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. In general, the tax expenditure estimates presented in this chapter are 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. An alternative approach would be to pattern the tax expenditure estimates on a comprehensive consumption tax. Which approach is used is perhaps the most important factor determining what is included as a tax expenditure. For example, because a consumption tax does not tax the return to saving or investment, using a comprehensive consumption tax as the normative baseline for determining tax expenditures would exclude current tax exemptions related to retirement and education saving accounts. Similarly, business provisions that provide accelerated depreciation or expensing of investment would also be excluded as tax expenditures because investment is generally deducted immediately under a comprehensive consumption tax.

The choice of the baseline—a comprehensive income or a comprehensive consumption tax—is arbitrary when viewed from the perspective of the current so-called income tax system, which includes elements of both income and consumption taxes. According to Treasury Department analysis, roughly 35 percent of household financial assets receive consumption tax treatment because assets are held in tax-preferred accounts such as individual retirement accounts (IRAs), defined-contribution retirement plans (401(k) type plans), defined-benefit pension plans, and tax-preferred annuities and various life insurance products. The balance of household financial assets reflecting most other saving vehicles receive income tax treatment.

The ambiguities in the tax expenditure concept are reviewed in greater detail in Appendix A. This review focuses on defining tax expenditures relative to a comprehensive income tax baseline and a consumption tax baseline, and defining negative tax expenditures, i.e., provisions of current law that over-tax certain items or activities.

The tax expenditure estimates presented below differ from a comprehensive income tax in a number of other important respects. While under a comprehensive income tax all income is taxed once, the U.S. income tax system generally taxes corporate income twice, first at the corporate level through the corporate income tax and then again when the income is received by investors as dividends or capital gains. This "double tax" is accounted for in some of the tax expenditure estimates, such as those related to retirement savings, but not in the corporate tax expenditures. Indeed, the tax expenditure estimates, in large part, view the individual and corporation income taxes separately, rather than as an integrated system as appropriate under comprehensive income tax principles. Other areas of divergence from a comprehensive income tax are detailed below.

An important assumption underlying each tax expenditure estimate reported below is that other parts of the tax code remain unchanged. The estimates would be different if 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.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2007–2013 using two methods of accounting: current revenue effects and present value effects. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

A discussion of performance measures and economic effects related to the assessment of the effect of tax expenditures on the achievement of program performance goals is presented in Appendix B. This section is a complement to the Government-wide performance plan required by the Government Performance and Results Act of 1993.

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, 2007. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2007. 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 2007–2013 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.

Two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify and estimate tax expenditures.[1] 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 2009–2013 revenue effect. The first column provides the number of the provision in order to cross reference this table to Tables 19–1 and 19–2 as well as to the descriptions below. Outlay Equivalent Estimates of Income Tax Expenditures, which were included in the FY2007 and prior volumes of Analytical Perspectives, are no longer included in this chapter.[2]

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. 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							
		2007	2008	2009	2010	2011	2012	2013	2009–13
	National Defense								
1	Exclusion of benefits and allowances to armed forces personnel	3,220	3,350	3,480	3,620	3,780	3,930	4,090	18,900
	International affairs:								
2	Exclusion of income earned abroad by U.S. citizens	2,630	2,760	2,900	3,050	3,200	3,360	3,530	16,040
3	Exclusion of certain allowances for Federal employees abroad	840	880	920	970	1,020	1,070	1,120	5,100
4	Inventory property sales source rules exception	1,940	2,180	2,410	2,610	2,820	3,060	3,310	14,210
5	Deferral of income from controlled foreign corporations (normal tax method)	12,490	13,120	13,780	14,480	15,220	15,990	16,810	76,280
6	Deferred taxes for financial firms on certain income earned overseas	2,370	2,490	1,060	....	....	....	....	1,060
	General science, space, and technology:								
7	Expensing of research and experimentation expenditures (normal tax method)	5,190	4,720	4,990	4,470	4,320	4,400	4,420	22,600
8	Credit for increasing research activities	10,320	4,660	2,100	920	360	70	....	3,450
	Energy:								
9	Expensing of exploration and development costs, fuels	530	510	460	390	310	240	150	1,550
10	Excess of percentage over cost depletion, fuels	790	910	950	910	880	850	840	4,430

[1] 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.

[2] 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.

Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued

(in millions of dollars)

		Total from corporations and individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13
11	Alternative fuel production credit	2,920	1,310	70	80	10	10	....	170
12	Exception from passive loss limitation for working interests in oil and gas properties	30	20	20	20	30	30	30	130
13	Capital gains treatment of royalties on coal	180	190	190	200	190	140	150	870
14	Exclusion of interest on energy facility bonds	30	30	30	30	30	30	30	150
15	New technology credit	410	800	1,000	1,030	1,010	1,000	970	5,010
16	Alcohol fuel credits [1]	40	40	50	50	30	....	....	130
17	Bio-Diesel and small agri-biodiesel producer tax credits	180	200	30	20	10	10	10	80
18	Tax credit and deduction for clean-fuel burning vehicles	260	150	130	–20	–50	–60	–50	–50
19	Exclusion of utility conservation subsidies	120	120	120	110	110	110	110	560
20	Credit for holding clean renewable energy bonds	20	40	70	70	70	70	70	350
21	Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	610	250	–60	–290	–490	–590	–570	–2,000
22	Credit for investment in clean coal facilities	30	50	80	130	180	245	290	925
23	Temporary 50% expensing for equipment used in the refining of liquid fuels	30	120	240	260	180	–50	–160	470
24	Natural gas distribution pipelines treated as 15–year property	60	80	90	110	120	110	100	530
25	Amortize all geological and geophysical expenditures over 2 years	50	40	30	10	10	10	10	70
26	Allowance of deduction for certain energy efficient commercial building property	190	170	90	30	....	....	....	120
27	Credit for construction of new energy efficient homes	20	30	20	10	....	....	....	30
28	Credit for energy efficiency improvements to existing homes	380	150	....	....	....	....	....	....
29	Credit for energy efficient appliances	80	....	....	....	....	....	....	....
30	30% credit for residential purchases/installations of solar and fuel cells	10	10	10	....	....	....	....	10
31	Credit for business installation of qualified fuel cells and stationary microturbine power plants	80	130	50	–10	–10	–10	–10	10
32	Partial expensing for advanced mine safety equipment	10	20	....	....	....	....	....	....
	Natural resources and environment:								
33	Expensing of exploration and development costs, nonfuel minerals	10	10	10	10	10	10	10	50
34	Excess of percentage over cost depletion, nonfuel minerals	380	400	410	440	450	460	480	2,240
35	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	370	390	410	420	430	440	450	2,150
36	Capital gains treatment of certain timber income	180	190	190	200	190	140	150	870
37	Expensing of multiperiod timber growing costs	290	290	310	310	320	340	340	1,620
38	Tax incentives for preservation of historic structures	400	430	440	470	490	520	540	2,460
39	Expensing of capital costs with respect to complying with EPA sulfur regulations	10	30	50	30	–10	....	....	70
40	Exclusion of gain or loss on sale or exchange of certain brownfield sites	10	30	40	40	40	30	30	180
	Agriculture:								
41	Expensing of certain capital outlays	110	110	110	120	120	120	120	590
42	Expensing of certain multiperiod production costs	80	80	80	80	90	90	90	430
43	Treatment of loans forgiven for solvent farmers	10	10	10	20	20	20	20	90
44	Capital gains treatment of certain income	980	1,030	1,030	1,090	1,060	760	800	4,740
45	Income averaging for farmers	80	80	80	80	80	80	80	400
46	Deferral of gain on sale of farm refiners	20	20	20	20	20	20	20	100
	Commerce and housing:								
	Financial institutions and insurance:								
47	Exemption of credit union income	1,310	1,380	1,450	1,530	1,610	1,690	1,780	8,060
48	Excess bad debt reserves of financial institutions	20	10	10	10	....	....	....	20
49	Exclusion of interest on life insurance savings	19,910	21,840	23,500	25,200	27,600	30,750	33,590	140,640
50	Special alternative tax on small property and casualty insurance companies	40	40	40	40	40	50	50	220
51	Tax exemption of certain insurance companies owned by tax-exempt organizations	180	190	190	200	200	210	210	1,010
52	Small life insurance company deduction	50	50	50	50	50	60	60	270
53	Exclusion of interest spread of financial institutions	520	450	480	500	630	660	690	2,960
	Housing:								
54	Exclusion of interest on owner-occupied mortgage subsidy bonds	900	960	990	1,020	1,060	1,090	1,120	5,280
55	Exclusion of interest on rental housing bonds	830	880	900	930	960	990	1,020	4,800
56	Deductibility of mortgage interest on owner-occupied homes	84,850	94,790	100,810	107,020	115,280	123,130	130,440	576,680
57	Deductibility of State and local property tax on owner-occupied homes	19,120	16,360	16,640	16,820	28,230	34,570	35,400	131,660
58	Deferral of income from installment sales	1,210	1,230	1,250	1,370	1,500	1,650	1,810	7,580
59	Capital gains exclusion on home sales	31,480	33,050	34,710	36,440	38,260	40,180	42,180	191,770
60	Exclusion of net imputed rental income	3,890	5,440	7,550	10,478	14,543	20,183	28,012	80,766
61	Exception from passive loss rules for $25,000 of rental loss	7,840	8,430	8,840	9,160	9,580	10,090	10,240	47,910
62	Credit for low-income housing investments	5,030	5,380	5,780	6,180	6,520	6,840	7,120	32,440
63	Accelerated depreciation on rental housing (normal tax method)	9,860	10,780	11,760	12,720	14,570	16,160	17,550	72,760
64	Discharge of mortgage indebtedness	....	293	239	176	....	....	....	415
	Commerce:								
65	Cancellation of indebtedness	110	90	60	40	30	30	30	190
66	Exceptions from imputed interest rules	50	50	50	50	50	50	50	250
67	Capital gains (except agriculture, timber, iron ore, and coal)	53,230	55,540	55,940	59,170	57,490	41,390	43,240	257,230
68	Capital gains exclusion of small corporation stock	270	320	340	370	490	540	590	2,330
69	Step-up basis of capital gains at death	32,600	35,900	36,750	37,950	39,450	41,010	42,632	197,792
70	Carryover basis of capital gains on gifts	650	760	800	1,270	6,340	1,500	1,600	11,510

Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued

(in millions of dollars)

