’s children or grandchildren.<sup>363</sup> Others have suggested that the GST exemption allocated to a trust should expire within a specified period of time. For example, the Secretary proposed a rule under which the generation skipping transfer exclusion allocated to a trust terminates on the 90th anniversary of the creation of the trust.<sup>364</sup>

These changes may make the wealth transfer tax system administratively less complex and increase tax collection. However, policymakers should consider how these changes may interact with each other, as well as with the wealth transfer tax system and the income tax system. By broadening the base, these changes would increase the transfer tax liability borne by taxpayers.

### **Implement an inheritance (accessions) tax or income inclusion regime**

Whereas estate and gift taxes are imposed on the transferor of a gift or on the estate of a decedent, an inheritance tax (sometimes referred to as an accessions tax) is imposed on the

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<sup>360</sup> The annuity is valued under tables prescribed by section 7520 of the Code, which requires use of an interest rate equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1). Sec. 2702(a). The remainder interest is valued by subtracting the value of the annuity interest (as derived from the annuity tables) from the value of assets transferred to the trust. If returns on trust assets exceed the rate of return assumed under the annuity tables, any excess appreciation may pass to the remainder beneficiaries and escape gift or estate taxation.

<sup>361</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

<sup>362</sup> Since the original enactment of the GST tax, many States have repealed or sharply limited application of their rules against perpetuities, which limited the maximum duration of a trust.

<sup>363</sup> See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 392.

<sup>364</sup> See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 183-184.



recipient of a gratuitous transfer. Among OECD countries, a significant majority have inheritance tax systems.<sup>365</sup>

Most frequently, an inheritance, or accessions, tax is structured as an annual inheritance tax. An annual inheritance tax is a tax imposed against receipts during a particular year. Most countries that tax transfers of wealth use annual inheritance taxes. As an alternative to an annual inheritance tax, an accessions tax may be structured to apply to cumulative receipts of lifetime gratuitous transfers in excess of a lifetime exemption amount. Relatively few countries currently use such a cumulative accessions tax system.

An inheritance tax, like an estate tax, often provides an exemption from the tax for up to a specified amount of gratuitous transfers. Under an annual inheritance tax, the exemption generally applies on an annual basis to receipts during a particular year. Under a cumulative accessions tax, on the other hand, receipts are cumulated with prior year receipts; only cumulative receipts in excess of a lifetime exemption generally are subject to tax.<sup>366</sup>

Under an income inclusion approach, gifts and bequests generally are treated as income of the recipient and thus are subject to income tax.<sup>367</sup> In Mexico, for example, there is no Federal or State tax on inheritances or gifts, but certain gifts may be included in the recipient's taxable income. Generally, under an income inclusion approach, gifts and bequests are cumulated with the recipient's other income and reported on the recipient's annual income tax return. Because charities generally are exempt from tax on their net income,<sup>368</sup> they would not be subject to tax on receipts of gifts or bequests.

Under present U.S. law, gross income generally excludes the value of property acquired through gift, bequest, devise, or inheritance (section 102(a)) and amounts received under a life insurance contract, if received by reason of the death of the insured (section 101(a)).

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<sup>365</sup> For a more detailed discussion of inheritance taxes in other countries, including selected features of the inheritance tax systems in Germany, France, Spain, Ireland, and Finland, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008.

<sup>366</sup> The amount of exemption typically varies based on the familial relationship of the recipient taxpayer and the transferor, with receipts from closer relatives qualifying for a higher exemption amount. An inheritance tax also may exempt or provide special treatment for certain types of property received. The tax rates also may vary with the relationship between the recipient taxpayer and the transferor, with lower tax rates applying to receipts from closer relatives.

<sup>367</sup> See, e.g., Lily L. Batchelder, "Leveling the Playing Field between Inherited Income and Income from Work through an Inheritance Tax," New York University School of Law, *Law and Economics Research Paper Series*, Working Paper No. 20-11, February 2020, available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3526520](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3526520). For a more detailed discussion of the income inclusion approach, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008.

<sup>368</sup> Sec. 501(a).

Commentators have noted that Congress could adopt an income inclusion approach by repealing sections 102(a) and 101(a).<sup>369</sup>

Proponents of an inheritance tax or income inclusion argue that tax systems that focus on the circumstances of transferees may be more effective in promoting fairness in the tax system. If the burden of any wealth transfer tax falls on the transferee in the form of a reduced inheritance or gift, such commentators argue that systems that compute tax based on the transferee's circumstances are preferable.<sup>370</sup> Some also question whether it is appropriate to exclude gifts and bequests from gross income (as under present U.S. law) while income earned through labor is subject to tax.<sup>371</sup>

Some commentators also argue that the need for complex and costly tax planning in advance of death would be reduced under an inheritance tax system, because the current system is unnecessarily complex.<sup>372</sup> Some might argue, however, that some of this complexity could be addressed through changes to the current estate and gift tax system.

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<sup>369</sup> See Joseph C. Dodge, "Taxing Gratuitous Transfers Under a Consumption Tax," *Tax Law Review*, vol. 51, 1996, pp. 529, 589-93; Joseph C. Dodge, "Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income," *Harvard Law Review*, vol. 93, 1978, p. 1177. Dodge argues that, under a comprehensive tax base, "receipts should be included in income regardless of source or nature." Therefore, a gift or bequest should be included in the income of the recipient. Dodge, "Beyond Estate and Gift Tax Reform," p. 1184. Dodge would not, however, allow the transferor a deduction for the gift or bequest, because "the making of a gift represents the voluntary exercise of the donor's economic power. In other words, the donor's voluntary transfer of the gift itself indicates the donor's ability to pay." *Ibid.*, p. 1186.

