

## 19. TAX EXPENDITURES

The Congressional Budget Act of 1974 (Public Law 93-344) requires that a list of “tax expenditures” be included in the budget. Tax expenditures are defined in the law as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.” These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs. Identification and measurement of tax expenditures depends importantly on the baseline tax system against which the actual tax system is compared.

The largest reported tax expenditures tend to be associated with the individual income tax. For example, sizeable deferrals, deductions and exclusions are provided for employer contributions for medical insurance, pension contributions and earnings, capital gains, and payments of State and local individual income and property taxes. Reported tax expenditures under the corporate income tax tend to be related to timing differences in the rate of cost recovery for various investments. As is discussed below, the extent to which these provisions are classified as tax expenditures varies according to the conceptual baseline used.

Each tax expenditure estimate in this chapter was calculated assuming other parts of the tax code remained unchanged. The estimates would be different if all tax expenditures or major groups of tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this

chapter does not present a grand total for the estimated tax expenditures. Moreover, past tax changes entailing broad elimination of tax expenditures were generally accompanied by changes in tax rates or other basic provisions, so that the net effects on Federal revenues were considerably (if not totally) offset.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2005–2011 using two methods of accounting: revenue effects and present values. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

The section of the chapter on performance measures and economic effects presents information related to assessment of the effect of tax expenditures on the achievement of program performance goals. This section is a complement to the Government-wide performance plan required by the Government Performance and Results Act of 1993.

The 2004, 2005, and 2006 Budgets included a thorough review of important ambiguities in the tax expenditure concept. In particular, this review focused on defining tax expenditures relative to a comprehensive income tax baseline, defining tax expenditures relative to a broad-based consumption tax baseline, and defining negative tax expenditures, i.e., provisions of current law that over-tax certain items or activities. A similar review is presented in the Appendix again this year.

### TAX EXPENDITURES IN THE INCOME TAX

#### Tax Expenditure Estimates

All tax expenditure estimates presented here are based upon current tax law enacted as of December 31, 2005. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2005. Due to the time required to estimate the large number of tax expenditures, the estimates are based on Mid-Session economic assumptions; exceptions are the earned income tax credit and child credit provisions, which involve outlay components and hence are updated to reflect the economic assumptions used elsewhere in the Budget.

The total revenue effects for tax expenditures for fiscal years 2005–2011 are displayed according to the Budget’s functional categories in Table 19–1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and the 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 income tax expenditures. These baseline concepts are thoroughly discussed in Special Analysis G of the 1985 Budget, where the former is referred to as the pre-1983 method and the latter the post-1982 method. 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 effects for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the tables.

Table 19–2 reports the respective portions of the total revenue effects that arise under the individual and corporate income taxes separately. The location of the 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 could be shareholders, employees, customers, or other providers of capital, depending on economic forces.

Table 19–3 ranks the major tax expenditures by the size of their 2007–2011 revenue effect. Outlay Equivalent Estimates of Income Tax Expenditures, which were included in prior volumes of *Analytical Perspectives*, are no longer included in this chapter.<sup>1</sup>

### Interpreting Tax Expenditure Estimates

The estimates shown for individual tax expenditures in Tables 19–1, 19–2, and 19–3 do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons:

First, eliminating a tax expenditure may have incentive effects that alter economic behavior. These incentives can affect the resulting magnitudes of the activity or of other tax provisions or Government programs.

<sup>1</sup>The Administration has dropped the estimates of the outlay equivalents because they were often the same as the normal tax expenditure estimates, and the criteria for applying the concepts as to when they should differ were often judgmental and hard to apply with consistency across time and across tax expenditure items.

For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, potentially resulting in a decline in tax receipts. Such behavioral effects are not reflected in the estimates.

Second, tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost 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, because each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 19–1 are the totals of individual and corporate income tax revenue effects reported in Table 19–2 and do not reflect any possible interactions between individual and corporate income tax receipts. For this reason, the estimates in Table 19–1 should be regarded as approximations.

**Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES**  
(in millions of dollars)

	Total from corporations and individuals							
	2005	2006	2007	2008	2009	2010	2011	2007–11
<b>National Defense</b>								
1 Exclusion of benefits and allowances to armed forces personnel .....	2,990	3,020	3,050	3,070	3,110	3,140	3,170	15,390
<b>International affairs:</b>								
2 Exclusion of income earned abroad by U.S. citizens .....	2,750	2,810	2,940	3,100	3,270	3,450	3,640	16,400
3 Exclusion of certain allowances for Federal employees abroad .....	900	950	1,000	1,050	1,100	1,160	1,230	5,540
4 Extraterritorial income exclusion .....	5,220	4,370	1,720	110	50	50	40	1,970
5 Inventory property sales source rules exception .....	1,560	1,680	1,840	2,040	2,230	2,380	2,540	11,030
6 Deferral of income from controlled foreign corporations (normal tax method) .....	10,500	11,160	11,940	12,770	13,650	14,600	15,620	68,580
7 Deferred taxes for financial firms on certain income earned overseas .....	2,190	2,260	960					960
<b>General science, space, and technology:</b>								
8 Expensing of research and experimentation expenditures (normal tax method) .....	4,110	7,920	6,990	6,260	5,360	4,800	4,840	28,250
9 Credit for increasing research activities .....	5,160	2,160	920	390	180	50		1,540
<b>Energy:</b>								
10 Expensing of exploration and development costs, fuels .....	390	680	870	830	650	500	380	3,230
11 Excess of percentage over cost depletion, fuels .....	590	670	690	660	640	620	620	3,230
12 Alternative fuel production credit .....	2,320	2,390	2,460	990				3,450
13 Exception from passive loss limitation for working interests in oil and gas properties .....	40	40	40	40	40	40	40	200
14 Capital gains treatment of royalties on coal .....	90	90	90	100	70	60	80	400
15 Exclusion of interest on energy facility bonds .....	80	90	90	100	100	110	110	510
16 Enhanced oil recovery credit .....	300						20	20
17 New technology credit .....	240	510	690	800	850	860	860	4,060
18 Alcohol fuel credits <sup>1</sup> .....	40	40	40	50	50	60	30	230
19 Tax credit and deduction for clean-fuel burning vehicles .....	70	90	200	140	140	–20	–40	420
20 Exclusion of utility conservation subsidies .....	80	80	80	80	80	70	70	380
21 Credit for holding clean renewable energy bonds .....			10	30	40	50	50	180
22 Deferral of gain from dispositions of transmission property to implement FERC restructuring policy .....	490	620	530	230	–100	–360	–510	–210
23 Credit for production from advanced nuclear power facilities .....								
24 Credit for investment in clean coal facilities .....		50	50	100	150	200	280	780
25 Temporary 50% expensing for equipment used in the refining of liquid fuels .....		10	30	120	240	260	180	830
26 Pass through low sulfur diesel expensing to cooperative owners .....	40		–10		–10		–10	–30
27 Natural gas distribution pipelines treated as 15-year property .....		20	50	90	120	150	150	560
28 Amortize all geological and geophysical expenditures over 2 years .....		40	150	180	140	100	60	630
29 Allowance of deduction for certain energy efficient commercial building property .....		80	190	140	30	–10	–10	340
30 Credit for construction of new energy efficient homes .....		10	20	10	10			40
31 Credit for energy efficiency improvements to existing homes .....		220	380	150				530
32 Credit for energy efficient appliances .....		120	80					80
33 30% credit for residential purchases/installations of solar and fuel cells .....		10	10	10				20
34 Credit for business installation of qualified fuel cells and stationary microturbine power plants .....		80	130	50	–10	–10	–10	150
35 Alternative Fuel and Fuel Mixture tax credit .....	150	170						
<b>Natural resources and environment:</b>								
36 Expensing of exploration and development costs, nonfuel minerals .....								
37 Excess of percentage over cost depletion, nonfuel minerals .....	270	280	300	310	310	330	340	1,590
38 Exclusion of interest on bonds for water, sewage, and hazardous waste facilities .....	450	480	500	550	580	600	620	2,850
39 Capital gains treatment of certain timber income .....	90	90	90	100	70	60	80	400
40 Expensing of multiperiod timber growing costs .....	350	370	380	400	410	430	430	2,050
41 Tax incentives for preservation of historic structures .....	350	370	380	400	420	440	470	2,110
42 Expensing of capital costs with respect to complying with EPA sulfur regulations .....	10	10	10	30	50	30		120
43 Exclusion of gain or loss on sale or exchange of certain brownfield sites .....			10	30	40	70	60	210
<b>Agriculture:</b>								
44 Expensing of certain capital outlays .....	110	130	130	130	140	140	150	690
45 Expensing of certain multiperiod production costs .....	60	70	70	80	80	80	90	400
46 Treatment of loans forgiven for solvent farmers .....	10	10	10	10	10	10	10	50
47 Capital gains treatment of certain income .....	880	870	900	1,050	750	590	780	4,070
48 Income averaging for farmers .....	40	40	40	40	40	40	50	210
49 Deferral of gain on sale of farm refiners .....	10	10	20	20	20	20	20	100
50 Bio-Diesel and small agri-biodiesel producer tax credits .....	30	90	100	90	40	20	20	270
<b>Commerce and housing:</b>								
<b>Financial institutions and insurance:</b>								
51 Exemption of credit union income .....	1,290	1,370	1,450	1,540	1,640	1,740	1,850	8,220
52 Excess bad debt reserves of financial institutions .....	10	10	10					10
53 Exclusion of interest on life insurance savings .....	19,200	19,970	20,770	22,600	26,100	28,990	31,350	129,810
54 Special alternative tax on small property and casualty insurance companies .....	20	20	20	20	20	20	30	110
55 Tax exemption of certain insurance companies owned by tax-exempt organizations .....	210	220	230	240	250	260	270	1,250
56 Small life insurance company deduction .....	60	60	60	60	60	60	50	290
57 Exclusion of interest spread of financial institutions .....	1,450	1,540	1,620	1,710	1,800	1,890	1,990	12,000

**Table 19-1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued**  
(in millions of dollars)

	Total from corporations and individuals								
	2005	2006	2007	2008	2009	2010	2011	2007-11	
<b>Housing:</b>									
58	Exclusion of interest on owner-occupied mortgage subsidy bonds .....	930	990	1,040	1,140	1,210	1,240	1,280	5,910
59	Exclusion of interest on rental housing bonds .....	410	430	450	500	530	540	550	2,570
60	Deductibility of mortgage interest on owner-occupied homes .....	62,160	72,060	79,860	87,820	94,490	100,980	108,280	471,430
61	Deductibility of State and local property tax on owner-occupied homes .....	19,110	15,020	12,810	12,910	12,830	12,720	22,930	74,200
62	Deferral of income from post 1987 installment sales .....	1,120	1,130	1,160	1,180	1,200	1,310	1,430	6,280
63	Capital gains exclusion on home sales .....	35,990	39,750	43,900	48,490	59,900	78,860	87,100	318,250
64	Exclusion of net imputed rental income .....	28,600	29,720	33,210	36,860	40,630	44,785	49,364	204,849
65	Exception from passive loss rules for \$25,000 of rental loss .....	6,470	6,370	6,230	6,060	5,880	5,700	5,510	29,380
66	Credit for low-income housing investments .....	3,880	4,060	4,250	4,460	4,710	4,950	5,220	23,590
67	Accelerated depreciation on rental housing (normal tax method) .....	9,610	10,630	11,470	12,660	13,820	14,710	15,920	68,580
<b>Commerce:</b>									
68	Cancellation of indebtedness .....	30	160	110	40	40	40	40	270
69	Exceptions from imputed interest rules .....	50	50	50	50	50	50	50	250
70	Capital gains (except agriculture, timber, iron ore, and coal) .....	26,170	25,990	26,760	31,280	22,340	17,580	23,410	121,370
71	Capital gains exclusion of small corporation stock .....	200	230	260	300	320	350	470	1,700
72	Step-up basis of capital gains at death .....	26,820	29,510	32,460	35,700	36,480	34,560	38,010	177,210
73	Carryover basis of capital gains on gifts .....	410	540	640	750	790	1,270	6,370	9,820
74	Ordinary income treatment of loss from small business corporation stock sale .....	50	50	50	50	50	50	50	250
75	Accelerated depreciation of buildings other than rental housing (normal tax method) .....	-910	-280	90	550	360	950	1,580	3,530
76	Accelerated depreciation of machinery and equipment (normal tax method) .....	20,220	40,520	52,230	61,940	73,480	81,090	88,460	353,600
77	Expensing of certain small investments (normal tax method) .....	5,390	4,720	4,360	350	868	1,110	1,460	8,148
78	Graduated corporation income tax rate (normal tax method) .....	3,160	3,450	3,590	3,940	4,180	4,300	4,390	20,400
79	Exclusion of interest on small issue bonds .....	390	420	440	480	510	530	540	2,500
80	Deduction for US production activities .....	6,220	5,150	10,670	12,190	13,110	20,320	22,270	78,560
81	Special rules for certain film and TV production .....	90	110	90	70	-40	-90	-60	-30
<b>Transportation:</b>									
82	Deferral of tax on shipping companies .....	20	20	20	20	20	20	20	100
83	Exclusion of reimbursed employee parking expenses .....	2,590	2,730	2,880	3,030	3,180	3,330	3,420	15,840
84	Exclusion for employer-provided transit passes .....	480	550	630	710	790	880	960	3,970
85	Tax credit for certain expenditures for maintaining railroad tracks .....	70	140	150	110	50	30	10	350
86	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities .....	.....	25	50	75	95	95	100	415
<b>Community and regional development:</b>									
87	Investment credit for rehabilitation of structures (other than historic) .....	40	40	40	40	40	40	40	200
88	Exclusion of interest for airport, dock, and similar bonds .....	800	860	910	990	1,060	1,080	1,120	5,160
89	Exemption of certain mutuals' and cooperatives' income .....	60	60	70	70	70	70	70	350
90	Empowerment zones and renewal communities .....	1,120	1,210	1,340	1,480	1,740	1,130	420	6,110
91	New markets tax credit .....	430	610	830	870	790	670	520	3,680
92	Expensing of environmental remediation costs .....	70	60	40	.....	-20	-10	-10	.....
93	Credit to holders of Gulf Tax Credit Bonds .....	.....	.....	10	10	10	10	10	50
<b>Education, training, employment, and social services:</b>									
<b>Education:</b>									
94	Exclusion of scholarship and fellowship income (normal tax method) .....	1,380	1,450	1,510	1,580	1,640	1,720	1,790	8,240
95	HOPE tax credit .....	3,710	3,650	3,060	3,090	3,220	3,240	3,480	16,090
96	Lifetime Learning tax credit .....	2,330	2,340	2,020	2,030	2,060	2,090	2,220	10,420
97	Education Individual Retirement Accounts .....	70	90	110	140	180	230	280	940
98	Deductibility of student-loan interest .....	780	800	810	820	830	840	780	4,080
99	Deduction for higher education expenses .....	1,830	1,840	.....	.....	.....	.....	.....	.....
100	State prepaid tuition plans .....	430	540	620	710	810	930	1,090	4,160
101	Exclusion of interest on student-loan bonds .....	280	300	320	350	370	380	390	1,810
102	Exclusion of interest on bonds for private nonprofit educational facilities .....	1,080	1,160	1,220	1,330	1,410	1,450	1,500	6,910
103	Credit for holders of zone academy bonds .....	110	130	140	150	150	150	150	740
104	Exclusion of interest on savings bonds redeemed to finance educational expenses .....	10	20	20	20	20	20	20	100
105	Parental personal exemption for students age 19 or over .....	3,760	2,500	1,760	1,650	1,510	1,420	2,740	9,080
106	Deductibility of charitable contributions (education) .....	3,420	3,680	4,030	4,260	4,550	4,870	5,210	22,920
107	Exclusion of employer-provided educational assistance .....	560	590	620	660	690	730	40	2,740
108	Special deduction for teacher expenses .....	160	150	.....	.....	.....	.....	.....	.....
109	Discharge of student loan indebtedness .....	20	20	20	20	20	20	20	100
<b>Training, employment, and social services:</b>									
110	Work opportunity tax credit .....	160	210	190	130	110	70	30	530
111	Welfare-to-work tax credit .....	70	80	70	40	10	.....	.....	120
112	Employer provided child care exclusion .....	610	810	920	960	1,010	1,060	1,070	5,020
113	Employer-provided child care credit .....	10	10	10	20	20	20	10	80
114	Assistance for adopted foster children .....	310	320	350	370	400	430	470	2,020
115	Adoption credit and exclusion .....	360	540	560	570	580	600	540	2,850
116	Exclusion of employee meals and lodging (other than military) .....	850	890	930	970	1,010	1,060	1,110	5,080

**Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued**  
(in millions of dollars)

	Total from corporations and individuals								
	2005	2006	2007	2008	2009	2010	2011	2007–11	
117	Child credit <sup>2</sup> .....	41,790	42,090	42,120	42,070	41,830	41,870	31,730	199,620
118	Credit for child and dependent care expenses .....	3,060	2,740	1,820	1,750	1,660	1,590	1,540	8,360
119	Credit for disabled access expenditures .....	30	30	30	40	40	40	40	190
120	Deductibility of charitable contributions, other than education and health .....	29,670	32,550	34,500	36,790	39,410	42,210	45,210	198,120
121	Exclusion of certain foster care payments .....	440	440	450	450	450	460	470	2,280
122	Exclusion of parsonage allowances .....	460	480	510	540	580	610	640	2,880
123	Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma .....		140	20	20				40
<b>Health:</b>									
124	Exclusion of employer contributions for medical insurance premiums and medical care .....	118,420	132,730	146,780	161,120	176,290	191,980	212,820	888,990
125	Self-employed medical insurance premiums .....	3,790	4,240	4,630	5,080	5,570	6,050	6,730	28,060
126	Medical Savings Accounts / Health Savings Accounts .....	1,050	1,830	2,650	3,510	3,960	3,910	3,860	17,890
127	Deductibility of medical expenses .....	6,110	4,410	5,310	6,490	7,720	9,220	12,260	41,000
128	Exclusion of interest on hospital construction bonds .....	1,880	2,010	2,110	2,300	2,450	2,520	2,600	11,980
129	Deductibility of charitable contributions (health) .....	3,350	3,670	3,890	4,150	4,450	4,770	5,110	22,370
130	Tax credit for orphan drug research .....	210	230	260	290	320	360	410	1,640
131	Special Blue Cross/Blue Shield deduction .....	710	780	850	920	760	830	920	4,280
132	Tax credit for health insurance purchased by certain displaced and retired individuals .....	20	20	30	30	30	30	30	150
<b>Income security:</b>									
133	Exclusion of railroad retirement system benefits .....	390	390	380	360	370	370	350	1,830
134	Exclusion of workers' compensation benefits .....	5,770	6,000	6,180	6,390	6,630	6,860	7,090	33,150
135	Exclusion of public assistance benefits (normal tax method) .....	430	450	470	490	510	530	550	2,550
136	Exclusion of special benefits for disabled coal miners .....	50	50	50	40	40	40	40	210
137	Exclusion of military disability pensions .....	100	110	110	120	120	130	130	610
Net exclusion of pension contributions and earnings:									
138	Employer plans .....	50,630	50,360	52,470	48,100	45,760	44,760	36,910	228,000
139	401(k) plans .....	37,440	37,330	39,800	43,100	48,810	53,870	47,290	232,870
140	Individual Retirement Accounts .....	3,100	4,230	5,970	7,180	8,300	8,840	8,060	38,350
141	Low and moderate income savers credit .....	1,310	1,380	830					830
142	Keogh plans .....	9,400	9,990	10,670	11,630	12,670	13,800	15,040	63,810
Exclusion of other employee benefits:									
143	Premiums on group term life insurance .....	2,020	2,070	2,180	2,250	2,310	2,380	2,490	11,610
144	Premiums on accident and disability insurance .....	280	290	300	310	320	330	340	1,600
145	Income of trusts to finance supplementary unemployment benefits .....	20	20	20	20	20	20	20	100
146	Special ESOP rules .....	1,650	1,760	1,890	2,030	2,170	2,330	2,490	10,910
147	Additional deduction for the blind .....	40	30	30	40	40	40	50	200
148	Additional deduction for the elderly .....	1,850	1,740	1,740	1,880	1,930	1,980	2,940	10,470
149	Tax credit for the elderly and disabled .....	20	20	20	10	10	10	10	60
150	Deductibility of casualty losses .....	250	980	640	300	320	330	360	1,950
151	Earned income tax credit <sup>3</sup> .....	4,925	5,050	5,150	5,445	5,640	5,810	6,070	28,115
152	Additional exemption for housing Hurricane Katrina displaced individuals .....		110	20					20
<b>Social Security:</b>									
Exclusion of social security benefits:									
153	Social Security benefits for retired workers .....	19,110	19,350	19,590	20,250	20,700	21,000	23,330	104,870
154	Social Security benefits for disabled .....	3,600	3,810	4,110	4,330	4,570	4,960	5,530	23,500
155	Social Security benefits for dependents and survivors .....	3,940	3,980	4,040	4,070	4,100	4,180	4,360	20,750
<b>Veterans benefits and services:</b>									
156	Exclusion of veterans death benefits and disability compensation .....	3,320	3,600	3,770	3,900	4,050	4,140	4,350	20,210
157	Exclusion of veterans pensions .....	130	140	140	140	140	150	150	720
158	Exclusion of GI bill benefits .....	150	170	210	240	280	330	400	1,460
159	Exclusion of interest on veterans housing bonds .....	40	40	50	50	50	50	50	250
<b>General purpose fiscal assistance:</b>									
160	Exclusion of interest on public purpose State and local bonds .....	26,360	28,180	29,640	32,330	34,410	35,440	36,510	168,330
161	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes .....	36,460	30,310	27,210	27,730	28,260	29,000	49,510	161,710
162	Tax credit for corporations receiving income from doing business in U.S. possessions .....	800	400	40					40
<b>Interest:</b>									
163	Deferral of interest on U.S. savings bonds .....	1,350	1,340	1,350	1,360	1,380	1,390	1,440	6,920
<b>Addendum: Aid to State and local governments:</b>									
Deductibility of:									
	Property taxes on owner-occupied homes .....	19,110	15,020	12,810	12,910	12,830	12,720	22,930	74,200
	Nonbusiness State and local taxes other than on owner-occupied homes .....	36,460	30,310	27,210	27,730	28,260	29,000	49,510	161,710
Exclusion of interest on State and local bonds for:									
	Public purposes .....	26,360	28,180	29,640	32,330	34,410	35,440	36,510	168,330
	Energy facilities .....	80	90	90	100	100	110	110	510
	Water, sewage, and hazardous waste disposal facilities .....	450	480	500	550	580	600	620	2,850

**Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued**  
(in millions of dollars)

	Total from corporations and individuals							
	2005	2006	2007	2008	2009	2010	2011	2007–11
Small-issues .....	390	420	440	480	510	530	540	2,500
Owner-occupied mortgage subsidies .....	930	990	1,040	1,140	1,210	1,240	1,280	5,910
Rental housing .....	410	430	450	500	530	540	550	2,570
Airports, docks, and similar facilities .....	800	860	910	990	1,060	1,080	1,120	5,160
Student loans .....	280	300	320	350	370	380	390	1,810
Private nonprofit educational facilities .....	1,080	1,160	1,220	1,330	1,410	1,450	1,500	6,910
Hospital construction .....	1,880	2,010	2,110	2,300	2,450	2,520	2,600	11,980
Veterans' housing .....	40	40	50	50	50	50	50	250
Credit for holders of zone academy bonds .....	110	130	140	150	150	150	150	740

<sup>1</sup>In addition, the alcohol fuel credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2005 \$1,500; 2006 \$2,110; 2007 \$2,400; 2008 \$2,740; 2009 \$3,080; 2010 \$3,410 and 2011 \$870.

