5. TAX EXPENDITURES

Tax expenditures are revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. Tax expenditures are an alternative to other Government policy instruments, such as direct expenditures and regulations. The Congressional Budget Act of 1974 (Public Law 93–344) requires that a list of tax expenditures be included in the budget.

Tax expenditures relating to the individual and corporate income taxes are considered first in this chapter, followed by those relating to the unified transfer tax. The supplement at the end of the chapter presents major tax expenditures in the income tax ranked by revenue loss.

Tax expenditures are estimated for fiscal years 1994–2000 using three methods of accounting: revenue loss, outlay equivalent, and present value. The present value approach provides estimates of the revenue losses for tax expenditures that involve deferrals of tax payments into the future or have similar long-term effects.

TAX EXPENDITURES IN THE INCOME TAX

Tax Expenditure Estimates

The Treasury Department prepared all tax expenditure estimates presented here based upon income tax law enacted as of December 31, 1994. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity in years before 1994.

The total revenue loss estimates for tax expenditures for fiscal years 1994–2000 are displayed by the budget's functional categories in table 5–1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and discussion of general features of the tax expenditure concept.

As in prior years, two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify tax expenditures. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method" in the tables. The revenue losses for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the estimates.

Table 5–2 reports the respective portions of the total revenue losses that arise under the individual and corporate income taxes. Listing revenue loss estimates under the individual and corporate headings does not imply that these categories of filers benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the specific tax accounts through which the various provisions are cleared. The ultimate beneficiaries of corporate tax expenditures, for example, could be stockholders, employees, customers, or others, depending on the circumstances.

Table 5–6 at the end of this chapter ranks the major tax expenditures by fiscal year 1996 revenue loss. This table merges several individual entries provided in table 5–1; for example, table 5–6 contains one merged entry for charitable contributions instead of the three separate entries found in table 5–1.

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX

(In millions of dollars)

Provision	Total Revenue Loss							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
National defense:								
Exclusion of benefits and allowances to armed forces personnel	2,000	2,005	2,020	2,030	2,045	2,065	2,085	10,245
International affairs:								
Exclusion of income earned abroad by United States citizens	1,900	2,010	2,125	2,250	2,385	2,525	2,670	11,955
Exclusion of income of foreign sales corporations	1,300	1,400	1,500	1,600	1,700	1,800	1,900	8,500
Inventory property sales source rules exception	1,200	1,300	1,400	1,500	1,600	1,700	1,800	8,000
Interest allocation rules exception for certain financial operations	95	95	95	95	95	95	95	475
Deferral of income from controlled foreign corporations (normal tax method)	1,600	1,700	1,800	2,000	2,200	2,400	2,600	11,000
General science, space, and technology:								
Expensing of research and experimentation expenditures (normal tax method)	2,235	2,390	2,560	2,735	2,930	3,135	3,355	14,715
Credit for increasing research activities	1,370	1,185	675	285	120	40	5	1,125
Suspension of the allocation of research and experimentation expenditures	325	325	....	....	....	....	....	....
Energy:								
Expensing of exploration and development costs:								
Oil and gas	–85	–70	–20	–50	85	165	215	395
Other fuels	15	15	20	20	20	20	20	100
Excess of percentage over cost depletion:								
Oil and gas	785	920	955	1,005	1,060	1,115	1,170	5,305
Other fuels	90	90	95	105	110	120	125	555
Alternative fuel production credit	900	970	1,000	990	940	880	820	4,630
Exception from passive loss limitation for working interests in oil and gas properties	90	100	110	120	130	145	160	665
Capital gains treatment of royalties on coal	10	15	15	15	15	15	15	75
Exclusion of interest on State and local IDBs for energy facilities	175	175	175	175	175	165	165	855
Enhanced oil recovery credit	85	85	80	80	80	75	75	390
New technology credit	60	95	115	125	135	140	150	665
Alcohol fuel credit [1]	15	35	45	50	50	50	50	245
Tax credit and deduction for clean-fuel burning vehicles and properties	50	65	65	65	75	80	85	370
Exclusion from income of conservation subsidies provided by public utilities	100	145	175	190	190	200	200	955
Natural resources and environment:								
Expensing of exploration and development costs, nonfuel minerals	45	45	45	45	50	50	50	240
Excess of percentage over cost depletion, nonfuel minerals	185	185	190	195	200	205	210	1,000
Capital gains treatment of iron ore	*	*	*	*	*	*	*	*
Special rules for mining reclamation reserves	50	50	50	50	50	50	50	250
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	610	625	615	600	585	565	550	2,915
Capital gains treatment of certain timber income	10	15	15	15	15	15	15	75
Expensing of multiperiod timber growing costs	350	370	395	415	440	460	485	2,195
Investment credit and seven-year amortization for reforestation expenditures	40	40	40	45	45	50	50	230
Tax incentives for preservation of historic structures	130	125	125	120	115	115	110	585
Agriculture:								
Expensing of certain capital outlays	70	70	65	65	65	70	70	335
Expensing of certain multiperiod production costs	85	85	80	80	80	85	85	410
Treatment of loans forgiven solvent farmers as if insolvent	10	10	10	10	10	10	10	50
Capital gains treatment of certain income	120	125	125	160	135	140	140	700
Commerce and housing:								
Financial institutions and insurance:								
Exemption of credit union income	765	855	940	1,035	1,140	1,255	1,380	5,750
Excess bad debt reserves of financial institutions	50	55	60	65	70	75	80	350
Exclusion of interest on life insurance savings	9,410	10,365	11,160	12,000	12,900	13,870	14,910	64,840
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
Tax exemption of certain insurance companies	225	235	240	245	255	260	280	1,280
Small life insurance company deduction	110	110	115	120	130	135	140	640
Housing:								
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,760	1,785	1,775	1,715	1,640	1,575	1,510	8,215
Exclusion of interest on State and local debt for rental housing	970	920	870	810	750	685	635	3,750
Deductibility of mortgage interest on owner-occupied homes	48,430	51,270	54,165	57,240	60,490	63,960	67,495	303,350
Deductibility of State and local property tax on owner-occupied homes	14,020	14,845	15,680	16,570	17,515	18,520	19,540	87,825
Deferral of income from post 1987 installment sales	915	935	950	965	980	995	1,010	4,900
Deferral of capital gains on home sales	16,640	17,140	17,850	18,180	18,725	19,290	19,870	93,915
Exclusion of capital gains on home sales for persons age 55 and over	4,690	4,820	4,920	5,010	5,070	5,125	5,120	25,245
Exception from passive loss rules for $25,000 of rental loss	4,765	4,255	4,170	4,120	4,085	4,065	4,055	20,495
Accelerated depreciation on rental housing (normal tax method)	1,145	1,290	1,425	1,580	1,735	1,895	2,055	8,690
Commerce:								
Cancellation of indebtedness	125	115	75	40	15	*	–10	120
Permanent exceptions from imputed interest rules	150	150	150	155	155	160	160	780

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Total Revenue Loss 1994	1995	1996	1997	1998	1999	2000	1996–2000
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	5,745	6,135	6,205	6,335	6,545	6,710	6,865	32,660
Capital gains exclusion of small corporation stock	*	*	*	*	*	30	250	280
Step-up basis of capital gains at death	26,850	28,305	29,480	30,285	30,710	31,160	31,615	153,250
Carryover basis of capital gains on gifts	125	130	135	140	145	150	155	725
Ordinary income treatment of loss from small business corporation stock sale	30	30	35	35	35	35	40	180
Accelerated depreciation of buildings other than rental housing (normal tax method)	5,145	4,920	4,385	3,580	2,675	1,745	1,080	13,465
Accelerated depreciation of machinery and equipment (normal tax method)	17,620	19,400	20,850	21,885	23,215	25,815	28,295	120,060
Expensing of certain small investments (normal tax method)	1,690	1,335	1,070	815	585	425	295	3,190
Amortization of start-up costs (normal tax method)	185	185	190	195	200	200	200	985
Graduated corporation income tax rate (normal tax method)	3,775	3,960	4,120	4,240	4,360	4,510	4,760	21,990
Exclusion of interest on small issue IDBs	690	545	420	325	280	255	230	1,510
Deferral of gains from sale of broadcasting facilities to minority owned business	285	300	315	330	345	360	380	1,730
Treatment of Alaska Native Corporations	45	30	20	15	10	5	5	55
Transportation:								
Deferral of tax on shipping companies	15	15	15	15	15	15	15	75
Exclusion of reimbursed employee parking expenses	1,845	1,930	2,015	2,100	2,190	2,275	2,365	10,945
Exclusion for employer-provided transit passes	30	40	50	65	80	95	110	400
Community and regional development:								
Credit for low-income housing investments	1,925	2,260	2,600	2,945	3,270	3,500	3,560	15,875
Investment credit for rehabilitation of structures (other than historic)	90	80	80	80	70	70	70	370
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	785	830	870	915	960	1,005	1,050	4,800
Exemption of certain mutuals' and cooperatives' income	25	30	30	30	35	35	40	170
Empowerment zones	*	330	440	510	565	595	630	2,740
Education, training, employment, and social services:								
Education:								
Exclusion of scholarship and fellowship income (normal tax method)	795	825	835	845	850	860	870	4,260
Exclusion of interest on State and local student loan bonds	310	305	295	275	255	240	225	1,290
Exclusion of interest on State and local debt for private nonprofit educational facilities	735	750	770	785	810	845	885	4,095
Exclusion of interest on savings bonds transferred to educational institutions	5	5	5	10	10	15	15	55
Parental personal exemption for students age 19 or over	800	815	825	855	895	930	965	4,470
Deductibility of charitable contributions (education)	1,610	1,705	1,810	1,915	2,025	2,140	2,265	10,155
Exclusion of employer provided educational assistance	235	85	....	....	....	....	....	....
Training, employment, and social services:								
Targeted jobs credit	305	395	325	60	40	10	5	440
Exclusion of employer provided child care	675	725	775	830	890	955	1,025	4,475
Exclusion of employee meals and lodging (other than military)	515	545	575	605	640	675	710	3,205
Credit for child and dependent care expenses	2,820	2,900	2,995	3,060	3,135	3,195	3,245	15,630
Credit for disabled access expenditures	160	160	160	165	165	165	170	825
Expensing of costs of removing certain architectural barriers to the handicapped	20	20	20	20	20	20	20	100
Deductibility of charitable contributions, other than education and health	17,805	18,910	19,995	21,135	22,325	23,515	24,945	111,915
Exclusion of certain foster care payments	30	30	35	35	40	40	40	190
Exclusion of parsonage allowances	250	265	285	300	320	345	365	1,615
Health:								
Exclusion of employer contributions for medical insurance premiums and medical care	56,000	60,670	66,620	72,300	78,815	86,245	94,110	398,090
Deductibility of medical expenses	3,380	3,660	3,965	4,295	4,650	5,035	5,455	23,400
Exclusion of interest on State and local debt for private nonprofit health facilities	1,455	1,495	1,535	1,585	1,640	1,700	1,750	8,210
Deductibility of charitable contributions (health)	2,085	2,210	2,340	2,490	2,630	2,750	2,900	13,110
Tax credit for orphan drug research	*	15	....	....	....	....	....	....
Special Blue Cross/Blue Shield deduction	115	125	140	100	170	185	190	785
Income security:								
Exclusion of railroad retirement system benefits	425	425	425	430	435	440	440	2,170
Exclusion of workmen's compensation benefits	4,240	4,475	4,860	5,120	5,380	5,645	5,950	26,955
Exclusion of public assistance benefits (normal tax method)	530	570	590	635	695	740	795	3,455
Exclusion of special benefits for disabled coal miners	100	95	90	85	85	80	75	415
Exclusion of military disability pensions	130	130	130	130	130	130	130	650
Net exclusion of pension contributions and earnings:								
Employer plans	48,750	55,540	59,010	59,490	59,950	60,400	60,850	299,700
Individual Retirement Accounts	5,185	6,245	6,375	6,120	5,675	4,970	3,950	27,090
Keogh plans	3,915	4,435	4,825	5,195	5,595	6,025	6,485	28,125
Exclusion of employer provided death benefits	30	30	35	35	35	40	40	185
Exclusion of other employee benefits:								
Premiums on group term life insurance	2,750	2,880	3,020	3,170	3,325	3,485	3,660	16,660
Premiums on accident and disability insurance	140	150	155	165	175	185	195	875
Income of trusts to finance supplementary unemployment benefits	35	35	35	35	35	35	35	175
Special ESOP rules (other than investment credit)	2,155	1,830	1,680	1,575	1,440	1,310	1,190	7,195
Additional deduction for the blind	30	35	35	35	35	40	40	185