<sup>370</sup> See, e.g., Batchelder, *supra*, pp. 46-50.

<sup>371</sup> *Ibid.* at 46-52.

<sup>372</sup> *Ibid.* at 52-53. Batchelder identifies the following aspects of the current system that add complexity and lead to costly and complicated planning: (1) allowing stepped up basis for bequests while requiring carryover basis for gifts; (2) the "tax-exclusivity" of the estate tax system (*i.e.*, the assets used to pay the estate tax are included in the estate tax base) versus the "tax inclusivity" of the gift tax system; and (3) the rules for valuing transfers of property through an entity or in trust, including valuation discounts and valuing annuity interests in grantor retained annuity trusts (both discussed above).

## APPENDIX

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

While both Tables 1 through 4 in this pamphlet and Joint Committee staff standard distributional tables use tax units as the unit of observation to rank by income category, the tables here group tax units into percentiles of the population ranked highest to lowest with a tax-unit size-adjustment, rather than according to dollar-based thresholds without any tax-unit size-adjustment. The tax-unit size-adjustment used for ranking tax units in Tables 1 through 4 is intended to account for the costs of supporting dependents and the economies of scale from shared resources. The adjustment is made by dividing tax unit income by the square-root of the number of individuals in the unit.<sup>373</sup>

The income definition used for Tables 1 through 4 differs from the definition of “expanded income” generally used by the Joint Committee staff. Expanded income is AGI plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad.<sup>374</sup>

Pre-tax/pre-transfer income (used for Tables 2 and 3) excludes transfers that are included in expanded income—the insurance value of Medicare, Social Security benefits, unemployment benefits, and workers' compensation benefits—and includes all additional sources included in national income, such as imputed rents from owner-occupied housing and undistributed retirement account income. This income measure also accounts for some additional Federal taxes, including the allocation of taxes paid by estates and trusts to beneficiaries and the allocation of estate and gift taxes by decedent income groups.

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

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

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<sup>373</sup> This is the same equivalence scale used by the Congressional Budget Office.

<sup>374</sup> See Joint Committee on Taxation, *Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses* (JCX-15-12), February 8, 2012 for a detailed description of expanded income.

taxes on business income of passthroughs) are attributed to labor and capital owners,<sup>375</sup> and excise taxes are attributed to consumers. The approach used for Table 4 follows the Joint Committee staff's standard methodology to distribute individual income and payroll taxes but differs in how corporate and excise taxes are distributed. For corporate taxes, calculations in Table 4 use the same assumption for the labor share but a different approach to allocate the non-labor share among capital owners, for example, ownership by non-profits is allocated more evenly over the income distribution. Excise taxes and custom duties are allocated by after-tax cash income less savings.

Under the approach used in Table 4 and the Joint Committee staff's standard methodology, Federal average tax rates follow roughly the same pattern in a given year; Federal average tax rates increase as income increases. Table A.1 presents the distribution of average tax rates in 2018<sup>376</sup> under the standard methodology.<sup>377</sup> For corresponding income groups, these are generally a few percentage points above the average tax rates calculated in Table 4 of this pamphlet.<sup>378</sup>

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<sup>375</sup> The Joint Committee staff assumes that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital, and five percent of taxes on business income of passthroughs is borne by domestic labor and 95 percent is borne by owners of domestic capital. See Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013.

<sup>376</sup> Average tax rates derived from Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2018* (JCX-3-18), February 7, 2018.

<sup>377</sup> The 50<sup>th</sup> percentile of tax-unit income by tax filing unit is approximately \$48,000. The 90<sup>th</sup> percentile of tax-unit income by tax filing unit is approximately \$167,000. The \$1,000,000 and over category corresponds to the top 0.3 percent of tax filing units.

<sup>378</sup> The income definition used in this pamphlet is broader than the Joint Committee staff's measure of expanded income leading to lower average tax rates.

### A.1–Distribution of Average Tax Rates in 2018 (Projected)

Income Category <sup>1</sup>	Combined Income, Payroll, Excise, and Corporate Taxes <sup>2</sup>	Individual Income Taxes	Payroll Taxes	Excise Taxes	Corporate Taxes
	Average Tax Rate	Average Tax Rate	Average Tax Rate	Average Tax Rate	Average Tax Rate
Less than \$10,000.....	10.10%	-8.80%	10.80%	6.80%	1.30%
\$10,000 to \$20,000.....	-0.90%	-13.60%	10.10%	1.80%	0.70%
\$20,000 to \$30,000.....	3.10%	-6.90%	8.00%	1.30%	0.80%
\$30,000 to \$40,000.....	7.20%	-3.30%	8.40%	1.20%	0.90%
\$40,000 to \$50,000.....	9.60%	-0.90%	8.30%	1.10%	1.10%
\$50,000 to \$75,000.....	13.60%	2.40%	8.90%	1.00%	1.30%
\$75,000 to \$100,000.....	15.80%	4.80%	8.60%	0.80%	1.50%
\$100,000 to \$200,000.....	19.60%	7.70%	9.40%	0.70%	1.90%
\$200,000 to \$500,000.....	24.50%	13.40%	8.10%	0.40%	2.50%
\$500,000 to \$1,000,000.....	28.90%	20.70%	4.80%	0.30%	3.10%
\$1,000,000 and over.....	31.50%	26.30%	2.00%	0.10%	3.10%
<b>Total, All Taxpayers.....</b>	<b>19.60%</b>	<b>9.20%</b>	<b>7.70%</b>	<b>0.70%</b>	<b>2.00%</b>

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

- [1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2018 levels.
- [2] Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

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