		Total from corporations and individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13
71	Ordinary income treatment of loss from small business corporation stock sale	50	50	50	60	60	60	60	290
72	Accelerated depreciation of buildings other than rental housing (normal tax method)	–4,610	–4,420	–4,140	–3,850	–3,920	–3,750	–3,110	–18,770
73	Accelerated depreciation of machinery and equipment (normal tax method)	26,410	35,180	44,120	49,760	53,330	58,440	64,390	270,040
74	Expensing of certain small investments (normal tax method)	3,660	3,660	3,400	500	–950	–960	–60	1,930
75	Graduated corporation income tax rate (normal tax method)	5,400	5,220	5,290	5,510	5,660	5,840	6,090	28,390
76	Exclusion of interest on small issue bonds	350	380	390	410	420	420	440	2,080
77	Deduction for US production activities	9,800	14,020	15,330	21,110	26,030	27,710	29,090	119,270
78	Special rules for certain film and TV production	90	70	–40	–90	–60	–50	–40	–280
	Transportation:								
79	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
80	Exclusion of reimbursed employee parking expenses	2,830	2,950	3,070	3,200	3,310	3,430	3,540	16,550
81	Exclusion for employer-provided transit passes	420	440	470	500	520	550	580	2,620
82	Tax credit for certain expenditures for maintaining railroad tracks	130	130	40	20	10	10	....	80
83	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	40	80	90	100	100	90	60	440
	Community and regional development:								
84	Investment credit for rehabilitation of structures (other than historic)	40	40	40	40	40	40	40	200
85	Exclusion of interest for airport, dock, and similar bonds	850	900	930	960	990	1,020	1,050	4,950
86	Exemption of certain mutuals' and cooperatives' income	70	70	70	70	70	70	80	360
87	Empowerment zones and renewal communities	1,450	1,550	1,760	1,170	480	660	790	4,860
88	New markets tax credit	810	990	970	860	730	590	340	3,490
89	Expensing of environmental remediation costs	300	130	–40	–20	–20	–20	–10	–110
90	Credit to holders of Gulf Tax Credit Bonds	10	10	10	10	10	10	10	50
	Education, training, employment, and social services:								
	Education:								
91	Exclusion of scholarship and fellowship income (normal tax method)	1,870	1,960	2,050	2,150	2,250	2,360	2,470	11,280
92	HOPE tax credit	3,370	3,380	3,640	3,750	4,400	4,790	4,980	21,560
93	Lifetime Learning tax credit	2,210	2,220	2,340	2,420	2,810	3,050	3,180	13,800
94	Education Individual Retirement Accounts	20	30	50	60	70	80	90	350
95	Deductibility of student-loan interest	810	820	830	840	780	530	540	3,520
96	Deduction for higher education expenses	1,450	1,180	....	....	....	....	....	....
97	State prepaid tuition plans	850	1,040	1,290	1,600	2,020	2,280	2,430	9,620
98	Exclusion of interest on student-loan bonds	440	460	480	490	510	520	540	2,540
99	Exclusion of interest on bonds for private nonprofit educational facilities	1,750	1,870	1,930	1,980	2,050	2,110	2,170	10,240
100	Credit for holders of zone academy bonds	140	160	170	170	170	160	140	810
101	Exclusion of interest on savings bonds redeemed to finance educational expenses	20	20	20	20	20	20	20	100
102	Parental personal exemption for students age 19 or over	2,690	1,880	1,760	1,710	2,790	3,130	2,860	12,250
103	Deductibility of charitable contributions (education)	4,330	4,880	5,270	5,670	6,110	6,600	7,010	30,660
104	Exclusion of employer-provided educational assistance	630	660	690	730	40	....	....	1,460
105	Special deduction for teacher expenses	170	160	....	....	....	....	....	....
106	Discharge of student loan indebtedness	20	20	20	20	20	20	20	100
	Training, employment, and social services:								
107	Work opportunity tax credit	370	490	600	680	670	500	260	2,710
108	Welfare-to-work tax credit	80	80	50	20	10	10	....	90
109	Employer provided child care exclusion	1,170	1,340	1,400	1,470	1,480	1,520	1,600	7,470
110	Employer-provided child care credit	10	10	10	20	10	....	....	40
111	Assistance for adopted foster children	350	380	420	450	480	520	560	2,430
112	Adoption credit and exclusion	370	380	400	410	370	70	80	1,330
113	Exclusion of employee meals and lodging (other than military)	930	970	1,010	1,060	1,110	1,170	1,230	5,580
114	Child credit [2]	30,910	30,160	29,950	29,870	23,270	13,590	13,080	109,760
115	Credit for child and dependent care expenses	2,780	1,810	1,720	1,650	1,560	1,410	1,340	7,680
116	Credit for disabled access expenditures	30	30	30	30	30	30	30	150
117	Deductibility of charitable contributions, other than education and health	38,200	43,370	46,980	50,550	54,600	59,070	62,790	273,990
118	Exclusion of certain foster care payments	420	420	420	420	420	420	420	2,100
119	Exclusion of parsonage allowances	510	550	580	610	640	670	700	3,200
120	Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma	30	10	....	....	....	....	....	....
121	Exclusion for benefits provided to volunteer EMS and firefighters	....	23	78	82	59	....	....	219
	Health:								
122	Exclusion of employer contributions for medical insurance premiums and medical care	133,790	151,810	168,460	185,250	210,110	233,320	254,810	1,051,950
123	Self-employed medical insurance premiums	4,260	4,680	5,170	5,710	6,590	7,450	8,180	33,100
124	Medical Savings Accounts / Health Savings Accounts	760	1,140	1,480	1,590	1,620	1,540	1,450	7,680
125	Deductibility of medical expenses	4,470	5,060	5,920	6,800	9,150	10,550	11,490	43,910
126	Exclusion of interest on hospital construction bonds	2,760	2,950	3,040	3,120	3,210	3,310	3,410	16,090
127	Deductibility of charitable contributions (health)	4,310	4,890	5,300	5,700	6,160	6,660	7,080	30,900
128	Tax credit for orphan drug research	260	290	320	360	410	460	510	2,060
129	Special Blue Cross/Blue Shield deduction	620	640	650	660	670	680	680	3,340

Table 19–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued

(in millions of dollars)

		Total from corporations and individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13
130	Tax credit for health insurance purchased by certain displaced and retired individuals [3]	10	10	10	10	10	20	20	70
131	Distributions from retirement plans for premiums for health and long-term care insurance	250	240	280	310	340	380	420	1,730
	Income security:								
132	Exclusion of railroad retirement system benefits	380	370	370	360	360	350	330	1,770
133	Exclusion of workers' compensation benefits	5,740	5,830	5,920	6,010	6,110	6,200	6,300	30,540
134	Exclusion of public assistance benefits (normal tax method)	470	490	510	530	550	580	600	2,770
135	Exclusion of special benefits for disabled coal miners	50	40	40	40	40	40	40	200
136	Exclusion of military disability pensions	100	110	130	150	180	220	260	940
	Net exclusion of pension contributions and earnings:								
137	Employer plans	47,060	46,120	45,670	44,370	42,420	42,230	41,620	216,310
138	401(k) plans	46,000	49,000	51,000	55,000	68,000	74,000	77,000	325,000
139	Individual Retirement Accounts	9,500	10,800	11,700	12,200	13,400	14,900	15,200	67,400
140	Low and moderate income savers credit	760	880	900	880	870	880	860	4,390
141	Keogh plans	11,000	12,000	13,000	14,000	16,000	18,000	21,000	82,000
	Exclusion of other employee benefits:								
142	Premiums on group term life insurance	2,100	2,170	2,250	2,290	2,400	2,570	2,620	12,130
143	Premiums on accident and disability insurance	300	310	320	330	340	350	360	1,700
144	Income of trusts to finance supplementary unemployment benefits	30	30	30	40	40	50	50	210
145	Special ESOP rules	1,500	1,600	1,700	1,800	1,900	1,900	2,000	9,300
146	Additional deduction for the blind	30	30	30	30	40	40	40	180
147	Additional deduction for the elderly	1,590	1,610	1,710	1,850	2,460	2,920	3,070	12,010
148	Tax credit for the elderly and disabled	10	10	10	10	10	10	10	50
149	Deductibility of casualty losses	560	600	630	670	730	760	790	3,580
150	Earned income tax credit [4]	4,990	5,200	5,440	5,720	5,860	7,890	8,170	33,080
151	Additional exemption for housing Hurricane Katrina displaced individuals	20	....	....	....	....	....	....	....
	Social Security:								
	Exclusion of social security benefits:								
152	Social Security benefits for retired workers	17,690	18,480	18,640	19,720	20,760	22,650	24,320	106,090
153	Social Security benefits for disabled	5,050	5,540	5,810	6,150	6,590	7,110	7,560	33,220
154	Social Security benefits for dependents and survivors	3,270	3,320	3,240	3,340	3,400	3,600	3,740	17,320
	Veterans benefits and services:								
155	Exclusion of veterans death benefits and disability compensation	3,760	3,870	3,950	4,140	4,480	4,850	5,260	22,680
156	Exclusion of veterans pensions	180	180	180	180	190	220	220	990
157	Exclusion of GI bill benefits	250	280	280	290	300	330	330	1,530
158	Exclusion of interest on veterans housing bonds	30	30	30	30	30	30	30	150
	General purpose fiscal assistance:								
159	Exclusion of interest on public purpose State and local bonds	23,540	25,140	25,900	26,670	27,470	28,300	29,150	137,490
160	Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	37,500	32,730	33,200	34,450	54,470	66,030	68,390	256,540
	Interest:								
161	Deferral of interest on U.S. savings bonds	1,290	1,310	1,320	1,330	1,380	1,470	1,490	6,990
	Addendum: Aid to State and local governments:								
	Deductibility of:								
	Property taxes on owner-occupied homes	19,120	16,360	16,640	16,820	28,230	34,570	35,400	131,660
	Nonbusiness State and local taxes other than on owner-occupied homes	37,500	32,730	33,200	34,450	54,470	66,030	68,390	256,540
	Exclusion of interest on State and local bonds for:								
	Public purposes	23,540	25,140	25,900	26,670	27,470	28,300	29,150	137,490
	Energy facilities	30	30	30	30	30	30	30	150
	Water, sewage, and hazardous waste disposal facilities	370	390	410	420	430	440	450	2,150
	Small-issues	350	380	390	410	420	420	440	2,080
	Owner-occupied mortgage subsidies	900	960	990	1,020	1,060	1,090	1,120	5,280
	Rental housing	830	880	900	930	960	990	1,020	4,800
	Airports, docks, and similar facilities	850	900	930	960	990	1,020	1,050	4,950
	Student loans	440	460	480	490	510	520	540	2,540
	Private nonprofit educational facilities	1,750	1,870	1,930	1,980	2,050	2,110	2,170	10,240
	Hospital construction	2,760	2,950	3,040	3,120	3,210	3,310	3,410	16,090
	Veterans' housing	30	30	30	30	30	30	30	150
	Credit for holders of zone academy bonds	140	160	170	170	170	160	140	810

[1] In addition, the alcohol fuel credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2007 $3,320; 2008 $4,020; 2009 $4,560; 2010 $4,740; 2011 $1,330; 2012 $0; 2013 $0.