<sup>2</sup>The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2005 \$14,620; 2006 \$14,110; 2007 \$13,540; 2008 \$12,950; 2009 \$12,760 and 2010 \$12,330; 2011 \$12,110.

<sup>3</sup>The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2005 \$34,559; 2006 \$35,098; 2007 \$35,645; 2008 \$36,955; 2009 \$38,048; 2010 \$38,823; and 2011 \$40,278.

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 \$10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

### Present-Value Estimates

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 19–4. 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. Although such estimates are useful as a measure of cash flows into the Government, they do not 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 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 effect on receipts to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful com-

plement to the cash-basis estimates for provisions involving deferrals, are discussed below.

Discounted present-value estimates of revenue effects are presented in Table 19–4 for certain provisions that involve tax deferrals or other 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 effects, net of future tax payments that follow from activities undertaken during calendar year 2005 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2005 would cause a deferral of tax payments on wages in 2005 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2005 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.



**Table 19-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued**  
(in millions of dollars)

	Corporations								Individuals								
	2005	2006	2007	2008	2009	2010	2011	2007-11	2005	2006	2007	2008	2009	2010	2011	2007-11	
43				10	20	30	50	40	150				10	10	20	20	60
	<b>Agriculture:</b>																
44	20	20	20	20	20	20	30	110	90	110	110	110	120	120	120	120	580
45	10	10	10	10	10	10	20	60	50	60	60	70	70	70	70	70	340
46										10	10	10	10	10	10	10	50
47									880	870	900	1,050	750	590	780	4,070	
48									40	40	40	40	40	40	50	210	
49	10	10	20	20	20	20	20	100									
50									30	90	100	90	40	20	20	270	
	<b>Commerce and housing:</b>																
	Financial institutions and insurance:																
51	1290	1370	1450	1540	1640	1,740	1,850	8,220									
52	10	10	10					10									
53	1,760	1,830	1,910	2,120	2,400	2,620	2,810	11,860	17,440	18,140	18,860	20,480	23,700	26,370	28,540	117,950	
54	20	20	20	20	20	20	30	110									
55	210	220	230	240	250	260	270	1,250									
56	60	60	60	60	60	60	50	290									
57									1,450	1,540	1,620	1,710	1,800	1,890	1,990	12,000	
	<b>Housing:</b>																
58	200	210	210	220	230	230	240	1,130	730	780	830	920	980	1,010	1,040	4,780	
59	90	90	90	100	100	100	100	490	320	340	360	400	430	440	450	2,080	
60									62,160	72,060	79,860	87,820	94,490	100,980	108,280	471,430	
61									19,110	15,020	12,810	12,910	12,830	12,720	22,930	74,200	
62	290	290	300	300	310	310	310	1,530	830	840	860	880	890	1,000	1,120	4,750	
63									35,990	39,750	43,900	48,490	59,900	78,860	87,100	318,250	
64									28,600	29,720	33,210	36,860	40,630	44,785	49,364	204,849	
65									6470	6370	6230	6060	5880	5700	5510	29,380	
66	3,300	3,450	3,610	3,790	4,000	4,210	4,440	20,050	580	610	640	670	710	740	780	3,540	
67	650	710	760	840	910	960	1,030	4,500	8,960	9,920	10,710	11,820	12,910	13,750	14,890	64,080	
	<b>Commerce:</b>																
68									30	160	110	40	40	40	40	270	
69									50	50	50	50	50	50	50	250	
70									26,170	25,990	26,760	31,280	22,340	17,580	23,410	121,370	
71									200	230	260	300	320	350	470	1,700	
72									26,820	29,510	32,460	35,700	36,480	34,560	38,010	177,210	
73									410	540	640	750	790	1,270	6,370	9,820	
74									50	50	50	50	50	50	50	250	
75	220	400	530	720	730	970	1,230	4,180	-1,130	-680	-440	-170	-370	-20	350	-650	
76	15,850	30,250	39,870	47,870	57,290	63,410	69,170	277,610	4,370	10,270	12,360	14,070	16,190	17,680	19,290	75,990	
77	1,710	1,440	1,240	-280	-2	160	310	1,428	3,680	3,280	3,120	630	870	950	1,150	6,720	
78	3,160	3,450	3,590	3,940	4,180	4,300	4,390	20,400									
79	80	90	90	90	100	100	100	480	310	330	350	390	410	430	440	2,020	
80	4,870	3,980	8,320	9,770	10,630	16,550	16,880	62,150	1,350	1,170	2,350	2,420	2,480	3,770	5,390	16,410	
81	70	90	70	60	-30	-70	-50	-20	20	20	20	10	-10	-20	-10	-10	
	<b>Transportation:</b>																
82	20	20	20	20	20	20	20	100									
83									2,590	2,730	2,880	3,030	3,180	3,330	3,420	15,840	
84									480	550	630	710	790	880	960	3,970	
85	70	140	150	110	50	30	10	350									
86		10	15	20	25	25	25	110		15	35	55	70	70	75	305	







**Table 19-2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued**  
(in millions of dollars)

	Corporations								Individuals							
	2005	2006	2007	2008	2009	2010	2011	2007-11	2005	2006	2007	2008	2009	2010	2011	2007-11
Credit for holders of zone academy bonds ..	110	130	140	150	150	150	150	740	.....	.....	.....	.....	.....	.....	.....	.....

<sup>1</sup>In addition, the alcohol fuel credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2005 \$1,500; 2006 \$2,110; 2007 \$2,400; 2008 \$2,740; 2009 \$3,080; 2010 \$3,410 and 2011 \$870.

<sup>2</sup>The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2005 \$14,620; 2006 \$14,110; 2007 \$13,540; 2008 \$12,950; 2009 \$12,760 and 2010 \$12,330; 2011 \$12,110.

<sup>3</sup>The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2005 \$34,559; 2006 \$35,098; 2007 \$35,645; 2008 \$36,955; 2009 \$38,048; 2010 \$38,823; and 2011 \$40,278.

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 \$10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

### Tax Expenditure Baselines

A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment. As in prior years, most of this year’s tax expenditure estimates are presented using two baselines: the normal tax baseline and the reference tax law baseline. An exception is provided for the lower tax rate on dividends and capital gains on corporate shares as discussed below.

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 deduction of 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.

In the case of income taxes, the reference tax law baseline is also patterned on a comprehensive income tax, but it is closer to existing law. Tax expenditures under the reference law baseline are generally tax expenditures under the normal tax baseline, but 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, under the normal and reference tax baselines:

- Income is taxable only when it is realized in exchange. Thus, either 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.
- A comprehensive income tax would generally not exclude from the tax base amounts for personal exemptions or a standard deduction, except perhaps to ease tax administration.
- There generally is a separate corporate income tax.
- Tax rates vary by level of income.

- Tax rates are allowed to vary with marital status.
- Values of assets and debt are not generally 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).

Although 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, by convention, 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. Again, by convention, 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.<sup>2</sup> The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Gov-

<sup>2</sup>Gross income does, however, include transfer payments associated with past employment, such as Social Security benefits.

ernment 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.<sup>3</sup>

*Capital recovery.* Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for property is computed using estimates of economic depreciation. The latter represents a change in the calculation of the tax expenditure under normal law first made in the 2004 Budget. The Appendix provides further details on the new methodology and how it differs from the prior methodology.

*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.

**Table 19-3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2007-2011 PROJECTED REVENUE EFFECT**

(in millions of dollars)

Provision	2007	2007-11
Exclusion of employer contributions for medical insurance premiums and medical care .....	146,780	888,990
Deductibility of mortgage interest on owner-occupied homes .....	79,860	471,430
Accelerated depreciation of machinery and equipment (normal tax method) .....	52,230	357,200
Capital gains exclusion on home sales .....	43,900	318,250
401(k) plans .....	39,800	232,870
Employer plans .....	52,470	228,000
Exclusion of net imputed rental income .....	33,210	204,849
Child credit .....	42,120	199,620
Deductibility of charitable contributions, other than education and health .....	34,430	198,120
Step-up basis of capital gains at death .....	32,460	177,210
Exclusion of interest on public purpose State and local bonds .....	29,640	168,330
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes .....	27,210	161,710
Exclusion of interest on life insurance savings .....	20,770	129,810
Capital gains (except agriculture, timber, iron ore, and coal) .....	26,760	121,370
Social Security benefits for retired workers .....	19,590	104,870
Deduction for US production activities .....	10,670	78,560
Deductibility of State and local property tax on owner-occupied homes .....	12,810	74,200
Deferral of income from controlled foreign corporations (normal tax method) .....	11,940	68,580
Keogh plans .....	10,670	63,810
Deductibility of medical expenses .....	5,310	41,000
Individual Retirement Accounts .....	5,970	38,350
Exclusion of workers' compensation benefits .....	6,180	33,150
Exception from passive loss rules for \$25,000 of rental loss .....	6,230	29,380
Expensing of research and experimentation expenditures (normal tax method) .....	6,990	28,250
Earned income tax credit .....	5,147	28,104
Self-employed medical insurance premiums .....	4,630	28,060
Credit for low-income housing investments .....	4,250	23,590
Social Security benefits for disabled .....	4,110	23,500
Deductibility of charitable contributions (education) .....	4,030	22,920
Deductibility of charitable contributions (health) .....	3,890	22,370
Social Security benefits for dependents and survivors .....	4,040	20,750
Graduated corporation income tax rate (normal tax method) .....	3,590	20,400
Exclusion of veterans death benefits and disability compensation .....	3,770	20,210
Medical Savings Accounts/Health Savings Accounts .....	2,650	17,890
Exclusion of income earned abroad by U.S. citizens .....	2,940	16,400
HOPE tax credit .....	3,060	16,090
Exclusion of reimbursed employee parking expenses .....	2,880	15,840

<sup>3</sup>In the case 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. In addition, costs of earning income may be limited under the alternative minimum tax.

**Table 19-3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2007-2011 PROJECTED REVENUE EFFECT—  
Continued**

(in millions of dollars)

Provision	2007	2007-11
Exclusion of benefits and allowances to armed forces personnel .....	3,050	15,390
Exclusion of interest spread of financial institutions .....	1,620	12,000
Exclusion of interest on hospital construction bonds .....	2,110	11,980
Premiums on group term life insurance .....	2,180	11,610
Inventory property sales source rules exception .....	1,840	11,030
Special ESOP rules .....	1,890	10,910
Additional deduction for the elderly .....	1,740	10,470
Lifetime Learning tax credit .....	2,020	10,420
Carryover basis of capital gains on gifts .....	640	9,820
Parental personal exemption for students age 19 or over .....	1,760	9,080
Credit for child and dependent care expenses .....	1,820	8,360
Exclusion of scholarship and fellowship income (normal tax method) .....	1,510	8,240
Exemption of credit union income .....	1,450	8,220
Expensing of certain small investments (normal tax method) .....	4,360	8,148
Deferral of interest on U.S. savings bonds .....	1,350	6,920
Exclusion of interest on bonds for private nonprofit educational facilities .....	1,220	6,910
Deferral of income from post 1987 installment sales .....	1,160	6,280
Empowerment zones, Enterprise communities, and Renewal communities .....	1,340	6,110
Exclusion of interest on owner-occupied mortgage subsidy bonds .....	1,040	5,910
Exclusion of certain allowances for Federal employees abroad .....	1,000	5,540
Exclusion of interest for airport, dock, and similar bonds .....	910	5,160
Exclusion of employee meals and lodging (other than military) .....	930	5,080
Employer provided child care exclusion .....	920	5,020
Special Blue Cross/Blue Shield deduction .....	850	4,280
State prepaid tuition plans .....	620	4,160
Deductibility of student-loan interest .....	810	4,080
Capital gains treatment of certain income .....	900	4,070
New technology credit .....	690	4,060
Exclusion for employer-provided transit passes .....	630	3,970
New markets tax credit .....	830	3,680
Accelerated depreciation of buildings other than rental housing (normal tax method) .....	90	3,530
Alternative fuel production credit .....	2,460	3,450
Excess of percentage over cost depletion, fuels .....	690	3,230
Expensing of exploration and development costs, fuels .....	870	3,230
Exclusion of parsonage allowances .....	510	2,880
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities .....	500	2,850
Adoption credit and exclusion .....	560	2,850
Exclusion of employer-provided educational assistance .....	620	2,740
Exclusion of interest on rental housing bonds .....	450	2,570
Exclusion of public assistance benefits (normal tax method) .....	470	2,550
Exclusion of interest on small issue bonds .....	440	2,500
Extraterritorial income exclusion .....	1,960	2,350
Exclusion of certain foster care payments .....	450	2,280
Tax incentives for preservation of historic structures .....	380	2,110
Expensing of multiperiod timber growing costs .....	380	2,050
Assistance for adopted foster children .....	350	2,020
Deductibility of casualty losses .....	640	1,950
Exclusion of railroad retirement system benefits .....	380	1,830
Exclusion of interest on student-loan bonds .....	320	1,810
Capital gains exclusion of small corporation stock .....	260	1,700
Tax credit for orphan drug research .....	260	1,640
Premiums on accident and disability insurance .....	300	1,600
Excess of percentage over cost depletion, nonfuel minerals .....	300	1,590
Credit for increasing research activities .....	920	1,540
Exclusion of GI bill benefits .....	210	1,460
Tax exemption of certain insurance companies owned by tax-exempt organizations .....	230	1,250
Deferred taxes for financial firms on certain income earned overseas .....	960	960
Education Individual Retirement Accounts .....	110	940
Low and moderate income savers credit .....	830	830
Temporary 50% expensing for equipment used in the refining of liquid fuels .....	30	830
Credit for investment in clean coal facilities .....	50	780
Credit for holders of zone academy bonds .....	140	740
Exclusion of veterans pensions .....	140	720
Expensing of certain capital outlays .....	130	690
Amortize all geological and geophysical expenditures over 2 years .....	150	630
Exclusion of military disability pensions .....	110	610
Natural gas distribution pipelines treated as 15-year property .....	50	560

**Table 19-3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2007-2011 PROJECTED REVENUE EFFECT—  
Continued**

(in millions of dollars)

Provision	2007	2007-11
Work opportunity tax credit .....	190	530
Credit for energy efficiency improvements to existing homes .....	380	530
Exclusion of interest on energy facility bonds .....	90	510
Tax credit and deduction for clean-fuel burning vehicles .....	200	420
Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities .....	50	415
Capital gains treatment of royalties on coal .....	90	400
Capital gains treatment of certain timber income .....	90	400
Expensing of certain multiperiod production costs .....	70	400
Exclusion of utility conservation subsidies .....	80	380
Tax credit for certain expenditures for maintaining railroad tracks .....	150	350
Exemption of certain mutuals' and cooperatives' income .....	70	350
Allowance of deduction for certain energy efficient commercial building property .....	190	340
Small life insurance company deduction .....	60	290
Cancellation of indebtedness .....	110	270
Bio-Diesel tax credit .....	100	270
Exclusion of interest on veterans housing bonds .....	50	250
Exceptions from imputed interest rules .....	50	250
Ordinary income treatment of loss from small business corporation stock sale .....	50	250
Alcohol fuel credits .....	40	230
Exclusion of special benefits for disabled coal miners .....	50	210
Income averaging for farmers .....	40	210
Exclusion of gain or loss on sale or exchange of certain brownfield sites .....	10	210
Investment credit for rehabilitation of structures (other than historic) .....	40	200
Additional deduction for the blind .....	30	200
Exception from passive loss limitation for working interests in oil and gas properties .....	40	200
Credit for disabled access expenditures .....	30	190
Credit for holding clean renewable energy bonds .....	10	180
Tax credit for health insurance purchased by certain displaced and retired individuals .....	30	150
Credit for business installation of qualified fuel cells and stationary microturbine power plants .....	130	150
Welfare-to-work tax credit .....	70	120
Expensing of capital costs with respect to complying with EPA sulfur regulations .....	11	113
Special alternative tax on small property and casualty insurance companies .....	20	110
Deferral of tax on shipping companies .....	20	100
Exclusion of interest on savings bonds redeemed to finance educational expenses .....	20	100
Discharge of student loan indebtedness .....	20	100
Income of trusts to finance supplementary unemployment benefits .....	20	100
Deferral of gain on sale of farm refiners .....	20	100
Employer-provided child care credit .....	10	80
Credit for energy efficient appliances .....	80	80
Tax credit for the elderly and disabled .....	20	60
Treatment of loans forgiven for solvent farmers .....	10	50
Credit to holders of Gulf Tax Credit Bonds .....	10	50
Tax credit for corporations receiving income from doing business in U.S. possessions .....	40	40
Credit for construction of new energy efficient homes .....	20	40
Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma .....	20	40
Enhanced oil recovery credit .....	.....	20
30% credit for residential purchases/installations of solar and fuel cells .....	10	20
Additional exemption for housing Hurricane Katrina displaced individuals .....	20	20
Excess bad debt reserves of financial institutions .....	10	10
Deduction for higher education expenses .....	.....	.....
Expensing of exploration and development costs, nonfuel minerals .....	.....	.....
Special deduction for teacher expenses .....	.....	.....
Expensing of environmental remediation costs .....	40	.....
Alternative Fuel and Fuel Mixture tax credit .....	.....	.....
Credit for production from advanced nuclear power facilities .....	.....	.....
Special rules for certain film and TV production .....	90	-30
Pass through low sulfur diesel expensing to cooperative owners .....	-10	-30
Deferral of gain from dispositions of transmission property to implement FERC restructuring policy .....	530	-210

**Table 19-4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2005**

(in millions of dollars)

	Provision	2005 Present Value of Revenue Loss
1	Deferral of income from controlled foreign corporations (normal tax method) .....	10,020
2	Deferred taxes for financial firms on income earned overseas .....	2,270
3	Expensing of research and experimentation expenditures (normal tax method) .....	2,390
4	Expensing of exploration and development costs—fuels .....	180
5	Expensing of exploration and development costs—nonfuels .....	10
6	Expensing of multiperiod timber growing costs .....	200
7	Expensing of certain multiperiod production costs—agriculture .....	140
8	Expensing of certain capital outlays—agriculture .....	180
9	Deferral of income on life insurance and annuity contracts .....	19,640
10	Accelerated depreciation on rental housing .....	16,088
11	Accelerated depreciation of buildings other than rental .....	15,980
12	Accelerated depreciation of machinery and equipment .....	64,330
13	Expensing of certain small investments (normal tax method) .....	1,100
14	Deferral of tax on shipping companies .....	20
15	Credit for holders of zone academy bonds .....	210
16	Credit for low-income housing investments .....	3,970
17	Deferral for state prepaid tuition plans .....	1,190
18	Exclusion of pension contributions—employer plans .....	81,160
19	Exclusion of 401(k) contributions .....	102,640
20	Exclusion of IRA contributions and earnings .....	4,460
21	Exclusion of contributions and earnings for Keogh plans .....	3,190
22	Exclusion of interest on public-purpose bonds .....	19,830
23	Exclusion of interest on non-public purpose bonds .....	6,700
24	Deferral of interest on U.S. savings bonds .....	410
25	Exclusion of Roth earnings and distributions .....	8,170
26	Exclusion of non-deductible IRA earnings .....	370

### Double Taxation of Corporate Profits

In a gradual transition to a more economically neutral tax system where corporate income is subject to a single layer of tax, the lower tax rates on dividends and capital gains on corporate equity have not been considered tax preferences since the 2005 Budget. Thus, the difference between ordinary tax rates and the lower tax rates on dividends, introduced by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), does not give rise to a tax expenditure. Similarly, the lower capital gains tax rates applied to gains realized from the disposition of corporate equity do not give rise to a tax expenditure. As a consequence, tax expenditure estimates for the lower tax rates on capital, step-up in basis, and the inside build-up on pension assets, 401k plans, IRAs, among others, are limited to capital gains from sources other than corporate equity. The Appendix provides a greater discussion of alternative baselines.

### Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives will be achieved through direct expenditure programs. Tax expenditures, however, may also contribute

to achieving these goals. The report of the Senate Governmental Affairs Committee on GPRA<sup>4</sup> calls on the Executive Branch to undertake a series of analyses to assess the effect of specific tax expenditures on the achievement of agencies' performance objectives.

The Executive Branch is continuing to focus on the availability of data needed to assess the effects of the tax expenditures designed to increase savings. Treasury's Office of Tax Analysis and Statistics of Income Division (IRS) have developed a new sample of individual income tax filers as one part of this effort. This new "panel" sample will follow the same taxpayers over a period of at least ten years. The first year of this panel sample was drawn from tax returns filed in 2000 for tax year 1999. The sample will capture the changing demographic and economic circumstances of individuals and the effects of changes in tax law over an extended period of time. Data from the sample will therefore permit more extensive, and better, analyses of many tax provisions than can be performed using only annual ("cross-section") data. In particular, data from this panel sample will enhance our ability to analyze the effect of tax expenditures designed to increase savings. Other efforts by OMB, Treasury, and other agencies to improve data available for the analysis of savings tax expenditures will continue over the next several years.

<sup>4</sup>Committee on Government Affairs, United States Senate, "Government Performance and Results Act of 1993" (Report 103-58, 1993).

*Comparison of tax expenditure, spending, and regulatory policies.* Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available.<sup>5</sup> Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in many cases. In addition, some tax expenditures actually simplify the operation of the tax system, (for example, the exclusion for up to \$500,000 of capital gains on home sales). Tax expenditures also implicitly subsidize certain activities. Spending, regulatory or tax-disincentive policies can also modify behavior, but may have different economic effects. Finally, a variety of tax expenditure tools can be used e.g., deductions, credits, exemptions, deferrals, floors, ceilings; phase-ins; phase-outs; dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range of policy instruments means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, personal exemptions, deductions, credits and phase-outs can complicate filing and decision-making. The income tax system may have little or no contact with persons who have no or very low incomes, and does not require information on certain characteristics of individuals used in some spending programs, such as wealth. These features may reduce the effectiveness of tax expenditures for addressing certain income-transfer objectives. Tax expenditures also generally do not enable the same degree of agency discretion as an outlay program. For example, grant or direct Federal service delivery programs can prioritize activities to be addressed with specific resources in a way that is difficult to emulate with tax expenditures.

Outlay programs have advantages where direct Government service provision is particularly warranted such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a tax return. Outlay programs may also receive more year-to-year oversight and fine tuning through the legislative and executive budget process. In addition, many different types of spending programs including direct Government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts provide flexibility for policy design. On the other hand, certain outlay programs such as direct Government service provision may rely less directly on economic incentives and private-market

provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Spending programs also require resources to be raised via taxes, user charges, or Government borrowing, which can impose further costs by diverting resources from their most efficient uses. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

Regulations have more direct and immediate effects than outlay and tax-expenditure programs because regulations apply directly and immediately to the regulated party (i.e., the intended actor) generally in the private sector. Regulations can also be fine-tuned more quickly than tax expenditures because they can often be changed as needed by the Executive Branch without legislation. Like tax expenditures, regulations often rely largely on voluntary compliance, rather than detailed inspections and policing. As such, the public administrative costs tend to be modest relative to the private resource costs associated with modifying activities. Historically, regulations have tended to rely on proscriptive measures, as opposed to economic incentives. This reliance can diminish their economic efficiency, although this feature can also promote full compliance where (as in certain safety-related cases) policymakers believe that trade-offs with economic considerations are not of paramount importance. Also, regulations generally do not directly affect Federal outlays or receipts. Thus, like tax expenditures, they may escape the degree of scrutiny that outlay programs receive. However, major regulations are subjected to a formal regulatory analysis that goes well beyond the analysis required for outlays and tax-expenditures. To some extent, the GPRA requirement for performance evaluation will address this lack of formal analysis.

Some policy objectives are achieved using multiple approaches. For example, minimum wage legislation, the earned income tax credit, and the food stamp program are regulatory, tax expenditure, and direct outlay programs, respectively, all having the objective of improving the economic welfare of low-wage workers.

Tax expenditures, like spending and regulatory programs, have a variety of objectives and effects. When measured against a comprehensive income tax, for example, these include: encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of Social Security income); reducing private compliance costs and Government administrative costs (e.g., the exclusion for up to \$500,000 of capital gains on home sales); and promoting tax neutrality (e.g., accelerated depreciation in the presence of inflation). Some of these objectives are well suited to quantitative measurement, while others are less well suited. Also, many tax expenditures, including those cited above, may have more than one objective. For example, accelerated depreciation may encourage investment. In addition, the economic effects of particular provisions can extend beyond their in-

<sup>5</sup> Although this chapter focuses upon tax expenditures under the income tax, tax expenditures also arise under the unified transfer, payroll, and excise tax systems. Such provisions can be useful when they relate to the base of those taxes, such as an excise tax exemption for certain types of consumption deemed meritorious.



tended objectives (e.g., a provision intended to promote an activity or raise certain incomes may have positive or negative effects on tax neutrality).

Performance measurement is generally concerned with inputs, outputs, and outcomes. In the case of tax expenditures, the principal input is usually the revenue effect. Outputs are quantitative or qualitative measures of goods and services, or changes in income and investment, directly produced by these inputs. Outcomes, in turn, represent the changes in the economy, society, or environment that are the ultimate goals of programs.

Thus, for a provision that reduces taxes on certain investment activity, an increase in the amount of investment would likely be a key output. The resulting production from that investment, and, in turn, the associated improvements in national income, welfare, or security, could be the outcomes of interest. For other provisions, such as those designed to address a potential inequity or unintended consequence in the tax code, an important performance measure might be how they change effective tax rates (the discounted present-value of taxes owed on new investments or incremental earnings) or excess burden (an economic measure of the distortions caused by taxes). Effects on the incomes of members of particular groups may be an important measure for certain provisions.

*An overview of evaluation issues by budget function.* The discussion below considers the types of measures that might be useful for some major programmatic groups of tax expenditures. The discussion is intended to be illustrative and not all encompassing. However, it is premised on the assumption that the data needed to perform the analysis are available or can be developed. In practice, data availability is likely to be a major challenge, and data constraints may limit the assessment of the effectiveness of many provisions. In addition, such assessments can raise significant challenges in economic modeling.

*National defense.* Some tax expenditures are intended to assist governmental activities. For example, tax preferences for military benefits reflect, among other things, the view that benefits such as housing, subsistence, and moving expenses are intrinsic aspects of military service, and are provided, in part, for the benefit of the employer, the U.S. Government. Tax benefits for combat service are intended to reduce tax burdens on military personnel undertaking hazardous service for the Nation. A portion of the tax expenditure associated with foreign earnings is targeted to benefit U.S. Government civilian personnel working abroad by offsetting the living costs that can be higher than those in the United States. These tax expenditures should be considered together with direct agency budget costs in making programmatic decisions.

*International affairs.* Tax expenditures are also aimed at goals such as tax neutrality. These include the exclusion for income earned abroad by nongovernmental employees and exclusions for income of U.S.-controlled foreign corporations. Measuring the effectiveness of these provisions raises challenging issues.

*General science, space and technology; energy; natural resources and the environment; agriculture; and commerce and housing.* A series of tax expenditures reduces the cost of investment, both in specific activities such as research and experimentation, extractive industries, and certain financial activities and more generally, through accelerated depreciation for plant and equipment. These provisions can be evaluated along a number of dimensions. For example, it could be useful to consider the strength of the incentives by measuring their effects on the cost of capital (the interest rate which investments must yield to cover their costs) and effective tax rates. The impact of these provisions on the amounts of corresponding forms of investment (e.g., research spending, exploration activity, equipment) might also be estimated. In some cases, such as research, there is evidence that the investment can provide significant positive externalities that is, economic benefits that are not reflected in the market transactions between private parties. It could be useful to quantify these externalities and compare them with the size of tax expenditures. Measures could also indicate the effects on production from these investments such as numbers or values of patents, energy production and reserves, and industrial production. Issues to be considered include the extent to which the preferences increase production (as opposed to benefiting existing output) and their cost-effectiveness relative to other policies. Analysis could also consider objectives that are more difficult to measure but still are ultimate goals, such as promoting the Nation's technological base, energy security, environmental quality, or economic growth. Such an assessment is likely to involve tax analysis as well as consideration of non-tax matters such as market structure, scientific, and other information (such as the effects of increased domestic fuel production on imports from various regions, or the effects of various energy sources on the environment).

Housing investment also benefits from tax expenditures. The imputed net rental income from owner-occupied housing is excluded from the tax base. The mortgage interest deduction and property tax deduction on personal residences also are reported as tax expenditures because the value of owner-occupied housing services is not included in a taxpayer's taxable income. Taxpayers also may exclude up to \$500,000 of the capital gains from the sale of personal residences. Measures of the effectiveness of these provisions could include their effects on increasing the extent of home ownership and the quality of housing. Similarly, analysis of the extent of accumulated inflationary gains is likely to be relevant to evaluation of the capital gains for home sales. Deductibility of State and local property taxes assists with making housing more affordable as well as easing the cost of providing community services through these taxes. Provisions intended to promote investment in rental housing could be evaluated for their effects on making such housing more available and affordable. These provisions should then be com-

pared with alternative programs that address housing supply and demand.

*Transportation.* Employer-provided parking is a fringe benefit that, for the most part, is excluded from taxation. The tax expenditure estimates reflect the cost of parking that is leased by employers for employees; an estimate is not currently available for the value of parking owned by employers and provided to their employees. The exclusion for employer-provided transit passes is intended to promote use of this mode of transportation, which has environmental and congestion benefits. The tax treatments of these different benefits could be compared with alternative transportation policies.

*Community and regional development.* A series of tax expenditures is intended to promote community and regional development by reducing the costs of financing specialized infrastructure, such as airports, docks, and stadiums. Empowerment zone and enterprise community provisions are designed to promote activity in disadvantaged areas. These provisions can be compared with grants and other policies designed to spur economic development.

*Education, training, employment, and social services.* Major provisions in this function are intended to promote post-secondary education, to offset costs of raising children, and to promote a variety of charitable activities. The education incentives can be compared with loans, grants, and other programs designed to promote higher education and training. The child credits are intended to adjust the tax system for the costs of raising children; as such, they could be compared to other Federal tax and spending policies, including related features of the tax system, such as personal exemptions (which are not defined as a tax expenditure). Evaluation of charitable activities requires consideration of the beneficiaries of these activities, who are generally not the parties receiving the tax reduction.

*Health.* Individuals also benefit from favorable treatment of employer-provided health insurance. Measures of these benefits could include increased coverage and pooling of risks. The effects of insurance coverage on final outcome measures of actual health (e.g., infant mortality, days of work lost due to illness, or life expectancy) or intermediate outcomes (e.g., use of preventive health care or health care costs) could also be investigated.

*Income security, Social Security, and veterans benefits and services.* Major tax expenditures in the income security function benefit retirement savings, through employer-provided pensions, individual retirement accounts, and Keogh plans. These provisions might be evaluated in terms of their effects on boosting retirement incomes, private savings, and national savings (which would include the effect on private savings as well as public savings or deficits). Interactions with other programs, including Social Security, also may merit analysis. As in the case of employer-provided health insurance, analysis of employer-provided pension

programs requires imputing the value of benefits funded at the firm level to individuals.

Other provisions principally affect the incomes of members of certain groups, rather than affecting incentives. For example, tax-favored treatment of Social Security benefits, certain veterans' benefits, and deductions for the blind and elderly provide increased incomes to eligible parties. The earned-income tax credit, in contrast, should be evaluated for its effects on labor force participation as well as the income it provides lower-income workers.

*General purpose fiscal assistance and interest.* The tax-exemption for public purpose State and local bonds reduces the costs of borrowing for a variety of purposes (borrowing for non-public purposes is reflected under other budget functions). The deductibility of certain State and local taxes reflected under this function primarily relates to personal income taxes (property tax deductibility is reflected under the commerce and housing function). Tax preferences for Puerto Rico and other U.S. possessions are also included here. These provisions can be compared with other tax and spending policies as means of benefiting fiscal and economic conditions in the States, localities, and possessions. Finally, the tax deferral for interest on U.S. savings bonds benefits savers who invest in these instruments. The extent of these benefits and any effects on Federal borrowing costs could be evaluated.

The above illustrative discussion, although broad, is nevertheless incomplete, omitting important details both for the provisions mentioned and the many that are not explicitly cited. Developing a framework that is sufficiently comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures will be a significant challenge. OMB, Treasury, and other agencies will work together, as appropriate, to address this challenge. As indicated above, over the next few years the Executive Branch's focus will be on the availability of the data needed to assess the effects of the tax expenditures designed to increase savings.

### Descriptions of Income Tax Provisions

Descriptions of the individual and corporate income tax expenditures reported on in this chapter follow. These descriptions relate to current law as of December 31, 2005, and do not reflect proposals made elsewhere in the Budget. Legislation enacted in 2005, such as the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy For Users, The Energy Tax Incentives Act of 2005, The Katrina Emergency Tax Relief Act of 2005, and the Gulf Opportunity Zone Act of 2005, expanded the scope of existing tax expenditures and introduced several new provisions. These include: (1) Exclusion of interest on clean renewable energy bonds; (2) Deferral of gain from dispositions of transmission property to implement FERC restructuring policy; (3) Credit for production from advanced nuclear power facilities; (4) Credit for investment in clean coal facilities; (5) Temporary 50 percent expensing for equip-

ment used in the refining of liquid fuels; (6) Pass-through low-sulfur diesel expensing to cooperative owners; (7) Natural gas distribution pipelines treated as 15-year property; (8) Amortize all geological and geophysical expenditures over 2 years; (9) Allowance of deduction for certain energy efficient commercial building property; (10) Credit for construction of new energy efficient homes; (11) Credit for energy efficiency improvements to existing homes; (12) Credit for energy efficient appliances; (13) 30 percent credit for residential purchases/installations of solar and fuel cells; (14) Credit for business installation of qualified fuel cells and stationary microturbine power plants; (15) Business solar investment tax credit; (16) Alternative motor vehicle credit; (17) Credit for installation of alternative fueling stations; (18) Small agri-biodiesel producer credit; (19) Alternative fuel and fuel mixture tax credit; (20) Exclusion of interest spread of financial institutions; (21) Exclusion of interest on bonds for financing of highway projects and rail-truck transfer facilities; and (22) expanded and extended scope of a number of existing benefits to taxpayers in areas affected by hurricanes Katrina, Rita, and Wilma.

### National Defense

1. **Benefits and allowances to armed forces personnel.**—The housing and meals provided military personnel, either in cash or in kind, as well as certain amounts of pay related to combat service, are excluded from income subject to tax.

### International Affairs

2. **Income earned abroad.**—U.S. citizens who lived abroad, worked in the private sector, and satisfied a foreign residency requirement may exclude up to \$80,000 in foreign earned income from U.S. taxes. In addition, if these taxpayers receive a specific allowance for foreign housing from their employers, they may also exclude the value of that allowance. If they do not receive a specific allowance for housing expenses, they may deduct against their U.S. taxes that portion of such expenses that exceeds one-sixth the salary of a civil servant at grade GS-14, step 1 (\$76,193 in 2005).

3. **Exclusion of certain allowances for Federal employees abroad.**—U.S. Federal civilian employees and Peace Corps members who work outside the continental United States are allowed to exclude from U.S. taxable income certain special allowances they receive to compensate them for the relatively high costs associated with living overseas. The allowances supplement wage income and cover expenses like rent, education, and the cost of travel to and from the United States.

4. **Extraterritorial income exclusion.**<sup>6</sup>—The exclusion for extraterritorial income was repealed by the American Jobs Creation Act of 2004. Under the transition rules, taxpayers retain 80% of ETI benefits for

2005, 60% of ETI benefits for 2006, and no ETI benefits thereafter. The exclusion for extraterritorial income remains in effect for certain transactions which occur pursuant to a binding contract entered into on or before September 17, 2003.

5. **Sales 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. The sales source rules for inventory property allow U.S. exporters to use more foreign tax credits by allowing the exporters to attribute a larger portion of their earnings abroad than would be the case if the allocation of earnings was based on actual economic activity.

6. **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 considered to be subject to U.S. taxation, whether or not distributed. Thus, the normal tax method considers the amount of controlled foreign corporation income not yet distributed to a U.S. shareholder as tax-deferred income.

7. **Exceptions under subpart F for active financing income.**—Financial firms can defer taxes on income earned overseas in an active business. Taxes on income earned through December 31, 2006 can be deferred.

### General Science, Space, and Technology

8. **Expensing R&E expenditures.**—Research and experimentation (R&E) projects can be viewed as investments because, if successful, their benefits accrue for several years. It is often difficult, however, to identify whether a specific R&E project is successful and, if successful, what its expected life will be. Under the normal tax method, 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.

9. **R&E credit.**—The research and experimentation (R&E) credit is 20 percent of qualified research expenditures in excess of a base amount. The base amount is generally determined by multiplying a “fixed-base percentage” by the average amount of the company’s gross receipts for the prior four years. The taxpayer’s fixed base percentage generally is the ratio of its research expenses to gross receipts for 1984 through 1988. Taxpayers may also elect an alternative credit regime. Under the alternative credit regime the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage that would otherwise apply, and the credit rate is reduced (the rates range from 2.65 percent to 3.75 percent). A 20-percent credit with a separate threshold is provided

<sup>6</sup>The determination of whether a provision is a tax expenditure is made on the basis of a broad concept of “income” that is larger in scope than is “income” as defined under general U.S. income tax principles. For that reason, the tax expenditure estimates include, for example, estimates related to the exclusion of extraterritorial income, as well as other exclusions, notwithstanding that such exclusions define income under the general rule of U.S. income taxation.

for a taxpayer's payments to universities for basic research. A 20-percent "flat" credit with no threshold base amount is available for energy research expenditures paid to certain research consortia. The credit applies to research conducted before January 1, 2006 and extends to research conducted in Puerto Rico and the U.S. possessions.

### Energy

10. **Exploration and development costs.**—For successful investments in domestic oil and gas wells, intangible drilling costs (e.g., wages, the costs of using machinery for grading and drilling, 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 deduct only 70 percent of such costs and must 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.

11. **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.

12. **Alternative fuel production credit.**—A credit of \$3 per oil-equivalent barrel of production (in 1979 dollars) is provided for gas produced from biomass and liquid, gaseous, or solid synthetic fuels produced from coal. The credit is generally available if the price of oil stays below \$29.50 (in 1979 dollars). The credit applies only to fuel (1) produced at a facility placed in service before July 1, 1998, and (2) sold before January 1, 2008.