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Total Revenue Loss							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
Additional deduction for the elderly	1,470	1,490	1,510	1,520	1,535	1,540	1,550	7,655
Tax credit for the elderly and disabled	55	55	60	60	65	65	70	320
Deductibility of casualty losses	715	450	315	315	315	315	315	1,575
Earned income credit [2]	4,020	5,110	5,740	6,440	6,715	7,025	7,325	33,245
Social Security:								
Exclusion of social security benefits:								
OASI benefits for retired workers	18,295	16,875	17,395	18,110	18,935	19,840	20,605	94,885
Disability insurance benefits	1,815	1,895	2,100	2,300	2,520	2,750	2,980	12,650
Benefits for dependents and survivors	3,620	3,610	3,730	3,940	4,150	4,365	4,590	20,775
Veterans benefits and services:								
Exclusion of veterans disability compensation	1,910	1,985	1,930	1,975	2,115	2,180	2,245	10,445
Exclusion of veterans pensions	80	75	70	70	75	80	90	385
Exclusion of GI bill benefits	55	70	75	80	85	90	95	425
Exclusion of interest on State and local debt for veterans housing	90	85	80	75	75	75	75	380
General purpose fiscal assistance:								
Exclusion of interest on public purpose State and local debt	11,970	12,350	12,690	13,085	13,535	14,040	14,590	67,940
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	25,745	27,250	28,795	30,425	32,155	34,000	35,880	161,255
Tax credit for corporations receiving income from doing business in U.S. possessions	2,890	2,630	2,680	2,735	2,815	2,960	3,110	14,300
Interest:								
Deferral of interest on savings bonds	1,250	1,360	1,470	1,600	1,730	1,880	2,040	8,720
Addendum—Aid to State and local governments:								
Deductibility of:								
Property taxes on owner-occupied homes	14,020	14,845	15,680	16,570	17,515	18,520	19,540	87,825
Nonbusiness State and local taxes other than on owner-occupied homes	25,745	27,250	28,795	30,425	32,155	34,000	35,880	161,255
Exclusion of interest on:								
Public purpose State and local debt	11,970	12,350	12,690	13,085	13,535	14,040	14,590	67,940
IDBs for certain energy facilities	175	175	175	175	175	165	165	855
IDBs for pollution control and sewage and waste disposal facilities	610	625	615	600	585	565	550	2,915
Small-issue IDBs	690	545	420	325	280	255	230	1,510
Owner-occupied mortgage revenue bonds	1,760	1,785	1,775	1,715	1,640	1,575	1,510	8,215
State and local debt for rental housing	970	920	870	810	750	685	635	3,750
IDBs for airports, docks, and sports and convention facilities	785	830	870	915	960	1,005	1,050	4,800
State and local student loan bonds	310	305	295	275	255	240	225	1,290
State and local debt for private nonprofit educational facilities	735	750	770	785	810	845	885	4,095
State and local debt for private nonprofit health facilities	1,455	1,495	1,535	1,585	1,640	1,700	1,750	8,210
State and local debt for veterans housing	90	85	80	75	75	75	75	380

* $2.5 million or less.
[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts for fiscal year 1996 of $725 million.
[2] The effect on outlays (in millions of dollars) is as follows: $10,990 in 1994; $16,845 in 1995; $20,230 in 1996; $22,755 in 1997; $23,850 in 1998; $25,000 in 1999; amd $26,035 in 2000.
Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method.
All estimates have been rounded to the nearest $5 million. Totals for fiscal years 1996–2000 are computed after rounding for these years.
Figures in Table 5–1 are the arithmetic sums of corporate and individual income tax revenue loss estimates from table 5–2, and do not reflect possible interactions across these two taxes.

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1994	1995	1996	1997	1998	1999	2000	1994	1995	1996	1997	1998	1999	2000
National defense:														
Exclusion of benefits and allowances to armed forces personnel	....	....	....	....	....	....	....	2,000	2,005	2,020	2,030	2,045	2,065	2,085
International affairs:														
Exclusion of income earned abroad by United States citizens	....	....	....	....	....	....	....	1,900	2,010	2,125	2,250	2,385	2,525	2,670
Exclusion of income of foreign sales corporations	1,300	1,400	1,500	1,600	1,700	1,800	1,900	....	....	....	....	....	....	....
Inventory property sales source rules exception	1,200	1,300	1,400	1,500	1,600	1,700	1,800	....	....	....	....	....	....	....
Interest allocation rules exception for certain financial operations	95	95	95	95	95	95	95	....	....	....	....	....	....	....
Deferral of income from controlled foreign corporations (normal tax method)	1,600	1,700	1,800	2,000	2,200	2,400	2,600	....	....	....	....	....	....	....
General science, space, and technology:														
Expensing of research and experimentation expenditures (normal tax method)	2,195	2,345	2,510	2,685	2,875	3,075	3,290	40	45	50	50	55	60	65
Credit for increasing research activities	1,340	1,155	665	285	120	40	5	30	30	10	....	....	....	....
Suspension of the allocation of research and experimentation expenditures	325	325	....	....	....	....	....	....	....	....	....	....	....	....
Energy:														
Expensing of exploration and development costs:														
Oil and gas	–80	–60	–25	–50	70	135	175	–5	–10	5	*	15	30	40
Other fuels	10	10	15	15	15	15	15	5	5	5	5	5	5	5
Excess of percentage over cost depletion:														
Oil and gas	500	620	645	680	715	755	790	285	300	310	325	345	360	380
Other fuels	85	85	90	100	105	115	120	5	5	5	5	5	5	5
Alternative fuel production credit	760	820	850	840	800	750	700	140	150	150	150	140	130	120
Exception from passive loss limitation for working interests in oil and gas properties	....	....	....	....	....	....	....	90	100	110	120	130	145	160
Capital gains treatment of royalties on coal	....	....	....	....	....	....	....	10	15	15	15	15	15	15
Exclusion of interest on State and local IDBs for energy facilities	70	70	70	70	70	65	65	105	105	105	105	105	100	100
Enhanced oil recovery credit	80	80	75	75	75	70	70	5	5	5	5	5	5	5
New technology credit	60	95	115	125	135	140	150	*	*	*	*	*	*	*
Alcohol fuel credit [1]	5	5	5	5	5	5	5	10	30	40	45	45	45	45
Tax credit and deduction for clean-fuel burning vehicles and properties	45	55	55	55	60	60	60	5	10	10	10	15	20	25
Exclusion from income of conservation subsidies provided by public utilities	45	85	110	120	120	125	125	55	60	65	70	70	75	75
Natural resources and environment:														
Expensing of exploration and development costs, nonfuel minerals	35	35	35	35	40	40	40	10	10	10	10	10	10	10
Excess of percentage over cost depletion, nonfuel minerals	165	165	170	175	180	185	190	20	20	20	20	20	20	20
Capital gains treatment of iron ore	....	....	....	....	....	....	....	*	*	*	*	*	*	*
Special rules for mining reclamation reserves	45	45	45	45	45	45	45	5	5	5	5	5	5	5
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	245	250	245	240	235	225	220	365	375	370	360	350	340	330
Capital gains treatment of certain timber income	....	....	....	....	....	....	....	10	15	15	15	15	15	15
Expensing of multiperiod timber growing costs	200	210	225	235	250	260	275	150	160	170	180	190	200	210
Investment credit and seven-year amortization for reforestation expenditures	15	15	15	20	20	20	20	25	25	25	25	25	30	30
Tax incentives for preservation of historic structures	25	25	25	25	25	25	20	105	100	100	95	90	90	90
Agriculture:														
Expensing of certain capital outlays	10	10	10	10	10	10	10	60	60	55	55	55	60	60
Expensing of certain multiperiod production costs	10	10	10	10	10	10	10	75	75	70	70	70	75	75
Treatment of loans forgiven solvent farmers as if insolvent	....	....	....	....	....	....	....	10	10	10	10	10	10	10
Capital gains treatment of certain income	....	....	....	....	....	....	....	120	125	125	160	135	140	140
Commerce and housing:														
Financial institutions and insurance:														
Exemption of credit union income	765	855	940	1,035	1,140	1,255	1,380	....	....	....	....	....	....	....
Excess bad debt reserves of financial institutions	50	55	60	65	70	75	80	....	....	....	....	....	....	....
Exclusion of interest on life insurance savings	265	290	310	335	360	390	415	9,145	10,075	10,850	11,665	12,540	13,480	14,495
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	....	....	....	....	....	....	....
Tax exemption of certain insurance companies	225	235	240	245	255	260	280	....	....	....	....	....	....	....
Small life insurance company deduction	110	110	115	120	130	135	140	....	....	....	....	....	....	....
Housing:														
Exclusion of interest on owner-occupied mortgage subsidy bonds	705	715	705	680	650	625	600	1,055	1,070	1,070	1,035	990	950	910
Exclusion of interest on State and local debt for rental housing	385	365	345	320	295	270	255	585	555	525	490	455	415	380
Deductibility of mortgage interest on owner-occupied homes	....	....	....	....	....	....	....	48,430	51,270	54,165	57,240	60,490	63,960	67,495

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1994	1995	1996	1997	1998	1999	2000	1994	1995	1996	1997	1998	1999	2000
Deductibility of State and local property tax on owner-occupied homes	....	....	....	....	....	....	....	14,020	14,845	15,680	16,570	17,515	18,520	19,540
Deferral of income from post 1987 installment sales	225	235	240	245	250	255	260	690	700	710	720	730	740	750
Deferral of capital gains on home sales	....	....	....	....	....	....	....	16,640	17,140	17,850	18,180	18,725	19,290	19,870
Exclusion of capital gains on home sales for persons age 55 and over	....	....	....	....	....	....	....	4,690	4,820	4,920	5,010	5,070	5,125	5,120
Exception from passive loss rules for $25,000 of rental loss	....	....	....	....	....	....	....	4,765	4,255	4,170	4,120	4,085	4,065	4,055
Accelerated depreciation on rental housing (normal tax method)	705	795	880	975	1,070	1,170	1,270	440	495	545	605	665	725	785
Commerce:														
Cancellation of indebtedness	....	....	....	....	....	....	....	125	115	75	40	15	*	–10
Permanent exceptions from imputed interest rules	....	....	....	....	....	....	....	150	150	150	155	155	160	160
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	....	....	....	....	....	....	....	5,745	6,135	6,205	6,335	6,545	6,710	6,865
Capital gains exclusion of small corporation stock	....	....	....	....	....	....	....	*	*	*	*	*	30	250
Step-up basis of capital gains at death	....	....	....	....	....	....	....	26,850	28,305	29,480	30,285	30,710	31,160	31,615
Carryover basis of capital gains on gifts	....	....	....	....	....	....	....	125	130	135	140	145	150	155
Ordinary income treatment of loss from small business corporation stock sale	....	....	....	....	....	....	....	30	30	35	35	35	35	40
Accelerated depreciation of buildings other than rental housing (normal tax method)	3,495	3,320	2,975	2,440	1,840	1,225	775	1,650	1,600	1,410	1,140	835	520	305
Accelerated depreciation of machinery and equipment (normal tax method)	14,765	16,120	17,105	17,815	18,830	20,805	22,480	2,855	3,280	3,745	4,070	4,385	5,010	5,815
Expensing of certain small investments (normal tax method)	1,035	825	665	510	370	280	210	655	510	405	305	215	145	85
Amortization of start-up costs (normal tax method)	85	85	85	90	90	90	90	100	100	105	105	110	110	110
Graduated corporation income tax rate (normal tax method)	3,775	3,960	4,120	4,240	4,360	4,510	4,760	....	....	....	....	....	....	....
Exclusion of interest on small issue IDBs	265	210	160	125	110	100	90	425	335	260	200	170	155	140
Deferral of gains from sale of broadcasting facilities to minority owned business	285	300	315	330	345	360	380	*	*	*	*	*	*	*
Treatment of Alaska Native Corporations	45	30	20	15	10	5	5	....	....	....	....	....	....	....
Transportation:														
Deferral of tax on shipping companies	15	15	15	15	15	15	15	....	....	....	....	....	....	....
Exclusion of reimbursed employee parking expenses	....	....	....	....	....	....	....	1,845	1,930	2,015	2,100	2,190	2,275	2,365
Exclusion for employer-provided transit passes	....	....	....	....	....	....	....	30	40	50	65	80	95	110
Community and regional development:														
Credit for low-income housing investments	385	450	520	590	655	700	710	1,540	1,810	2,080	2,355	2,615	2,800	2,850
Investment credit for rehabilitation of structures (other than historic)	20	15	15	15	15	15	15	70	65	65	65	55	55	55
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	315	335	350	370	385	405	425	470	495	520	545	575	600	625
Exemption of certain mutuals' and cooperatives' income	25	30	30	30	35	35	40	....	....	....	....	....	....	....
Empowerment zones	....	95	130	155	175	185	195	*	235	310	355	390	410	435
Education, training, employment, and social services:														
Education:														
Exclusion of scholarship and fellowship income (normal tax method)	....	....	....	....	....	....	....	795	825	835	845	850	860	870
Exclusion of interest on State and local student loan bonds	125	120	115	110	100	95	90	185	185	180	165	155	145	135
Exclusion of interest on State and local debt for private nonprofit educational facilities	295	300	310	315	325	340	360	440	450	460	470	485	505	525
Exclusion of interest on savings bonds transferred to educational institutions	....	....	....	....	....	....	....	5	5	5	10	10	15	15
Parental personal exemption for students age 19 or over	....	....	....	....	....	....	....	800	815	825	855	895	930	965
Deductibility of charitable contributions (education)	160	170	180	190	200	210	220	1,450	1,535	1,630	1,725	1,825	1,930	2,045
Exclusion of employer provided educational assistance	....	....	....	....	....	....	....	235	85	....	....	....	....	....
Training, employment, and social services:														
Targeted jobs credit	260	320	270	50	30	5	5	45	75	55	10	10	5	*
Exclusion of employer provided child care	....	....	....	....	....	....	....	675	725	775	830	890	955	1,025
Exclusion of employee meals and lodging (other than military)	....	....	....	....	....	....	....	515	545	575	605	640	675	710
Credit for child and dependent care expenses	....	....	....	....	....	....	....	2,820	2,900	2,995	3,060	3,135	3,195	3,245
Credit for disabled access expenditures	130	130	130	130	130	130	135	30	30	30	35	35	35	35
Expensing of costs of removing certain architectural barriers to the handicapped	15	15	15	15	15	15	15	5	5	5	5	5	5	5
Deductibility of charitable contributions, other than education and health	4,570	4,895	5,160	5,425	5,690	5,910	6,320	13,235	14,015	14,835	15,710	16,635	17,605	18,625
Exclusion of certain foster care payments	....	....	....	....	....	....	....	30	30	35	35	40	40	40
Exclusion of parsonage allowances	....	....	....	....	....	....	....	250	265	285	300	320	345	365