[2] 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: 2007 $16,159; 2008 $16,321; 2009 $16,780; 2010 $16,738; 2011 $16,394; 2012 $1,554; and 2013 $1,537

[3] The figures in the table indicate the effect of the health insurance tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2007 $100; 2008 $110; 2009 $120; 2010 $130; 2011 $140; 2012 $150; and 2013 $160.

[4] 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: 2007 $38,270;2008 $39,460; 2009 $41,020; 2010 $42,940; 2011 $43,460; 2012 $39,890; and 2013 $40,850.

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 complement 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 2007 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2007 would cause a deferral of tax payments on wages in 2007 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2007 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

(in millions of dollars)

		Corporations								Individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13	2007	2008	2009	2010	2011	2012	2013	2009–13
	National Defense																
1	Exclusion of benefits and allowances to armed forces personnel									3,220	3,350	3,480	3,620	3,780	3,930	4,090	18,900
	International affairs:																
2	Exclusion of income earned abroad by U.S. citizens									2,630	2,760	2,900	3,050	3,200	3,360	3,530	16,040
3	Exclusion of certain allowances for Federal employees abroad									840	880	920	970	1020	1070	1120	5,100
4	Inventory property sales source rules exception	1,940	2,180	2,410	2,610	2,820	3,060	3,310	14,210								
5	Deferral of income from controlled foreign corporations (normal tax method)	12,490	13,120	13,780	14,480	15,220	15,990	16,810	76,280								
6	Deferred taxes for financial firms on certain income earned overseas	2,370	2,490	1,060					1,060								
	General science, space, and technology:																
7	Expensing of research and experimentation expenditures (normal tax method)	5,090	4,620	4,890	4,380	4,220	4,300	4,320	22,110	100	100	100	90	100	100	100	490
8	Credit for increasing research activities	10,260	4,610	2,100	920	360	70		3,450	60	50						
	Energy:																
9	Expensing of exploration and development costs, fuels	460	440	400	340	270	210	130	1,350	70	70	60	50	40	30	20	200
10	Excess of percentage over cost depletion, fuels	710	820	860	820	790	770	760	4,000	80	90	90	90	90	80	80	430
11	Alternative fuel production credit	2,800	1,260	70	80	10	10		170	120	50						
12	Exception from passive loss limitation for working interests in oil and gas properties									30	20	20	20	30	30	30	130
13	Capital gains treatment of royalties on coal									180	190	190	200	190	140	150	870
14	Exclusion of interest on energy facility bonds	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
15	New technology credit	380	730	910	940	920	910	880	4,560	30	70	90	90	90	90	90	450
16	Alcohol fuel credits [1]	30	30	40	40	20			100	10	10	10	10	10			30
17	Bio-Diesel and small agri-biodiesel producer tax credits									180	200	30	20	10	10	10	80
18	Tax credit and deduction for clean-fuel burning vehicles	30		–30	–30	–40	–50	–40	–190	230	150	160	10	–10	–10	–10	140
19	Exclusion of utility conservation subsidies									120	120	120	110	110	110	110	560
20	Credit for holding clean renewable energy bonds	10	10	20	20	20	20	20	100	10	30	50	50	50	50	50	250
21	Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	610	250	–60	–290	–490	–590	–570	–2,000								
22	Credit for investment in clean coal facilities	30	50	80	130	180	245	290	925								
23	Temporary 50% expensing for equipment used in the refining of liquid fuels	30	120	240	260	180	–50	–160	470								
24	Natural gas distribution pipelines treated as 15–year property	60	80	90	110	120	110	100	530								
25	Amortize all geological and geophysical expenditures over 2 years	40	30	20	10	10	10	10	60	10	10	10					10
26	Allowance of deduction for certain energy efficient commercial building property	140	130	70	20				90	50	40	20	10				30
27	Credit for construction of new energy efficient homes	20	20	20	10				30		10						
28	Credit for energy efficiency improvements to existing homes									380	150						
29	Credit for energy efficient appliances	80															
30	30% credit for residential purchases/installations of solar and fuel cells									10	10	10					10
31	Credit for business installation of qualified fuel cells and stationary microturbine power plants	20	30	10					10	60	100	40	–10	–10	–10	–10	
32	Partial expensing for advanced mine safety equipment	10	20														
	Natural resources and environment:																
33	Expensing of exploration and development costs, nonfuel minerals	10	10	10	10	10	10	10	50								
34	Excess of percentage over cost depletion, nonfuel minerals	360	380	390	410	420	430	450	2,100	20	20	20	30	30	30	30	140
35	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	120	120	130	130	130	140	140	670	250	270	280	290	300	300	310	1,480
36	Capital gains treatment of certain timber income									180	190	190	200	190	140	150	870
37	Expensing of multiperiod timber growing costs	180	180	190	190	200	210	210	1,000	110	110	120	120	120	130	130	620
38	Tax incentives for preservation of historic structures	310	330	340	360	380	400	420	1,900	90	100	100	110	110	120	120	560
39	Expensing of capital costs with respect to complying with EPA sulfur regulations	10	30	50	30	–10			70								
40	Exclusion of gain or loss on sale or exchange of certain brownfield sites	10	20	30	30	30	20	20	130		10	10	10	10	10	10	50
	Agriculture:																
41	Expensing of certain capital outlays	10	10	10	10	10	10	10	50	100	100	100	110	110	110	110	540
42	Expensing of certain multiperiod production costs	10	10	10	10	10	10	10	50	70	70	70	70	80	80	80	380

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

		Corporations								Individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13	2007	2008	2009	2010	2011	2012	2013	2009–13
43	Treatment of loans forgiven for solvent farmers									10	10	10	20	20	20	20	90
44	Capital gains treatment of certain income									980	1030	1030	1090	1060	760	800	4,740
45	Income averaging for farmers									80	80	80	80	80	80	80	400
46	Deferral of gain on sale of farm refiners	20	20	20	20	20	20	20	100								
	Commerce and housing:																
	Financial institutions and insurance:																
47	Exemption of credit union income	1310	1380	1450	1530	1610	1690	1780	8,060								
48	Excess bad debt reserves of financial institutions	20	10	10	10				20								
49	Exclusion of interest on life insurance savings	2540	2740	2920	3100	3260	3480	3740	16,500	17370	19100	20580	22100	24340	27270	29850	124,140
50	Special alternative tax on small property and casualty insurance companies	40	40	40	40	40	50	50	220								
51	Tax exemption of certain insurance companies owned by tax-exempt organizations	180	190	190	200	200	210	210	1,010								
52	Small life insurance company deduction	50	50	50	50	50	60	60	270								
53	Exclusion of interest spread of financial institutions									520	450	480	500	630	660	690	2,960
	Housing:																
54	Exclusion of interest on owner-occupied mortgage subsidy bonds	280	300	310	320	330	340	350	1,650	620	660	680	700	730	750	770	3,630
55	Exclusion of interest on rental housing bonds	260	270	280	290	300	310	320	1,500	570	610	620	640	660	680	700	3,300
56	Deductibility of mortgage interest on owner-occupied homes									84,850	94,790	100,810	107,020	115,280	123,130	130,440	576,680
57	Deductibility of State and local property tax on owner-occupied homes									19,120	16,360	16,640	16,820	28,230	34,570	35,400	131,660
58	Deferral of income from installment sales	310	310	320	320	320	330	330	1,620	900	920	930	1,050	1,180	1,320	1,480	5,960
59	Capital gains exclusion on home sales									31,480	33,050	34,710	36,440	38,260	40,180	42,180	191,770
60	Exclusion of net imputed rental income									3,890	5,440	7,550	10,478	14,543	20,183	28,012	80,766
61	Exception from passive loss rules for $25,000 of rental loss									7,840	8,430	8,840	9,160	9,580	10,090	10,240	47,910
62	Credit for low-income housing investments	4,660	4,980	5,360	5,720	6,040	6,330	6,590	30,040	370	400	420	460	480	510	530	2,400
63	Accelerated depreciation on rental housing (normal tax method)	620	660	700	740	800	860	920	4,020	9,240	10,120	11,060	11,980	13,770	15,300	16,630	68,740
64	Discharge of mortgage indebtedness										293	239	176				415
	Commerce:																
65	Cancellation of indebtedness									110	90	60	40	30	30	30	190
66	Exceptions from imputed interest rules									50	50	50	50	50	50	50	250
67	Capital gains (except agriculture, timber, iron ore, and coal)									53,230	55,540	55,940	59,170	57,490	41,390	43,240	257,230
68	Capital gains exclusion of small corporation stock									270	320	340	370	490	540	590	2,330
69	Step-up basis of capital gains at death									32,600	35,900	36,750	37,950	39,450	41,010	42,632	197,792
70	Carryover basis of capital gains on gifts									650	760	800	1,270	6,340	1,500	1,600	11,510
71	Ordinary income treatment of loss from small business corporation stock sale									50	50	50	60	60	60	60	290
72	Accelerated depreciation of buildings other than rental housing (normal tax method)	–1,320	–1,240	–1,110	–990	–900	–800	–650	–4,450	–3,290	–3,180	–3,030	–2,860	–3,020	–2,950	–2,460	–14,320
73	Accelerated depreciation of machinery and equipment (normal tax method)	14,760	21,540	28,600	34,130	38,090	41,690	45,440	187,950	11,650	13,640	15,520	15,630	15,240	16,750	18,950	82,090
74	Expensing of certain small investments (normal tax method)	730	720	630	–220	–380	–380	–140	–490	2930	2940	2770	720	–570	–580	80	2,420
75	Graduated corporation income tax rate (normal tax method)	5,400	5,220	5,290	5,510	5,660	5,840	6,090	28,390								
76	Exclusion of interest on small issue bonds	110	120	120	130	130	130	140	650	240	260	270	280	290	290	300	1,430
77	Deduction for US production activities	7,380	10,710	11,690	16,030	19,340	20,310	21,320	88,690	2,420	3,310	3,640	5,080	6,690	7,400	7,770	30,580
78	Special rules for certain film and TV production	70	60	–30	–70	–50	–40	–30	–220	20	10	–10	–20	–10	–10	–10	–60
	Transportation:																
79	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100								
80	Exclusion of reimbursed employee parking expenses									2,830	2,950	3,070	3,200	3,310	3,430	3,540	16,550
81	Exclusion for employer-provided transit passes									420	440	470	500	520	550	580	2,620
82	Tax credit for certain expenditures for maintaining railroad tracks	120	120	40	20	10	10		80	10	10						
83	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	10	20	20	30	30	20	10	110	30	60	70	70	70	70	50	330
	Community and regional development:																
84	Investment credit for rehabilitation of structures (other than historic)	20	20	20	20	20	20	20	100	20	20	20	20	20	20	20	100
85	Exclusion of interest for airport, dock, and similar bonds	270	280	290	300	310	320	330	1,550	580	620	640	660	680	700	720	3,400
86	Exemption of certain mutuals' and cooperatives' income	70	70	70	70	70	70	80	360								
87	Empowerment zones and renewal communities	360	380	420	200	70	110	140	940	1,090	1,170	1,340	970	410	550	650	3,920
88	New markets tax credit	210	250	240	210	180	140	80	850	600	740	730	650	550	450	260	2,640