13. **Oil and gas exception to passive loss limitation.**—Owners of working interests in oil and gas properties are exempt from the "passive income" limitations. As a result, 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.

14. **Capital gains treatment of royalties on coal.**—Sales of certain coal under royalty contracts can be treated as capital gains rather than ordinary income.

15. **Energy facility bonds.**—Interest earned on State and local bonds used to finance construction of certain energy facilities is tax-exempt. These bonds are generally subject to the State private-activity bond annual volume cap.

16. **Enhanced oil recovery credit.**—A credit is provided equal to 15 percent of the taxpayer's costs for tertiary oil recovery on U.S. projects. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaska natural gas for pipeline transportation and any of the following costs with respect to a qualified EOR project: (1) the cost of depreciable or amortizable tangible property that is an integral part of the project; (2) intangible drilling costs (IDCs) that the taxpayer can elect to deduct; and (3) deductible tertiary injectant costs. The credit rate is reduced in taxable years following calendar years during which the annual average unregulated wellhead price per barrel of domestic crude oil exceeds an inflation adjusted threshold of \$28 (adjusted for inflation).

17. **New technology, refined coal, Indian coal and coke and coke gas credits.**—A credit is provided equal to 10 percent of the basis of solar property (30 percent for purchases beginning in 2006 through 2007) and 10 percent of the basis of geothermal property placed in service during the taxable year. Equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for a 30 percent credit in 2006 and 2007. A credit is also available for certain electricity produced from wind energy, biomass, poultry waste, geothermal energy, solar energy, small irrigation power, municipal solid waste, or qualified hydropower and sold to an unrelated party. The credit rate in 2005 is 1.9 cents per kilowatt hour (0.9 cents per kilowatt hour for open-loop biomass, small irrigation power, municipal solid waste and qualified hydropower) and the rate is indexed in subsequent years. To qualify for the credit the electricity must be produced at a facility placed in service after a specified date (December 31, 1992, in the case of a closed-loop biomass facility, December 31, 1993, in the case of a wind energy facility, December 31, 1999, in the case of a poultry waste facility, August 8, 2005 in the case of qualified hydropower and October 22, 2004, in all other cases) and before January 1, 2006 for solar facilities and January 1, 2008 for all other qualifying facilities with the exception of hydropower facilities. To qualify for the credit, qualifying hydropower facilities must be placed in service before January 1, 2009. In addition, the electricity must be produced during the 10-year period after the facility is originally placed in service. A credit is available for refined coal produced at facilities placed in service during the period from October 22, 2004, through December 31, 2008, and sold during the 10-year period beginning on the date the facility was placed in service. The credit rate in 2005 is \$5.481 per ton and the rate is indexed in subsequent years. A credit is available for Indian coal. The taxpayer may claim a credit for sales of coal to an unrelated third party from a quali-

fied facility for the seven-year period beginning on January 1, 2006, and ending after December 31, 2012. The value of the credit is \$1.50 per ton for the first four years of the seven-year production period and \$2.00 per ton for the last three years of the seven-year period. The credit amounts are indexed for inflation. A credit is available for the production of coke or coke gas from a qualified facility. Qualified facilities must have been placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010.

18. **Alcohol fuel credits.**—An income tax credit is provided for ethanol that is derived from renewable sources and used as fuel. The credit equals 51 cents per gallon through 2010. In lieu of the alcohol mixture credit, the taxpayer may claim a refundable excise tax credit. In addition, small ethanol producers are eligible for a separate 10 cents per gallon credit.

19. **Credit and deduction for clean-fuel vehicles and property and alternative motor vehicle credits.**—A tax credit of 10 percent (not to exceed \$4,000) is provided for purchasers of electric vehicles. The credit is reduced by 75 percent for vehicles placed in service in 2006 and is not available for vehicles placed in service after December 31, 2006. Purchasers of other clean-fuel burning vehicles and owners of clean-fuel refueling property may deduct part of their expenditures. No deduction is available to taxpayers for vehicles placed in service after December 31, 2005. The deduction for clean-fuel property is available for costs incurred before January 1, 2007. A taxpayer may claim a 30 percent credit for the cost of installing clean-fuel vehicle refueling property for property placed in service after December 31, 2005 and before January 1, 2008. The taxpayer may not claim deductions with respect to property for which the credit is claimed. A tax credit is also available for the purchase of hybrid vehicles, fuel cell vehicles, alternative fuel vehicles and advanced lean burn vehicles. The provision applies to vehicles placed in service after December 31, 2005, in the case of qualified fuel cell motor vehicles, before January 1, 2015; in the case of qualified hybrid motor vehicles that are automobiles and light trucks and in the case of advanced lean-burn technology vehicles, before January 1, 2011; in the case of qualified hybrid motor vehicles that are medium and heavy trucks, before January 1, 2010; and in the case of qualified alternative fuel motor vehicles, before January 1, 2011. A tax credit is available for the purchase of hybrid vehicles, fuel cell vehicles, alternative fuel vehicles and advanced lean burn vehicles. The provision applies to vehicles placed in service after December 31, 2005, in the case of qualified fuel cell motor vehicles, before January 1, 2015; in the case of qualified hybrid motor vehicles that are automobiles and light trucks and in the case of advanced lean-burn technology vehicles, before January 1, 2011; in the case of qualified hybrid motor vehicles that are medium and heavy trucks, before January 1, 2010; and in the case of qualified alternative fuel motor vehicles, before January 1, 2011.

20. **Exclusion of utility conservation subsidies.**—Non-business customers can exclude from gross income subsidies received from public utilities for expenditures on energy conservation measures.

21. **Credit to holders of clean renewable energy bonds.**—The Energy Tax Incentives Act of 2005 introduced this provision which provides for up to \$800 million in aggregate issuance of Clean Renewable Energy Bonds (CREBs) through December 31, 2007. Taxpayers holding CREBs on a credit allowance date are entitled to a tax credit.

22. **Deferral of gain from dispositions of transmission property to implement FERC restructuring policy.**—Utilities that sell their transmission assets to a FERC-approved independent transmission company are allowed a longer recognition period for their gains from sale. Rather than paying tax on any gain from the sale in the year that the sale is completed, utilities will have 8 years to pay the tax on any gain from the sale. The rule expires at the end of 2007.

23. **Credit for production from advanced nuclear power facilities.**—This provision was introduced by the Energy Tax Incentives Act of 2005. A taxpayer producing electricity at a qualifying advanced nuclear power facility may claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight-year period starting when the facility is placed in service, limited no more than \$125 million in tax credits per 1,000 megawatts of allocated capacity in any one year.

24. **Credit for investment in clean coal facilities.**—This provision was introduced by the Energy Tax Incentives Act of 2005. Three investment tax credits for clean coal facilities are available: a 15 percent and 20 percent investment tax credit for clean coal facilities producing electricity; and a 20 percent credit for industrial gasification projects. Integrated gasification combined cycle (IGCC) projects get a 20 percent investment tax credit and other advanced coal-based projects that produce electricity get a 15 percent credit. The Secretary of the Treasury may allocate up to \$800 million for IGCC projects and up to \$500 million for other advanced coal-based technologies and up to \$350 million for industrial gasification.

25. **Temporary 50 percent expensing for equipment used in the refining of liquid fuels.**—This provision was introduced by the Energy Tax Incentives Act of 2005. Taxpayers may expense 50 percent of the cost of refinery investments which increase the capacity of an existing refinery by at least 5 percent or increase the throughput of qualified fuels by at least 25 percent. Qualified fuels include oil from shale and tar sands. Investments must be placed in service before January 1, 2012.

26. **Pass through low sulfur diesel expensing to cooperative owners.**—This provision was introduced by the Energy Tax Incentives Act of 2005. Taxpayers may expense certain costs for investments to comply with EPA low sulfur diesel regulations. The deduction

may be passed-through to members of a cooperative if the cooperative makes an election on their tax return.

**27. Natural gas distribution pipelines treated as 15-year property.**—This provision was introduced by the Energy Tax Incentives Act of 2005. The depreciation period is shortened to 15 years for any gas distribution lines the original use of which occurred after April 11, 2004 and before January 1, 2011. The provision does not apply to any property which the taxpayer or a related party had entered into a binding contract for the construction thereof or self-constructed on or before April 11, 2005.

**28. Amortize all geological and geophysical expenditures over 2 years.**—This provision was introduced by the Energy Tax Incentives Act of 2005. Geological and geophysical amounts incurred in connection with oil and gas exploration in the United States may be amortized over two years. In the case of abandoned property, any remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

**29. Allowance of deduction for certain energy efficient commercial building property.**—This provision was introduced by the Energy Tax Incentives Act of 2005. A deduction for energy efficient commercial buildings that reduce annual energy and power consumption by 50 percent compared to the American Society of Heating, Refrigerating, and Air Conditioning Engineers (ASHRAE) standard is allowed. The provision is effective for property placed in service after December 31, 2005 and prior to January 1, 2008.

**30. Credit for construction of new energy efficient homes.**—This provision was introduced by the Energy Tax Incentives Act of 2005. A credit is available to eligible contractors for construction of a qualified new energy-efficient home. The credit applies to homes whose construction is substantially completed after December 31, 2005 and which are purchased after December 31, 2005 and prior to January 1, 2008.

**31. Credit for energy efficiency improvements to existing homes.**—This provision was introduced by the Energy Tax Incentives Act of 2005. A 10 percent investment tax credit for expenditures with respect to improvements to building envelope is available. Credits for purchases of advanced main air circulating fans, natural gas, propane, or oil furnaces or hot water boilers, and other qualified energy efficient property are also available. Credit applies to property placed in service after December 31, 2005 and prior to January 1, 2008.

**32. Credit for energy efficient appliances.**—This provision was introduced by the Energy Tax Incentives Act of 2005. Tax credits for the manufacture of efficient dishwashers, clothes washers, and refrigerators are available. Credits vary depending on the efficiency of the unit. The provision is effective for appliances manufactured in 2006 and 2007.

**33. Credit for residential purchases/installations of solar and fuel cells.**—This provision was intro-

duced by the Energy Tax Incentives Act of 2005. A credit, equal to 30 percent of qualifying expenditures, for purchase for qualified photovoltaic property and solar water heating property is available. A 30 percent credit for the purchase of qualified fuel cell power plants is also allowed and applies to property placed in service after December 31, 2005 and prior to January 1, 2008.

**34. Credit for business installation of qualified fuel cells and stationary microturbine power plants.**—This provision was introduced by the Energy Tax Incentives Act of 2005. A 30 percent business energy credit for purchase of qualified fuel cell power plants for businesses and a 10 percent credit for purchase of qualifying stationary microturbine power plants are allowed.

**35. Alternative fuel and fuel mixture tax credit.**—This provision was introduced in the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005. A tax credit is available against the excise tax imposed on the retail sale or use of alternative fuels or mixture of alternative fuel and other taxable fuel. The credit is 50 cents per gallon of alternative fuel.

#### Natural Resources and Environment

**36. Exploration and development costs.**—Certain capital outlays associated with exploration and development of nonfuel minerals may be expensed rather than depreciated over the life of the asset.

**37. Percentage depletion.**—Most nonfuel mineral extractors may use percentage depletion rather than cost depletion, with percentage depletion rates ranging from 22 percent for sulfur to 5 percent for sand and gravel.

**38. Sewage, water, solid and hazardous waste facility bonds.**—Interest earned on State and local bonds used to finance the construction of sewage, water, or hazardous waste facilities is tax-exempt. These bonds are generally subject to the State private-activity bond annual volume cap.

**39. Capital gains treatment of certain timber.**—Certain timber sales can be treated as a capital gain rather than ordinary income.

**40. Expensing multiperiod timber growing costs.**—Most of the production costs of growing timber may be expensed rather than capitalized and deducted when the timber is sold. In most other industries, these costs are capitalized under the uniform capitalization rules.

**41. 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.

**42. Expensing of capital costs with respect to complying with EPA sulfur regulations.**—Small refiners are allowed to deduct 75 percent of qualified capital costs incurred by the taxpayer during the taxable year. This provision was introduced by the American Jobs Creation Act (AJCA) enacted in 2004.

43. **Exclusion of gain or loss on sale or exchange of certain brownfield sites.**—In general, an organization that is otherwise exempt from federal income tax is taxed on income from any trade or business regularly carried on by the organization that is not substantially related to the organization's exempt purpose. The AJCA of 2004 created a special exclusion from unrelated business taxable income of the gain or loss from the sale or exchange of certain qualifying brownfield properties. The exclusion applies regardless of whether the property is debt-financed. In order to qualify, a minimum amount of remediation expenditures must be incurred by the organization.

### Agriculture

44. **Expensing certain capital outlays.**—Farmers, except for certain agricultural corporations and partnerships, are allowed to expense 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.

45. **Expensing multiperiod livestock and crop production costs.**—The production of livestock and crops with a production period of less than two years is exempt 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.

46. **Loans forgiven solvent farmers.**—Farmers are forgiven the tax liability on certain forgiven debt. Normally, debtors must include the amount of loan forgiveness as income or reduce their recoverable basis in the property to which the loan relates. If the debtor elects to reduce basis and the amount of forgiveness exceeds the basis in the property, the excess forgiveness is taxable. For insolvent (bankrupt) debtors, however, the amount of loan forgiveness reduces carryover losses, then unused credits, and then basis; any remainder of the forgiven debt is excluded from tax. Farmers with forgiven debt are considered insolvent for tax purposes, and thus qualify for income tax forgiveness.

47. **Capital gains treatment of certain income.**—Certain agricultural income, such as unharvested crops, can be treated as capital gains rather than ordinary income.

48. **Income averaging for farmers.**—Taxpayers can lower their tax liability by averaging, over the prior three-year period, their taxable income from farming and fishing.

49. **Deferral of gain on sales of farm refiners.**—A taxpayer who sells stock in a farm refiner to a farmers' cooperative can defer recognition of gain if the taxpayer reinvests the proceeds in qualified replacement property.

50. **Bio-Diesel tax credit.**—An income tax credit of \$0.50, similar to Ethanol benefits, is available for each gallon of biodiesel used or sold. Biodiesel derived from virgin sources (agri-biodiesel) receives an increased credit of \$1.00 per gallon. The provision was introduced by the AJCA in 2004. The Energy Tax Incentives Act of 2005 extends the income tax credit, excise tax credit, and payment provisions through December 31, 2008 and adds a credit for small agri-biodiesel producers. The conference agreement also creates a similar income tax credit, excise tax credit and payment system for renewable diesel, however there is no credit for small producers of renewable diesel. Renewable diesel means diesel fuel derived from biomass using thermal depolymerization process.

### 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 be classified under the energy, natural resources and environment, agriculture, or transportation categories.

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

52. **Bad debt reserves.**—Small (less than \$500 million in assets) commercial banks, mutual savings banks, and savings and loan associations may deduct additions to bad debt reserves in excess of actually experienced losses.

53. **Deferral of income on life insurance and annuity contracts.**—Favorable tax treatment is provided for investment income within qualified life insurance and annuity contracts. Investment income earned on qualified life insurance contracts held until death is permanently exempt from income tax. Investment income distributed prior to the death of the insured is tax-deferred, if not tax-exempt. Investment income earned on annuities is treated less favorably than income earned on life insurance contracts, but it benefits from tax deferral without annual contribution or income limits generally applicable to other tax-favored retirement income plans.

54. **Small property and casualty insurance companies.**—For taxable years beginning before January 1, 2004, insurance companies that were not life insurance companies and which had annual net premiums of less than \$350,000 were exempt from tax; those with \$350,000 to \$1.2 million of annual net premiums could elect to pay tax only on the income earned by their taxable investment portfolio. For taxable years beginning after December 31, 2003, stock non-life insurance companies are generally exempt from tax if their gross receipts for the taxable year do not exceed \$600,00 and more than 50 percent of such gross receipts consists of premiums. Mutual non-life insurance companies are generally tax-exempt if their annual gross receipts do not exceed \$150,000 and more than 35 percent of gross receipts consist of premiums. Also, for taxable years



beginning after December 31, 2003, non-life insurance companies with no more than \$1.2 million of annual net premiums may elect to pay tax only on their taxable investment income.

**55. 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 exempt from tax.

**56. Small life insurance company deduction.**—Small life insurance companies (gross assets of less than \$500 million) can deduct 60 percent of the first \$3 million of otherwise taxable income. The deduction phases out for otherwise taxable income between \$3 million and \$15 million.

**57. Exclusion of interest spread of financial institutions.**—Consumers and non-profit organizations pay for some deposit-linked services, such as check cashing, by accepting a below-market interest rate on their demand deposits. If they received a market rate of interest on those deposits and paid explicit fees for the associated services, they would pay taxes on the full market rate and (unlike businesses) could not deduct the fees. The government thus foregoes tax on the difference between the risk-free market interest rate and below-market interest rates on demand deposits, which under competitive conditions should equal the value added of deposit services.

**58. Mortgage housing bonds.**—Interest earned on State and local bonds used to finance homes purchased by first-time, low-to-moderate-income buyers is tax-exempt. The amount of State and local tax-exempt bonds that can be issued to finance these and other private activity is limited. The combined volume cap for private activity bonds, including mortgage housing bonds, rental housing bonds, student loan bonds, and industrial development bonds was \$62.50 per capita (\$187.5 million minimum) per State in 2001, and \$75 per capita (\$225 million minimum) in 2002. The Community Renewal Tax Relief Act of 2000 accelerated the scheduled increase in the state volume cap and indexed the cap for inflation, beginning in 2003. States may issue mortgage credit certificates (MCCs) in lieu of mortgage revenue bonds. MCCs entitle home buyers to income tax credits for a specified percentage of interest on qualified mortgages. The total amount of MCCs issued by a State cannot exceed 25 percent of its annual ceiling for mortgage-revenue bonds.

**59. Rental housing bonds.**—Interest earned on State and local government bonds used to finance multifamily rental housing projects is tax-exempt. At least 20 percent (15 percent in targeted areas) of the units must be 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.

**60. Interest on owner-occupied homes.**—Owner-occupants of homes may deduct mortgage interest 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 value of owner-occupied housing services is not included in a taxpayer's taxable income.

**61. Taxes on owner-occupied homes.**—Owner-occupants of homes may deduct property taxes on their primary and secondary residences even though they are not required to report the value of owner-occupied housing services as gross income.

**62. Installment sales.**—Dealers in real and personal property (i.e., sellers who regularly hold property for sale or resale) cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers (i.e., sellers of real property used in their business) are required to pay interest 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 million is, therefore, a tax expenditure.

**63. Capital gains exclusion on home sales.**—A homeowner can exclude from tax up to \$500,000 (\$250,000 for singles) of the capital gains from the sale of a principal residence. The exclusion may not be used more than once every two years.

**64. Imputed net rental income on owner occupied housing.**—The implicit rental value of home ownership, net of expenses such as mortgage interest and depreciation, is excluded from income. The appendix provides a greater explanation of this new addition to the tax expenditure budget.

**65. 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 exempt from this rule.

**66. Low-income housing credit.**—Taxpayers who invest in certain low-income housing are eligible for a tax credit. The credit rate is set so that the present value of the credit is equal to 70 percent for new construction and 30 percent for (1) housing receiving other Federal benefits (such as tax-exempt bond financing), or (2) substantially rehabilitated existing housing. The credit is allowed in equal amounts over 10 years. State



agencies determine who receives the credit; States are limited in the amount of credit they may authorize annually. The Community Renewal Tax Relief Act of 2000 increased the per-resident limit to \$1.50 in 2001 and to \$1.75 in 2002 and indexed the limit for inflation, beginning in 2003. The Act also created a \$2 million minimum annual cap for small States beginning in 2002; the cap is indexed for inflation, beginning in 2003.

**67. Accelerated depreciation of rental property.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under the reference method. Under the normal tax method, however, economic depreciation is assumed. This calculation is described in more detail in the Appendix.

**68. Cancellation of indebtedness.**—Individuals are not required to report the cancellation of certain indebtedness as current income. If the canceled debt is not reported as current income, however, the basis of the underlying property must be reduced by the amount canceled.

**69. Imputed interest rules.**—Holders (issuers) of debt instruments are generally required to report interest earned (paid) in the period it accrues, not when paid. In addition, the amount of interest accrued is determined by the actual price paid, not by the stated principal and interest stipulated in the instrument. In general, any debt associated with the sale of property worth less than \$250,000 is excepted from the general interest accounting rules. This general \$250,000 exception is not a tax expenditure under reference law but is under normal law. Exceptions above \$250,000 are a tax expenditure under reference law; these exceptions include the following: (1) sales of personal residences worth more than \$250,000, and (2) sales of farms and small businesses worth between \$250,000 and \$1 million.