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1994	1995	1996	1997	1998	1999	2000	1994	1995	1996	1997	1998	1999	2000
Health:														
Exclusion of employer contributions for medical insurance premiums and medical care	....	....	....	....	....	....	....	56,000	60,670	66,620	72,300	78,815	86,245	9,410
Deductibility of medical expenses	....	....	....	....	....	....	....	3,380	3,660	3,965	4,295	4,650	5,035	5,455
Exclusion of interest on State and local debt for private nonprofit health facilities	585	600	615	635	660	685	700	870	895	920	950	980	1,015	1,050
Deductibility of charitable contributions (health)	605	640	680	710	750	780	825	1,480	1,570	1,660	1,780	1,880	1,970	2,075
Tax credit for orphan drug research	*	15	....	....	....	....	....	....	....	....	....	....	....	....
Special Blue Cross/Blue Shield deduction	115	125	140	100	170	185	190	....	....	....	....	....	....	....
Income security:														
Exclusion of railroad retirement system benefits	....	....	....	....	....	....	....	425	425	425	430	435	440	440
Exclusion of workmen's compensation benefits	....	....	....	....	....	....	....	4,240	4,475	4,860	5,120	5,380	5,645	5,950
Exclusion of public assistance benefits (normal tax method)	....	....	....	....	....	....	....	530	570	590	635	695	740	795
Exclusion of special benefits for disabled coal miners	....	....	....	....	....	....	....	100	95	90	85	85	80	75
Exclusion of military disability pensions	....	....	....	....	....	....	....	130	130	130	130	130	130	130
Net exclusion of pension contributions and earnings:														
Employer plans	....	....	....	....	....	....	....	48,750	55,540	59,010	59,490	59,950	60,400	60,850
Individual Retirement Accounts	....	....	....	....	....	....	....	5,185	6,245	6,375	6,120	5,675	4,970	3,950
Keogh plans	....	....	....	....	....	....	....	3,915	4,435	4,825	5,195	5,595	6,025	6,485
Exclusion of employer provided death benefits	....	....	....	....	....	....	....	30	30	35	35	35	40	40
Exclusion of other employee benefits:														
Premiums on group term life insurance	....	....	....	....	....	....	....	2,750	2,880	3,020	3,170	3,325	3,485	3,660
Premiums on accident and disability insurance	....	....	....	....	....	....	....	140	150	155	165	175	185	195
Income of trusts to finance supplementary unemployment benefits	....	....	....	....	....	....	....	35	35	35	35	35	35	35
Special ESOP rules (other than investment credit)	2,155	1,830	1,680	1,575	1,440	1,310	1,190	....	....	....	....	....	....	....
Additional deduction for the blind	....	....	....	....	....	....	....	30	35	35	35	35	40	40
Additional deduction for the elderly	....	....	....	....	....	....	....	1,470	1,490	1,510	1,520	1,535	1,540	1,550
Tax credit for the elderly and disabled	....	....	....	....	....	....	....	55	55	60	60	65	65	70
Deductibility of casualty losses	....	....	....	....	....	....	....	715	450	315	315	315	315	315
Earned income credit [2]	....	....	....	....	....	....	....	4,020	5,110	5,740	6,440	6,715	7,025	7,325
Social Security:														
Exclusion of social security benefits:														
OASI benefits for retired workers	....	....	....	....	....	....	....	18,295	16,875	17,395	18,110	18,935	19,840	20.605
Disability insurance benefits	....	....	....	....	....	....	....	1,815	1,895	2,100	2,300	2,520	2,750	2,980
Benefits for dependents and survivors	....	....	....	....	....	....	....	3,620	3,610	3,730	3,940	4,150	4,365	4,590
Veterans benefits and services:														
Exclusion of veterans disability compensation	....	....	....	....	....	....	....	1,910	1,985	1,930	1,975	2,115	2,180	2,245
Exclusion of veterans pensions	....	....	....	....	....	....	....	80	75	70	70	75	80	90
Exclusion of GI bill benefits	....	....	....	....	....	....	....	55	70	75	80	85	90	95
Exclusion of interest on State and local debt for veterans housing	35	35	30	30	30	30	30	55	50	50	45	45	45	45
General purpose fiscal assistance:														
Exclusion of interest on public purpose State and local debt	4,810	4,955	5,095	5,255	5,440	5,645	5,880	7,160	7,395	7,595	7,830	8,095	8,395	8,710
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	....	....	....	....	....	....	....	25,745	27,250	28,795	30,425	32,155	34,000	35,880
Tax credit for corporations receiving income from doing business in U.S. possessions	2,890	2,630	2,680	2,735	2,815	2,960	3,110	....	....	....	....	....	....	....
Interest:														
Deferral of interest on savings bonds	....	....	....	....	....	....	....	1,250	1,360	1,470	1,600	1,730	1,880	2,040
Addendum—Aid to State and local governments:														
Deductibility of:														
Property taxes on owner-occupied homes	....	....	....	....	....	....	....	14,020	14,845	15,680	16,570	17,515	18,520	19,540
Nonbusiness State and local taxes other than on owner-occupied homes	....	....	....	....	....	....	....	25,745	27,250	28,795	30,425	32,155	34,000	35,880
Exclusion of interest on:														
Public purpose State and local debt	4,810	4,955	5,095	5,255	5,440	5,645	5,880	7,160	7,395	7,595	7,830	8,095	8,395	8,710
IDBs for certain energy facilities	70	70	70	70	70	65	65	105	105	105	105	105	100	100
IDBs for pollution control and sewage and waste disposal facilities	245	250	245	240	235	225	220	365	375	370	360	350	340	330
Small-issue IDBs	265	210	160	125	110	100	90	425	335	260	200	170	155	140
Owner-occupied mortgage revenue bonds	705	715	705	680	650	625	600	1,055	1,070	1,070	1,035	990	950	910
State and local debt for rental housing	385	365	345	320	295	270	255	585	555	525	490	455	415	380
IDBs for airports, docks, and sports and convention facilities	315	335	350	370	385	405	425	470	495	520	545	575	600	625
State and local student loan bonds	125	120	115	110	100	95	90	185	185	180	165	155	145	135
State and local debt for private nonprofit educational facilities	295	300	310	315	325	340	360	440	450	460	470	485	505	525

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1994	1995	1996	1997	1998	1999	2000	1994	1995	1996	1997	1998	1999	2000
State and local debt for private nonprofit health facilities	585	600	615	635	660	685	700	870	895	920	950	980	1,015	1,050
State and local debt for veterans housing	35	35	30	30	30	30	30	55	50	50	45	45	45	45

* $2.5 million or less.

[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts for fiscal year 1996 of $725 million.

[2] The effect on outlays (in millions of dollars) is as follows: $10,990 in 1994; $16,845 in 1995; $20,230 in 1996; $22,755 in 1997; $23,850 in 1998; $25,000 in 1999; amd $26,035 in 2000.

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest $5 million.

Interpreting Tax Expenditure Estimates

Tax expenditure revenue loss estimates do not necessarily equal the increase in Federal revenues (or the reduction in budget deficits) that would result from repealing the special provisions, for the following reasons:

- *Eliminating a tax expenditure may have incentive effects that alter economic behavior.* These incentives can affect the resulting magnitudes of the formerly subsidized activity or of other tax preferences or Government programs. For example, if deductibility of mortgage interest were limited, some taxpayers would hold smaller mortgages, with a concomitantly smaller effect on the budget than if no such limits were in force.
- *Tax expenditures are interdependent even without incentive effects.* Repeal of a tax expenditure provision can increase or decrease the the revenue losses associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue losses from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue loss from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, since each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 5–1 are the totals of individual and corporate income tax revenue losses reported in Table 5–2 and do not reflect any possible interactions between the individual and corporate income tax receipts. For this reason, the figures in Table 5–1 (as well as those in Table 5–4, which are also based on summing individual and corporate estimates) should be regarded as approximations.
- *The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except table 5–3.* Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. While such estimates are useful as a measure of cash flows into the Government, they do not always accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals do have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real cost to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful supplement to the cash-basis estimates for provisions involving deferrals, are discussed below.
- *Repeal of some provisions could affect overall levels of income and rates of economic growth.* In principle, repeal of major tax provisions may have some impact on the budget economic assumptions. In general, however, most changes in particular provisions are unlikely to have significant macroeconomic effects.

Present-Value Estimates

Discounted present-value estimates of revenue losses are presented in table 5–3 for certain provisions that involve tax deferrals or similar long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue losses, net of future tax payments, that follow from activities undertaken during calendar year 1995 which cause the deferrals or related revenue effects. For instance, a pension contribution in 1995 would cause a deferral of tax payments on wages in 1995 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 1995 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows.

The discount rate used for the present-value estimates is the interest rate on comparable maturity Treasury debt. As noted in the table, the estimates

Table 5–3. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 1995

(In millions of dollars)

Provision	Present Value of Revenue Loss
Deferral of income from controlled foreign corporations (normal tax method)	1,740
Expensing of research and experimentation expenditures (normal tax method)	2,460
Expensing of exploration and development costs—oil and gas	185
Expensing of exploration and development costs—other fuels	45
Expensing of exploration and development costs—nonfuels	65
Expensing of multiperiod timber growing costs	225
Expensing of certain multiperiod production costs—agriculture	85
Expensing of certain capital outlays—agriculture	65
Deferral of capital gains on home sales	16,455
Accelerated depreciation of rental housing (normal tax method)	1,805
Accelerated depreciation of buildings other than rental housing (normal tax method)	400
Accelerated depreciation of machinery and equipment (normal tax method)	18,745
Expensing of certain small investments (normal tax method)	1,220
Amortization of start-up costs (normal tax method)	160
Deferral of capital gains from sale of broadcasting facilities to minority-owned businesses	260
Deferral of tax on shipping companies	10
Credit for low-income housing investments	2,420
Exclusion of pension contributions and earnings—employer plans	47,895
Exclusion of IRA contributions and earnings	2,185
Exclusions of contribution and earnings for Keogh plans	3,065
Exclusion of interest on State and local public-purpose bonds	16,460
Exclusion of interest on State and local non-public purpose bonds	8,865
Deferral of interest on U.S. savings bonds	615

Note: Provisions with estimates denoted "normal tax method" have no revenue loss under the reference tax law method.

for several of the provisions have been made based on the normal tax baseline, as by definition these provisions would not be treated as tax expenditures under the reference tax law baseline.

Outlay Equivalents

The concept of "outlay equivalents" complements "revenue losses" as a measure of the budget effect of tax expenditures. It is the amount of outlay that would be required to provide the taxpayer the same after-tax income as would be received through the tax preference. The outlay equivalent measure allows a comparison of the cost of the tax expenditure with that of a direct Federal outlay. Outlay equivalents are reported in table 5–4.

The measure is larger than the revenue loss estimate when the tax expenditure is judged to function as a Government payment for service. This occurs because an outlay program would increase the taxpayer's pre-tax income. For some tax expenditures, however, the revenue loss equals the outlay equivalent measure. This occurs when the tax expenditure is judged to function like a price reduction or tax deferral that does not directly enter the taxpayer's pre-tax income.[1]

[1] Budget outlay figures generally reflect the pre-tax price of the resources. In some instances, however, Government purchases or subsidies are exempted from tax by a special tax provision. When this occurs, the outlay figure understates the resource cost of the program and is, therefore, not comparable with other outlay amounts. For example, the outlays for certain military personnel allowances are not taxed. If this form of compensation were treated as part of the employee's taxable income, the Defense Department would have to make larger cash payments to its military personnel to leave them as well off after tax as they are now. The tax subsidy must be added to the tax-exempt budget outlay to make this element of national defense expenditures comparable with other outlays.