Table 19–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued

(in millions of dollars)

		Corporations								Individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13	2007	2008	2009	2010	2011	2012	2013	2009–13
89	Expensing of environmental remediation costs	250	110	−30	−20	−20	−20	−10	−100	50	20	−10					−10
90	Credit to holders of Gulf Tax Credit Bonds									10	10	10	10	10	10	10	50
	Education, training, employment, and social services:																
	Education:																
91	Exclusion of scholarship and fellowship income (normal tax method)									1,870	1,960	2,050	2,150	2,250	2,360	2,470	11,280
92	HOPE tax credit									3,370	3,380	3,640	3,750	4,400	4,790	4,980	21,560
93	Lifetime Learning tax credit									2,210	2,220	2,340	2,420	2,810	3,050	3,180	13,800
94	Education Individual Retirement Accounts									20	30	50	60	70	80	90	350
95	Deductibility of student-loan interest									810	820	830	840	780	530	540	3,520
96	Deduction for higher education expenses									1,450	1,180						
97	State prepaid tuition plans									850	1,040	1,290	1,600	2,020	2,280	2,430	9,620
98	Exclusion of interest on student-loan bonds	140	140	150	150	160	160	170	790	300	320	330	340	350	360	370	1,750
99	Exclusion of interest on bonds for private nonprofit educational facilities	550	580	600	620	640	660	680	3,200	1200	1290	1330	1360	1410	1450	1490	7,040
100	Credit for holders of zone academy bonds	140	160	170	170	170	160	140	810								
101	Exclusion of interest on savings bonds redeemed to finance educational expenses									20	20	20	20	20	20	20	100
102	Parental personal exemption for students age 19 or over									2,690	1,880	1,760	1,710	2,790	3,130	2,860	12,250
103	Deductibility of charitable contributions (education)	600	630	670	710	750	790	830	3,750	3,730	4,250	4,600	4,960	5,360	5,810	6,180	26,910
104	Exclusion of employer-provided educational assistance									630	660	690	730	40			1,460
105	Special deduction for teacher expenses									170	160						
106	Discharge of student loan indebtedness									20	20	20	20	20	20	20	100
	Training, employment, and social services:																
107	Work opportunity tax credit	330	440	510	560	550	410	220	2,250	40	50	90	120	120	90	40	460
108	Welfare-to-work tax credit	70	60	40	20	10	10		80	10	20	10					10
109	Employer provided child care exclusion									1170	1340	1400	1470	1480	1520	1600	7,470
110	Employer-provided child care credit	10	10	10	20	10			40								
111	Assistance for adopted foster children									350	380	420	450	480	520	560	2,430
112	Adoption credit and exclusion									370	380	400	410	370	70	80	1,330
113	Exclusion of employee meals and lodging (other than military)									930	970	1,010	1,060	1,110	1,170	1,230	5,580
114	Child credit [2]									30,910	30,160	29,950	29,870	23,270	13,590	13,080	109,760
115	Credit for child and dependent care expenses									2,780	1,810	1,720	1,650	1,560	1,410	1,340	7,680
116	Credit for disabled access expenditures	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
117	Deductibility of charitable contributions, other than education and health	1,370	1,440	1,510	1,580	1,650	1,720	1790	8,250	36,830	41,930	45,470	48,970	52,950	57,350	61,000	265,740
118	Exclusion of certain foster care payments									420	420	420	420	420	420	420	2,100
119	Exclusion of parsonage allowances									510	550	580	610	640	670	700	3,200
120	Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma	10								20	10						
121	Exclusion for benefits provided to volunteer EMS and firefighters										23	78	82	59			219
	Health:																
122	Exclusion of employer contributions for medical insurance premiums and medical care									133,790	151,810	168,460	185,250	210,110	233,320	254,810	1,051,950
123	Self-employed medical insurance premiums									4,260	4,680	5,170	5,710	6,590	7,450	8,180	33,100
124	Medical Savings Accounts / Health Savings Accounts									760	1,140	1,480	1,590	1,620	1,540	1,450	7,680
125	Deductibility of medical expenses									4,470	5,060	5,920	6,800	9,150	10,550	11,490	43,910
126	Exclusion of interest on hospital construction bonds	870	920	950	970	1,000	1,030	1,060	5,010	1,890	2,030	2,090	2,150	2,210	2,280	2,350	11,080
127	Deductibility of charitable contributions (health)	180	190	200	210	220	230	240	1,100	4,130	4,700	5,100	5,490	5,940	6,430	6,840	29,800
128	Tax credit for orphan drug research	260	290	320	360	410	460	510	2,060								
129	Special Blue Cross/Blue Shield deduction	620	640	650	660	670	680	680	3,340								
130	Tax credit for health insurance purchased by certain displaced and retired individuals [3]									10	10	10	10	10	20	20	70
131	Distributions from retirement plans for premiums for health and long-term care insurance									250	240	280	310	340	380	420	1,730
	Income security:																
132	Exclusion of railroad retirement system benefits									380	370	370	360	360	350	330	1,770
133	Exclusion of workers' compensation benefits									5,740	5,830	5,920	6,010	6,110	6,200	6,300	30,540
134	Exclusion of public assistance benefits (normal tax method)									470	490	510	530	550	580	600	2,770
135	Exclusion of special benefits for disabled coal miners									50	40	40	40	40	40	40	200
136	Exclusion of military disability pensions									100	110	130	150	180	220	260	940
	Net exclusion of pension contributions and earnings:																
137	Employer plans									47,060	46,120	45,670	44,370	42,420	42,230	41,620	216,310

Table 19–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued

(in millions of dollars)

		Corporations								Individuals							
		2007	2008	2009	2010	2011	2012	2013	2009–13	2007	2008	2009	2010	2011	2012	2013	2009–13
138	401(k) plans									46,000	49,000	51,000	55,000	68,000	74,000	77,000	325,000
139	Individual Retirement Accounts									9,500	10,800	11,700	12,200	13,400	14,900	15,200	67,400
140	Low and moderate income savers credit									760	880	900	880	870	880	860	4,390
141	Keogh plans									11,000	12,000	13,000	14,000	16,000	18,000	21,000	82,000
	Exclusion of other employee benefits:																
142	Premiums on group term life insurance									2,100	2,170	2,250	2,290	2,400	2,570	2,620	12,130
143	Premiums on accident and disability insurance									300	310	320	330	340	350	360	1,700
144	Income of trusts to finance supplementary unemployment benefits									30	30	30	40	40	50	50	210
145	Special ESOP rules	1,100	1,200	1,300	1,300	1,400	1,400	1,500	6,900	400	400	400	500	500	500	500	2,400
146	Additional deduction for the blind									30	30	30	30	40	40	40	180
147	Additional deduction for the elderly									1,590	1,610	1,710	1,850	2,460	2,920	3,070	12,010
148	Tax credit for the elderly and disabled									10	10	10	10	10	10	10	50
149	Deductibility of casualty losses									560	600	630	670	730	760	790	3,580
150	Earned income tax credit [4]									4,990	5,200	5,440	5,720	5,860	7,890	8,170	33,080
151	Additional exemption for housing Hurricane Katrina displaced individuals									20							
	Social Security:																
	Exclusion of social security benefits:																
152	Social Security benefits for retired workers									17,690	18,480	18,640	19,720	20,760	22,650	24,320	106,090
153	Social Security benefits for disabled									5,050	5,540	5,810	6,150	6,590	7,110	7,560	33,220
154	Social Security benefits for dependents and survivors									3,270	3,320	3,240	3,340	3,400	3,600	3,740	17,320
	Veterans benefits and services:																
155	Exclusion of veterans death benefits and disability compensation									3,760	3,870	3,950	4,140	4,480	4,850	5,260	22,680
156	Exclusion of veterans pensions									180	180	180	180	190	220	220	990
157	Exclusion of GI bill benefits									250	280	280	290	300	330	330	1,530
158	Exclusion of interest on veterans housing bonds	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
	General purpose fiscal assistance:																
159	Exclusion of interest on public purpose State and local bonds	7,410	7,840	8,080	8,320	8,570	8,830	9,090	42,890	16,130	17,300	17,820	18,350	18,900	19,470	20,060	94,600
160	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes									37,500	32,730	33,200	34,450	54,470	66,030	68,390	256,540
	Interest:																
161	Deferral of interest on U.S. savings bonds									1,290	1,310	1,320	1,330	1,380	1,470	1,490	6,990
	Addendum: Aid to State and local governments:																
	Deductibility of:																
	Property taxes on owner-occupied homes									19,120	16,360	16,640	16,820	28,230	34,570	35,400	131,660
	Nonbusiness State and local taxes other than on owner-occupied homes									37,500	32,730	33,200	34,450	54,470	66,030	68,390	256,540
	Exclusion of interest on State and local bonds for:																
	Public purposes	7,410	7,840	8,080	8,320	8,570	8,830	9,090	42,890	16,130	17,300	17,820	18,350	18,900	19,470	20,060	94,600
	Energy facilities	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
	Water, sewage, and hazardous waste disposal facilities	120	120	130	130	130	140	140	670	250	270	280	290	300	300	310	1,480
	Small-issues	110	120	120	130	130	130	140	650	240	260	270	280	290	290	300	1,430
	Owner-occupied mortgage subsidies	280	300	310	320	330	340	350	1,650	620	660	680	700	730	750	770	3,630
	Rental housing	260	270	280	290	300	310	320	1,500	570	610	620	640	660	680	700	3,300
	Airports, docks, and similar facilities	270	280	290	300	310	320	330	1,550	580	620	640	660	680	700	720	3,400
	Student loans	140	140	150	150	160	160	170	790	300	320	330	340	350	360	370	1,750
	Private nonprofit educational facilities	550	580	600	620	640	660	680	3,200	1,200	1,290	1,330	1,360	1,410	1,450	1,490	7,040
	Hospital construction	870	920	950	970	1000	1030	1060	5,010	1,890	2,030	2,090	2,150	2,210	2,280	2,350	11,080
	Veterans' housing	10	10	10	10	10	10	10	50	20	20	20	20	20	20	20	100
	Credit for holders of zone academy bonds	140	160	170	170	170	160	140	810								

[1] In addition, the alcohol fuel credit results in a reduction in excise tax receipts (in millions of dollars) as follows: 2007 $3,380; 2008 $4,300; 2009 $5,140; 2010 $5,940; 2011 $1,720; 2012 $0; 2013 $0.