**70. Capital gains (other than agriculture, timber, iron ore, and coal).**—Capital gains on assets held for more than 1 year are taxed at a lower rate than ordinary income. Under the revised reference law baseline used for the 2005 Budget, the lower rate on capital gains is considered a tax expenditure under the reference law method, but only for capital gains that have not been previously taxed under the corporate income tax. As discussed above, this treatment partially adjusts for the double tax on corporate income and is more consistent with a comprehensive income tax base.

Prior to passage of the Jobs Growth Tax Relief Reconciliation Act (JGTRRA), the top capital gains tax rate for most assets held for more than 1 year was 20 percent. For assets acquired after December 31, 2000, the top capital gains tax rate for assets held for more than 5 years was 18 percent. Since January 1, 2001, taxpayers may mark-to-market existing assets to start the 5-year holding period. Losses from the mark-to-market are not recognized.

For assets held for more than 1 year by taxpayers in the 15-percent ordinary tax bracket, the top capital

gains tax rate was 10 percent. After December 31, 2000, the top capital gains tax rate for assets held by these taxpayers for more than 5 years was 8 percent. JGTRRA reduced the previous 20 percent and 18 percent rates on net capital gains to 15 percent and the previous 10 percent and 8 percent rates to 5 percent (0 percent, in 2008). The lower rates apply to assets held for more than one year. The lower rates apply to assets sold after May 6, 2003 through 2008.

**71. 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.

**72. 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. After repeal of the estate tax for 2010 under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the basis for property acquired from a decedent will be the lesser of fair market value or the decedent's basis. Certain types of additions to basis will be allowed so that assets in most estates that are not currently subject to estate tax will not be subject to capital gains tax in the hands of the heirs.

**73. Carryover basis of capital gains on gifts.**—When a gift is made, the donor's basis in the transferred property (the cost that was incurred when the transferred property was first acquired) carries-over to the donee. The carryover of the donor's basis allows a continued deferral of unrealized capital gains. Even though the estate tax is repealed for 2010 under EGTRRA, the gift tax is retained with a lifetime exemption of \$1 million.

**74. Ordinary income treatment of losses from sale of small business corporate stock shares.**—Up to \$100,000 in losses from the sale of small business corporate stock (capitalization less than \$1 million) may be treated as ordinary losses. Such losses would, thus, not be subject to the \$3,000 annual capital loss write-off limit.

**75. Accelerated depreciation of non-rental-housing buildings.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, economic depreciation is assumed. This calculation is described in more detail in the Appendix.

**76. Accelerated depreciation of machinery and equipment.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under the normal tax baseline, this tax depreciation allowance is measured relative to economic depreciation. This calculation is described in more detail in the Appendix.

77. **Expensing of certain small investments.**—As of 2003, under prior law, qualifying investments in tangible property up to \$25,000 could have been expensed rather than depreciated over time. The amount eligible for expensing was decreased to the extent the taxpayer's qualifying investment during the year exceeded \$200,000. For 2003, however, the expensing limit was temporarily increased to \$100,000, the phase-out limit was temporarily increased to \$400,000, and computer software became temporarily eligible for expensing treatment. For 2004, through 2007, these higher limits are indexed for inflation, and computer software continues to be an eligible investment. In all years, the amount expensed cannot exceed the taxpayer's taxable income for the year. The prior rules will apply for taxable years beginning after 2007.

78. **Graduated corporation income tax rate schedule.**—The corporate income tax schedule is graduated, with rates of 15 percent on the first \$50,000 of taxable income, 25 percent on the next \$25,000, and 34 percent on the next \$9.925 million. Compared with a flat 34-percent rate, the lower rates provide an \$11,750 reduction in tax liability for corporations with taxable income of \$75,000. This benefit is recaptured for corporations with taxable incomes exceeding \$100,000 by a 5-percent additional tax on corporate incomes in excess of \$100,000 but less than \$335,000.

The corporate tax rate is 35 percent on income over \$10 million. Compared with a flat 35-percent tax rate, the 34-percent rate provides a \$100,000 reduction in tax liability for corporations with taxable incomes of \$10 million. This benefit is recaptured for corporations with taxable incomes exceeding \$15 million by a 3-percent additional tax on income over \$15 million but less than \$18.33 million. Because the corporate rate schedule is part of reference tax law, it is not considered 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 is considered a tax expenditure under this concept.

79. **Small issue industrial development bonds.**—Interest earned on small issue industrial development bonds (IDBs) issued by State and local governments to finance manufacturing facilities is tax-exempt. Depreciable property financed with small issue IDBs must be depreciated, however, using the straight-line method. The annual volume of small issue IDBs is subject to the unified volume cap discussed in the mortgage housing bond section above.

80. **Deduction for U.S. production activities.**—This provision was introduced by the AJCA in 2004 and allows for a deduction equal to a portion of taxable income attributable to domestic production. For taxable years beginning in 2004, 2005, 2006, 2007, and 2008, the amount of the deduction is 5, 5, 5, 6, and 7 percent, respectively. For taxable years beginning after 2008, the amount of the deduction is 9 percent.

81. **Special rules for certain film and TV production.**—Taxpayers may deduct up to \$15 million (\$15

million in certain distressed areas) per production expenditures in the year incurred. Excess expenditures may be deducted over three years using the straight line method. This provision was introduced by the AJCA enacted in 2004. Under prior law, production expenses were depreciated.

### Transportation

82. **Deferral of tax on U.S. shipping companies.**—Certain companies that operate U.S. flag vessels can defer 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 investments. Once indefinite, the deferral has been limited to 25 years since January 1, 1987.

83. **Exclusion of employee parking expenses.**—Employee parking expenses that are paid for by the employer or that are received in lieu of wages are excludable from the income of the employee. In 2005, the maximum amount of the parking exclusion is \$200 (indexed) per month. The tax expenditure estimate does not include parking at facilities owned by the employer.

84. **Exclusion of employee transit pass expenses.**—Transit passes, tokens, fare cards, and van-pool expenses paid for by an employer or provided in lieu of wages to defray an employee's commuting costs are excludable from the employee's income. In 2005, the maximum amount of the exclusion is \$105 (indexed) per month.

85. **Tax credit for certain expenditures for maintaining railroad tracks.**—Eligible taxpayers may claim a credit equal to the lesser of 50 percent of maintenance expenditures and the product of \$3,500 and the number of miles of track owned or leased. This provision was introduced by the AJCA in 2004.

86. **Exclusion of interest on bonds for Financing of Highway Projects and Rail-Truck Transfer Facilities.**—This provision provides for \$15 billion of tax-exempt bond authority to finance qualified highway or surface freight transfer facilities. It was introduced by the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy For Users enacted in 2005. The authority to issue these bonds expires on December 31, 2015.

### Community and Regional Development

87. **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. The taxpayer's recoverable basis must be reduced by the amount of the credit.

88. **Airport, dock, and similar facility bonds.**—Interest earned on State and local bonds issued to finance high-speed rail facilities and government-owned airports, docks, wharves, and sport and convention facilities is tax-exempt. These bonds are not subject to a volume cap.

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

90. **Empowerment zones and renewal communities.**—Qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increased expensing of investment in equipment, special tax-exempt financing, accelerated depreciation, and certain capital gains incentives. Empowerment zone and renewal community designations expire at the end of 2009. The Job Creation and Worker Assistance Act of 2002 expanded the existing provisions by adding the “New York City Liberty Zone.” In addition, the Working Families Tax Relief Act of 2004 extended the District of Columbia Enterprise Zone and the District of Columbia first time homebuyer credit by two years through 2005.

The Gulf Opportunity Zone Act of 2005 added several provisions targeted to encourage the redevelopment of areas affected by hurricanes Katrina, Rita and Wilma, including some provisions that have already been listed elsewhere in this table. Gulf Opportunity Zone Act provisions not listed elsewhere include additional tax-exempt bond financing authority, accelerated depreciation of investment in both structures and equipment, partial expensing for certain demolition and clean-up costs, increased carryback of certain net operating losses, increased authority to allocate low-income housing tax credits and new markets tax credits within the affected areas and other provisions.

91. **New markets tax credit.**—Taxpayers who make qualified equity investments in a community development entity (CDE), which then makes qualified investments in low-income communities, are eligible for a tax credit received over 7 years. The amount of the credit equals (1) 5 percent in the year of purchase and the following 2 years, and (2) 6 percent in the following 4 years. A CDE is any domestic firm whose primary mission is to serve or provide investment capital for low-income communities/individuals; a CDE must be accountable to residents of low-income communities. The total equity investment available for the credit across all CDEs is \$1.0 billion in 2001, \$1.5 billion in 2002 and 2003, \$2.0 billion in 2004 and 2005, and \$3.5 billion in 2006 and 2007. Credit authority is allocated to CDEs through a competitive application process.

92. **Expensing of environmental remediation costs.**—Taxpayers who clean up certain hazardous substances at a qualified site may expense the clean-up costs, even though the expenses will generally increase the value of the property significantly or appreciably prolong the life of the property. The Working Families Tax Relief Act of 2004 extended this provision for two years, allowing remediation expenditures incurred before December 31, 2005 to be eligible for expensing.

The Gulf Opportunity Zone Act of 2005 extends this provision through December 31, 2007 for sites located

in the Gulf Opportunity Zone and expands the allowable costs to include petroleum product remediation.

93. **Credit to holders of Gulf Tax Credit Bonds.**—Taxpayers that own Gulf Tax Credit bonds receive a non-refundable tax credit (at a rate set by the Treasury Department) rather than interest. The credit is included in gross income. The maximum amount that can be issued is \$200 million in the case of Louisiana, \$100 million in the case of Mississippi, and \$50 million in the case of Alabama.

### Education, Training, Employment, and Social Services

94. **Scholarship and fellowship income.**—Scholarships and fellowships are excluded from taxable income to the extent they pay for tuition and course-related expenses of the grantee. Similarly, tuition reductions for employees of educational institutions and their families are not included in taxable income. 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, this exclusion is not a tax expenditure because this method does not include either gifts or price reductions in a taxpayer’s gross income. The exclusion, however, is considered a tax expenditure under the normal tax method, which includes gift-like transfers of Government funds in gross income (many scholarships are derived directly or indirectly from Government funding).

95. **HOPE tax credit.**—The non-refundable HOPE tax credit allows a credit for 100 percent of an eligible student’s first \$1,000 of tuition and fees and 50 percent of the next \$1,000 of tuition and fees. The credit only covers tuition and fees paid during the first two years of a student’s post-secondary education. In 2005, the credit is phased out ratably for taxpayers with modified AGI between \$87,000 and \$107,000 (\$43,000 and \$53,000 for singles), indexed.

96. **Lifetime Learning tax credit.**—The non-refundable Lifetime Learning tax credit allows a credit for 20 percent of an eligible student’s tuition and fees, up to a maximum credit per return is \$2,000. The credit is phased out ratably for taxpayers with modified AGI between \$87,000 and \$107,000 (\$43,000 and \$53,000 for singles) (indexed beginning in 2002). The credit applies to both undergraduate and graduate students.

97. **Deduction for Higher Education Expenses.**—The maximum annual deduction for qualified higher education expenses is \$4,000 in 2005 for taxpayers with adjusted gross income up to \$130,000 on a joint return (\$65,000 for singles). Taxpayers with adjusted gross income up to \$160,000 on a joint return (\$80,000 for singles) may deduct up to \$2,000 beginning in 2004. No deduction is allowed for expenses paid after December 31, 2005.

98. **Education Individual Retirement Accounts.**—Contributions to an education IRA are not tax-deductible. Investment income earned by education IRAs is not taxed when earned, and investment income from

an education IRA is tax-exempt when withdrawn to pay for a student's tuition and fees. The maximum contribution to an education IRA in 2005 is \$2000 per beneficiary. The maximum contribution is phased down ratably for taxpayers with modified AGI between \$190,000 and \$220,000 (\$95,000 and \$110,000 for singles).

99. **Student-loan interest.**—Taxpayers may claim an above-the-line deduction of up to \$2,500 on interest paid on an education loan. Interest may only be deducted for the first five years in which interest payments are required. In 2005, the maximum deduction is phased down ratably for taxpayers with modified AGI between \$105,000 and \$135,000 (\$50,000 and \$65,000 for singles), indexed.

100. **State prepaid tuition plans.**—Some States have adopted prepaid tuition plans and prepaid room and board plans, which allow persons to pay in advance for college expenses for designated beneficiaries. In 2001 taxes on the earnings from these plans are paid by the beneficiaries and are deferred until tuition is actually paid. Beginning in 2002, investment income is not taxed when earned, and is tax-exempt when withdrawn to pay for qualified expenses.

101. **Student-loan bonds.**—Interest earned on State and local bonds issued to finance student loans is tax-exempt. The volume of all such private activity bonds that each State may issue annually is limited.

102. **Bonds for private nonprofit educational institutions.**—Interest earned on State and local Government bonds issued to finance the construction of facilities used by private nonprofit educational institutions is not taxed.

103. **Credit for holders of zone academy bonds.**—Financial institutions that own zone academy bonds receive a non-refundable tax credit (at a rate set by the Treasury Department) rather than interest. The credit is included in gross income. Proceeds from zone academy bonds may only be used to renovate, but not construct, qualifying schools and for certain other school purposes. The total amount of zone academy bonds that may be issued is limited to \$1.6 billion—\$400 million in each year from 1998 to 2005.

104. **U.S. savings bonds for education.**—Interest earned on U.S. savings bonds issued after December 31, 1989 is tax-exempt if the bonds are transferred to an educational institution to pay for educational expenses. The tax exemption is phased out for taxpayers with AGI between \$91,850 and \$121,850 (\$61,200 and \$76,200 for singles) in 2005.

105. **Dependent students age 19 or older.**—Taxpayers may claim personal exemptions for dependent children who are over the age of 18 or under the age of 24 and who (1) reside with the taxpayer for over half the year (with exceptions for temporary absences from home, such as for school attendance), (2) are full-time students, and (3) do not claim a personal exemption on their own tax returns.

106. **Charitable contributions to educational institutions.**—Taxpayers may deduct contributions to

nonprofit educational institutions. Taxpayers who donate capital assets to educational institutions can deduct the asset's current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

107. **Employer-provided educational assistance.**—Employer-provided educational assistance is excluded from an employee's gross income even though the employer's costs for this assistance are a deductible business expense. EGTRRA permanently extended this exclusion and extended the exclusion to also include graduate education (beginning in 2002).

108. **Special deduction for teacher expenses.**—Educators in both public and private elementary and secondary schools, who work at least 900 hours during a school year as a teacher, instructor, counselor, principal or aide, may subtract up to \$250 of qualified expenses when figuring their adjusted gross income (AGI).

109. **Discharge of student loan indebtedness.**—Certain professionals who perform in underserved areas, and as a consequence get their student loans discharged, may not recognize such discharge as income. This provision was expanded by the AJCA to include health professionals.

110. **Work opportunity tax credit.**—Employers can claim a tax credit for qualified wages paid to individuals who begin work on or before December 31, 2005 and who are certified as members of various targeted groups. The amount of the credit that can be claimed is 25 percent for employment of less than 400 hours and 40 percent for employment of 400 hours or more. The maximum credit per employee is \$2,400 and can only be claimed on the first year of wages an individual earns from an employer. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The Katrina Emergency Tax Relief Act of 2005 expanded WOTC eligibility to Hurricane Katrina Employees, defined as persons whose principal places of abode on August 28, 2005 were in the core disaster area and who beginning on such date and through August 28, 2007, are hired for a position principally located in the core disaster area; and beginning on such date and through December 31, 2005, are hired for a position regardless of its location. The usual certification process rules are waived for Hurricane Katrina employees.

111. **Welfare-to-work tax credit.**—An employer is eligible for a tax credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first \$10,000 of wages in the first year of employment and 50 percent of the first \$10,000 of wages in the second year of employment. The maximum credit is \$8,500 per employee. The credit applies to wages paid to employees who are hired on or before December 31, 2005.

112. **Employer-provided child care exclusion.**—Up to \$5,000 of employer-provided child care is excluded from an employee's gross income even though the employer's costs for the child care are a deductible business expense.

113. **Employer-provided child care credit.**—Employers can deduct expenses for supporting child care or child care resource and referral services. EGTRRA provides a tax credit to employers for qualified expenses beginning in 2002. The credit is equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. Employer deductions for such expenses are reduced by the amount of the credit. The maximum total credit is limited to \$150,000 per taxable year.

114. **Assistance for adopted foster children.**—Taxpayers who adopt eligible children from the public foster care system can receive monthly payments for the children's significant and varied needs and a reimbursement of up to \$2,000 for nonrecurring adoption expenses. These payments are excluded from gross income.

115. **Adoption credit and exclusion.**—Taxpayers can receive a nonrefundable tax credit for qualified adoption expenses. The maximum credit is \$10,630 per child for 2005, and is phased-out ratably for taxpayers with modified AGI between \$159,450 and \$199,450. The credit amounts and the phase-out thresholds are indexed for inflation beginning in 2003. Unused credits may be carried forward and used during the five subsequent years. Taxpayers may also exclude qualified adoption expenses from income, subject to the same maximum amounts and phase-out as the credit. The same expenses cannot qualify for tax benefits under both programs; however, a taxpayer may use the benefits of the exclusion and the tax credit for different expenses. Stepchild adoptions are not eligible for either benefit.

116. **Employer-provided meals and lodging.**—Employer-provided meals and lodging are excluded from an employee's gross income even though the employer's costs for these items are a deductible business expense.

117. **Child credit.**—Taxpayers with children under age 17 can qualify for a \$1,000 partially refundable per child credit. The maximum credit declines to \$500 in 2011 and later years. The credit is phased out for taxpayers at the rate of \$50 per \$1,000 of modified AGI above \$110,000 (\$75,000 for singles).

118. **Child and dependent care expenses.**—Married couples with child and dependent care expenses may claim a tax credit 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 single parents and by divorced or separated parents who have custody of children. Expenditures up to a maximum \$3,000 for one dependent and \$6,000 for two or more dependents are eligible for the credit. The credit is equal to 35 percent of qualified expenditures for taxpayers with incomes of \$15,000. The credit is reduced

to a minimum of 20 percent by one percentage point for each \$2,000 of income in excess of \$15,000.

119. **Disabled access expenditure credit.**—Small businesses (less than \$1 million in gross receipts or fewer than 31 full-time employees) can claim a 50-percent credit for expenditures in excess of \$250 to remove access barriers for disabled persons. The credit is limited to \$5,000.

120. **Charitable contributions, other than education and health.**—Taxpayers may deduct contributions to charitable, religious, and certain other non-profit organizations. Taxpayers who donate capital assets to charitable organizations can deduct the assets' current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

121. **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 excluded from the gross incomes of foster parents; the expenses they incur are nondeductible.

122. **Parsonage allowances.**—The value of a minister's housing allowance and the rental value of parsonages are not included in a minister's taxable income.

123. **Provide an employee retention credit to employers affected by hurricane Katrina, Rita, and Wilma.**—Businesses located within the Gulf Opportunity (GO) Zone on August 28, 2005 are eligible for a 40 percent tax credit on the first \$6,000 in qualified wages paid to qualified employees employed within the GO Zone. Qualified wages are those paid by an eligible employer to an eligible employee on any day after August 28, 2005 and before January 1, 2006 during the period beginning on the date on which the trade or business first became inoperable at the principal place of employment of the employee by reason of hurricane Katrina and ending on the date on which such trade or business resumed significant operations at such principal place of employment. Similar rules apply to the Rita GO Zone and the Wilma GO Zone with initial effective dates of September 23, 2005, and October 23, 2005, respectively.

## Health

124. **Employer-paid medical insurance and expenses.**—Employer-paid health insurance premiums and other medical expenses (including long-term care) are deducted as a business expense by employers, but they are not included in employee gross income. The self-employed also may deduct part of their family health insurance premiums.

125. **Self-employed medical insurance premiums.**—Self-employed taxpayers may deduct a percentage of their family health insurance premiums. Taxpayers without self-employment income are not eligible for the special percentage deduction. The deduct-

ible percentage is 60 percent in 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter.

126. **Medical and health savings accounts.**—Some employees may deduct annual contributions to a medical savings account (MSA); employer contributions to MSAs (except those made through cafeteria plans) for qualified employees are also excluded from income. An employee may contribute to an MSA in a given year only if the employer does not contribute to the MSA in that year. MSAs are only available to self-employed individuals or employees covered under an employer-sponsored high deductible health plan of a small employer. The maximum annual MSA contribution is 75 percent of the deductible under the high deductible plan for family coverage (65 percent for individual coverage). Earnings from MSAs are excluded from taxable income. Distributions from an MSA for medical expenses are not taxable. The number of taxpayers who may benefit annually from MSAs is generally limited to 750,000. No new MSAs may be established after December 31, 2003. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 introduced health savings accounts (HSA) which provides a tax-favored savings for health care expenses. The definition of a high-deductible health plan is less restrictive for HSAs than for MSAs.