TABLE 5–4. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX

(In millions of dollars)

Provision	Outlay Equivalents							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
National defense:								
Exclusion of benefits and allowances to armed forces personnel	2,330	2,335	2,355	2,365	2,385	2,410	2,435	11,950
International affairs:								
Exclusion of income earned abroad by United States citizens	2,875	3,045	3,225	3,410	3,615	3,830	4,045	18,125
Exclusion of income of foreign sales corporations	2,000	2,155	2,310	2,460	2,615	2,770	2,925	13,080
Inventory property sales source rules exception	1,845	2,000	2,155	2,310	2,460	2,615	2,770	12,310
Interest allocation rules exception for certain financial operations	140	140	140	140	140	140	140	700
Deferral of income from controlled foreign corporations (normal tax method)	1,600	1,700	1,800	2,000	2,200	2,400	2,600	11,000
General science, space, and technology:								
Expensing of research and experimentation expenditures (normal tax method)	2,060	2,230	2,390	2,560	2,740	2,930	3,130	14,715
Credit for increasing research activities	2,110	1,820	1,040	440	185	60	10	1,735
Suspension of the allocation of research and experimentation expenditures	465	465	....	....	....	....	....	....
Energy:								
Expensing of exploration and development costs:								
Oil and gas	–85	–70	–20	–50	85	165	215	395
Other fuels	15	15	20	20	20	20	20	100
Excess of percentage over cost depletion:								
Oil and gas	1,130	1,290	1,345	1,420	1,495	1,570	1,645	7,475
Other fuels	130	130	140	150	165	175	185	815
Alternative fuel production credit	1,260	1,370	1,400	1,390	1,330	1,240	1,160	6,520
Exception from passive loss limitation for working interests in oil and gas properties	90	100	110	120	130	145	160	665
Capital gains treatment of royalties on coal	15	20	20	20	20	20	20	100
Exclusion of interest on State and local IDBs for energy facilities	245	250	255	250	245	240	240	1,230
New technology credit	90	150	175	185	200	210	230	1,000
Enhanced oil recovery credit	120	115	110	105	105	105	105	530
Alcohol fuel credit [1]	15	35	45	50	50	50	50	245
Tax credit and deduction for clean-fuel burning vehicles and properties	65	90	90	95	105	110	120	520
Exclusion from income of conservation subsidies provided by public utilities	140	205	245	265	265	280	280	1,335
Natural resources and environment:								
Expensing of exploration and development costs, nonfuel minerals	45	45	45	45	50	50	50	240
Excess of percentage over cost depletion, nonfuel minerals	260	260	265	270	280	285	290	1,390
Capital gains treatment of iron ore	*	*	*	*	*	*	*	*
Special rules for mining reclamation reserves	50	50	50	50	50	50	50	250
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	885	895	885	865	840	815	790	4,195
Capital gains treatment of certain timber income	15	20	20	20	20	20	20	100
Expensing of multiperiod timber growing costs	350	370	395	415	440	460	485	2,195
Investment credit and seven-year amortization for reforestation expenditures	45	45	45	45	50	50	50	240
Tax incentives for preservation of historic structures	130	125	125	120	115	115	110	585
Agriculture:								
Expensing of certain capital outlays	70	65	65	60	65	70	70	330
Expensing of certain multiperiod production costs	90	85	80	80	80	85	85	410
Treatment of loans forgiven solvent farmers as if insolvent	10	10	10	10	10	10	10	50
Capital gains treatment of certain income	160	165	165	175	180	185	185	890
Commerce and housing:								
Financial institutions and insurance:								
Exemption of credit union income	975	1,090	1,200	1,320	1,450	1,595	1,755	7,320
Excess bad debt reserves of financial institutions	70	80	90	95	105	115	120	525
Exclusion of interest on life insurance savings	12,355	13,610	14,660	15,760	16,945	18,215	19,585	85,165
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
Tax exemption of certain insurance companies	315	330	340	345	365	380	395	1,825
Small life insurance company deduction	155	155	160	170	185	190	200	905
Housing:								
Exclusion of interest on owner-occupied mortgage revenue bonds	2,540	2,575	2,545	2,465	2,360	2,260	2,165	11,795

TABLE 5–4. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Outlay Equivalents 1994	1995	1996	1997	1998	1999	2000	1996–2000
Exclusion of interest on State and local debt for rental housing	1,395	1,325	1,245	1,160	1,070	985	900	5,360
Deductibility of mortgage interest on owner-occupied homes	48,430	51,270	54,165	57,240	60,490	63,960	67,495	303,350
Deductibility of State and local property tax on owner-occupied homes	14,020	14,845	15,680	16,570	17,515	18,520	19,540	87,825
Deferral of income from post 1987 installment sales	915	935	950	965	980	995	1,010	4,900
Deferral of capital gains on home sales	16,640	17,140	17,650	18,180	18,725	19,290	19,870	93,715
Exclusion of capital gains on home sales for persons age 55 and over	6,255	6,425	6,580	6,680	6,760	6,835	6,945	33,800
Exception from passive loss rules for $25,000 of rental loss	4,765	4,255	4,170	4,120	4,085	4,065	4,055	20,495
Accelerated depreciation on rental housing (normal tax method)	1,140	1,285	1,430	1,580	1,735	1,890	2,055	8,690
Commerce:								
Cancellation of indebtedness	165	155	100	55	20	*	–15	160
Permanent exceptions from imputed interest rules	150	150	150	155	155	160	160	780
Capital gains (other than agriculture,timber, iron ore, and coal) (normal tax method)	7,680	8,180	8,275	8,445	8,725	8,945	9,155	43,545
Capital gains exclusion of small corporation stock	*	*	*	*	*	40	335	375
Step-up basis of capital gains at death	35,800	37,740	38,305	40,355	40,945	41,545	42,155	203,305
Carryover basis of capital gains on gifts	125	130	135	140	145	150	155	725
Ordinary income treatment of loss from small business corp. stock sale	40	40	50	50	50	50	55	255
Accelerated depreciation of buildings other than rental housing (normal tax method)	5,145	4,925	4,380	3,580	2,675	1,750	1,075	13,460
Accelerated depreciation of machinery and equipment (normal tax method)	17,625	19,400	20,855	21,885	23,210	25,815	28,295	120,060
Expensing of certain small investments (normal tax method)	1,690	1,335	1,070	815	585	420	300	3,190
Amortization of start-up costs (normal tax method)	200	200	210	215	220	225	230	1,100
Graduated corporation income tax rate (normal tax method)	5,395	5,655	5,885	6,060	6,230	6,440	6,800	31,415
Exclusion of interest on small issue industrial development bonds	985	770	595	465	400	370	335	2,165
Deferral of gains from sale of broadcasting facilities to minority owned business	285	300	315	330	345	360	380	1,730
Treatment of Alaska Native Corporations	45	30	20	15	10	5	5	55
Transportation:								
Deferral of tax on shipping companies	15	15	15	15	15	15	15	75
Exclusion of reimbursed employee parking expenses	2,400	2,510	2,625	2,735	2,845	2,960	3,080	14,245
Exclusion for employer-provided transit passes	35	50	65	80	100	115	135	495
Community and regional development:								
Credit for low-income housing investments	1,925	2,260	2,800	2,945	3,270	3,500	3,660	16,175
Investment credit for rehabilitation of structures (other than historic)	90	80	80	80	70	70	70	370
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	1,135	1,200	1,260	1,320	1,385	1,450	1,510	6,925
Exemption of certain mutuals' and cooperatives' income	25	30	30	30	35	35	40	170
Empowerment zones	*	330	440	510	565	600	630	2,745
Education, training, employment, and social services:								
Education:								
Exclusion of scholarship and fellowship income (normal tax method)	875	910	915	925	935	945	955	4,675
Exclusion of interest on State and local student loan bonds	445	440	420	395	370	345	320	1,850
Exclusion of interest on State and local debt for private nonprofit educational facilities	1,055	1,080	1,105	1,135	1,170	1,210	1,260	5,880
Exclusion of interest on savings bonds transferred to educational institutions	5	5	10	10	15	20	20	75
Parental personal exemption for students age 19 or over	890	905	920	955	995	1,035	1,075	4,980
Deductibility of charitable contributions (education)	2,145	2,270	2,415	2,555	2,700	2,855	3,020	13,545
Exclusion of employer provided educational assistance	275	100	....	....	....	....	....	....
Training, employment, and social services:								
Targeted jobs credit	305	395	325	60	40	20	5	450
Exclusion of employer provided child care	880	945	1,010	1,085	1,160	1,245	1,315	5,815
Exclusion of employee meals and lodging (other than military)	625	660	700	740	780	820	865	3,905
Credit for child and dependent care expenses	3,780	3,865	3,980	4,080	4,180	4,260	4,325	20,825
Credit for disabled access expenditures	210	210	210	215	215	215	220	1,075
Expensing of costs of removing certain architectural barriers to the handicapped	20	20	20	20	20	20	20	100

TABLE 5–4. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Outlay Equivalents							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
Deductibility of charitable contributions, other than education and health	23,740	25,040	26,520	28,040	29,625	31,235	33,040	148,460
Exclusion of certain foster care payments	40	40	45	45	50	50	50	240
Exclusion of parsonage allowances	305	325	350	375	400	425	455	2,005
Health:								
Exclusion of employer contributions for medical insurance premiums and medical care	71,150	77,340	85,065	92,470	100,975	100,675	120,975	500,160
Deductibility of medical expenses	3,380	3,660	3,965	4,295	4,650	5,035	5,455	23,400
Exclusion of interest on State and local debt for private nonprofit health facilities	2,100	2,155	2,215	2,285	2,365	2,455	2,540	11,860
Deductibility of charitable contributions (health)	2,780	2,950	3,120	3,290	3,480	3,665	3,880	17,435
Tax credit for orphan drug research	20	*	....	....	....	....	....	....
Special Blue Cross/Blue Shield deduction	160	175	185	140	240	260	270	1,095
Income security:								
Exclusion of railroad retirement system benefits	425	425	425	430	435	440	440	2,170
Exclusion of workmen's compensation benefits	4,240	4,475	4,860	5,120	5,380	5,645	5,950	26,955
Exclusion of public assistance benefits (normal tax method)	530	570	590	635	695	740	795	3,455
Exclusion of special benefits for disabled coal miners	100	95	90	85	85	80	75	415
Exclusion of military disability pensions	130	130	130	130	130	130	130	650
Net exclusion of pension contributions and earnings:								
Employer plans	66,960	75,940	80,410	81,040	81,650	82,230	82,845	408,175
Individual Retirement Accounts	7,590	8,900	9,550	8,940	8,485	7,720	6,555	41,250
Keogh plans	5,295	6,000	6,525	7,030	7,565	8,145	8,770	38,035
Exclusion of employer provided death benefits	40	40	40	45	50	50	55	240
Exclusion of other employee benefits:								
Premiums on group term life insurance	3,570	3,745	3,925	4,120	4,320	4,530	4,755	21,650
Premiums on accident and disability insurance	180	190	200	210	225	235	245	1,115
Income of trusts to finance supplementary unemployment benefits	35	35	35	35	35	35	35	175
Special ESOP rules (other than investment credit)	3,080	2,610	2,400	2,250	2,055	1,870	1,700	10,275
Additional deduction for the blind	40	40	40	45	45	45	50	225
Additional deduction for the elderly	1,780	1,800	1,825	1,840	1,855	1,865	1,875	9,260
Tax credit for the elderly and disabled	70	70	75	75	80	80	85	395
Deductibility of casualty losses	930	585	405	405	405	405	405	2,025
Earned income credit [2]	4,465	5,680	6,380	7,155	7,460	7,805	8,140	36,940
Social Security:								
Exclusion of social security benefits:								
OASI benefits for retired workers	18,295	16,875	17,395	18,110	18,935	19,840	20,605	94,885
Disability insurance benefits	1,815	1,895	2,100	2,300	2,520	2,570	2,980	12,470
Benefits for dependents and survivors	3,620	3,610	3,730	3,940	4,150	4,365	4,590	20,775
Veterans benefits and services:								
Exclusion of veterans disability compensation	1,910	1,985	1,930	1,975	2,115	2,180	2,245	10,445
Exclusion of veterans pensions	80	75	70	70	75	80	90	385
Exclusion of GI bill benefits	55	70	75	80	85	90	95	425
Exclusion of interest on State and local debt for veterans housing	130	120	115	110	105	105	105	540
General purpose fiscal assistance:								
Exclusion of interest on public purpose State and local debt	17,265	17,800	18,295	18,870	19,525	20,250	21,010	97,950
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	25,745	27,250	28,795	30,425	32,155	34,000	35,880	161,255
Tax credit for corporations receiving income from doing business in U.S. possessions	4,160	3,810	3,885	3,960	4,085	4,295	4,510	20,735
Interest:								
Deferral of interest on savings bonds	1,250	1,360	1,470	1,600	1,730	1,880	2,040	8,720
Addendum—Aid to State and local governments:								
Deductibility of:								
Property taxes on owner-occupied homes	14,020	14,845	15,680	16,570	17,515	18,520	19,540	87,825
Nonbusiness State and local taxes other than on owner-occupied homes	25,745	27,250	28,795	30,425	32,155	34,000	35,880	161,255
Exclusion of interest on:								
Public purpose State and local debt	17,265	17,800	18,295	18,870	19,525	20,250	21,010	97,950
IDBs for certain energy facilities	245	250	255	250	245	240	240	1,230
IDBs for pollution control and sewage and waste disposal facilities	885	895	885	865	840	815	790	4,195
Small-issue IDBs	985	770	595	465	400	370	335	2,165

TABLE 5–4. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Outlay Equivalents							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
Owner-occupied mortgage revenue bonds	2,540	2,575	2,545	2,465	2,360	2,260	2,165	11,795
State and local debt for rental housing	1,395	1,325	1,245	1,160	1,070	985	900	5,360
IDBs for airports, docks, and sports and convention facilities	1,135	1,200	1,260	1,320	1,385	1,450	1,510	6,925
State and local student loan bonds	445	440	420	395	370	345	320	1,850
State and local debt for private nonprofit educational facilities	1,055	1,080	1,105	1,135	1,170	1,210	1,260	5,880
State and local debt for private nonprofit health facilities	2,100	2,155	2,215	2,285	2,365	2,455	2,540	11,860
State and local debt for veterans housing	130	120	115	110	105	105	105	540

* $2.5 million or less.
[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts for fiscal year 1996 of $725 million.
[2] The effect on outlays (in millions of dollars) is as follows: $10,990 in 1994; $16,845 in 1995; $20,230 in 1996; $22,755 in 1997; $23,850 in 1998; $25,010 in 1999; amd $26,035 in 2000.
Note: Provisions with estimates denoted ''normal tax method'' have outlay equivalents of zero under the reference tax law method.
All estimates have been rounded to the nearest $5 million.

Tax Expenditure Baselines

A tax expenditure is a preferential exception to the baseline provisions of the tax structure. The 1974 Congressional Budget Act does not, however, specify the baseline provisions of the tax law. Deciding whether provisions are preferential exceptions, therefore, is a matter of judgement. As in prior years, this year's tax expenditure estimates are presented using two baselines: the *normal tax baseline,* which is used by the Joint Committee on Taxation, and the *reference tax law baseline,* which has been used by the Administration since 1983.

The normal tax baseline is patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit.

