

Excerpt

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**OVERVIEW OF THE FEDERAL TAX SYSTEM  
AS IN EFFECT FOR 2013**

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## I. SUMMARY OF PRESENT-LAW FEDERAL TAX SYSTEM

### A. Individual Income Tax

#### In general

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

#### Adjusted gross income

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

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

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<sup>3</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 nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

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

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

## **Taxable income**

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

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer’s filing status. For 2013, the amount of the standard deduction is \$6,100 for single individuals and married individuals filing separate returns, \$8,950 for heads of households, and \$12,200 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.<sup>7</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 State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of \$100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). Additionally, the total amount of itemized deductions allowed is reduced by \$0.03 for each dollar of AGI in excess of \$250,000 (single), \$275,000 (head-of-household), \$300,000 (married filing jointly) and \$150,000 (married filing separately).<sup>8</sup> These threshold amounts are indexed for inflation.

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

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

<sup>8</sup> This rule is sometimes referred to as the “Pease limitation.” A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.

**Table 1.—2013 Standard Deduction and Personal Exemption Values**

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

**Tax liability**

In general

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

Regular tax liability

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

**Table 2.—Federal Individual Income Tax Rates for 2013**

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

Over \$223,050 but not over \$398,350.....	\$49,919.50 plus 33% of the excess over \$223,050
Over \$398,350 but not over \$450,000 .....	\$107,768.50 plus 35% of the excess over \$398,350
Over \$450,000 .....	\$125,846 plus 39.6% of the excess over \$450,000

***Married Individuals Filing Separate Returns***

Not over \$8,925 .....	10% of the taxable income
Over \$8,925 but not over \$36,250.....	\$892.50 plus 15% of the excess over \$8,925
Over \$36,250 but not over \$73,200.....	\$4,991.25 plus 25% of the excess over \$36,250
Over \$73,200 but not over \$111,525 .....	\$14,228.75 plus 28% of the excess over \$73,200
Over \$111,525 but not over \$199,175.....	\$24,959.75 plus 33% of the excess over \$111,525
Over \$199,175 but not over \$225,000.....	\$53,884.25 plus 35% of the excess over \$199,175
Over \$225,000 .....	\$62,923 plus 39.6% of the excess over \$225,000

An individual’s marginal tax rate may be reduced by the allowance of a deduction equal to a percentage of income from certain domestic manufacturing activities.<sup>9</sup>

**Alternative minimum tax liability**

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

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

<sup>9</sup> This deduction is described in more detail below in the summary of the tax rules applicable to corporations.

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

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

#### Special capital gains and dividends rates

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

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

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

#### Credits against tax

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

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

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

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

### **Tax on net investment income**

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.<sup>13</sup> 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.<sup>14</sup>

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<sup>10</sup> A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

<sup>11</sup> The refundable credit may not exceed the maximum credit per child of \$1,000.

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

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

<sup>14</sup> These amounts are not indexed for inflation.



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

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

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

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