127. **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.

128. **Hospital construction bonds.**—Interest earned on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

129. **Charitable contributions to health institutions.**—Individuals and corporations may deduct contributions to nonprofit health institutions. Tax expenditures resulting from the deductibility of contributions to other charitable institutions are listed under the education, training, employment, and social services function.

130. **Orphan drugs.**—Drug firms can claim a tax credit of 50 percent of the costs for clinical testing required by the Food and Drug Administration for drugs that treat rare physical conditions or rare diseases.

131. **Blue Cross and Blue Shield.**—Blue Cross and Blue Shield health insurance providers in existence on August 16, 1986 and certain other nonprofit health insurers are provided exceptions from otherwise applicable insurance company income tax accounting rules that substantially reduce (or even eliminate) their tax liabilities.

132. **Tax credit for health insurance purchased by certain displaced and retired individuals.**—The Trade Act of 2002 provided a refundable tax credit of 65 percent for the purchase of health insurance coverage by individuals eligible for Trade Adjustment Assistance and certain PBGC pension recipients.

## Income Security

133. **Railroad retirement benefits.**—Railroad retirement benefits are not generally subject to the income tax unless the recipient's gross income reaches a certain threshold. The threshold is discussed more fully under the Social Security function.

134. **Workers' compensation benefits.**—Workers compensation provides payments to disabled workers. These benefits, although income to the recipients, are not subject to the income tax.

135. **Public assistance benefits.**—Public assistance benefits are excluded from tax. The normal tax method considers cash transfers from the Government as taxable and, thus, treats the exclusion for public assistance benefits as a tax expenditure.

136. **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.

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

138. **Employer-provided pension contributions and earnings.**—Certain employer contributions to pension plans are excluded from an employee's gross income even though the employer can deduct the contributions. In addition, the tax on the investment income earned by the pension plans is deferred until the money is withdrawn.

139. **401(k) plans.**—Individual taxpayers can make tax-preferred contributions to certain types of employer-provided 401(k) plans (and 401(k)-type plans like 403(b) plans and the Federal government's Thrift Savings Plan). In 2004, an employee could exclude up to \$14,000 of wages from AGI under a qualified arrangement with an employer's 401(k) plan. This increases to \$15,000 in 2006 (indexed thereafter). The tax on the investment income earned by 401(k)-type plans is deferred until withdrawn.

Employees are allowed to make after-tax contributions to 401(k) and 401(k)-type plans. These contributions are not excluded from AGI, but the investment income of such after-tax contributions is not taxed when earned or withdrawn.

140. **Individual Retirement Accounts.**—Individual taxpayers can take advantage of several different Individual Retirement Accounts (IRAs): deductible IRAs, non-deductible IRAs, and Roth IRAs. The annual contributions limit applies to the total of a taxpayer's deductible, non-deductible, and Roth IRAs contributions. The IRA contribution limit is \$4,000 in 2005, and \$5,000 in 2008 (indexed thereafter) and allows taxpayers over age 50 to make additional "catch-up" contributions of \$1,000 (by 2006).

Taxpayers whose AGI is below \$80,000 (\$60,000 for non-joint filers) in 2005 can claim a deduction for IRA contributions. The IRA deduction is phased out for taxpayers with AGI between \$70,000 and \$80,000 (\$50,000 and \$60,000 for non-joint). The phase-out range in-

creases annually until it reaches \$80,000 to \$100,000 in 2007. Taxpayers whose AGI is above the phase-out range can also claim a deduction for their IRA contributions depending on whether they (or their spouse) are an active participant in an employer-provided retirement plan. The tax on the investment income earned by 401(k) plans, non-deductible IRAs, and deductible IRAs is deferred until the money is withdrawn.

Taxpayers with incomes below \$160,000 (\$110,000 for nonjoint filers) can make contributions to Roth IRAs. The maximum contribution to a Roth IRA is phased out for taxpayers with AGI between \$150,000 and \$160,000 (\$95,000 and \$110,000 for singles). Investment income of a Roth IRA is not taxed when earned nor when withdrawn. Withdrawals from a Roth IRA are penalty free if: (1) the Roth IRA was opened at least 5 years before the withdrawal, and (2) the taxpayer either (a) is at least 59½, (b) dies, (c) is disabled, or (d) purchases a first-time house.

Taxpayers can contribute to a non-deductible IRA regardless of their income and whether they are an active participant in an employer-provided retirement plan. The tax on investment income earned by non-deductible IRAs is deferred until the money is withdrawn.

**141. Low and moderate income savers' credit.**—The Tax Code provides an additional incentive for lower-income taxpayers to save through a nonrefundable credit of up to 50 percent on IRA and other retirement contributions of up to \$2,000. This credit is in addition to any deduction or exclusion. The credit is completely phased out by \$50,000 for joint filers and \$25,000 for single filers. This temporary credit is in effect from 2002 through 2006.

**142. Keogh plans.**—Self-employed individuals can make deductible contributions to their own retirement (Keogh) plans equal to 25 percent of their income, up to a maximum of \$42,000 in 2005. Total plan contributions are limited to 25 percent of a firm's total wages. The tax on the investment income earned by Keogh plans is deferred until withdrawn.

**143. Employer-provided life insurance benefits.**—Employer-provided life insurance benefits are excluded from an employee's gross income even though the employer's costs for the insurance are a deductible business expense, but only to the extent that the employer's share of the total costs does not exceed the cost of \$50,000 of such insurance.

**144. Employer-provided accident and disability benefits.**—Employer-provided accident and disability benefits are excluded from an employee's gross income even though the employer's costs for the benefits are a deductible business expense.

**145. Employer-provided supplementary unemployment benefits.**—Employers may establish trusts to pay supplemental unemployment benefits to employees separated from employment. Interest payments to such trusts are exempt from taxation.

**146. Employer Stock Ownership Plan (ESOP) provisions.**—ESOPs are a special type of tax-exempt employee benefit plan. 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; (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) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (4) dividends paid to ESOP-held stock are deductible by the employer.

**147. Additional deduction for the blind.**—Taxpayers who are blind may take an additional \$1,200 standard deduction if single, or \$1,000 if married in 2005.

**148. Additional deduction for the elderly.**—Taxpayers who are 65 years or older may take an additional \$1,200 standard deduction if single, or \$1,000 if married in 2005.

**149. Tax credit for the elderly and disabled.**—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. Income is limited to no more than \$5,000 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older, and up to \$7,500 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.

**150. 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. Taxpayers, however, may deduct uninsured casualty and theft losses of more than \$100 each, but only to the extent that total losses during the year exceed 10 percent of AGI.

**151. Earned income tax credit (EITC).**—The EITC may be claimed by low income workers. For a family with one qualifying child, the credit is 34 percent of the first \$7,830 of earned income in 2005. The credit is 40 percent of the first \$11,000 of income for a family with two or more qualifying children. The credit is phased out beginning when the taxpayer's income exceeds \$14,370 at the rate of 15.98 percent (21.06 percent if two or more qualifying children are present). It is completely phased out when the taxpayer's modified adjusted gross income reaches \$31,030 (\$35,263 if two or more qualifying children are present), \$33,030 (or \$37,263) for those married.

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 2005, the credit is 7.65 percent of the first \$5,220 of earned income. When the taxpayer's income exceeds \$6,530 (8,530 if married), the credit is phased out at the rate of 7.65 percent. It is completely phased out at \$11,750 (\$13,750 for married) of modified adjusted gross income.

For workers with or without children, the income levels at which the credit begins to phase-out and the maximum amounts of income on which the credit can be taken are adjusted for inflation. For married taxpayers filing a joint return, the base amount for the phase-out increases by \$2,000 in 2005 through 2007, and \$3,000 in 2008 (indexed thereafter).

Earned income tax credits in excess of tax liabilities owed through the individual income tax system are refundable to individuals. This portion of the credit is shown as an outlay, while the amount that offsets tax liabilities is shown as a tax expenditure.

152. **Additional exemption for housing Hurricane Katrina displaced individuals.**—This provision, introduced by the Katrina Emergency Tax Relief Act of 2005, provides an additional exemption of \$500 for each Hurricane Katrina displaced individual for whom the taxpayer is providing shelter in his or her home, for a maximum additional exemption amount is \$2,000.

### Social Security

153. **Social Security benefits for retired workers.**—The non-taxation of Social Security benefits that exceed the beneficiary's contributions out of taxed income 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.

154. **Social Security benefits for the disabled.**—Benefit payments from the Social Security Trust Fund for disability are partially excluded from a beneficiary's gross incomes.

155. **Social Security benefits for dependents and survivors.**—Benefit payments from the Social Security Trust Fund for dependents and survivors are partially excluded from a beneficiary's gross income.

### Veterans Benefits and Services

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

157. **Veterans pension payments.**—Pension payments made by the Veterans Administration are excluded from gross income.

158. **G.I. Bill benefits.**—G.I. Bill benefits paid by the Veterans Administration are excluded from gross income.

159. **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

160. **Public purpose State and local bonds.**—Interest earned on State and local government bonds issued to finance public-purpose construction (e.g., schools, roads, sewers), equipment acquisition, and other public purposes is tax-exempt. Interest on bonds issued by Indian tribal governments for essential governmental purposes is also tax-exempt.

161. **Deductibility of certain nonbusiness State and local taxes.**—Taxpayers may deduct State and local income taxes and property taxes even though these taxes primarily pay for services that, if purchased directly by taxpayers, would not be deductible.

162. **Business income earned in U.S. possessions.**—U.S. corporations operating in a U.S. possession (e.g., Puerto Rico) can claim a credit against some or all of their U.S. tax liability on possession business income. The credit expires December 31, 2005.

### Interest

163. **U.S. savings bonds.**—Taxpayers may defer paying tax on interest earned on U.S. savings bonds until the bonds are redeemed.

## Appendix:

### TREASURY REVIEW OF THE TAX EXPENDITURE PRESENTATION

This appendix provides a presentation of the Treasury Department's continuing review of the tax expenditure budget. The review focuses on three issues: (1) using comprehensive income as a baseline tax system;

(2) using a consumption tax as a baseline tax system; and (3) defining negative tax expenditures (provisions that cause taxpayers to pay too much tax).



The first section of this appendix compares major tax expenditures in the current budget to those implied by a comprehensive income baseline. This comparison includes a discussion of negative tax expenditures. The second section compares the major tax expenditures in the current budget to those implied by a consumption tax baseline, and also discusses negative tax expenditures. The final section addresses concerns that have been raised over the measurement of some current tax

expenditures by describing new estimates of the tax expenditure caused by accelerated depreciation and by the tax exemption of the return earned on owner-occupied housing, and an alternative estimate of the tax expenditure for the preferential treatment of capital gains. The final section also provides an estimate of the negative tax expenditure caused by the double tax on corporate profits.

### DIFFERENCES BETWEEN OFFICIAL TAX EXPENDITURES AND THOSE BASED ON COMPREHENSIVE INCOME

As discussed in the main body of the tax expenditure chapter, official tax expenditures are measured relative to normal law or reference law baselines that deviate from a uniform tax on a comprehensive concept of income. Consequently, tax expenditures identified in the Budget can differ from those that would be identified if a comprehensive income tax were chosen as the baseline tax system. This appendix addresses this issue by comparing major tax expenditures listed in the current tax expenditure budget with those implied by a comprehensive income baseline. Many large tax expenditures would continue to be tax expenditures were the baseline taken to be comprehensive income, although some would be smaller. A comprehensive income baseline would also result in a number of additional tax provisions being counted as tax expenditures.

Current budgetary practice excludes from the list of official tax expenditures those provisions that over-tax certain items of income. This exclusion conforms to the view that tax expenditures are substitutes for direct Government spending programs. However, this treatment gives a one-sided picture of how current law deviates from the baseline tax system. Relative to comprehensive income, a number of current tax provisions would be negative tax expenditures. Some of these also might be negative tax expenditures under the reference law or normal law baselines, expanded to admit negative tax expenditures.

#### *Treatment of Major Tax Expenditures from the Current Budget under a Comprehensive Income Tax Baseline*

Comprehensive income, also called Haig-Simons income, is the real, inflation-adjusted accretion to one's economic power arising between two points in time, e.g., the beginning and ending of the year. It includes all accretions to wealth, whether or not realized, whether or not related to a market transaction, and whether a return to capital or labor. Inflation-adjusted capital gains (and losses) would be included in comprehensive income as they accrue. Business investment and casualty losses, including losses caused by depreciation, would be deducted. Implicit returns, such as those accruing to homeowners, also would be included in comprehensive income. A comprehensive income tax baseline would tax all sources of income once. Thus, it would not include a separate tax on corporate income that leads to the double taxation of corporate profits.

While comprehensive income can be defined on the sources side of the consumer's balance sheet, it sometimes is instructive to use the identity between the sources of wealth and the uses of wealth to redefine it as the sum of consumption during the period plus the change in net worth between the beginning and the end of the period.

Comprehensive income is widely held to be the idealized base for an income tax even though it is not a perfectly defined concept.<sup>7</sup> It suffers from conceptual ambiguities, some of which are discussed below, as well as practical problems in measurement and tax administration, e.g., how to implement a practicable deduction for economic depreciation or include in income the return earned on consumer durable goods, including housing, automobiles, and major appliances.

Furthermore, comprehensive income does not necessarily represent an ideal tax base; efficiency or equity would be improved by deviating from comprehensive income as a tax base, e.g., by reducing the tax on capital income in order to spur economic growth further or by subsidizing certain types of activities to correct for market failures or to improve the after-tax distribution of income. In addition, some elements of comprehensive income would be difficult or impossible to include in a tax system that is administrable.

Classifying individual tax provisions relative to a comprehensive income baseline is difficult, in part because of the ambiguity of the baseline. It also is difficult because of interactions between tax provisions (or their absence). These interactions mean that it may not always be appropriate to consider each provision in isolation. Nonetheless, Appendix Table 1 attempts such a classification for each of the thirty largest tax expenditures from the Budget.

We classify fourteen of the thirty items as tax expenditures under a comprehensive tax base (those in panel A). Most of these give preferential tax treatment to the return on certain types of savings or investment. They are a result of the explicitly hybrid nature of the existing tax system and arise out of policy decisions that reflect discomfort with the high tax rate on capital income that would otherwise arise under the current

<sup>7</sup>See, e.g., David F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986), pp. 15-31, and Richard Goode, "The Economic Definition of Income" in Joseph Pechman, ed., *Comprehensive Income Taxation* (Washington, D.C.: The Brookings Institution, 1977), pp. 1-29.

structure of the income tax. Even these relatively clear-cut items, however, can raise ambiguities particularly in light of the absence of integration of the corporate and individual tax systems. Given current law's corporate income tax, the reduction or elimination of individual level tax on income from investment in corporate equities might not be a tax expenditure relative to a comprehensive income baseline. Rather, an individual income tax preference might undo the corporate tax penalty (i.e., the double tax). A similar line of reasoning could be used to argue that in the case of corporations, expensing<sup>8</sup> of R&E and accelerated depreciation are not a tax expenditures because they serve to offset the corporate tax penalty.

Because net rental income (gross rents minus depreciation, interest, taxes, and other expenses) would be in the homeowner's tax base under a comprehensive income tax baseline, this item would be a tax expenditure relative to a comprehensive income baseline.

The exclusion of worker's compensation benefits also would be a tax expenditure under comprehensive income principles. Under comprehensive income tax principles, if the worker were to buy the insurance himself, he would be able to deduct the premium (since it represents a reduction in net worth) but should include in income the benefit when paid (since it represents an increase in net worth).<sup>9</sup> If the employer pays the premium, the proper treatment would allow the employer a deduction and allow the employee to disregard the premium, but he would take the proceeds, if any, into income. Current law allows the employer to deduct the premium and excludes both the premium and the benefits from the employee's tax base.

Panel B deals with items that probably are tax expenditures, but that raise issues. Current law allows deductions for home mortgage interest and for property taxes on owner-occupied housing. The tax expenditure budget includes both of these deductions. From one perspective, these two deductions would not be considered tax expenditures relative to a comprehensive tax base; a comprehensive base would allow both deductions. However, this perspective ignores current law's failure to impute gross rental income. Conditional on this failure, the deductions for interest and property taxes might be viewed as inappropriate, because they move the tax system away from rather than towards a comprehensive income tax base.<sup>10</sup> Indeed, the sum of the tax expenditure for these two deductions, plus the tax expenditure for the failure to include net rental income, sums to the tax expenditure for owner-occupied housing

<sup>8</sup>Expensing means immediate deduction. Proper income tax treatment requires capitalization followed by annual depreciation allowances reflecting the decay in value of the associated R&E spending.

<sup>9</sup>Suppose a taxpayer buys a one year term unemployment insurance policy at the beginning of the year. At that time he exchanges one asset, cash, for another, the insurance policy, so there is no change in net worth. But, at the end of the year, the policy expires and so is worthless, hence the taxpayer has a reduction in net worth equal to the premium. If the policy pays off during the year (i.e., the taxpayer has a work related injury), then the taxpayer would include the proceeds in income because they represent an increase in his net worth.

<sup>10</sup>If there were no deduction for interest and property taxes, the tax expenditure base (i.e., the proper tax base minus the actual tax base) for owner-occupied housing would equal the homeowner's net rental income: gross rents minus (depreciation+interest+property taxes+other expenses). With the deduction for interest and property taxes, the tax expenditure base rises to gross rents minus (depreciation+other expenses).

relative to a comprehensive income tax base. Consequently, there is a strong argument for classifying them as tax expenditures relative to a comprehensive income baseline.

The deduction of nonbusiness State and local taxes other than on owner-occupied homes also is included in this section. These taxes include income, sales, and property taxes. The stated justification for this tax expenditure is that "Taxpayers may deduct State and local income taxes and property taxes even though these taxes primarily pay for services that, if purchased directly by taxpayers, would not be deductible."<sup>11</sup> The idea is that these taxes represent (or serve as proxies for) consumption expenditures for which current law makes no imputations to income.<sup>12</sup> The difficulty is that this presumes that one's consumption of State and local services relates directly to the amount of State and local taxes paid. Such a presumption is difficult to sustain when taxes are levied inconsistently across taxpayers.

In contrast to the view in the official Budget, however, the deduction for State and local taxes might not be a tax expenditure if the baseline were comprehensive income. Properly measured comprehensive income would include the value of State and local government benefits received, but would allow a deduction for State and local taxes paid.<sup>13</sup> Thus, in this sense the deductibility of State and local taxes is consistent with comprehensive income tax principles; it should not be a tax expenditure. Nonetheless, imputing the value of State and local services is difficult and is not done under current law. Consequently, a deduction for taxes might sensibly be viewed as a (roughly measured) tax expenditure relative to a comprehensive income baseline.<sup>14</sup>

To the extent that the personal and dependent care exemptions and the standard deduction properly remove from taxable income all expenditures that do not yield suitably discretionary consumption value, or otherwise appropriately adjust for differing taxpaying capacity, then the child care credit and the earned income tax credit would be tax expenditures. In contrast, a competing perspective views these credits as appropriate modifications that account for differing taxpaying capacity. Even accepting this competing perspective, however, one might question why these programs come in the form of credits rather than deductions.

The step-up of basis at death lowers the income tax on capital gains for those who inherit assets below what it would be otherwise. From that perspective it would be a tax expenditure under a comprehensive income

<sup>11</sup>Fiscal Year 2003 Budget of the United States Government, Analytical Perspectives (Washington, D.C.: U.S. Government Printing Office, 2002) p. 127.

<sup>12</sup>Property taxes on owner-occupied housing also might serve as a proxy for the value of untaxed local services provided to homeowners. As such, they would be listed in the tax expenditure budget (as configured, i.e., building on the estimate for the failure to tax net rents) twice, once because current law does not tax rental income and again as a proxy for government services received. Property taxes on other consumer durables such as automobiles also might be included twice, owing to current law's exclusion from income of the associated service flow.

<sup>13</sup>U.S. Treasury, Blueprints for Basic Tax Reform (Washington, D.C.: U.S. Government Printing Office, 1977) p. 92.

<sup>14</sup>Under the normal tax method employed by the Joint Committee on Taxation, the value of some public assistance benefits provided by State Governments is included as a tax expenditure, thereby raising a potential double counting issue.

baseline. Nonetheless, there are ambiguities. Under a comprehensive income baseline, all real inflation adjusted gains would be taxed as accrued, so there would be no deferred unrealized gains on assets held at death.

The lack of full taxation of Social Security benefits also is listed in panel B. Consider first Social Security retirement benefits. To the extent that Social Security is viewed as a pension, a comprehensive income tax would include in income all contributions to Social Security retirement funds (payroll taxes) and tax accretions to value as they arise (inside build-up).<sup>15</sup> Benefits paid out of prior contributions and the inside build-up, however, would not be included in the tax base because the fall in the value of the individual's Social Security account would be offset by an increase in cash. In contrast, to the extent that Social Security is viewed as a transfer program, all contributions should be deductible from the income tax base and all benefits received should be included in the income tax base.