The reference tax law baseline is closer to existing law. Reference law tax expenditures are limited to special exceptions in the tax code that serve programmatic functions. These functions correspond to specific budget categories such as national defense, agriculture, or health care. While tax expenditures under the reference law baseline are generally tax expenditures under the normal tax baseline, the reverse is not always true.

Both the normal and reference tax baselines allow several major departures from a pure comprehensive income tax. For example:

- *Income is taxable when realized in exchange.* Thus, neither the deferral of tax on unrealized capital gains nor the tax exclusion of imputed income (such as the rental value of owner-occupied housing or farmers' consumption of their own produce) is regarded as a tax expenditure. Both accrued and imputed income would be taxed under a comprehensive income tax.
- *There is a separate corporation income tax.* Under a comprehensive income tax corporate income would be taxed only once—at the shareholder level, whether or not distributed in the form of dividends.
- *Values of assets and debt are not adjusted for inflation.* A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the price level during the time the assets or debt are held. Thus, under a comprehensive income tax baseline the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

While the reference law and normal tax baselines are generally similar, areas of difference include:

- *Tax rates.* The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first $10 million of corporate income are thus regarded as a tax expenditure. Similarly, under the reference law baseline, preferential tax rates for capital gains generally do not yield a tax expenditure; only capital gains treatment of otherwise "ordinary income," such as that from coal and iron ore royalties and the sale of timber and certain agricultural products, is considered a tax expenditure. The alternative minimum tax is treated as part of the baseline rate structure under both the reference and normal tax methods.
- *Income subject to the tax.* Income subject to tax is defined as gross income less the costs of earning that income. The Federal income tax defines gross income to include: (1) consideration received in the exchange of goods and services, including labor services or property; and (2) the taxpayer's share of gross or net income earned and/or reported by another entity (such as a partnership). Under the reference tax rules, therefore, gross income does not include gifts—defined as receipts of money or property that are not consideration in an exchange—or most transfer payments, which can be

thought of as gifts from the Government.[2] The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.[3]

- *Capital recovery.* Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for machinery and equipment is determined using straight-line depreciation over tax lives equal to mid-values of the asset depreciation range (a depreciation system in effect from 1971 through 1980). The normal tax baseline for real property is computed using 40-year straight-line depreciation.
- *Treatment of foreign income.* Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad. Under the normal tax method, however, controlled foreign corporations (CFCs) are not regarded as entities separate from their controlling U.S. shareholders. Thus, the deferral of tax on income received by CFCs is regarded as a tax expenditure under this method. In contrast, except for tax haven activities, the reference law baseline follows current law in treating CFCs as separate taxable entities whose income is not subject to U.S. tax until distributed to U.S. taxpayers. Under this baseline, deferral of tax on CFC income is not a tax expenditure because U.S. taxpayers generally are not taxed on accrued, but unrealized, income.

In addition to these areas of difference, the Joint Committee on Taxation considers a somewhat broader set of tax expenditures under its normal tax baseline than is considered here.

Other Considerations

Additional tax expenditure analysis may be helpful to policy makers. For example, information on the programmatic and economic effects of tax expenditures could be useful. The outputs and efficiency of tax expenditures could then be compared more systematically with direct outlay programs.

In addition, the tax expenditure analysis could be extended beyond the income and transfer taxes to include payroll and excise taxes. The exclusion of certain forms of compensation from the wage base, for instance, reduces payroll taxes, as well as income taxes. Payroll tax exclusions are complex to analyze, however, because they also affect social insurance benefits. Certain targeted excise tax provisions might also be considered tax expenditures. In this case challenges include determining an appropriate baseline.

[2] Gross income does, however, include transfer payments associated with past employment, such as social security benefits.

[3] In the cases of individuals who hold "passive" equity interests in businesses, however, the pro rata shares of sales and expense deductions reportable in a year are limited. A passive business activity is defined to be one in which the holder of the interest, usually a partnership interest, does not actively perform managerial or other participatory functions. The taxpayer may generally report no larger deductions for a year than will reduce taxable income from such activities to zero. Deductions in excess of the limitation may be taken in subsequent years, or when the interest is liquidated.

Descriptions of Income Tax Provisions

Descriptions of the individual and corporate income tax expenditures reported upon in this chapter follow.

National Defense

Benefits and allowances to armed forces personnel.—The housing and meals provided military personnel, either in cash or in kind, are excluded from income subject to tax.

International Affairs

Income earned abroad.—A U.S. citizen or resident alien who resides in a foreign country or who stays in one or more foreign countries for a minimum of 11 out of the past 12 months may exclude $70,000 per year of foreign-earned income. Eligible taxpayers also may exclude or deduct reasonable housing costs in excess of one-sixth of the salary of a civil servant at grade GS –14, step 1. These provisions do not apply to Federal employees working abroad; however, the tax expenditure estimate does reflect certain allowances that are excluded from their taxable income.

Income of Foreign Sales Corporations.—The Foreign Sales Corporation (FSC) provisions exempt from tax a portion of U.S. exporters' foreign trading income to reflect the FSC's sales functions as foreign corporations. These provisions conform to the General Agreement on Tariffs and Trade.

Source rule exceptions.—The worldwide income of U.S. persons is taxable by the United States and a credit for foreign taxes paid is allowed. The amount of foreign taxes that can be credited is limited to the pre-credit U.S. tax on the foreign source income. Two exceptions give rise to tax expenditures: sales of inventory property that reduces the U.S. tax of exporters; and, for financial institutions and certain financing operations of nonfinancial enterprises, an exception from the rules that require allocation of interest expenses between domestic and foreign activities of a U.S. taxpayer.

Income of U.S.-controlled foreign corporations.—The income of foreign corporations controlled by U.S. shareholders is not subject to U.S. taxation. The income becomes taxable only when the controlling U.S. shareholders receive dividends or other distributions from their foreign stockholding. Under the normal tax method, the currently attributable foreign source pre-tax income from such a controlling interest is subject to U.S.

taxation, whether or not distributed. Thus, under the normal tax baseline the excess of controlled foreign corporation income over the amount distributed to a U.S. shareholder gives rise to a tax expenditure in the form of a tax deferral.

GENERAL SCIENCE, SPACE, AND TECHNOLOGY

Expensing R&E expenditures.—Research and experimentation (R&E) projects can be viewed as investments because their benefits accrue for several years when they are successful. It is difficult, however, to identify whether a specific R&E project is completed and successful and, if it is successful, what its expected life will be. For these reasons, the statutory provision that these expenditures may be expensed is considered part of the reference law. Under the normal tax method, however, the expensing of R&E expenditures is viewed as a tax expenditure. The baseline assumed for the normal tax method is that all R&E expenditures are successful and have an expected life of five years.

R&E credit.—Under legislation that expires on July 1, 1995, the tax credit is 20 percent of the qualified expenditures in excess of each year's base amount. This threshold is determined by multiplying a "fixed-base percentage" (limited to a maximum of .16 for existing companies) by the average amount of the company's gross receipts for the four preceding years. The "fixed-base percentage" is the ratio of R&E expenses to gross receipts for the 1984 to 1988 period. Start-up companies that did not both incur qualified expenses and have gross receipts in at least three of the base years are assigned a "fixed-base percentage" of .03. A similar credit with its own separate threshold is provided for taxpayers' basic research grants to universities. Beginning in 1989, the otherwise deductible qualified R&E expenditures were reduced by the amount of the credit.

Allocation of R&E expenditures.—Regulations issued in 1977 were designed to achieve a reasonable allocation of R&E expenses between corporations' domestic and foreign activities, but successive legislative and administrative actions suspended this requirement. Under legislation that expires on July 31, 1995, 50 percent of both U.S.- and foreign-based R&E expenses were allocated to their respective income sources. The remaining R&E expenses then had to be allocated on the basis of gross sales or gross income.

ENERGY

Exploration and development costs.—In the case of successful investments in domestic oil and gas wells, intangible drilling costs, such as wages, the costs of using machinery for grading and drilling, and the cost of unsalvageable materials used in constructing wells, may be expensed rather than amortized over the productive life of the property.

Integrated oil companies may currently deduct only 70 percent of such costs and amortize the remaining 30 percent over five years. The same rule applies to the exploration and development costs of surface stripping and the construction of shafts and tunnels for other fuel minerals.

Percentage depletion.—Independent fuel mineral producers and royalty owners are generally allowed to take percentage depletion deductions rather than cost depletion on limited quantities of output. Under cost depletion, outlays are deducted over the productive life of the property based on the fraction of the resource extracted. Under percentage depletion taxpayers deduct a percentage of gross income from mineral production at rates of 22 percent for uranium, 15 percent for oil, gas and oil shale, and 10 percent for coal. The deduction is limited to 50 percent of net income from the property, except for oil and gas where the deduction can be 100 percent of net property income. Production from geothermal deposits is eligible for percentage depletion at 65 percent of net income, but with no limit on output and no limitation with respect to qualified producers. Unlike depreciation or cost depletion, percentage depletion deductions can exceed the cost of the investment.

Alternative fuel production credit.—A nontaxable credit of $3 per barrel (in 1979 dollars) of oil-equivalent production is provided for several forms of alternative fuels. It is generally available as long as the price of oil stays below $29.50 (in 1979 dollars).

Oil and gas exception to passive loss limitation.—Although owners of working interests in oil and gas properties are subject to the alternative minimum tax, they are exempted from the "passive income" limitations. This means that the working interest-holder, who manages on behalf of himself and all other owners the development of wells and incurs all the costs of their operation, may aggregate negative taxable income from such interests with his income from all other sources. Thus, he will be relieved of the minimum tax rules limit on tax deferrals.

Capital gains treatment of royalties on coal.—Sales of certain coal under royalty contracts can be treated as capital gains. While the top statutory rate on ordinary income is 39.6 percent, the rates on capital gains are limited to 28 percent.

Tax-exempt bonds for energy facilities.—Certain energy facilities, such as municipal electric and gas utilities, may benefit from tax-exempt financing.

Enhanced oil recovery credit.—A credit is provided equal to 15 percent of the taxpayer's costs for tertiary oil recovery on projects in the United States. Qualifying costs include tertiary injectant expenses, intangible drilling and development costs on a qualified enhanced oil recovery project, and amounts incurred for tangible depreciable property.

New technology credits.—A credit of 10 percent is available for investment in solar and geothermal energy facilities. In addition, a credit of 1.5 cents is provided per kilowatt hour of electricity produced from renewable resources such as wind and biomass. The renewable resources credit applies only to electricity produced by a facility placed in service before July 1, 1999.

Alcohol fuel credit.—Gasohol, a motor fuel composed of at least 10 percent alcohol, is exempt from 5.4 of the 18.4 cents per gallon Federal excise tax on gasoline. Smaller exemptions are allowed for motor fuel with lower alcohol content. There is a corresponding income tax credit for alcohol used as a fuel in applications where the excise tax is not assessed. This credit, equal to a subsidy of 54 cents per gallon for alcohol used as a motor fuel, is intended to encourage substitution of alcohol for petroleum-based gasoline. In addition, small producers of ethanol are eligible for a 10 cent per gallon credit.

Credit and deduction for clean-fuel vehicles and property.—A tax credit of 10 percent is provided for electric vehicles. In addition, a deduction is provided for other clean-fuel burning vehicles as well as refueling property.

Exclusion of utility conservation subsidies.—Subsidies by public utilities for customer expenditures on energy conservation measures are excluded from the gross income of the customer.

NATURAL RESOURCES AND ENVIRONMENT

Exploration and development costs.—As is true for fuel minerals, certain capital outlays associated with exploration and development of nonfuel minerals may be expensed rather than depreciated over the life of the asset.

Percentage depletion.—Most nonfuel mineral extractors also make use of percentage depletion rather than cost depletion, with percentage depletion rates ranging from 22 percent for sulphur down to 5 percent for sand and gravel.

Capital gains treatment of iron ore and of certain timber income.—Iron ore and certain timber sold under a royalty contract can be treated as capital gains.

Mining reclamation reserves.—Taxpayers are allowed to establish reserves to cover certain costs of mine reclamation and of closing solid waste disposal properties. Net increases in reserves may be taken as a deduction against taxable income.

Tax-exempt bonds for pollution control and waste disposal.—Interest on State and local government debt issued to finance private pollution control and waste disposal facilities was excludable from income subject to tax. This authorization was repealed for pollution control equipment and limits placed on the amount of debt that can be issued for private waste disposal facilities by the Tax Reform Act of 1986.

Expensing multiperiod timber growing costs.—Generally, costs must be capitalized when goods are produced for inventory used in one's own trade or business, or under contract to another party. Timber production, however, was specifically exempted from these multiperiod cost capitalization rules, creating a special benefit derived from this deferral of taxable income.

Credit and seven-year amortization for reforestation.—A special 10 percent investment tax credit is allowed for up to $10,000 invested annually in clearing land and planting trees for the ultimate production of timber. The same amount of forestation investment may also be amortized over a seven-year period. Without this preference, the amount would have to be capitalized and could be recovered (deducted) only when the trees were sold or harvested 20 or more years later. Moreover, the amount of forestation investment that is amortizable is not reduced by any of the investment credit that is allowed.

Historic preservation.—Expenditures to preserve and restore historic structures qualify for a 20 percent investment credit, but the depreciable basis must be reduced by the full amount of the credit taken.

AGRICULTURE

Expensing certain capital outlays.—Farmers, except for certain agricultural corporations and partnerships, are allowed to deduct certain expenditures for feed and fertilizer, as well as for soil and water conservation measures. Expensing is allowed, even though these expenditures are for inventories held beyond the end of the year, or for capital improvements that would otherwise be capitalized.