[2] 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: 2007 $16,159; 2008 $16,321; 2009 $16,780; 2010 $16,738; 2011 $16,394; 2012 $1,554; and 2013 $1,537

[3] The figures in the table indicate the effect of the health insurance tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2007 $100; 2008 $110; 2009 $120; 2010 $130; 2011 $140; 2012 $150; and 2013 $160.

[4] 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: 2007 $38,270;2008 $39,460; 2009 $41,020; 2010 $42,940; 2011 $43,460; 2012 $39,890; and 2013 $40,850.

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, the deferral of tax on unrealized capital gains is not regarded as tax expenditure. Accrued 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.
- A separate corporate income tax is not part of a comprehensive income tax.
- Tax rates vary by level of income. Multiple tax rates exist as a means to facilitate the redistribution 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 nor does gross income include most transfer payments which can be thought of as gifts from the Government.[3] The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.[4]

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. Appendix A 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.

[3] Gross income does, however, include transfer payments associated with past employment, such as Social Security benefits.

[4] 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 2009–2013 PROJECTED REVENUE EFFECT

(in millions of dollars)

	Provision	2009	2009–13
122	Exclusion of employer contributions for medical insurance premiums and medical care	168,460	1,051,950
56	Deductibility of mortgage interest on owner-occupied homes	100,810	576,680
138	401(k) plans	51,000	325,000
117	Deductibility of charitable contributions, other than education and health	46,980	273,990
73	Accelerated depreciation of machinery and equipment (normal tax method)	44,120	270,040
67	Capital gains (except agriculture, timber, iron ore, and coal)	55,940	257,230
160	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	33,200	256,540
137	Employer plans	45,670	216,310
69	Step-up basis of capital gains at death	36,750	197,792
59	Capital gains exclusion on home sales	34,710	191,770
49	Exclusion of interest on life insurance savings	23,500	140,640
159	Exclusion of interest on public purpose State and local bonds	25,900	137,490
57	Deductibility of State and local property tax on owner-occupied homes	16,640	131,660
77	Deduction for U.S. production activities	15,330	119,270
114	Child credit	29,950	109,760
152	Social Security benefits for retired workers	18,640	106,090
141	Keogh plans	13,000	82,000
60	Exclusion of net imputed rental income	7,550	80,766
5	Deferral of income from controlled foreign corporations (normal tax method)	13,780	76,280
63	Accelerated depreciation on rental housing (normal tax method)	11,760	72,760
139	Individual Retirement Accounts	11,700	67,400
61	Exception from passive loss rules for $25,000 of rental loss	8,840	47,910
125	Deductibility of medical expenses	5,920	43,910
153	Social Security benefits for disabled	5,810	33,220
123	Self-employed medical insurance premiums	5,170	33,100
150	Earned income tax credit	5,440	33,080
62	Credit for low-income housing investments	5,780	32,440
127	Deductibility of charitable contributions (health)	5,300	30,900
103	Deductibility of charitable contributions (education)	5,270	30,660
133	Exclusion of workers' compensation benefits	5,920	30,540
75	Graduated corporation income tax rate (normal tax method)	5,290	28,390
155	Exclusion of veterans death benefits and disability compensation	3,950	22,680
7	Expensing of research and experimentation expenditures (normal tax method)	4,990	22,600
92	HOPE tax credit	3,640	21,560
1	Exclusion of benefits and allowances to armed forces personnel	3,480	18,900
154	Social Security benefits for dependents and survivors	3,240	17,320
80	Exclusion of reimbursed employee parking expenses	3,070	16,550
126	Exclusion of interest on hospital construction bonds	3,040	16,090
2	Exclusion of income earned abroad by U.S. citizens	2,900	16,040
4	Inventory property sales source rules exception	2,410	14,210
93	Lifetime Learning tax credit	2,340	13,800
102	Parental personal exemption for students age 19 or over	1,760	12,250
142	Premiums on group term life insurance	2,250	12,130
147	Additional deduction for the elderly	1,710	12,010
70	Carryover basis of capital gains on gifts	800	11,510
91	Exclusion of scholarship and fellowship income (normal tax method)	2,050	11,280
99	Exclusion of interest on bonds for private nonprofit educational facilities	1,930	10,240
97	State prepaid tuition plans	1,290	9,620
145	Special ESOP rules	1,700	9,300
47	Exemption of credit union income	1,450	8,060
115	Credit for child and dependent care expenses	1,720	7,680
124	Medical Savings Accounts / Health Savings Accounts	1,480	7,680
58	Deferral of income from installment sales	1,250	7,580
109	Employer provided child care exclusion	1,400	7,470
161	Deferral of interest on U.S. savings bonds	1,320	6,990
113	Exclusion of employee meals and lodging (other than military)	1,010	5,580
54	Exclusion of interest on owner-occupied mortgage subsidy bonds	990	5,280
3	Exclusion of certain allowances for Federal employees abroad	920	5,100
15	New technology credit	1,000	5,010
85	Exclusion of interest for airport, dock, and similar bonds	930	4,950
87	Empowerment zones, Enterprise communities, and Renewal communities	1,760	4,860
55	Exclusion of interest on rental housing bonds	900	4,800
44	Capital gains treatment of certain income	1,030	4,740
10	Excess of percentage over cost depletion, fuels	950	4,430
140	Low and moderate income savers credit	900	4,390
149	Deductibility of casualty losses	630	3,580

Table 19–3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2009–2013 PROJECTED REVENUE EFFECT—Continued

(in millions of dollars)

	Provision	2009	2009–13
95	Deductibility of student-loan interest	830	3,520
88	New markets tax credit	970	3,490
8	Credit for increasing research activities	2,100	3,450
129	Special Blue Cross/Blue Shield deduction	650	3,340
119	Exclusion of parsonage allowances	580	3,200
53	Exclusion of interest spread of financial institutions	480	2,960
134	Exclusion of public assistance benefits (normal tax method)	510	2,770
107	Work opportunity tax credit	600	2,710
81	Exclusion for employer-provided transit passes	470	2,620
98	Exclusion of interest on student-loan bonds	480	2,540
38	Tax incentives for preservation of historic structures	440	2,460
111	Assistance for adopted foster children	420	2,430
68	Capital gains exclusion of small corporation stock	340	2,330
34	Excess of percentage over cost depletion, nonfuel minerals	410	2,240
35	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	410	2,150
118	Exclusion of certain foster care payments	420	2,100
76	Exclusion of interest on small issue bonds	390	2,080
128	Tax credit for orphan drug research	320	2,060
74	Expensing of certain small investments (normal tax method)	3,400	1,930
132	Exclusion of railroad retirement system benefits	370	1,770
131	Distributions from retirement plans for premiums for health and long-term care insurance	280	1,730
143	Premiums on accident and disability insurance	320	1,700
37	Expensing of multiperiod timber growing costs	310	1,620
9	Expensing of exploration and development costs, fuels	460	1,550
157	Exclusion of GI bill benefits	280	1,530
104	Exclusion of employer-provided educational assistance	690	1,460
112	Adoption credit and exclusion	400	1,330
6	Deferred taxes for financial firms on certain income earned overseas	1,060	1,060
51	Tax exemption of certain insurance companies owned by tax-exempt organizations	190	1,010
156	Exclusion of veterans pensions	180	990
136	Exclusion of military disability pensions	130	940
22	Credit for investment in clean coal facilities	80	925
13	Capital gains treatment of royalties on coal	190	870
36	Capital gains treatment of certain timber income	190	870
100	Credit for holders of zone academy bonds	170	810
41	Expensing of certain capital outlays	110	590
19	Exclusion of utility conservation subsidies	120	560
24	Natural gas distribution pipelines treated as 15–year property	90	530
23	Temporary 50% expensing for equipment used in the refining of liquid fuels	240	470
83	Exclusion of interest on bonds for Financing of Highway Projects and rail-truck transfer facilities	90	440
42	Expensing of certain multiperiod production costs	80	430
64	Discharge of mortgage indebtedness	239	415
45	Income averaging for farmers	80	400
86	Exemption of certain mutuals' and cooperatives' income	70	360
20	Credit for holding clean renewable energy bonds	70	350
94	Education Individual Retirement Accounts	50	350
71	Ordinary income treatment of loss from small business corporation stock sale	50	290
52	Small life insurance company deduction	50	270
66	Exceptions from imputed interest rules	50	250
50	Special alternative tax on small property and casualty insurance companies	40	220
121	Exclusion for benefits provided to volunteer EMS and firefighters	78	219
144	Income of trusts to finance supplementary unemployment benefits	30	210
84	Investment credit for rehabilitation of structures (other than historic)	40	200
135	Exclusion of special benefits for disabled coal miners	40	200
65	Cancellation of indebtedness	60	190
40	Exclusion of gain or loss on sale or exchange of certain brownfield sites	40	180
146	Additional deduction for the blind	30	180
11	Alternative fuel production credit	70	170
14	Exclusion of interest on energy facility bonds	30	150
116	Credit for disabled access expenditures	30	150
158	Exclusion of interest on veterans housing bonds	30	150
12	Exception from passive loss limitation for working interests in oil and gas properties	20	130
16	Alcohol fuel credits	50	130
26	Allowance of deduction for certain energy efficient commercial building property	90	120
46	Deferral of gain on sale of farm refiners	20	100
79	Deferral of tax on shipping companies	20	100
101	Exclusion of interest on savings bonds redeemed to finance educational expenses	20	100
106	Discharge of student loan indebtedness	20	100

Table 19–3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2009–2013 PROJECTED REVENUE EFFECT—Continued

(in millions of dollars)

	Provision	2009	2009–13
43	Treatment of loans forgiven for solvent farmers	10	90
108	Welfare-to-work tax credit	50	90
17	Alcohol fuel credits	30	80
82	Tax credit for certain expenditures for maintaining railroad tracks	40	80
25	Amortize all geological and geophysical expenditures over 2 years	30	70
39	Expensing of capital costs with respect to complying with EPA sulfur regulations	50	70
130	Tax credit for health insurance purchased by certain displaced and retired individuals	10	70
33	Expensing of exploration and development costs, nonfuel minerals	10	50
90	Credit to holders of Gulf Tax Credit Bonds.	10	50
148	Tax credit for the elderly and disabled	10	50
110	Employer-provided child care credit	10	40
27	Credit for construction of new energy efficient homes	20	30
48	Excess bad debt reserves of financial institutions	10	20
30	30% credit for residential purchases/installations of solar and fuel cells	10	10
31	Credit for business installation of qualified fuel cells and stationary microturbine power plants	50	10
28	Credit for energy efficiency improvements to existing homes	....	....
29	Credit for energy efficient appliances	....	....
32	Partial expensing for advanced mine safety equipment	....	....
96	Deduction for higher education expenses	....	....
105	Special deduction for teacher expenses	....	....
120	Employee retention credit for employers affected by Hurricane Katrina, Rita, and Wilma	....	....
151	Additional exemption for housing Hurricane Katrina displaced individuals	....	....
18	Tax credit and deduction for clean-fuel burning vehicles	130	–50
89	Expensing of environmental remediation costs	–40	–110
78	Special rules for certain film and TV production	–40	–280
21	Deferral of gain from dispositions of transmission property to implement FERC restructuring policy	–60	–2,000
72	Accelerated depreciation of buildings other than rental housing (normal tax method)	–4,140	–18,770