A similar analysis applies to Social Security benefits paid to dependents and survivors. If these benefits represent transfers from the Government, then they should be included in the tax base. If the taxpaying unit consists of the worker plus dependents and survivors, then to the extent that Social Security benefits represent payments from a pension, the annual pension earnings should be taxed. However, benefits paid to dependents and survivors might be viewed as a gift or transfer from the decedent, in which case the dependents and survivors should pay tax on the full amount of the benefit received. (In this case the decedent or his estate should pay tax on the pension income as well, to the extent that the gift represents consumption rather than a reduction in net worth).

In addition, dependent and survivors' benefits might be viewed in part as providing life insurance. In that case, the annual premiums paid each year, or the portion of Social Security taxes attributable to the premiums, should be deducted from income, since they represent a decline in net worth, while benefits should be included in income. Alternatively, taxing premiums and excluding benefits also would represent appropriate income tax policy.

In contrast to any of these treatments, current law excludes one-half of Social Security contributions (employer-paid payroll taxes) from the base of the income tax, makes no attempt to tax accretions, and subjects some, but not all, benefits to taxation. The difference between current law's treatment of Social Security benefits and their treatment under a comprehensive income tax would qualify as a tax expenditure, but such a tax expenditure differs in concept from that included in the official Budget.

The tax expenditures in the official Budget<sup>16</sup> reflect exemptions for lower-income beneficiaries from the tax

<sup>15</sup>As a practical matter, this may be impossible to do. Valuing claims subject to future contingencies is very difficult, as discussed in Bradford, *Untangling the Income Tax*, pp. 23–24.

<sup>16</sup>This includes the tax expenditure for benefits paid to workers, that for benefits paid to survivors and dependents, and that for benefits paid to dependents.

on 85 percent of Social Security benefits.<sup>17</sup> Historically, payroll taxes paid by the employee represented no more than 15 percent of the expected value of the retirement benefits received by a lower-earning Social Security beneficiary. The 85 percent inclusion rate is intended to tax upon distribution the remaining amount of the retirement benefit payment—the portion arising from the payroll tax contributions made by employers and the implicit return on the employee and employer contributions. Thus, the tax expenditure conceived and measured in the current budget is not intended to capture the deviation from a comprehensive income baseline, which would additionally account for the deferral of tax on the employer's contributions and on the rate of return (less an inflation adjustment attributable to the employee's payroll tax contributions). Rather, it is intended to approximate the taxation of private pensions with employee contributions made from after-tax income,<sup>18</sup> on the assumption that Social Security is comparable to such pensions. Hence, the official tax expenditure understates the tax advantage accorded Social Security retirement benefits relative to a comprehensive income baseline.

To the extent that the benefits paid to dependents and survivors should be taxed as private pensions, the same conclusion applies: the official tax expenditure understates the tax advantage.

The deduction for U.S. production activities also raises some problems. To the extent it is viewed as a tax break for certain qualifying businesses (“manufacturers”), it would be a tax expenditure. In contrast, the deduction may prove to be so broad that it is available to most U.S. businesses, in which case it might not be seen as a tax expenditure. Rather, it would represent a feature of the baseline tax rate system, because the deduction is equivalent to a lower tax rate. In addition, to the extent that it is viewed as providing relief from the double tax on corporate profits, it might not be a tax expenditure.

The next category (panel C) includes items whose treatment is less certain. The proper treatment of some of these items under a comprehensive income tax is ambiguous, while others perhaps serve as proxies for what would be a tax expenditure under a comprehensive income base.<sup>19</sup> Consider, for example, the items relating to charitable contributions. Under existing law, charitable contributions are deductible, and this deduction is considered on its face a tax expenditure in the current budget.<sup>20</sup>

The treatment of charitable donations, however, is ambiguous under a comprehensive income tax. If chari-

<sup>17</sup>The current Budget does not include as a tax expenditure the absence of income taxation on the employer's contributions (payroll taxes) to Social Security retirement at the time these contributions are made.

<sup>18</sup>Private pensions allow the employee to defer tax on all inside build-up. They also allow the employee to defer tax on contributions made by the employer, but not on contributions made directly by the employee. Applying these tax rules to Social Security would require the employee to include in his taxable income benefits paid out of inside build-up and out of the employer's contributions, but would allow the employee to exclude from his taxable income benefits paid out of his own contributions.

<sup>19</sup>See, for example, Goode, *The Economic Definition of Income*, pp. 16–17, and Bradford, *Untangling the Income Tax*, pp. 19–21, and pp.30–31.

<sup>20</sup>The item also includes gifts of appreciated property, at least part of which represents a tax expenditure relative to an ideal income tax, even if one assumes that charitable donations are not consumption.

table contributions are a consumption item for the giver, then they are properly included in his taxable income; a deduction for contributions would then be a tax expenditure relative to a comprehensive income tax baseline. In contrast, charitable contributions could represent a transfer of purchasing power from the giver to the receiver. As such, they would represent a reduction in the giver's net worth, not an item of consumption, and so properly would be deductible, implying that current law's treatment is not a tax expenditure. At the same time, however, the value of the charitable benefits received is income to the recipient. Under current law, such income generally is not taxed, and so represents a tax expenditure to the extent the recipient has net taxable income.<sup>21</sup>

Medical expenditures may or may not be an element of income (or consumption). Some argue that medical expenditures do not represent discretionary spending, and so are not really consumption. Instead, these expenditures are a reduction of net worth and should be excluded from the tax base. In contrast, others argue that there is no way to distinguish logically medical care from other consumption items. Those who view medical spending as consumption point out that there is choice in many health care decisions, e.g., whether to go to the best doctor, whether to have voluntary surgical procedures, and whether to exercise and eat nutritiously so as to improve and maintain one's health and minimize medical expenditures. This element of choice makes it more difficult to argue, at least in many cases, that medical spending is more "necessary" than, or otherwise different from, other consumption spending.

The exemption of full taxation of Social Security benefits paid to the disabled also raises some issues. Social Security benefits for the disabled most closely resemble either Government transfers or insurance. From either perspective, a comprehensive income tax would require the worker to include the benefit fully in his income and would allow him to deduct associated Social Security taxes. If viewed as insurance, an equivalent treatment would allow the taxpayer to include the premium (i.e., tax) and exclude the benefit. The deviation between either of these treatments and current law's treatment (described above) would be a tax expenditure under a comprehensive income baseline.

In contrast, as described above, the official tax expenditure measures the benefit of exemption for low-income beneficiaries from the tax on 85 percent of Social Security benefits. This measurement does not correspond closely to that required under a comprehensive income base. If the payment of the benefit is viewed as a transfer and divorced from the treatment of Social Security taxes, then the current tax expenditure understates the tax expenditure measured relative to a comprehensive income baseline. If the payment of the benefit is viewed as a transfer but the inability to deduct the employee's share of the Social Security tax is simul-

taneously considered, then it is less likely that the current tax expenditure overstates the tax expenditure relative to a comprehensive income baseline, and in some cases it may generate a negative tax expenditure. If the benefit is viewed as insurance and the tax as a premium, then the current tax expenditure overstates the tax expenditure relative to a comprehensive income baseline. Indeed, in the insurance model, the ability to exclude from tax only one-half of the premium might suggest that one-half of the payout should be taxed, so that the current tax rules impose a greater tax burden than that implied by a comprehensive income tax, i.e., a negative tax expenditure.

The final category (panel D) includes items that would not be tax expenditures under a comprehensive income tax base. A tax based on comprehensive income would allow all losses to be deducted. Hence, the exception from the passive loss rules would not be a tax expenditure.<sup>22</sup>

#### *Major Tax Expenditures under a Comprehensive Income Tax That Are Excluded from the Current Budget*

While most of the major tax expenditures in the current budget also would be tax expenditures under a comprehensive income base, there also are tax expenditures relative to a comprehensive income base that are not found on the existing tax expenditure list. These additional tax expenditures include the imputed return from certain consumer durables (e.g., automobiles), the difference between capital gains (and losses) as they accrue and capital gains as they are realized, private gifts and inheritances received, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, the value of payouts from insurance policies,<sup>23</sup> and benefits received from private charities. Under some ideas of comprehensive income, the value of leisure and of household production of goods and services also would be included as tax expenditures. The personal exemption and standard deduction also might be considered tax expenditures, although they can be viewed differently, e.g., as elements of the basic tax rate schedule. The foreign tax credit also might be a tax expenditure, since a deduction for foreign taxes, rather than a credit, would seem to measure the income of U.S. residents properly.

#### *Negative Tax Expenditures*

Under current budgetary practice, negative tax expenditures, tax provisions that raise rather than lower taxes, are excluded from the official tax expenditure list. This exclusion conforms with the view that tax expenditures are intended to be similar to Government spending programs.

If attention is expanded from a focus on spending-like programs to include any deviation from the baseline tax system, negative tax expenditures would be of interest. Relative to a comprehensive income baseline, there are a number of important negative tax ex-

<sup>21</sup>If recipients tend to be in lower tax brackets, then the tax expenditure is smaller than when measured at the donor's tax rates.

<sup>22</sup>In contrast, the passive loss rules themselves, which restrict the deduction of losses, would be a negative tax expenditure when compared to a comprehensive tax base.

<sup>23</sup>To the extent that premiums are deductible.

penditures, some of which also might be viewed as negative tax expenditures under an expanded interpretation of the normal or reference law baseline. Among the more important negative tax expenditures is the corporation income tax, or more generally the double tax on corporate profits, which would be eliminated under a comprehensive income tax. The Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA) reduced the tax rate on dividends and capital gains to 15 percent, thus reducing the double tax compared to prior law. Nonetheless, as discussed later in the Appendix, current law still imposes a substantial double tax on corporate profits. The passive loss rules, restrictions on the deductibility of capital losses, and net operating loss (NOL) carry-forward requirements each would generate a negative tax expenditure, since a comprehensive income tax would allow full deductibility of losses. If human capital were considered an asset, then its cost (e.g., certain education and training expenses, including perhaps the cost of college and professional school) should be amortizable, but it is not under current law.<sup>24</sup> Some restricted deductions under the individual AMT might be negative tax expenditures as might the phase-out of personal exemptions and of

itemized deductions. The inability to deduct consumer interest also might be a negative tax expenditure, as an interest deduction may be required to measure income properly, as seen by the equivalence between borrowing and reduced lending.<sup>25</sup> As discussed above, the current treatment of Social Security payments to the disabled also might represent a negative tax expenditure, if viewed as payments on an insurance policy.

Current tax law also fails to index for inflation interest receipts, capital gains, depreciation, and inventories. This failure leads to negative tax expenditures because comprehensive income would be indexed for inflation. Current law, however, also fails to index for inflation the deduction for interest payments; this represents a (positive) tax expenditure.

The issue of indexing also highlights that even if one wished to focus only on tax policies that are similar to spending programs, accounting for some negative tax expenditures may be required. For example, the net subsidy created by accelerated depreciation is properly measured by the difference between depreciation allowances specified under existing tax law and economic depreciation, which is indexed for inflation.<sup>26</sup>

### DIFFERENCES BETWEEN OFFICIAL TAX EXPENDITURES AND TAX EXPENDITURES RELATIVE TO A CONSUMPTION BASE

This section compares tax expenditures listed in the official tax expenditure budget with those implied by a comprehensive consumption tax baseline. It first discusses some of the difficulties encountered in trying to compare current tax provisions to those that would be observed under a comprehensive consumption tax. Next, it discusses which of the thirty largest official tax expenditures would be tax expenditures under the consumption tax baseline, concluding that about one-half of the top thirty official tax expenditures would remain tax expenditures under a consumption tax baseline. Most of those that fall off the list are tax incentives for saving and investment.

The section next discusses some major differences between current law and a comprehensive consumption tax baseline that are excluded from the current list of tax expenditures. These differences include the consumption value of owner-occupied housing and other consumer durables, benefits from in-kind Government transfers, and gifts. It concludes with a discussion of negative tax expenditures relative to a consumption tax baseline

#### *Ambiguities in Determining Tax Expenditures Relative to a Consumption Baseline*

A broad-based consumption tax is a combination of an income tax plus a deduction for net saving. This follows from the definition of comprehensive income as

consumption plus the change in net worth. It therefore seems straightforward to say that current law's deviations from a consumption base are the sum of (a) tax expenditures on an income base associated with exemptions and deductions for certain types of income, plus (b) overpayments of tax, or negative tax expenditures, to the extent net saving is not deductible from the tax base. In reality, however, the situation is more complicated. A number of issues arise, some of which also are problems in defining a comprehensive income tax, but seem more severe, or at least only more obvious, for the consumption tax baseline.

It is not always clear how to treat certain items under a consumption tax. One problem is determining whether a particular expenditure is an item of consumption. Spending on medical care and charitable donations are two examples. The classification below suggests that medical spending and charitable contributions might be included in the definition of consumption, but also considers an alternative view.

There may be more than one way to treat various items under a consumption tax. For example, a consumption tax might ignore borrowing and lending by excluding from the borrower's tax base the proceeds from loans, denying the borrower a deduction for payments of interest and principal, and excluding interest and principal payments received from the lender's tax base. On the other hand, a consumption tax might in-

<sup>24</sup> Current law offers favorable treatment to some education costs, thereby creating (positive) tax expenditures. Current law allows expensing of that part of the cost of education and career training that is related to foregone earnings and this would be a tax expenditure under a comprehensive income baseline.

<sup>25</sup> See Bradford, *Untangling the Income Tax*, p. 41.

<sup>26</sup> Accelerated depreciation can be described as the equivalent of an interest free loan from the Government to the taxpayer. Under federal budget accounting principles, such a loan would be treated as an outlay equal to the present value of the foregone interest.

clude borrowing and lending in the tax base by requiring the borrower to add the proceeds from loans in his tax base, allowing the lender to deduct loans from his tax base, allowing the borrower to deduct payments of principal and interest, and requiring the lender to include receipt of principal and interest payments. In present value terms, the two approaches are equivalent for both the borrower and the lender; in particular both allow the tax base to measure consumption and both impose a zero effective tax rate on interest income. But which approach is taken obviously has different implications (at least on an annual flow basis) for the treatment of many important items of income and expense, such as the home mortgage interest deduction. The classification below suggests that the deduction for home mortgage interest could well be a tax expenditure, but takes note of alternative views.

Some exclusions of income are equivalent in many respects to consumption tax treatment that immediately deducts the cost of an investment while taxing the future cash flow. For example, exempting investment income is equivalent to consumption tax treatment as far as the normal rate of return on new investment is concerned. This is because expensing generates a tax reduction that offsets in present value terms the tax paid on the investment's future normal returns. Expensing gives the normal income from a marginal investment a zero effective tax rate. However, a yield exemption approach differs from a consumption tax as far as the distribution of income and Government revenue is concerned. Pure profits in excess of the normal rate of return would be taxed under a consumption tax, because they are an element of cash flow, but would not be taxed under a yield exemption tax system. Should exemption of certain kinds of investment income, and certain investment tax credits, be regarded as the equivalent of consumption tax treatment? The classification that follows takes a fairly broad view of this equivalence and considers many tax provisions that reduce or eliminate the tax on capital income to be roughly consistent with a broad-based consumption tax.

Looking at provisions one at a time can be misleading. The hybrid character of the existing tax system leads to many provisions that might make good sense in the context of a consumption tax, but that generate inefficiencies because of the problem of the "uneven playing field" when evaluated within the context of the existing tax rules. It is not clear how these should be classified. For example, many saving incentives are targeted to specific tax-favored sources of capital income. The inability to save on a similar tax-favored basis irrespective of the ultimate purpose to which the saving is applied potentially distorts economic choices in ways that would not occur under a broad-based consumption tax.

In addition, provisions can interact even once an appropriate treatment is determined. For example, suppose that it is determined that financial flows should be excluded from the tax base. Then the deduction for home mortgage interest would seem to be a tax expend-

iture. However, this conclusion is cast into doubt because current law generally taxes interest income. When combined with the mortgage interest deduction, this results in a zero tax rate on the interest flow, consistent with consumption tax treatment.

Capital gains would not be a part of a comprehensive consumption tax base. Proceeds from asset sales and sometimes borrowing would be part of the cash-flow tax base, but, for transactions between domestic investors at a flat tax rate, would cancel out in the economy as a whole. How should existing tax expenditures related to capital gains be classified? The classification below generally views available capital gains tax breaks as consistent with a broad-based consumption tax because they lower the tax rate on capital income toward the zero rate that is consistent with a consumption-based tax.

Such considerations suggest that, as with an income tax, trying to compute the current tax's deviations from "the" base of a consumption tax is very difficult because deviations cannot be uniquely determined, making it problematic to do a consistent accounting of the differences between the current tax base and a consumption tax base. Nonetheless, Appendix Table 2 attempts a classification based on the judgments outlined above.

#### *Treatment of Major Tax Expenditures under a Comprehensive Consumption Baseline*

As noted above, the major difference between a comprehensive consumption tax and a comprehensive income tax is in the treatment of saving, or in the taxation of capital income. Consequently, many current tax expenditures related to preferential taxation of capital income would not be tax expenditures under a consumption tax. However, preferential treatment of items of income that is unrelated to saving or investment incentives would remain tax expenditures under a consumption baseline. In addition, several official tax expenditures relating to items of income and expense are difficult to classify properly, while others may serve as proxies for properly measured tax expenditures.

Appendix Table 2 shows thirty large official tax expenditures from the Budget classified according to whether they would be considered a tax expenditure under a consumption tax. One of the thirty items clearly would be a tax expenditure (shown in panel A) under a consumption tax, while an additional seven (those in panel B) probably would be tax expenditures.

Exclusion of workers' compensation benefits allows an exclusion from income that is unrelated to investment, and so should be included in the base of a comprehensive consumption tax.

The deductibility of home mortgage interest is a strong candidate for inclusion as a tax expenditure. A consumption tax would seek to tax the entire value of the flow of services from housing, and so would not allow a deduction for home mortgage interest. This would be the case regardless of whether the tax base included the annual flow of housing services, or instead

used a tax-prepayment or yield exemption approach (discussed more completely below) to taxing housing services. A deduction for interest would be allowed under a consumption tax applied to both real and financial cash flows, but current law does not require the homeowner to take into income the proceeds of a home loan, nor does it allow him a deduction for principle repayments.

Nonetheless, an ambiguity about the treatment of home mortgage interest arises as a result of current law's taxation of interest income. Under a consumption tax, interest income generally would not be taxed (at least in present value terms). In a sense, the homeowner's mortgage interest deduction could be viewed as counterbalancing the lender's inclusion, eliminating interest flows from the tax base, as would be appropriate under many types of consumption taxes.<sup>27</sup>

The deductibility of property taxes on owner-occupied housing also is a strong candidate for inclusion as a tax expenditure under a consumption tax baseline, although there is a bit of ambiguity. Property taxes would be deducted under a consumption tax under which the base allowed expensing of the cost of the house and included the rental value of the house in the annual tax base. But, as discussed above in the income tax section, this deduction nonetheless is a strong candidate for inclusion as a tax expenditure because the current tax system does not impute the consumption value of housing services to the homeowner's tax base.

Under a consumption tax that applied the yield exemption or tax prepayment approach to housing, property taxes would not be deducted by the homeowner because the cash flows (positive and negative) related to the investment are simply ignored for tax purposes—they are outside the tax base. Their deduction under current law would represent a clear case of a tax expenditure. As discussed below, current law's taxation of housing approximates a yield exemption approach; no deduction of the purchase price of the house, no tax on the house's service flow. Consequently, the deduction for property taxes probably should be a tax expenditure relative to a consumption base—there is not even the slightest ambiguity here.

With respect to the household sector's deduction of state and local income taxes, some ambiguity arises because these taxes, when considered separately from the value of any consumption type government services they might fund, should be excluded from the base of a consumption tax because they represent a reduction in net worth. Under a consumed income tax collected from the household, they would need to be deducted to properly measure consumption.

But state and local income taxes are used to fund government services, many of which would be included in the base of a consumption tax if paid for privately. The value of these services probably should be included in the base of a broad consumption tax. The value

of such services is generally not imputed to the household under current tax law. One rough proxy for their value is the tax payments made to support them.<sup>28</sup> Stated another way, the payment of state and local income taxes might not represent a reduction in net worth (or a real net cost to the household) to the extent that the payment is accompanied by the provision of services of equal value.

The analysis of state and local sales taxes on consumption items would seem to parallel that of income taxes. When these taxes are considered in isolation from government services they might fund, they should be excluded from the base of a federal consumption tax. But to the extent sales taxes represent a user charges for government provided consumption goods, their deduction might be inappropriate because current federal tax law fails to impute to income the value of the state and local services funded by sales tax payments.