Expensing multiperiod livestock and crop production costs.—The production of livestock and crops with a production period of less than two years is exempted from the uniform cost capitalization rules. Farmers establishing orchards, constructing farm facilities for their own use, or producing any goods for sale with a production period of two years or more may elect not to capitalize costs. If they do, they must apply straight-line depreciation to all depreciable property they use in farming.

Loans forgiven solvent farmers.—Farmers are granted special tax treatment by being forgiven the tax liability on certain forgiven debt. Normally, the amount of loan forgiveness is accounted for as a gain (income) of the debtor and he must either report the gain, or reduce his recoverable basis in the property to which the loan relates. If the debtor elects to reduce basis and the amount of forgiveness exceeds his basis in the property, the excess forgiveness is taxable. However, in the case of insolvent (bankrupt) debtors, the amount of loan forgiveness never results in an income tax liability.[4] Farmers with forgiven debt are considered insolvent for tax purposes, and thus qualify for income tax forgiveness.

Capital gains treatment of certain income.—Certain agricultural income, such as unharvested crops, can be treated as capital gains.

Commerce and Housing

This category includes a number of tax expenditure provisions that also affect economic activity in other functional categories. For example, provisions related to investment, such as accelerated depreciation, could also have been classified under the energy, natural resources and environment, agriculture, or transportation categories.

Credit union income.—The earnings of credit unions not distributed to members as interest or dividends are exempt from income tax.

Bad debt reserves.—Only commercial banks with less than $500 million in assets, mutual savings banks, and savings and loan associations are permitted to deduct additions to bad debt reserves in excess of actually experienced losses. The deduction for additions to loss reserves allowed qualifying mutual savings banks and savings and loan associations is 8 percent of otherwise taxable income. To qualify, the thrift institutions must maintain a specified fraction of their assets in the form of mortgages, primarily residential.

Interest on life insurance savings.—Savings in the form of policyholder reserves are accumulated from premium payments and interest is earned on the reserves. Such interest income is not taxed as it accrues nor when received by beneficiaries upon the death of the insured.

Small property and casualty insurance companies.— Insurance companies that have annual net premium incomes of less than $350,000 are exempted from tax; those with $350,000 to $2,100,000 of net premium incomes may elect to pay tax only on the income earned by their investment portfolio.

Insurance companies owned by exempt organizations.—Generally, the income generated by life and property and casualty insurance companies is subject to tax, albeit by special rules. Insurance operations conducted by such exempt organizations as fraternal societies and voluntary employee benefit associations, however, are exempted from tax.

Mortgage housing bonds.—Interest on all mortgage revenue bonds issued by State and local governments is exempt from taxation. Proceeds are used to finance homes purchased by first-time buyers—with low to moderate incomes—of dwellings with prices under 90 percent of the average area purchase price.

There are limits imposed on the amount of tax-exempt State and local government bonds that could be issued to fund private activity. The volume cap for single-family mortgage revenue bonds and multifamily rental housing bonds is combined with the cap for student loans and industrial development bonds (IDBs). The cap is set at $50 per capita or a minimum of $150 million for each State.

States are authorized to issue mortgage credit certificates (MCCs) in lieu of qualified mortgage revenue bonds because the bonds are relatively inefficient subsidies to first-time home buyers. MCCs entitle home buyers to income tax credits for a specified percentage of interest on qualified mortgage loans. In this way, the entire amount of the subsidy flows directly to the home buyer without being partly diverted to financial middlemen or bondholders. A State cannot issue an aggregate annual amount of MCCs greater than 25 percent of its annual ceiling for qualified mortgage bonds. Because of the relationship between MCCs and qualified mortgage bonds, their estimates are presented as one line item in the tables.

Rental housing bonds.—State and local government issues of IDBs are restricted to multifamily rental housing projects in which 20 percent (15 percent in targeted areas) of the units are reserved for families whose income does not exceed 50 percent of the area's median income; or 40 percent for families with incomes of no more than 60 percent of the area median income. Other tax-exempt bonds for multifamily rental projects are generally issued with the requirement that all tenants must be low or moderate income families. Rental housing bonds are subject to the volume cap discussed in the mortgage housing bond section above.

Interest and taxes on owner-occupied homes.—Owner-occupants of homes may deduct mortgage interest and property taxes on their primary and secondary residences as itemized nonbusiness deductions. The mortgage interest deduction is limited to interest on debt no greater than the owner's basis in the residence and, for debt incurred after October 13, 1987, it is limited to no more than $1 million. Interest on up to $100,000 of other debt secured by a lien on a principal or second residence is also deductible, irrespective of the purpose of borrowing, provided the debt does not exceed the fair market value of the residence. Mortgage interest deductions on personal residences are tax expenditures because the taxpayers are not required to report the value of owner-occupied housing services as gross income.

Real property installment sales.—Dealers in real and personal property, i.e., sellers that regularly hold property for sale or resale, cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers, defined as sellers of real property used in their business, are required to pay interest

[4] The insolvent taxpayer's carryover losses and unused credits are extinguished first, and then his basis in assets reduced to no less than amounts still owed creditors. Finally, the remainder of the forgiven debt is excluded from tax.

to the Federal Government on deferred taxes attributable to their total installment obligations in excess of $5 million. Only properties with sales prices exceeding $150,000 are includable in the total. The payment of a market rate of interest eliminates the benefit of the tax deferral. The tax exemption for nondealers with total installment obligations of less than $5,000,000 is, therefore, a tax expenditure.

Capital gains on home sales.—When a primary residence is sold, the homeowner can defer paying a capital gains tax on the proceeds by purchasing or constructing a home of value at least equal to that of the prior home (net of sales and qualified fix-up expenses) within two years. This deferral is a tax expenditure.

Capital gains on sales by owners aged 55 or older.—A taxpayer who is 55 years of age or older at the time of the sale of his residence may elect to exclude from tax up to $125,000 of the gain from its sale. This is a once-in-a-lifetime election. In effect, this provision converts some prior deferrals of tax into forgiveness of tax.

Passive loss real estate exemption.—In general, passive losses may not offset income from other sources. Losses up to $25,000 attributable to certain rental real estate activity, however, are exempted from this rule.

Accelerated depreciation of real property, machinery and equipment.—As previously noted, the tax depreciation allowance provisions are part of the reference law rules, and thus do not cause tax expenditures under the reference method. Under the normal tax method, however, a 40-year tax life for depreciable real property is the norm. So, the statutory depreciation period in effect from 1987 to 1993 for nonresidential properties of 31.5 years, and the 39-year period for property placed in service after February 25, 1993, give rise to tax expenditures. The statutory depreciation period for residential property is 27.5 years, which also results in tax expenditures. Statutory depreciation of machinery and equipment also is somewhat accelerated relative to the normal tax baseline. In addition, tax expenditures arise from pre-1987 tax allowances for real and personal property.

Cancellation of indebtedness.—Individuals are not required to report the cancellation of certain indebtedness as current income. However, if they do not, it would be included as an adjustment in the basis of the underlying property.

Imputed interest rules.—Under reference law rules commonly referred to as original issue discount (OID), both the holder and seller of a financial contract are generally required to report interest earned in the period it accrues, not when the contract payments are made. Moreover, the amount of interest accruable is determined by the actual price paid for the contract, not by the stated or nominal principal and interest stipulated in the contract.[5]

Exceptions to the general rules for accounting for interest expense or income include the following: (a) permission for the mortgagor of his personal residence to treat the discount from the nominal principal of his mortgage loan, commonly called "points," as prepaid interest which is deductible in the year paid, not the year accrued; and (b) sellers of farms and small businesses worth less than $1 million, in exchange for the purchaser's debt obligation, are exempted from the OID rules. This is $750,000 more than the $250,000 exemption that the reference tax law generally allows for such transactions.

Capital gains (other than agriculture, timber, iron ore and coal).—While the top statutory rate on ordinary income is 39.6 percent, the rates on capital gains are limited to 28 percent. This treatment is considered a tax expenditure under the normal tax method but not under the reference law method.

Capital gains exclusion for small business stock.—An exclusion of 50 percent is provided for capital gains from qualified small business stock held by individuals for more than 5 years. A qualified small business is a corporation whose gross assets do not exceed $50 million as of the date of issuance of the stock. Certain activities such as personal services and banking are ineligible for the exclusion.

Step-up in basis of capital gains at death.—Capital gains on assets held at the owner's death are not subject to capital gains taxes. The cost basis of the appreciated assets is adjusted upward to the market value at the owner's date of death. The step-up in the heir's cost basis means that, in effect, the capital gain is forgiven.

Carryover basis of capital gains on gifts.—When a gift is made, the transferred property carries to the donee the donor's basis—the cost that was incurred when the property was first acquired. The carryover of the donor's basis allows a continued deferral of unrealized capital gains.

Ordinary income treatment of losses from sale of small business corporate stock shares.—Up to $100,000 in losses from the sale of such stock may be treated as ordinary losses, and therefore not be subject to the $3,000 annual capital loss write-off limit if the corporation's capitalization is less than $1 million.

Expensing of certain small investments.—Qualifying investments in tangible property up to $17,500 ($10,000 prior to 1993) can be expensed rather than depreciated over time. To the extent that qualifying

[5] Thus, when a borrower on December 31, 1994, issues a promise to pay $1,000 plus interest at 10 percent on December 30, 1995, for a total repayment of $1,100, and accepts $900 from a lender in exchange for the contract, the rules require that both parties: (a) recognize that $900 is the amount lent, so that the effective loan interest rate is not the nominal 10 percent rate but is 22.2 percent; and (b) both report $200 as interest paid or received in 1995, as the case may be.

investment during the year exceeds $200,000, the amount eligible for expensing is decreased. The amount expensed is completely phased out when qualifying investments exceed $217,500.

Business start-up costs.—When an individual or corporation acquires or otherwise enters into a new business, certain start-up expenses, such as the costs of investigating opportunities and legal services, are normally incurred. The taxpayer may elect to amortize these outlays over 60 months although they are similar to other payments he makes for nondepreciable intangible assets that are not recoverable until the business is sold. Under the normal tax method this gives rise to a tax expenditure, while under the reference method it does not.

Graduated corporation income tax rate schedule.—The schedule is graduated, with rates of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, 34 percent on the next $9.925 million, and a rate of 35 percent on income over $10 million. As compared with a flat 35 percent tax rate, the lower rates provide a $111,000 reduction in tax liability for corporations with taxable incomes of $10 million. This benefit is recaptured in the cases of corporations with taxable incomes exceeding $100,000. This is accomplished by (1) a 5 percent additional tax on corporate incomes in excess of $100,000, but less than $335,000 and (2) a 3 percent additional tax on income over $15 million but less than $18.33 million. At this point the $111,000 is fully recaptured. Since this rate schedule is part of the reference tax law, it does not give rise to a tax expenditure under the reference method. A flat corporation income tax rate is taken as the baseline under the normal tax method; therefore the lower rates do yield a tax expenditure under this concept.

Small issue industrial development bonds.—The interest on small issue industrial development bonds (IDBs) issued by State and local governments to finance private business property is excluded from income subject to tax. Depreciable property financed with small issue IDBs must be depreciated, however, using the straight-line method. The tax exemption of small issue bonds expired in 1986, except for small issue IDBs exclusively issued to finance manufacturing facilities for which the tax exemption is permanent. The annual volume of small issue IDBs is subject to the unified volume cap discussed in the mortgage housing bond section above.

Deferral of gains from sale of broadcasting facility to minority owned business.—The voluntary sale of assets generally requires the seller to pay tax on the gain that has accrued over the period of ownership. However, in the case of an involuntary sale, as when an owner's property must be sold in a condemnation preceding, or to implement a change in a government's regulatory policy, the owner is permitted to defer payment of tax, provided the proceeds are reinvested in similar property within a specified period. In 1979, the Federal Communications Commission instituted a policy of encouraging minority group ownership of broadcast licenses. Since that time, the tax laws have been interpreted to permit voluntary sellers of licensed broadcasting facilities to defer payment of capital gains tax when the buyer has been certified as a "minority business," in effect treating the sale as "involuntary."

Treatment of Alaskan Native Corporations losses.—Tax law restricts the ability of profitable corporations to reduce their tax liabilities by merging or buying corporations with accumulated net operating losses (NOLs) and as yet unrefunded claims to investment credits. Alaska Native Corporations have a limited exemption (fifteen years after the NOL or credit claim was first experienced) from these restrictions that includes NOLs and credits claimable prior to April 26, 1988.

TRANSPORTATION

Shipping companies that are U.S. flag carriers.—Certain companies that operate U.S. flag vessels receive a deferral of income taxes on that portion of their income used for shipping purposes, primarily construction, modernization and major repairs to ships, and repayment of loans to finance these qualified investments. Once indefinite, the deferral has been limited to 25 years since January 1, 1987.

Exclusion of reimbursed employee parking expenses.—Parking at or near an employer's business premises that is paid for by the employer is excludable from the income of the employee as a working condition fringe benefit. The maximum amount of the parking exclusion is $155 month (in 1993 dollars), indexed in $5 increments. The tax expenditure estimate does not include parking at facilities owned by the employer.

Exclusion of employer-provided transit passes.—Transit passes, tokens, and fare cards provided by an employer to defray an employee's commuting costs are excludable from the employee's income as a de minimis fringe benefit, if the total value of the benefit does not exceed $60 per month (in 1993 dollars), indexed in $5 increments.

COMMUNITY AND REGIONAL DEVELOPMENT

Low-income housing investment.—Through 1989, a tax credit for investment in new, substantially rehabilitated, and certain unrehabilitated low-income housing was structured to have a present value of 70 percent of construction or rehabilitation costs incurred and was allowed over 10 years. For Federally subsidized projects and those involving unrehabilitated existing low income housing, the credit was structured to have a present value of 30 percent. Beginning on January

1, 1990, the credit was extended at a present value of 70 percent, including projects financed with other Federal subsidies, but only if substantial rehabilitation was done. Notwithstanding the capital grant character of this subsidy, the investor's recoverable basis is not reduced by the substantial credit allowed.