Table 19–4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2007

(in millions of dollars)

	Provision	2007 Present Value of Revenue Loss
5	Deferral of income from controlled foreign corporations (normal tax method)	11,460
6	Deferred taxes for financial firms on income earned overseas	2,500
7	Expensing of research and experimentation expenditures (normal tax method)	2,620
18	Credit for holding clean renewable energy bonds	360
9	Expensing of exploration and development costs—fuels	220
33	Expensing of exploration and development costs—nonfuels	10
37	Expensing of multiperiod timber growing costs	190
42	Expensing of certain multiperiod production costs—agriculture	150
41	Expensing of certain capital outlays—agriculture	200
49	Deferral of income on life insurance and annuity contracts	19,060
63	Accelerated depreciation on rental housing	12,860
72	Accelerated depreciation of buildings other than rental	3,000
73	Accelerated depreciation of machinery and equipment	39,040
74	Expensing of certain small investments (normal tax method)	680
79	Deferral of tax on shipping companies	20
100	Credit for holders of zone academy bonds	160
62	Credit for low-income housing investments	5,630
97	Deferral for state prepaid tuition plans	7,000
137	Exclusion of pension contributions—employer plans	74,120
138	Exclusion of 401(k) contributions	121,000
139	Exclusion of IRA contributions and earnings	4,300
139	Exclusion of Roth earnings and distributions	9,200
139	Exclusion of non-deductible IRA earnings	480
141	Exclusion of contributions and earnings for Keogh plans	8,600
159	Exclusion of interest on public-purpose bonds	19,930
	Exclusion of interest on non-public purpose bonds	6,980
161	Deferral of interest on U.S. savings bonds	320

Double Taxation of Corporate Profits

In a gradual transition to a more economically neutral tax system under which all income is taxed no more than once, the lower tax rates on dividends and capital gains on corporate equity under current law 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. Appendix A provides a greater discussion of alternative baselines.

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, 2007, and do not reflect proposals made elsewhere in the Budget. Legislation enacted in 2007, such as the Small Business and Work Opportunity Tax Act of 2007 and the Mortgage Forgiveness Debt Relief Act of 2007, expanded the scope of a number of provisions.

Provisions extended or expanded by the Small Business and Work Opportunity Tax Act include:

- enhanced and extended expensing
- enhanced and extended expensing for property used in highly damaged Gulf Opportunity (GO) Zone areas
- eased tax-exempt qualified mortgage bond treatment for rehabilitating GO Zone residences
- eased low-income housing credit rules for buildings in the GO Zones

Provisions in the Mortgage Forgiveness Debt Relief Act include:

- exclude discharges of principal residence acquisition indebtedness from gross income
- extension of deduction for private mortgage insurance as deductible qualified interest for three years
- exclusion from income for benefits provided to volunteer Emergency Medical Services (EMS) and firefighters

Other changes also introduced in 2007 are not listed as they have small revenue consequences.

Chapter 17 on Federal Receipts has more detailed descriptions of the provisions of these three bills.

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, then 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 ($79,115 in 2007).

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. ***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.

5. ***Income of U.S.-controlled foreign corporations.***—Certain active income of foreign corporations controlled by U.S. shareholders is not subject to U.S. taxation when it is earned. 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.

6. ***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

7. ***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.

8. ***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 incremental credit regime. Under the alternative incremental 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). Beginning in 2007, the rates for the alternative incremental credit increases to a range of 3 percent to 5 percent. An alternative simplified credit is also allowed which is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. A 20-percent credit with a separate threshold is provided 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, 2008 and extends to research conducted in Puerto Rico and the U.S. possessions.

Energy

9. ***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.

10. ***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.

11. ***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. A credit is also 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.

12. ***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.

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

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

15. ***New technology, refined coal, and Indian coal credits.***—A credit is provided equal to 10 percent of the basis of solar energy property (30 percent for purchases beginning in 2006 through 2008) and 10 percent of the basis of geothermal energy property placed in service during the taxable year. A credit is also available for certain electricity produced from wind energy, biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, or qualified hydropower and sold to an unrelated party. The credit rate in 2007 is 2.0 cents per kilowatt hour (1.0 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. Another credit is available for refined coal. The credit rate in 2007 is $5.877 per ton and the rate is indexed in subsequent years. An additional credit is available for the production of Indian coal. The value of the credit is $1.544 per ton in 2007 and indexed for inflation in subsequent years.

16. ***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.

17. ***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 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 form biomass using thermal depolymerization process.

18. ***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. 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. The credit ranges from $250 to $40,000 per vehicle depending upon the vehicle's energy efficiency, weight and other characteristics. The number of hybrid and lean burn vehicles eligible for the credit phases out when a manufacturer has sold 60,000 vehicles.

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

20. ***Credit to holders of clean renewable energy bonds.***—This provision provides for up to $1.2 billion in aggregate issuance of Clean Renewable Energy Bonds (CREBs) through December 31, 2008. Taxpayers

holding CREBs on a credit allowance date are entitled to a tax credit in lieu of interest.

21. ***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.

22. ***Credit for investment in clean coal facilities.***—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. These credits are effective for investments made after August 8, 2005.

23. ***Temporary 50 percent expensing for equipment used in the refining of liquid fuels.***—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.

24. ***Natural gas distribution pipelines treated as 15-year property.***—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.

25. ***Amortize all geological and geophysical expenditures over 2 years.***—Geological and geophysical amounts incurred in connection with oil and gas exploration in the United States may be amortized over two years for non-integrated oil companies and seven years for certain major integrated oil companies. 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.

26. ***Allowance of deduction for certain energy efficient commercial building property.***—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 deduction generally is limited to $1.80 per square foot. The provision is effective for property placed in service after December 31, 2005 and prior to January 1, 2008.

27. ***Credit for construction of new energy efficient homes.***—A credit is available to eligible contractors for construction of a qualified new energy-efficient home. The maximum credit is $2,000. 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, 2009.

28. ***Credit for energy efficiency improvements to existing homes.***—A 10 percent investment tax credit up to a maximum credit of $500 per dwelling is available for expenditures on insulation, exterior windows and doors that improve the energy efficiency of homes and meet certain standards. 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, 2009.

29. ***Credit for energy efficient appliances.***—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.

30. ***Credit for residential purchases/installations of solar and fuel cell property.***—A credit, equal to 30 percent of qualifying expenditures, for purchase for qualified photovoltaic property and solar water heating property is available. The maximum credit for each of these types of property is $2,000 per tax year. A 30 percent credit for the purchase of qualified fuel cell power plants up to $500 for each 0.5 kilowatt of capacity is also allowed. The credit applies to property placed in service after December 31, 2005 and prior to January 1, 2009.

31. ***Credit for business installation of qualified fuel cells and stationary microturbine power plants.***—A 30 percent business energy credit for purchase of qualified fuel cell power plants for businesses (up to $500 for each 0.5 kilowatt of capacity) and a 10 percent credit for purchase of qualifying stationary microturbine power plants (up to a maximum of $200 for each kilowatt of capacity) are allowed. The credit applies to property placed in service prior to January 1, 2009.

32. ***Expensing for advanced mine safety equipment.***—The cost of qualified mine safety equipment may be expensed rather than recovered through depreciation (subject to certain limitations). Provision limited to property placed in service on or before December 31, 2008.

Natural Resources and Environment

33. ***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.

34. ***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.

35. ***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.

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

37. ***Expensing multi-period 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.

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

39. ***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.

40. ***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

41. ***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.

42. ***Expensing multi-period 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.

43. ***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.

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

45. ***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.

46. ***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.

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.

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

48. ***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.

49. ***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.

50. ***Small property and casualty insurance companies.***—For taxable years beginning before January 1, 2004, insurance companies that were not life insur-

ance 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.

51. ***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.

52. ***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.

53. ***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.

54. ***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.

55. ***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.

56. ***Interest on owner-occupied homes.***—Owner-occupants of homes may deduct mortgage interest on their primary and secondary residences as itemized nonbusiness deductions. In general, the mortgage interest deduction is limited to interest on debt no greater than the owner's basis in the residence, and is also 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.

57. ***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.

58. ***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.

59. ***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.

60. ***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. Appendix A provides a fuller explanation of this new addition to the tax expenditure budget.

61. ***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.

62. ***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.

63. ***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 Appendix A.

64. ***Discharge of mortgage indebtedness.***—This provision excludes from the income of a taxpayer any discharge of indebtedness of a qualified principal residence. Provision sunsets on December 31, 2009.

65. ***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.

66. ***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.

67. ***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.

The Jobs Growth Tax Relief Reconciliation Act (JGTRRA) lowered the top tax rate on capital gains from 20 percent to 15 percent, which is effective through 2010. For taxpayers in the 15 percent or below ordinary tax bracket, JGTRRA lowered the tax rate on capital gains to 5 percent (0 percent in 2008). These lower rates apply to assets held for more than one year.

Previously, 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.

68. ***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.

69. ***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.

70. ***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.

71. ***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.

72. ***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 Appendix A.

73. ***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 Appendix A.

74. ***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 2009, 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 2009.

75. ***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 rate is considered a tax expenditure under this concept.

76. ***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.

77. ***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.

78. ***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

79. ***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.

80. ***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 2007, the maximum amount of the parking exclusion is $215 (indexed) per month. The tax expenditure estimate does not include parking at facilities owned by the employer.

81. ***Exclusion of employee transit pass expenses.***—Transit passes, tokens, fare cards, and vanpool 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 2007, the maximum amount of the exclusion is $110 (indexed) per month.

82. ***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.

83. ***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. The authority to issue these bonds expires on December 31, 2015.

Community and Regional Development

84. ***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.

85. ***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.

86. ***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.

87. ***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 2007.

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.

88. ***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 the primary mission of which 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 2008. Credit authority is allocated to CDEs through a competitive application process.

89. ***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, 2007 to be eligible for expensing.

90. ***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

91. ***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).

92. ***HOPE tax credit.***—The non-refundable HOPE tax credit allows a credit for 100 percent of an eligible student's first $1,100 of tuition and fees and 50 percent of the next $1,100 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 2007, the credit is phased out ratably for taxpayers with modified AGI between $94,000 and $114,000 ($47,000 and $57,000 for singles), indexed.

93. ***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 $90,000 and $110,000 ($47,000 and $57,000 for singles) (indexed beginning in 2002). The credit applies to both undergraduate and graduate students.