Property taxes on assets other than housing would seem to be best thought of using the model discussed above for housing. These taxes typically are paid on assets, such as automobiles and boats, that yield a stream of services that current federal tax law fails to impute to income.

The official tax expenditures for Social Security benefits reflects exceptions for low-income taxpayers from the general rule that 85 percent of Social Security benefits are included in the recipient's tax base. The 85 percent inclusion is intended as a simplified mechanism for taxing Social Security benefits as if the Social Security program were a private pension with employee contributions made from after-tax income. Under these tax rules, income earned on contributions made by both employers and employees benefits from tax deferral, but employer contributions also benefit because the employee may exclude them from his taxable income, while the employee's own contributions are included in his taxable income. These tax rules give the equivalent of consumption tax treatment, a zero effective tax rate on the return, to the extent that the original pension contributions are made by the employer, but give less generous treatment to the extent that the original contributions are made by the employee. Income earned on employee contributions is taxed at a low, but positive, effective tax rate. Based on historical calculations, the 85 percent inclusion reflects roughly the outcome of applying these tax rules to a lower-income earner when one-half of the contributions are from the employer and one-half from the employee.

The current tax expenditure measures a tax benefit relative to a baseline that is somewhere between a comprehensive income tax and a consumption tax. The properly measured tax expenditure relative to a consumption tax baseline would include only those Social Security benefits that are accorded treatment more favorable than that implied by a consumption tax, which

<sup>27</sup>One must guard against double counting here, however, to the extent that current law's general taxation of capital income is calculated elsewhere in the tax expenditure budget as a negative tax expenditure.

<sup>28</sup>The failure to impute the value of government provided services casts doubt on the appropriateness of deducting property taxes on owner-occupied housing even under a consumption tax that allowed the homeowner to deduct the cost of the house from his taxable consumption and imputed to his tax base the house's annual consumption flow.

would correspond to including 50 percent of Social Security benefits in the recipient's tax base. Thus, the existing tax expenditure is correct conceptually, but is not measured properly relative to a comprehensive income tax. A similar analysis would apply to exclusion of Social Security benefits of dependents and retirees.

There is a strong case for viewing the child credit and the earned income tax credit as social welfare programs (transfers). As such, they would be tax expenditures relative to a consumption baseline. Nonetheless, these credits could alternatively be viewed as relieving tax on "nondiscretionary" consumption, and so not properly considered a tax expenditure.

The treatment of the items in panel C is less uncertain. Several of these items relate to the costs of medical care or to charitable contributions. As discussed in the previous section of the appendix, there is disagreement within the tax policy community over the extent to which medical care and charitable giving represent consumption items. Medical care is widely held to be consumption, except perhaps the medical care that actually raises, rather than simply sustains the individual's ability to work. Charitable giving, on the other hand, may be considered to be a reduction in net worth that should be excluded from the tax base because it does not yield direct satisfaction to taxpayer who makes the expenditure. In this case, the tax expenditure lies not with the individual making the charitable deduction, but with the exclusion from taxation of the amounts received by the recipient.

There also is the issue of how to tax medical insurance premiums. Under current law, employees do not have to include insurance premiums paid for by employers in their income. The self-employed also may exclude (via a deduction) medical insurance premiums from their taxable income. From some perspectives, these premiums should be in the tax base because they appear to represent consumption. Yet an alternative perspective would support excluding the premium from tax as long as the consumption tax base included the value of any medical services paid for by the insurance policy, because the premium equals the expected value of insurance benefits received. But even from this alternative perspective, the official tax expenditure might continue to be a tax expenditure under a consumption tax baseline because current law excludes the value of medical services paid with insurance benefits from the employee's taxable income.

If medical spending is not consumption, one approach to measuring the consumption base would ignore insurance, but allow the consumer to deduct the value of all medical services obtained. An alternative approach would allow a deduction for the premium but include the value of any insurance benefits received, while continuing to allow a deduction for a value of all medical services obtained. In either case, the official tax expenditure for the exclusion of employer-provided medical insurance and expenses would not be a tax expenditure relative to a consumption tax baseline.

Current law does not tax the annual rental value of owner-occupied housing. In contrast, the annual rental value of the housing would be taxed under a consumption tax. Hence, from one perspective, the exclusion of the net annual rental value of owner-occupied housing would be a tax expenditure relative to a consumption tax baseline.

However, a consumption tax that included in its base the annual rental value of housing also would allow the homeowner a deduction for the price of the house in the year it was purchased; the investment in housing would be expensed. Current law fails to allow such a deduction, raising doubt about classifying as a tax expenditure the exclusion of net rental income from owner-occupied housing. Indeed, it is possible to interpret current law as applying the tax pre-payment or yield exemption method to housing, in which the purchase price of an investment, rather than the annual cash flow generated by the investment, is taxed. In the textbook case, the tax pre-payment approach is equivalent in expected present value terms to taxing directly the annual consumption value of the house. So it is not clear whether the failure to tax the rental income from housing represents a tax expenditure.

The taxation of Social Security benefits for the disabled also is difficult to classify. As discussed in this appendix above, these benefits generally ought to be taxed because they represent purchasing power. However, the associated Social Security taxes ought to be fully deductible, but they are not. Hence the proper treatment is unclear. Moreover, if the insurance model is applied, the taxation of Social Security benefits might be a negative tax expenditure.

The credit for low-income housing acts to lower the tax burden on qualified investment, and so from one perspective would not be a tax expenditure under a consumption tax baseline. However, in some cases the credit is too generous; it can give a negative tax on income from qualified investment rather than the zero tax called for under consumption tax principles. In addition, the credit is very narrowly targeted. Consequently, it could be considered a tax expenditure relative to a consumption tax baseline.

The final panel (D) shows items that are not likely to be tax expenditures under a consumption base. Most of these relate to tax provisions that eliminate or reduce the tax on various types of capital income because a zero tax on capital income is consistent with consumption tax principles.

The deduction for U.S. production activities is not classified as a tax expenditure. This reflects the view that it represents a widespread reduction in taxes on capital income or an offset to the corporate income tax. In contrast to this classification, however, it would be a tax expenditure to the extent that it is viewed as a targeted tax incentive.

The exception from the passive loss rules probably would not be a tax expenditure because proper measurement of income, and hence of consumption, requires full deduction of losses.



### *Major Tax Expenditures under a Consumption Tax That Are Excluded from the Current Budget*

Several differences between current law and a consumption tax are left off the official tax expenditure list. Additional tax expenditures possibly include benefits paid by insurance policies, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, and benefits received from charities. Under some ideas of a comprehensive consumption tax, the value of leisure and of household production of goods and services would be included as a tax expenditure.

A consumption tax implemented as a tax on gross cash flows would tax all proceeds from sales of capital assets when consumed, rather than just capital gains; because of expensing, taxpayers effectively would have a zero basis. The proceeds from borrowing would be in the base of a consumption tax that also allowed a deduction for repayment of principal and interest, but are excluded from the current tax base. The deduction of business interest expense might be a tax expenditure, since under some forms of consumption taxation interest is neither deducted from the borrower's tax base nor included in the lender's tax base. The personal exemption and standard deduction also might be considered tax expenditures, although they can be viewed differently, e.g., as elements of the basic tax rate schedule.

### *Negative Tax Expenditures*

Importantly, current law also deviates from a consumption tax norm in ways that increase, rather than decrease, tax liability. These could be called negative

tax expenditures. The official Budget excludes negative tax expenditures on the theory that tax expenditures are intended to substitute for Government spending programs. Yet excluding negative tax expenditures gives a very one-sided look at the differences between the existing tax system and a consumption tax.

A large item on this list would be the inclusion of capital income in the current individual income tax base, including the income earned on inside-build up in Social Security accounts. The revenue from the corporate income tax, or more generally a measure of the double tax on corporate profits, also would be a negative tax expenditure. Depreciation allowances, even if accelerated, would be a negative tax expenditure since consumption tax treatment generally would require expensing. Depending on the treatment of loans, the borrower's inability to deduct payments of principal and the lender's inability to deduct loans might be a negative tax expenditure. The passive loss rules and NOL carry-forward provisions also might generate negative tax expenditures, because the change in net worth requires a deduction for losses (consumption = income—the change in net worth). If human capital were considered an asset, then its cost (e.g., certain education and training expenses, including perhaps costs of college and professional school) should be expensed, but it is not under current law. Certain restrictions under the individual AMT as well as the phase-out of personal exemptions and of itemized deductions also might be considered negative tax expenditures. Under some views, the current tax treatment of Social Security benefits paid to the disabled would be a negative tax expenditure.

## REVISED ESTIMATES OF SELECTED TAX EXPENDITURES

### *Accelerated Depreciation*

Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. In the past, official tax expenditure estimates of accelerated depreciation under the normal tax law baseline compared tax allowances based on the historic cost of an asset with allowances calculated using the straight-line method over relatively long recovery periods. Normal law allowances also were determined by the historical cost of the asset and so did not adjust for inflation, although such an adjustment is required when measuring economic depreciation, the age related fall in the real value of the asset.

Beginning with the 2004 Budget, the tax expenditures for accelerated depreciation under the normal law concept have been recalculated using as a baseline depreciation rates and replacement cost indexes from the National Income and Product Accounts.<sup>29</sup> The revised

estimates are intended to approximate the degree of acceleration provided by current law over a baseline determined by real, inflation adjusted, and economic depreciation. Current law depreciation allowances for machinery and equipment include the benefits of a temporary expensing provision.<sup>30</sup> The estimates are shown in tables in the body of the main text, e.g., Table 19-1.

### *Owner-Occupied Housing*

A homeowner receives a flow of housing services equal in gross value to the rent that could have been earned had the owner chosen to rent the house to others. Comprehensive income would include in the homeowner's tax base this gross rental flow, and would allow the homeowner a deduction for expenses such as interest, depreciation, property taxes, and other costs associated with earning the rental income. Thus, a com-

<sup>29</sup> See Barbara Fraumeni, "The Measurement of Depreciation in the U.S. National Income and Product Accounts," in *Survey of Current Business* 77 No. 7 (Washington, D.C.: Department of Commerce, Bureau of Economic Analysis, July, 1997), pp. 7-42, and the National Income and Product Accounts of the United States, Table 7.6, "Chain-type Quantity and Price Indexes for Private Fixed Investment by Type," U.S. Department of Commerce, Bureau of Economic Analysis.

<sup>30</sup> The temporary provision allows 30 percent of the cost of a qualifying investment to be deducted immediately rather than capitalized and depreciated over time. It is generally effective for qualifying investments made after September 10, 2001 and before September 11, 2004. The Jobs and Growth Tax Relief Reconciliation Act of 2003 raised the deduction to 50 percent depreciation (up from 30 percent) of the cost new equipment purchased after May 5, 2003 and placed into service before January 1, 2005. Qualifying investments generally are limited to tangible property with depreciation recovery periods of 20 years or less, certain software, and leasehold improvements, but this set of assets corresponds closely to machinery and equipment.

prehensive tax base would include in its base the homeowner's implicit net rental income (gross income minus deductions) earned on investment in owner-occupied housing.

In contrast to a comprehensive income tax, current law makes no imputation for gross rental income and allows no deduction for depreciation or for other expenses, such as utilities and maintenance. Current law does, however, allow a deduction for home mortgage interest and for property taxes. Consequently, relative to a comprehensive income baseline, the total tax expenditure for owner-occupied housing is the sum of tax on net rental income plus the tax saving from the deduction for property taxes and for home mortgage interest.<sup>31</sup>

Prior to 2006, the official list of tax expenditures did not include the exclusion of net implicit rental income on owner-occupied housing. Instead, it included as tax expenditures deductions for home mortgage interest and for property taxes. While these deductions are legitimately considered tax expenditures, given current law's failure to impute rental income, they are highly flawed as estimates of the total tax advantage to housing; they overlook the additional exclusion of implicit net rental income. To the extent that a homeowner owns his house outright, unencumbered by a mortgage, he would have no home mortgage interest deduction, yet he still would enjoy the benefits of receiving tax free the implicit rental income earned on his house. The treatment of owner-occupied housing has been revised beginning in the 2006 budget, which now includes an item for the exclusion of net rental income of homeowners.<sup>32</sup>

Appendix Table 3, as well as the tables in the body of the main text, e.g., Tables 19–1 and 19–2, show estimates of the tax expenditure caused by the exclusion of implicit net rental income from investment in owner-occupied housing. This estimate starts with the NIPA calculated value of gross rent on owner-occupied housing, and subtracts interest, taxes, economic depreciation, and other costs in arriving at an estimate of net-rental income from owner-occupied housing.<sup>33</sup>

#### *Accrued Capital Gains*

Under a comprehensive income baseline, all real gains would be taxed as accrued. These gains would be taxed as ordinary income rather than at preferential rates. There would be no deferred unrealized gains on assets held at death, nor gains carried over on gifts, or other preferential treatments. Indeed, all of the pro-

visions related to capitals gains listed in the tax expenditure budget would be dropped. Instead, in their place the difference between the ordinary tax on real gains accrued and the actual tax paid would be calculated. For 1999, for instance, the tax on real accrued gains on corporate equity is estimated at \$594 billion. This compares to an estimated tax on realized gains of \$62 billion, for forgone revenues of \$562 billion. However, this forgone revenue may easily turn into a revenue gain given the limits on capital losses. For 2000, for instance, real accrued losses in corporate equity amounted to \$1.4 trillion. Yet, taxpayers paid an estimated \$70 billion in capital gains taxes. This roughly translates into an overpayment of taxes to the tune of \$464 billion.

#### *Double Tax on Corporate Profits*

A comprehensive income tax would tax all sources of income once. Taxes would not vary by type or source of income.

In contrast to this benchmark, current law taxes income that shareholders earn on investment in corporate stocks at least twice, and at combined rates that generally are higher than those imposed on other sources of income. Corporate profits are taxed once at the company level under the corporation income tax. They are taxed again at the shareholder level when received as a dividend or recognized as a capital gain. Corporate profits can be taxed more than twice when they pass through multiple corporations before being distributed to noncorporate shareholders. Corporate level taxes cascade because corporations are taxed on capital gains they realize on the sale of stock shares and on some dividend income received. Compared to a comprehensive income tax, current law's double (or more) tax on corporate profits is an example of a negative tax expenditure because it subjects income to a larger tax burden than implied by a comprehensive income baseline.

Appendix Table 3 provides an estimate of the negative tax expenditure caused by the multiple levels of tax on corporate profits. This negative tax expenditure is measured as the shareholder level tax on dividends paid and capital gains realized out of earnings that have been fully taxed at the corporate level. It also includes the corporate tax paid on inter-corporate dividends and on corporate capital gains attributable to the sale of stock shares. The estimate includes the reduction in the dividends and capital gains tax rates enacted in JGTRRA.

The negative tax expenditure is large in magnitude; it exceeds \$34 billion in the years 2007 through in 2011. It is comparable in size (but opposite in sign) to all but the largest official tax expenditures. JGTRRA reduced but did not eliminate the double tax on corporate profits.

<sup>31</sup>The homeowner's tax base under a comprehensive income tax is net rents. Under current law, the homeowner's tax base is -(interest + property taxes). The tax expenditure base is the difference between the comprehensive income base and current law's tax base, which for homeowners is the sum of net rents plus interest plus property taxes.

<sup>32</sup>This estimate combines the positive tax expenditure for the failure to impute rental income with the negative tax expenditure for the failure to allow a deduction for depreciation and other costs.

<sup>33</sup>National Income and Production Accounts, Table 2.4.

**Appendix Table 1. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE INCOME TAX <sup>1</sup>**

Description	Revenue Effect 2007
<i>A. Tax Expenditure Under a Comprehensive Income Tax</i>	
Net exclusion of pension contributions and earnings: Employer plans .....	52,470
Accelerated depreciation of machinery and equipment (normal tax method) .....	52,230
Net exclusion of pension contributions and earnings: 401(k) plans .....	39,800
Capital gains exclusion on home sales .....	43,900
Exclusion of net imputed rental income on owner-occupied housing .....	33,210
Capital gains (except agriculture, timber, iron ore, and coal) .....	26,760
Exclusion of interest on public purpose State and local bonds .....	29,640
Exclusion of interest on life insurance savings .....	20,770
Net exclusion of pension contributions and earnings: Keogh plans .....	10,670
Expensing of research and experimentation expenditures (normal tax method) .....	6,990
Deferral of income from controlled foreign corporations (normal tax method) .....	11,940
Net exclusion of pension contributions and earnings: Individual Retirement Accounts .....	5,970
Exclusion of workers' compensation benefits .....	6,180
Credit for low-income housing investments .....	4,250
<i>B. Possibly a Tax Expenditure Under a Comprehensive Income Tax, But With Some Qualifications</i>	
Deductibility of mortgage interest on owner-occupied homes .....	79,860
Child credit .....	42,120
Step-up basis of capital gains at death .....	32,460
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes .....	27,210
Exclusion of Social Security benefits for retired workers .....	19,590
Deductibility of State and local property tax on owner-occupied homes .....	12,810
Deduction for U.S. production activities .....	10,670
Earned income tax credit .....	5,150
Exclusion of Social security benefits of dependents and survivors .....	4,040
<i>C. Uncertain</i>	
Exclusion of employer contributions for medical insurance premiums and medical care .....	146,780
Deductibility of charitable contributions, other than education and health .....	34,500
Deductibility of medical expenses .....	5,310
Deductibility of self-employed medical insurance premiums .....	4,630
Social security benefits for the disabled .....	4,110
Deductibility of charitable contributions, education .....	4,030
<i>D. Probably Not a Tax Expenditure Under a Comprehensive Income Tax</i>	
Exception from passive loss rules for \$25,000 of rental loss .....	6,230

<sup>1</sup> The measurement of certain tax expenditures under a comprehensive income tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines. Source: Table 19-2, Tax Expenditure Budget.

**Appendix Table 2. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE CONSUMPTION TAX <sup>1</sup>**

Description	Revenue Effect 2007
<i>A. Tax Expenditure Under a Consumption Base</i>	
Exclusion of workers' compensation benefits .....	6,180
<i>B. Probably a Tax Expenditure Under a Consumption Base</i>	
Deductibility of mortgage interest on owner-occupied homes .....	79,860
Child credit .....	42,120
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes .....	27,210
Exclusion of Social Security benefits for retired workers .....	19,590
Deductibility of State and local property tax on owner-occupied homes .....	12,810
Earned income tax credit .....	5,150
Exclusion of Social Security benefits of dependents and survivors .....	4,040
<i>C. Uncertain</i>	
Exclusion of employer contributions for medical insurance premiums and medical care .....	146,780
Deductibility of charitable contributions, other than education and health .....	34,500
Exclusion of net imputed rental income on owner-occupied housing .....	33,210
Deductibility of medical expenses .....	5,310
Deductibility of self-employed medical insurance premiums .....	4,630
Credit for low-income housing investments .....	4,250
Social Security benefits for disabled .....	4,110
Deductibility of charitable contributions, education .....	3,440
<i>D. Not a Tax Expenditure Under a Consumption Base</i>	
Net exclusion of pension contributions and earnings: Employer plans .....	52,470
Accelerated depreciation of machinery and equipment (normal tax method) .....	52,230
Capital gains exclusion on home sales .....	43,900
Net exclusion of pension contributions and earnings: 401(k) plans .....	39,800
Step-up basis of capital gains at death .....	32,460
Exclusion of interest on public purpose State and local bonds .....	29,640
Capital gains (except agriculture, timber, iron ore, and coal) .....	26,760
Exclusion of interest on life insurance savings .....	20,770
Deferral of income from controlled foreign corporations (normal tax method) .....	11,940
Net exclusion of pension contributions and earnings: Keogh plans .....	10,670
Deduction for U.S. production activities .....	10,670
Expensing of research and experimentation expenditures (normal tax method) .....	6,990
Exception from passive loss rules for \$25,000 of rental loss .....	6,230
Net exclusion of pension contributions and earnings: Individual Retirement Accounts .....	5,970

<sup>1</sup> The measurement of certain tax expenditures under a consumption tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines. Source: Table 19-2, Tax Expenditure Budget.

**Appendix Table 3. REVISED TAX EXPENDITURE ESTIMATES <sup>1</sup>**

Provision	Revenue Loss						
	2005	2006	2007	2008	2009	2010	2011
Imputed Rent On Owner-Occupied Housing .....	28,600	29,720	33,210	36,860	40,630	44,785	49,364
Double Tax on corporate profit <sup>2</sup> .....	-33,940	-33,320	-34,660	-35,900	-37,040	-38,216	-39,430

<sup>1</sup> Calculations described in the appendix text.

<sup>2</sup> This is a negative tax expenditure, a tax provision that overtaxes income relative to the treatment specified by the baseline tax system.