Rehabilitation of structures.—A 10 percent investment tax credit is available for the rehabilitation of buildings that are used for business or productive activities and that were erected before 1936 for other than residential purposes. A full reduction by the amount of the credit is required in the taxpayer's recoverable basis.

Tax-exempt bonds for airports and similar facilities.—Government-owned airports, docks and wharves, as well as high-speed rail facilities that need not be government-owned, may be financed with tax-exempt bonds. These bonds are not covered by a volume cap.

Exemption of certain mutuals' and cooperatives' income.—The incomes of mutual and cooperative telephone and electric companies are exempted from tax if at least 85 percent of their revenues are derived from patron service charges.

Empowerment zones—Qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increasing expensing of investment in equipment, tax-exempt financing, and accelerated depreciation. In addition, a tax credit for contributions to certain community development corporations can be available.

EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES

Scholarship and fellowship income.—Scholarships and fellowships are not excluded from taxable income to the extent they exceed tuition and course-related expenses of the grantee. From an economic point of view, scholarships and fellowships are either gifts not conditioned on the performance of services, or they are rebates of educational costs. Thus, under the reference law method, the exclusion is not a tax expenditure because this method does not include either gifts or price reductions in a taxpayer's gross income. Under the normal tax method, however, the exclusion is considered a tax expenditure because under this method gift-like transfers of government funds—and many scholarships are derived directly or indirectly from government funding—are included in gross income.

Tax-exempt bonds for educational purposes.—Interest on State and local government debt issued to finance student loans or the construction of facilities used by private nonprofit educational institutions is excluded from income subject to tax. The aggregate volume of such private activity bonds that each State may issue during any calendar year is limited.

U.S. savings bonds for education.—Interest on U.S. savings bonds, issued after December 31, 1989, may be excluded from tax if the bonds, plus accrued interest, are transferred to an educational institution as payment for educational expenses. The exclusion from tax is phased out for joint returns with adjusted gross incomes of $63,450 to $93,450 and $42,300 to $57,300 for single and head of household returns in 1994.

Dependent students age 19 or older.—Taxpayers can claim personal exemptions for dependent children age 19 or over who receive parental support payments of $1,000 or more per year, are full-time students, and do not claim a personal exemption on their own tax returns. This preferential arrangement usually generates tax savings because the students' marginal tax rates are more often than not lower than their parents' marginal tax rates.

Charitable contributions.—Contributions to charitable, religious, and certain other nonprofit organizations are allowed as an itemized deduction for individuals, generally up to 50 percent of adjusted gross income. Taxpayers who donate capital assets to charitable or educational organizations can deduct the assets' current value without the taxation of any appreciation in value. Corporations can also deduct charitable contributions up to 10 percent of their pre-tax income. Tax expenditures resulting from the deductibility of contributions are shown separately for educational and other institutions. Contributions to health institutions are reported under the health function.

Employer provided benefits.—Many employers provide employee benefits that are not counted in employee income. The employers' costs for these benefits are deductible business expenses. The exclusion from an employee's income of the value of educational assistance, child care, meals and lodging, as well as ministers' housing allowances and the rental value of parsonages are tax expenditures. The exclusion for educational assistance expired on December 31, 1994. Health and other insurance benefits are reported under the health and income security functions. Certain parking and transit benefits are reported under the transportation function.

Targeted jobs credit.—Employers may claim a tax credit for qualified wages paid to individuals who began work before January 1, 1995, and who are certified as members of various targeted groups. The amount of the credit that may be claimed is 40 percent of the first $3,000 paid during the first year of employment. The 40 percent credit also applies to the summer employment wages paid 16 and 17 year old youths who are members of low income families. Employers must reduce their deduction for wages paid by the amount of the credit claimed.

Child and dependent care expenses.—A tax credit may be claimed by married couples for child and dependent care expenses incurred when one spouse works full time and the other works at least part time or goes to school. The credit may also be claimed by divorced or separated parents who have custody of children, and by single parents. Expenditures up to a maximum $2,400 for one dependent and $4,800 for two or more dependents are eligible for the credit. The credit is equal to 30 percent of qualified expenditures for taxpayers with incomes of $10,000 or less. The credit is reduced to a minimum of 20 percent by one percentage point for each $2,000 of income between $10,000 and $28,000.

Disabled access expenditures.—A credit is provided of 50 percent of eligible disabled access expenditures in excess of $250. The credit is limited to $5,000.

Costs of removing architectural barriers to the handicapped.—The investment cost of making any business accessible to persons suffering physical or mental disabilities may be deducted, rather than capitalized as part of the taxpayer's basis in such property and recovered by subsequent depreciation allowances, as is generally required.

Foster care payments.—Foster parents provide a home and care for children who are wards of the State, under contract with the State. Compensation received for this service is explicitly excluded from the gross incomes of foster parents, making the expenses they incur nondeductible. This activity is, in effect, tax-exempt.

Health

Employer paid medical insurance and expenses.—Employee compensation, in the form of payments by employers for health insurance premiums and other medical expenses, is deducted as a business expense by employers, but it is not included in employee gross income.

Medical care expenses.—Personal expenditures for medical care (including the costs of prescription drugs) exceeding 7.5 percent of the taxpayer's adjusted gross income are deductible.

Tax-exempt bonds for hospital construction.—Interest earned on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

Charitable contributions to health institutions.—Contributions to nonprofit health institutions are allowed as a deduction for individuals and corporations. Tax expenditures resulting from the deductibility of contributions to other charitable institutions are listed under the education, training, employment, and social services function.

Orphan drugs.—To encourage the development of drugs for the treatment of rare diseases or physical conditions, a tax credit is granted equal to 50 percent of the costs for clinical testing that has to be completed before manufacture and distribution are approved by the Food and Drug Administration. Because the drug firm is not required to reduce its deduction for testing expenses (an R&D expenditure) by the amount of this credit, the private cost of clinically testing orphan drugs is reduced substantially. This tax expenditure expired December 31, 1994.

Blue Cross and Blue Shield.—Although these organizations are not qualified as exempt, they are provided exceptions from otherwise applicable insurance company income tax accounting rules that effectively eliminate their tax liabilities.

Income Security

Railroad retirement benefits.—These benefits are not generally subject to the income tax unless the recipient's gross income reaches a certain threshold discussed more fully under the social security function.

Workmen's compensation benefits.—Workmen's compensation provides payments to disabled workers. These benefits, although income to the recipients, are a tax preference because they are not subject to the income tax.

Public assistance benefits.—The exclusion from taxable income of public assistance benefits received by individuals is listed as a tax expenditure under the normal tax method because, under this method, cash transfers from government are included in gross income. In contrast, gifts not conditioned on the performance of services, including transfers from government, are not taxable under the reference law. Therefore, under the reference tax method, the tax exclusion for public assistance benefits is not shown as a tax expenditure.

Special benefits for disabled coal miners.—Disability payments to former coal miners out of the Black Lung Trust Fund, although income to the recipient, are not subject to the income tax.

Military disability pensions.—Most of the military pension income received by current disabled retired veterans is excluded from their income subject to tax.

Pension contributions and earnings.—Certain employer contributions to pension plans, along with individual contributions to individual retirement accounts (IRAs) and amounts set aside by the self-employed, are excluded from adjusted gross income in the year of contribution. The investment income earned by pension funds and other qualifying retirement plans is not taxable when earned, and this deferral is, therefore, also a tax expenditure.

Limited amounts ($9,240 in 1995) can be excluded from an employee's adjusted gross income under a qualified cash or deferred arrangement with the employer (401(k) plan). An employee's own contribution of no more than $9,500 or the 401(k) limitation (whichever is greater) may be excluded annually from an employee's adjusted gross income when placed in a tax-sheltered annuity (403(b) plan).

Employees may deduct annual contributions to an IRA of $2,000 (or 100 percent of compensation, if less), or $2,250 on a joint return with only one spouse earning income, if: (a) neither the individual or spouse is an active participant in an employer-provided retirement plan; or (b) their adjusted gross income falls below $40,000 ($25,000 for a single taxpayer). The allowable IRA deduction is phased out between $40,000 and $50,000 for a joint return and $25,000 and $35,000 for a single return. Beyond these income limits, nondeductible contributions to IRAs are available to taxpayers who are active participants in employer-provided retirement plans. Self-employed persons can make deductible contributions to their own retirement (Keogh) plans equal to 25 percent of their income, up to a maximum of $30,000 per year.

Employer provided insurance benefits.—Many employers cover part or all the cost of premiums or payments for: (a) employees' life insurance benefits; (b) accident and disability benefits; (c) death benefits; and (d) supplementary unemployment benefits. The amounts are deductible by the employers and are excluded as well from employees' gross incomes for tax purposes.

Employer Stock Ownership Plan (ESOP) provisions.—A special type of employee benefit plan, organized as a trust, is tax-exempt. Employer-paid contributions (the value of stock issued to the ESOP) are deductible by the employer as part of employee compensation costs. They are not included in the employees' gross income for tax purposes, however, until they are paid out as benefits. The following special income tax provisions for ESOPs are intended to increase ownership of corporations by their employees: (1) annual employer contributions are subject to less restrictive limitations (percentages of employees' cash compensation); (2) ESOPs may borrow to purchase employer stock, guaranteed by their agreement with the employer that the debt will be serviced by his payment (deductible by him) of a portion of wages (excludable by the employees) to service the loan; (3) ESOPs' lenders may exclude half the interest from their gross income; (4) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (5) dividends paid to ESOP-held stock are deductible by the employer.

Support of the aged and the blind.—Taxpayers who are blind or 65 years of age or older may take an additional $950 standard deduction if single, or $750 if married. In addition, individuals who are 65 years of age or older, or who are permanently disabled, can take a tax credit equal to 15 percent of the sum of their earned and retirement income. Qualified income is limited to no more than $2,500 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older, and up to $3,750 for joint returns where both spouses are 65 years of age or older. These limits are reduced by one-half of the taxpayer's adjusted gross income over $7,500 for single individuals and $10,000 for married couples filing a joint return.

Casualty losses.—Neither the purchase of property nor insurance premiums to protect its value are deductible as costs of earning income; therefore, reimbursement for insured loss of such property is not reportable as a part of gross income. However, a special provision permits relief for taxpayers suffering an uninsured loss. They may deduct casualty and theft losses of more than $100 each, but only to the extent that total losses during the year exceed 10 percent of adjusted gross income.

Earned income credit.—This credit may be claimed by low income workers. For a family with one qualifying child, the credit is 34 percent of the first $6,160 of earned income in 1995. The credit is 36 percent of the first $8,640 of income for a family with two or more qualifying children. When the taxpayer's income exceeds $11,290, the credit is phased out at the rate of 15.98 percent (20.22 percent if two or more qualifying children are present). It is completely phased out at $24,396 of adjusted gross income ($26,673 if two or more qualifying children are present).

Beginning in 1994, the credit may also be claimed by workers who do not have children living with them. Qualifying workers must be at least age 25 and may not be claimed as a dependent on another taxpayer's return. The credit is not available to workers age 65 or older. In 1995, the credit is 7.65 percent of the first $4,100 of earned income. When the taxpayer's income exceeds $5,130, the credit is phased out at the rate of 7.65 percent. It is completely phased out at $9,230 of adjusted gross income.

For workers with or without children, the income level at which the credit's phase-outs begin and the maximum amounts of income on which the credit can be taken are adjusted for inflation. Earned income tax credits in excess of tax liabilities are refundable to individuals, and as such are paid by the Federal Government. This portion of the credit is included in outlays, while the amount that offsets tax liabilities is shown as a tax expenditure.

Social Security

Old Age and Survivors Insurance (OASI) benefits for retired workers.—Social security benefits that exceed the beneficiary's contributions out of taxed income are deferred employee compensation and the deferral of tax on that compensation is a tax expenditure. These additional retirement benefits are paid for partly by employers' contributions that were not included in employees' taxable compensation. Portions (reaching as much as 85 percent) of recipients' social security and tier 1 railroad retirement benefits are included in the income tax base, however, if the recipient's provisional income exceeds certain base amounts. Provisional income is equal to adjusted gross income plus foreign or U.S. possession income and tax-exempt interest, and one half of social security and tier 1 railroad retirement benefits. The tax expenditure is limited to the portion of the benefits received by taxpayers who are below the base amounts at which 85 percent of the benefits are taxable.

Social Security benefits for the disabled, dependents and survivors.—Benefit payments from the Social Security Trust Fund, for disability and for dependents and survivors, are excluded from the beneficiaries' gross incomes, and thus give rise to tax expenditures.

VETERANS BENEFITS AND SERVICES

Veterans benefits.—All compensation due to death or disability and pensions paid by the Veterans Administration are excluded from taxable income.

Tax-exempt mortgage bonds for veterans.—Interest earned on general obligation bonds issued by State and local governments to finance housing for veterans is excluded from taxable income. The issuance of such bonds is limited, however, to five pre-existing State programs and to amounts based upon previous volume levels for the period January 1, 1979 to June 22, 1984. Furthermore, future issues are limited to veterans who served on active duty before 1977.

GENERAL GOVERNMENT

Public purpose State and local debt.—Interest on State and local government debt, issued to finance government activities, is excluded from Federal taxation. State and local governments, therefore, can sell debt obligations at a lower interest cost than would be possible if such interest were subject to tax. Only the excluded interest on bonds for public purposes, such as schools, roads, and sewers, is included here.