94. ***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 2007 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).

95. ***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 2007, the maximum deduction is phased down ratably for taxpayers with modified AGI between $110,000 and $140,000 ($55,000 and $70,000 for singles), indexed.

96. ***Deduction for Higher Education Expenses.***—The maximum annual deduction for qualified higher education expenses is $4,000 in 2007 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, 2007.

97. ***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.

98. ***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.

99. ***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.

100. ***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 2007.

101. ***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 $98,400 and $128,400 ($65,600 and $80,600 for singles) in 2007.

102. ***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.

103. ***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.

104. ***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.

105. ***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). Provision expires at end of December 31, 2007.

106. ***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.

106. ***Work opportunity tax credit.***— Employers can claim a tax credit for qualified wages paid to individuals who begin work on or before August 31, 2011 and who are certified as members of various targeted groups. The amount of the credit that can be claimed is 25 percent of qualified wages for employment less than 400 hours and 40 percent for employment of 400 hours or more. The maximum credit per employee is generally $2,400 and can only be claimed on the first year of wages an individual earns from an employer. Employees must work at least 120 hours to be eligible for the credit. 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. The Tax Relief and Health Care Act of 2006 modified the Work opportunity tax credit by changing definitions of the Food Stamp and Ex-Convict target groups and adding persons eligible for the Welfare-to-work credit as a new WOTC target group with a $10,000 ceiling on qualified first year wages and a 50 percent credit on qualified second year wages up to $10,000. The 2006

Act extended credits to qualified employees of WOTC target groups as defined by the 2006 Act hired through December 31, 2007 . The Small Business and Work Opportunity Act of 2007 expanded WOTC's Vocational Rehabilitation and Zone target groups and made WOTC credits useable against both the regular and AMT taxes. Specifically the Act authorized enhanced WOTC credits of up to $4,800 for qualified Veterans with service connected disabilities and increased the qualifying age limit for the Enterprise Zone/Enterprise Community/Renewal Community target group from 18–24 to 18–39. The 2007 Act extended credits to qualified employees of WOTC target groups as defined by the 2007 Act hired through August 31, 2011.

108. ***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. Employees must work at least 400 hours to be eligible for the credit. The maximum credit is $8,500 per employee. The credit applies to wages paid to employees who are hired on or before December 31, 2006. The Tax Relief and Health Care Act of 2006 modified the Welfare to Work credit by making qualified long-term family assistance recipients a WOTC target group after December 31, 2007.

109. ***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.

110. ***Employer-provided child care credit.***—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.

111. ***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.

112. ***Adoption credit and exclusion.***—Taxpayers can receive a nonrefundable tax credit for qualified adoption expenses. The maximum credit is $11,390per child for 2007, and is phased-out ratably for taxpayers with modified AGI between $170,820 and $210,820. 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.

113. ***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.

114. ***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).

115. ***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. In 2007, 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.

116. ***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.

117. ***Charitable contributions, other than education and health.***—Taxpayers may deduct contributions to charitable, religious, and certain other nonprofit 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.

118. ***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.

119. ***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.

120. ***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 Au-

gust 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.

121. ***Exclusion for benefits provided to volunteer EMS and firefighters.***—Certain benefits received by volunteer EMS and firefighters excluded from income. This provision sunsets on December 31, 2010.

Health

122. ***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.

123. ***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 deductible percentage is 60 percent in 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter.

124. ***Medical and health savings accounts.***—Individual contributions to Archer Medical Savings Accounts (Archer MSAs) and Health Savings Accounts (HSAs) are allowed as a deduction in determining adjusted gross income whether or not the individual itemizes deductions. Employer contributions to Archer MSAs and HSAs are excluded from income and employment taxes. Archer MSAs and HSAs require that the individual have coverage by a qualifying high deductible health plan. Earnings from the accounts are excluded from taxable income. Distributions from the accounts used for medical expenses are not taxable. The rules for HSAs are generally more flexible than for Archer MSAs and the deductible contribution amounts are greater (in 2007, $2850 for taxpayers with individual coverage and $5,650 for taxpayers with family coverage). Thus, HSAs have largely replaced MSAs.

125. ***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.

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

127. ***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.

128. ***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.

129. ***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.

130. ***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.

131. ***Distributions for premiums for health and long-term care insurance.***—This provision provides for tax-free distributions of up to $3,000 from governmental retirement plans for premiums for health and long term care premiums of public safety officers.

Income Security

132. ***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.

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

134. ***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.

135. ***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.

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

137. ***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.

138. ***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 2007, an employee could exclude up to $15,500

(indexed) of wages from AGI under a qualified arrangement with an employer's 401(k) plan. 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.

139. ***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 2006 and 2007, and $5,000 in 2008 (indexed thereafter) and allows taxpayers over age 50 to make additional "catch-up" contributions of $1,000.

Taxpayers whose AGI is below $83,000 ($62,000 for non-joint filers) in 2007 can claim a deduction for IRA contributions. The IRA deduction is phased out for taxpayers with AGI between $83,000 to $103,000 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 $166,000 ($114,000 for nonjoint filers) can make contributions to Roth IRAs. The maximum contribution to a Roth IRA is phased out for taxpayers with AGI between $156,000 and $166,000 ($99,000 and $114,000 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 591/2, (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.

140. ***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 $52,000 for joint filers and $26,000 for single filers.

141. ***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 $45,000 in 2007. 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.

142. ***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.

143. ***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.

144. ***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.

145. ***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.

146. ***Additional deduction for the blind.***—Taxpayers who are blind may take an additional $1,300 standard deduction if single, or $1,050 if married in 2007.

147. ***Additional deduction for the elderly.***—Taxpayers who are 65 years or older may take an additional $1,300 standard deduction if single, or $1,050 if married in 2007.

148. ***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.

149. ***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.

150. ***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 $8,080 of earned income in 2007. The credit is 40 percent of the first $11,790 of income for a family with two or more qualifying children. The credit is phased out beginning when the taxpayer's income exceeds $15,390 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 $33,241 ($37,783 if two or more qualifying children are present), $35,241 (or $39,783) 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 2007, the credit is 7.65 percent of the first $5,590 of earned income. When the taxpayer's income exceeds $7,000 (9,000 if married), the credit is phased out at the rate of 7.65 percent. It is completely phased out at $12,590 ($14,590 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 2006 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.

151. ***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

152. ***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.

153. ***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.

154. ***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

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

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

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

158. ***Tax-exempt mortgage bonds for veteran.***—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

159. ***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.

160. ***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. The deductibility of state and local sales taxes is set to expire at the end of 2007.

Interest

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

Appendix A

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 chapter, tax expenditures are measured relative to normal law or reference law baselines that deviate from a comprehensive concept of income. Consequently, tax expenditures identified in the Budget can differ from those that would be identified under a comprehensive income tax baseline. This appendix compares major tax expenditures listed in the tax expenditure budget with those implied by a comprehensive income baseline.

Current budgetary practice excludes from the list of tax expenditures those provisions that over-tax certain items of income because the original motivation for the analysis was to identify tax provisions that substitute 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.

Major Tax Expenditures from the Traditional 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 and only once. Thus, it would not levy a separate tax on corporate income leading to the double taxation of corporate profits.

Comprehensive income is widely held to be the idealized base for an income tax even though it is not a perfectly defined concept.[5] 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 such as housing, automobiles, and major appliances.

Furthermore, comprehensive income does not necessarily represent an ideal tax base; economic efficiency would be improved by deviating from comprehensive income as a tax base by reducing the tax on capital income to spur economic growth further or by subsidizing certain types of activities to correct for market failures. 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 thirty illustrative large tax expenditures from the Budget.

Table 1 classifies fifteen 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 reflect the hybrid nature of the existing tax system and arise out of policy decisions to reduce the high tax rate on capital income that would otherwise arise. Even these relatively clear-cut items, how-

[5] 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.

ever, can raise ambiguities in light of the absence of integration of the corporate and individual tax systems. For example, 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 because the income is taxed first at the corporate level. A similar line of reasoning suggests that in the case of corporations, expensing[6] of R&E or accelerated depreciation are not tax expenditures because they 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 continue to 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 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 benefits when paid (since it represents an increase in net worth).[7] 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 any proceeds 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 displays items that probably are tax expenditures, but that raise additional issues. Current law, for instance, allows deductions for home mortgage interest and for property taxes on owner-occupied housing. The tax expenditure budget includes both of these provisions. A comprehensive tax base would allow both deductions, but it would also include imputed gross rental income. Current law does not include gross rental income, however, and so on this basis the home mortgage interest deduction and the deduction for property taxes on owner-occupied housing are properly tax expenditures under a comprehensive income tax base.[8] 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 relative to a comprehensive income tax base.

The deduction of nonbusiness State and local taxes other than on owner-occupied homes also is included in Panel B. The 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.[9] 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.[10]

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.[11] 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.[12]

The comprehensive income tax base is an objective measure of income. Traditionally, this measure is modified to reflect a subjective or social economic policy concern regarding the financial ability of an individual to pay tax. Absent this modification, provisions such as the personal exemption and the child tax credit would be treated as tax expenditures. However, once the definition of income is modified to reflect the ability of an individual to pay tax, then these and similar provisions are typically dropped from the list of tax expenditures.

The step-up of basis at death lowers the tax on capital gains for those who inherit assets. From that perspective it would be a tax expenditure under a comprehensive income baseline. Nonetheless, there are ambiguities. Under a comprehensive income baseline, all inflation-adjusted gains would be taxed as accrued, so there would be no deferred unrealized gains on assets held at death.

The partial exclusion of Social Security benefits from tax is also listed in panel B. To the extent Social Security is viewed as a pension, comprehensive income would include all contributions to Social Security retirement funds (payroll taxes) and tax accretions to value as they arise.[13] Benefits paid out of contributions and the inside build-up in value, however, would not be

[6] 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.

[7] 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.

[8] 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).

[9] Fiscal Year 2003 Budget of the United States Government, Analytical Perspectives (Washington, D.C.: U.S. Government Printing Office, 2002) p. 127.

[10] 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.

[11] U.S. Treasury, Blueprints for Basic Tax Reform (Washington, D.C.: U.S. Government Printing Office, 1977) p. 92.

[12] 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.

[13] 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.

included 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 income and all benefits received should be included.

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[14] reflect exemptions for lower-income beneficiaries from the tax on 85 percent of Social Security benefits.[15] 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.[16] Hence, the tax expenditure budget understates the tax advantage accorded Social Security retirement benefits relative to a comprehensive income baseline.

The deduction for U.S. production activities also raises 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 then represent a feature of the baseline tax rate system because the deduction is equivalent to a lower tax rate. In addition, it might not be a tax expenditure to the extent it is viewed as providing relief from the double tax on corporate profits.

[14] 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.

[15] 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.

[16] 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.

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 may serve as proxies for provisions that would be a tax expenditure under a comprehensive income base.[17]

For example, under existing law charitable contributions are deductible, and this deduction is considered on its face a tax expenditure in the current budget.[18] The treatment of charitable donations, however, is ambiguous under a comprehensive income tax. If charitable contributions are a consumption item for the giver, then they are properly included in his taxable income and a deduction for contributions would be a tax expenditure under a comprehensive income tax base. 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 the charitable deduction 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 is not taxed.[19]

Medical expenditures may or may not be an element of income. These expenditures may be viewed as a reduction of net worth (e.g. cost of earning income) rather than as discretionary spending, and so are not really consumption and should be excluded from the tax base. However, expenditures for medical care may be considered as indistinguishable from other consumption items which are not excluded from a comprehensive income base.

The exemption of full taxation of Social Security benefits paid to the disabled also raises issues. Social Security benefits for the disabled most closely resemble either Government transfers or insurance. From either perspective, a comprehensive income tax would require that the benefit be included in income and would allow a deduction for 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 tax expenditure budget displays the benefit of exempting 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

[17] 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.

[18] 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.

[19] If recipients tend to be in lower tax brackets, then the tax expenditure is smaller than when measured at the donor's tax rates.

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 simultaneously 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 half of the premium might suggest that 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.[20]

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,[21] and benefits received from private charities. Under some theories 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, might measure the income of U.S. residents properly.

Negative Tax Expenditures

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.

Human capital is generally considered a productive asset, and so its cost (e.g., certain education and training expenses, including perhaps the cost of college and professional school) should be amortizable under a comprehensive income tax, but it is not under current law.[22]

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.[23] 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 and so 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.[24]

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

This section compares tax expenditures listed in the tax expenditure budget with those implied by a comprehensive consumption tax baseline. It first discusses some of the difficulties encountered in contemplating current tax provisions as part of a comprehensive consumption tax. Next, it assesses which of thirty large income tax expenditures would be tax expenditures under the consumption tax baseline, concluding that about half would remain under a consumption tax baseline. Most that fall off the list are incentives for saving and investment.

The section next discusses some major differences between current law and a comprehensive consumption tax baseline. These differences include the consumption

[20] 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.

[21] To the extent that premiums are deductible.

[22] 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.

[23] See Bradford, Untangling the Income Tax, p. 41.

[24] 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.

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 can be viewed as 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. Some issues arise which are also 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 discussed earlier in the context of the comprehensive income tax is determining whether a particular expenditure, such as spending on medical care and charitable donations, is an item of consumption.

Also, 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 include 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 an investment's income (or yield) is equivalent to consumption tax treatment with respect to the normal rate of return on new investment; expensing generates a tax reduction that offsets in present value terms the tax paid on the investment's future normal returns. Because of this equivalence, in the context of consumption taxes, a yield exemption approach is sometimes called a tax prepayment approach. That is, tax is paid on an asset's purchase price rather than on the consumption flow that it generates.

However, a yield exemption approach differs from a pure consumption tax with respect to the distribution of income and Government revenue. Pure profits in excess of the normal rate of return would be taxed under a consumption tax because pure profits are an element of cash flow; however, pure profits would not be taxed under a yield exemption tax system. The question arises whether an exemption of certain kinds of investment income, and certain investment tax credits, should 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.

Considering provisions individually can be misleading. The hybrid character of the existing tax system reflects many provisions that might be good policy 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, if financial flows are excluded from the tax base, then the deduction for home mortgage interest would be a tax expenditure except that current law generally taxes interest income. When combined with the mortgage interest deduction, this offsets the inclusion of 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, the effects of these transactions would cancel out in the economy as a whole. The classification below generally views available capital gains tax relief as consistent with a broad-based consumption tax because they lower tax rate on capital income is consistent with a consumption-based tax.

Such considerations suggest that, as with an income tax, computing the current tax's deviations from "the" base of a consumption tax is difficult because deviations cannot always 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 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 six (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.

In one respect 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 a deduction for principal repayments.

From another perspective, however, the home mortgage interest deduction would not be a tax expenditure under a consumption tax. Under a consumption tax, the interest income accruing to the mortgage lender generally would not be taxed (at least in present value terms). As interest income is subject to tax under current law, 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.[25]

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 based on 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 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 would be a tax expenditure relative to a consumption base.

As discussed in the section on comprehensive income, whether the deduction for State and local income taxes gives rise to a tax expenditure under a consumption tax depends on whether the services paid for with these taxes constitute consumption value to the taxpayer. If there is not a firm relationship between the taxes paid and the services received, then the deduction may not be viewed as a tax expenditure.

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, yielding a stream of services that current federal tax law fails to impute to income.

The tax expenditures for Social Security benefits discussed in the section on comprehensive income measure 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 would correspond to including 50 percent of Social Security benefits in the recipient's tax base.[26] Thus, the existing tax expenditure is correct conceptually, but is not measured properly relative to a comprehensive income tax. A similar analysis would

[25] 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.

[26] The current tax expenditure estimates reflect 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.

apply to the exclusion of Social Security benefits of dependents and retirees.

There is a strong case for viewing the child tax credit and the earned income tax credit as social welfare programs (transfers). As such, they would be tax expenditures relative to a consumption baseline. 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.

There also is the issue of how to tax medical insurance premiums. Under current law, employees may exclude insurance premiums paid for by employers from 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 included in the tax base because they represent consumption. Yet an alternative perspective would support excluding the premium from the tax base as long as the value of any medical services paid for by the insurance policy were included. 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.

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, 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 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. 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 possible tax expenditures 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 theories 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 provisions are called negative tax expenditures.

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 requires 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 net operating loss 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). Human capital is a productive asset, and so 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 Alternative Minimum Tax 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, 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.[27] 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.[28] 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 comprehensive 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.[29]

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 income tax advantage to housing; they overlook the additional exclusion of implicit net rental income. To the extent 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. On the other hand, a homeowner with a mortgage approximately matching the value of the house might make interest payments that exceed the implicit rental income. 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.[30]

[27] 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.

[28] 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.

[29] 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.

[30] 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.

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.[31]

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 provisions 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.

[31] National Income and Production Accounts, Table 2.4.

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 then 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 A 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 $41 billion in the years 2007 through 2013. 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.

Appendix Table 1. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE INCOME TAX[1]

Description	Revenue Effect 2009
A. Tax Expenditure Under a Comprehensive Income Tax	
Capital gains (except agriculture, timber, iron ore, and coal)	55,940
Net exclusion of pension contributions and earnings: 401(k) plans	51,000
Net exclusion of pension contributions and earnings: Employer plans	45,670
Accelerated depreciation of machinery and equipment (normal tax method)	44,120
Capital gains exclusion on home sales	34,710
Exclusion of interest on public purpose State and local bonds	25,900
Exclusion of interest on life insurance savings	23,500
Deferral of income from controlled foreign corporations (normal tax method)	13,780
Net exclusion of pension contributions and earnings: Keogh plans	13,000
Accelerated depreciation on rental housing (normal tax method)	11,760
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	11,700
Exclusion of net imputed rental income on owner-occupied housing	7,550
Exclusion of workers' compensation benefits	5,920
Credit for low-income housing investments	5,780
Expensing of research and experimentation expenditures (normal tax method)	4,990
B. Possibly a Tax Expenditure Under a Comprehensive Income Tax, But With Some Qualifications	
Deductibility of mortgage interest on owner-occupied homes	100,810
Step-up basis of capital gains at death	36,750
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	33,200
Child credit	29,950
Exclusion of Social Security benefits for retired workers	18,640
Deductibility of State and local property tax on owner-occupied homes	16,640
Deduction for U.S. production activities	15,330
Earned income tax credit	5,440
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	168,460
Deductibility of charitable contributions, other than education and health	46,980
Deductibility of medical expenses	5,920
Social Security benefits for the disabled	5,810
Deductibility of charitable contributions, health	5,300
Deductibility of charitable contributions, education	5,270
D. Probably Not a Tax Expenditure Under a Comprehensive Income Tax	
Exception from passive loss rules for $25,000 of rental loss	8,840

[1] 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[1]

Description	Revenue Effect 2009
A. Tax Expenditure Under a Consumption Base	
Exclusion of workers' compensation benefits	5,920
B. Probably a Tax Expenditure Under a Consumption Base	
Deductibility of mortgage interest on owner-occupied homes	100,810
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	33,200
Child credit	29,950
Exclusion of Social Security benefits for retired workers	18,640
Deductibility of State and local property tax on owner-occupied homes	16,640
Earned income tax credit	5,440
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	168,460
Deductibility of charitable contributions, other than education and health	46,980
Exclusion of net imputed rental income on owner-occupied housing	7,550
Deductibility of medical expenses	5,920
Social Security benefits for disabled	5,810
Credit for low-income housing investments	5,780
Deductibility of charitable contributions, health	5,300
Deductibility of charitable contributions, education	5,270
D. Not a Tax Expenditure Under a Consumption Base	
Capital gains (except agriculture, timber, iron ore, and coal)	55,940
Net exclusion of pension contributions and earnings: 401(k) plans	51,000
Net exclusion of pension contributions and earnings: Employer plans	45,670
Accelerated depreciation of machinery and equipment (normal tax method)	44,120
Step-up basis of capital gains at death	36,750
Capital gains exclusion on home sales	34,710
Exclusion of interest on public purpose State and local bonds	25,900
Exclusion of interest on life insurance savings	23,500
Deduction for U.S. production activities	15,330
Deferral of income from controlled foreign corporations (normal tax method)	13,780
Net exclusion of pension contributions and earnings: Keogh plans	13,000
Accelerated depreciation on rental housing (normal tax method)	11,760
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	11,700
Exception from passive loss rules for $25,000 of rental loss	8,840
Expensing of research and experimentation expenditures (normal tax method)	4,990

[1] 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[1]

Provision	Revenue Loss						
	2007	2008	2009	2010	2011	2012	2013
Imputed Rent On Owner-Occupied Housing	3,890	5,440	7,550	10,480	14,540	20,180	28,010
Double Tax on corporate profit[2]	–41,230	–44,340	–46,860	–49,520	–52,340	–55,310	–58,460

[1] Calculations described in the appendix text.
[2] This is a negative tax expenditure, a tax provision that overtaxes income relative to the treatment specified by the baseline tax system.

Appendix B

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. This Appendix responds to the report of the Senate Governmental Affairs Committee on GPRA4[32] calling on the Executive Branch to undertake a series of analyses to assess the effect

[32] Committee on Government Affairs, United States Senate, "Government Performance and Results Act of 1993" (Report 103–58, 1993).

of specific tax expenditures on the achievement of agencies' performance objectives.

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.[33] 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

[33] 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.

encourage investment. In addition, the economic effects of particular provisions can extend beyond their intended 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 compared 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.