Nonbusiness State and local taxes excluding home-owner property taxes.—The deductibility of nonbusiness State and local income and personal property taxes gives indirect assistance to these governments by reducing the costs of the services they provide.

Business income earned in U.S. possessions.—Under certain conditions, U.S. corporations receiving income from an active trade or business, or from investments located in a U.S. possession, can claim a special credit against U.S. tax otherwise due.

INTEREST

U.S. savings bonds.—The interest on U.S. savings bonds is not taxable until the bonds are redeemed, thereby deferring tax liability. The deferral is equivalent to an interest-free loan and, therefore, it is a tax expenditure.

TAX EXPENDITURES IN THE UNIFIED TRANSFER TAX

Exceptions to the general terms of the Federal unified transfer tax favor particular transferees or dispositions of transferors, similar to Federal direct expenditure or loan programs. The transfer tax provisions identified as tax expenditures satisfy the reference law criteria for inclusion in the tax expenditure budget that were described above. There is no generally accepted normal tax baseline for transfer taxes.

Unified Transfer Tax Reference Rules

The reference tax rules for the unified transfer tax from which departures represent tax expenditures include:

- *Definition of the taxpaying unit.* The payment of the tax is the liability of the transferor whether the transfer of cash or property was made by gift or bequest.
- *Definition of the tax base.* The base for the tax is the transferor's cumulative, taxable lifetime gifts made plus the net estate at death. Gifts in the tax base are all annual transfers in excess of $10,000 to any donee except the donor's spouse. Excluded are, however, payments on behalf of family members' educational and medical expenses, as well as the cost of ceremonial gatherings and celebrations that are not in honor of the donor.
- *Property valuation.* In general, property is valued at its fair market value at the time it is transferred. This is not necessarily the case in the valuation of property for transfer tax purposes. Executors of estates are provided the option to value assets at the time of the testator's death or up to six months later.
- *Tax rate schedule.* A single graduated tax rate schedule applies to all taxable transfers. This is reflected in the name of the "unified transfer tax" that has replaced the former separate gift and estate taxes. The tax rates vary from 18 percent on the first $10,000 of aggregate taxable transfers, to 55 percent on amounts exceeding $3 million. A $192,800 lifetime credit is provided against the tax in determining the final amount of transfer taxes that are due and payable. This allows each

taxpayer to make a $600,000 tax-free transfer of assets that otherwise would be liable to the unified transfer tax.[6]

- *Time when tax is due and payable.* Donors are required to pay the tax annually as gifts are made. The generation-skipping transfer tax is payable by the donees whenever they accede to the gift. The net estate tax liability is due and payable within nine months after the decedent's death. The Internal Revenue Service may grant an extension of up to 10 years for a reasonable cause. Interest is charged on the unpaid tax liability at a rate equal to the cost of Federal short-term borrowing, plus three percentage points.

Tax Expenditures by Function

The estimates of tax expenditures in the Federal unified transfer tax for fiscal years 1994–2000 are displayed by functional category in table 5–5. Outlay equivalent estimates are similar to revenue loss estimates for transfer tax expenditures and, therefore, are not shown separately. A description of the provisions follows.

Natural Resources and Environment

Donations of conservation easements.—Bequests for conservation are excluded from taxable estates. A conservation bequest is the value of property and easements (in perpetuity) to such property the use of which is restricted to any one or more of the following: the public for outdoor recreation; protection of the natural habitats of fish, wildlife, plants, etc.; scenic enjoyment of the public; and preservation of historic land areas and structures. Similar conservation gifts are excluded from the gift tax base and are also deductible from the donor's otherwise taxable income in the year of the gift.

Agriculture

Special use valuation of farms.—Farmland owned and operated by a decedent and/or a member of the family may be valued for estate tax purposes on the basis of its "continued use" as a farm if: the farmland is at least 25 percent of the decedent's gross estate; the entire value of all farm property is at least 50 percent of the gross estate; and family heirs to the farm agree to continue to operate the property as a farm for at least 10 years. Since continued use valuation of farmland is frequently substantially less than the fair market value, the resulting reduction in tax liability serves as a subsidy to the continued operation of family farms.

Tax deferral of closely held farms.—Decedents' estates may use a preferential, extended installment payment period of five to 15 years to discharge estate tax liabilities if the value of the farm properties exceeds 35 percent of the net estates. The interest charged is only 4 percent for the first five years, rather than the standard Federal short-term borrowing rate plus three percentage points, which applies during the last 10 years of the repayment period.

Commerce and Housing Credit

Special use valuation of closely held businesses.—The two estate tax incentives to family farming are also available to the estates of owners of nonfarm family businesses. If the same three conditions previously described are met, the real property in their estates is eligible for continued use valuation.

Tax deferral of closely held businesses.—Nonfarm family businesses that satisfy the net estate requirements qualify for preferential 15 year deferred estate

[6] An additional tax, at a flat rate of 55 percent, is imposed on lifetime, generation-skipping transfers in excess of $1 million. It is considered a generation-skipping transfer whenever the transferee is at least two generations younger than the transferor, as it would be in the case of transfers to grandchildren or great-grandchildren. The liability of this tax is on the recipients of the transfer.

TABLE 5–5. REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE FEDERAL UNIFIED TRANSFER TAX

(In millions of dollars)

Provision	Fiscal Years							
	1994	1995	1996	1997	1998	1999	2000	1996–2000
Natural Resources and Environment:								
Deductions for donations of conservation easements	*	*	*	*	*	*	*	*
Agriculture:								
Special use valuation of farm real property	70	75	80	85	90	95	100	450
Tax deferral of closely held farms	55	60	65	70	75	80	85	375
Commerce:								
Special use valuation of real property used in closely held businesses	20	20	20	25	25	25	25	120
Tax deferral of closely held business	10	10	10	10	15	15	15	65
Education, training, employment, and social services:								
Deduction for charitable contributions (education)	530	580	620	660	700	750	800	3,530
Deduction for charitable contributions (other than education and health)	1,565	1,700	1,820	1,945	2,065	2,200	2,350	10,380
Health:								
Deduction for charitable contributions (health)	480	525	565	610	650	700	755	3,280
General government:								
Credit for State death taxes	2,975	3,275	3,525	3,800	4,090	4,380	4,695	20,490

* $2.5 million or less.
Note: All estimates have been rounded to the nearest $5 million.

tax payment. To be eligible for this special provision, the value of stock in closely held corporations must exceed 35 percent of the decedent's gross estate, less debt and funeral expenses.

Education, Training, Employment, and Social Services

Bequests to tax-exempt organizations.—These bequests are deductible from decedent's otherwise taxable lifetime transfers.

Health

Bequests to health providers.—Such bequests, that are exempt from the income tax, are deductible from otherwise taxable lifetime transfers of decedents.

General Government

State and local death taxes.—A credit is allowed for state death taxes against any Federal estate tax that otherwise would be due. The amount of the state death tax credit is determined by a rate schedule that reaches a limit of 16 percent of the taxable estate in excess of $60,000.

TABLE 5–6. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 1996 REVENUE LOSS

(In millions of dollars)

Provision	1996	1996–2000
Exclusion of employer contributions for medical insurance premiums and medical care	66,620	398,090
Net exclusion of employer pension plan contributions and earnings	59,010	299,700
Deductibility of mortgage interest on owner-occupied homes	54,165	303,350
Step-up basis of capital gains at death	29,480	153,250
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	28,795	161,255
Deductibility of charitable contributions (all types)	24,145	135,180
Accelerated depreciation of machinery and equipment (normal tax method)	20,850	120,060
Deferral of capital gains on home sales	17,850	93,915
Exclusion of OASI benefits for retired workers	17,395	94,885
Deductibility of State and local property tax on owner-occupied homes	15,680	87,825
Exclusion of interest on public purpose State and local debt	12,690	67,940
Exclusion of interest on life insurance savings	11,160	64,840
Exclusion of interest on State and local debt for various non-public purposes	7,405	36,020
Net exclusion of Individual Retirement Account conbtributions and earnings	6,375	27,090
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	6,205	32,660
Earned income credit [1]	5,740	33,245
Exclusion of capital gains on home sales for persons age 55 and over	4,920	25,245
Exclusion of workmen's compensation benefits	4,860	26,955
Net exclusion of Keogh plan contributions and earnings	4,825	28,125
Accelerated depreciation of buildings other than rental housing (normal tax method)	4,385	13,465
Exception from passive loss rules for $25,000 of rental loss	4,170	20,495
Graduated corporation income tax rate (normal tax method)	4,120	21,990
Deductibility of medical expenses	3,965	23,400
Exclusion of social security benefits for dependents and survivors	3,730	20,775
Premiums on group term life insurance	3,020	16,660
Credit for child and dependent care expenses	2,995	15,630
Tax credit for corporations receiving income from doing business in U.S. possessions	2,680	14,300
Credit for low-income housing investments	2,600	15,875
Expensing of research and experimentation expenditures (normal tax method)	2,560	14,715
Exclusion of income earned abroad by United States citizens	2,125	11,955
Exclusion of social security disability insurance benefits	2,100	12,650
Exclusion of benefits and allowances to armed forces personnel	2,020	10,245
Exclusion of reimbursed employee parking expenses	2,015	10,945
Exclusion of veterans disability compensation	1,930	10,445
Deferral of income from controlled foreign corporations (normal tax method)	1,800	11,000
Special ESOP rules (other than investment credit)	1,680	7,195
Additional deduction for the elderly	1,510	7,655
Exclusion of income of foreign sales corporations	1,500	8,500
Deferral of interest on savings bonds	1,470	8,720
Accelerated depreciation on rental housing (normal tax method)	1,425	8,690
Inventory property sales source rules exception	1,400	8,000
Excess of percentage over cost depletion (fuel and nonfuel minerals)	1,240	6,860
Expensing of certain small investments (normal tax method)	1,070	3,190
Alternative fuel production credit	1,000	4,630
Deferral of income from post 1987 installment sales	950	4,900
Exemption of credit union income	940	5,750
Exclusion of scholarship and fellowship income (normal tax method)	835	4,260
Parental personal exemption for students age 19 or over	825	4,470
Exclusion of employer provided child care	775	4,475
Credit for increasing research activities	675	1,125
Exclusion of public assistance benefits (normal tax method)	590	3,455
Exclusion of employee meals and lodging (other than military)	575	3,205
Empowerment zones	440	2,740
Exclusion of railroad retirement system benefits	425	2,170
Expensing of multiperiod timber growing costs	395	2,195
Targeted jobs credit	325	440
Deferral of gains from sale of broadcasting facilities to minority owned business	315	1,730
Deductibility of casualty losses	315	1,575
Exclusion of parsonage allowances	285	1,615
Tax exemption of certain insurance companies	240	1,280
Amortization of start-up costs (normal tax method)	190	985
Exclusion from income of conservation subsidies provided by public utilities	175	955
Credit for disabled access expenditures	160	825
Premiums on accident and disability insurance	155	875
Permanent exceptions from imputed interest rules	150	780
Special Blue Cross/Blue Shield deduction	140	785
Carryover basis of capital gains on gifts	135	725
Exclusion of military disability pensions	130	650
Capital gains treatment of certain agricultural income	125	700

TABLE 5–6. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 1996 REVENUE LOSS—Continued

(In millions of dollars)

Provision	1996	1996–2000
Tax incentives for preservation of historic structures	125	585
New technology credit	115	665
Small life insurance company deduction	115	640
Exception from passive loss limitation for working interests in oil and gas properties	110	665
Interest allocation rules exception for certain financial operations	95	475
Exclusion of special benefits for disabled coal miners	90	415
Expensing of certain multiperiod production costs	80	410
Enhanced oil recovery credit	80	390
Investment credit for rehabilitation of structures (other than historic)	80	370
Exclusion of GI bill benefits	75	425
Cancellation of indebtedness	75	120
Exclusion of veterans pensions	70	385
Tax credit and deduction for clean-fuel burning vehicles and properties	65	370
Expensing of certain capital outlays	65	335
Excess bad debt reserves of financial institutions	60	350
Tax credit for the elderly and disabled	60	320
Exclusion for employer-provided transit passes	50	400
Special rules for mining reclamation reserves	50	250
Expensing of exploration and development costs (fuel and nonfuel minerals)	45	735
Alcohol fuel credit [2]	45	245
Investment credit and seven-year amortization for reforestation expenditures	40	230
Exclusion of certain foster care payments	35	190
Additional deduction for the blind	35	185
Exclusion of employer provided death benefits	35	185
Ordinary income treatment of loss from small business corporation stock sale	35	180
Income of trusts to finance supplementary unemployment benefits	35	175
Exemption of certain mutuals' and cooperatives' income	30	170
Expensing of costs of removing certain architectural barriers to the handicapped	20	100
Treatment of Alaska Native Corporations	20	55
Capital gains treatment of certain timber income	15	75
Deferral of tax on shipping companies	15	75
Capital gains treatment of royalties on coal	15	75
Treatment of loans forgiven solvent farmers as if insolvent	10	50
Exclusion of interest on savings bonds transferred to educational institutions	5	55
Special alternative tax on small property and casualty insurance companies	5	25
Capital gains exclusion of small corporation stock	*	280

* $2.5 million or less.
[1] The effect of the earned income tax credit on outlays is $20,230 million in 1996 and $117,870 million for 1996–2000.
[2] In addition, the partial exemption from the excide tax for alcohol fuels results in a reduction in excise tax receipts for 1996 of $725 million.
Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method.
All estimates have been rounded to the nearest $5 million.
Figures in table 5–6 are the arithmetic sums of corporate and individual income tax revenue loss estimates from table 6–2, and do not reflect possible interactions across these two taxes.