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105th Congress
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105–70

TAX EXPENDITURES

Compendium of Background Material on Individual Provisions

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

DECEMBER 1998

PREPARED BY THE

CONGRESSIONAL RESEARCH SERVICE

Prepared for the use of the Committee on the Budget by the Congressional Research Service. This document has not been officially approved by the Committee and may not reflect the views of its members.

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TAX EXPENDITURES—Compendium of Background Material on Individual Provisions

LETTER OF TRANSMITTAL

December 22, 1998

UNITED STATES SENATE
COMMITTEE ON THE BUDGET
WASHINGTON, DC

To the Members of the Committee on the Budget:

The Congressional Budget and Impoundment and Control Act of 1974 (as amended) requires the Budget Committees to examine tax expenditures as they develop the Congressional Budget Resolution. There are over 120 separate tax expenditures in current law. Section 3(3) of the Budget Act of 1974 defines tax expenditures as those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Tax expenditures are becoming increasingly important when considering the budget. They are often enacted as permanent legislation and can be compared to direct spending on entitlement programs. Both tax expenditures and entitlement spending have received, as they should in the current budget environment, increased scrutiny.

This print was prepared by the Congressional Research Service (CRS) and was coördinated by Cheri Reidy of the Senate Budget Committee staff. All tax code changes through the end of the 105th Congress are included.

The CRS has produced an extraordinarily useful document which incorporates not only a description of each provision and an estimate of its revenue cost, but also a discussion of its impact, a review of its underlying rationale, an assessment which addresses the arguments for and against the provision, and a set of bibliographic references. Nothing in this print should be interpreted as representing the views or recommendations of the Senate Budget Committee or any of its members.

Pete V. Domenici
Chairman

LETTER OF SUBMITTAL

CONGRESSIONAL RESEARCH SERVICE
THE LIBRARY OF CONGRESS
Washington, D.C., December 15, 1998

Honorable Pete V. Domenici
Chairman, Committee on the Budget
U.S. Senate
Washington, DC 20510.

Dear Mr. Chairman:

I am pleased to submit a revision of the December 1996 Committee Print on Tax Expenditures.

As in earlier versions, each entry includes an estimate of the revenue cost, the legal authorization, a description, the impact of the provision, the rationale at the time of adoption, an assessment, and bibliographic citations. The impact section includes quantitative data on the distribution of tax expenditures across income classes where relevant and where data are available. The rationale section contains some detail about the historical development of each provision. The assessment section summarizes the issues surrounding each tax expenditure.

The revision was written under the general direction of Jane G. Gravelle, Senior Specialist in Economic Policy. Contributors of individual entries include James M. Bickley, David L. Brumbaugh, Gregg A. Esenwein, Jane G. Gravelle, Donald W. Kiefer, Salvatore Lazzari, Linda Levine, Nonna A. Noto, Louis A. Talley, Jack H. Taylor, and Dennis Zimmerman of the Economics Division; and Velma W. Burke, Geoffrey C. Kollman, Robert F. Lyke, Joseph I. Richardson, and James R. Storey of the Education and Public Welfare Division. Thomas A. Holbrook provided editorial assistance and prepared the document for publication.

DANIEL P. MULHOLLAN, *Director*

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INTRODUCTION

This compendium gathers basic information concerning 125 Federal tax provisions currently treated as tax expenditures. They include those listed in Tax Expenditure Budgets prepared for fiscal years 1997-2001 by the Joint Committee on Taxation,[1] although certain separate items that are closely related and are within a major function may be combined.

With respect to each tax expenditure, this compendium provides:

The estimated Federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 1997-2001, as estimated by the Joint Committee on Taxation;

The legal authorization for the provision (e.g., Internal Revenue Code section, Treasury Department regulation, or Treasury ruling);

A description of the tax expenditure, including an example of its operation where this is useful;

A brief analysis of the impact of the provision, including information on the distribution of benefits where data are available;

A brief statement of the rationale for the adoption of the tax expenditure where it is known, including relevant legislative history;

An assessment, which addresses the arguments for and against the provision; and

---

[1]U.S. Congress, Joint Committee on Taxation. *Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001*, Joint Committee Print. Washington, DC: U.S. Government Printing Office, December 15, 1998.

References to selected bibliography.

The information presented for each tax expenditure is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory understanding of the nature, effect, and background of each provision. Good starting points for further research are listed in the selected bibliography following each provision.

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as spending programs channeled through the tax system. They are, in fact, classified in the same functional categories as the U.S. budget.

Section 3(3) of the Congressional Budget and Impoundment Control Act of 1974 specifically defines tax expenditures as:

> . . . those 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 tax liability; . . .

In the legislative history of the Congressional Budget Act, provisions classified as tax expenditures are contrasted with those provisions which are part of the "normal structure" of the individual and corporate income tax necessary to collect government revenues.

The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or non-tax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs relating to the same goals--both non-tax and tax--when developing its annual budget. Only when tax expenditures are considered will congressional budget decisions take into account the full spectrum of Federal programs.

Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals for which they were established.

Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure first were required to be published in 1975 as part of the Administration budget for fiscal year 1976, and have been required to be published by the Budget Committees since 1976. The tax expenditure concept is still being refined, and therefore the classification of certain provisions as tax expenditures continues to be discussed. Nevertheless, there has been widespread agreement for the treatment as tax expenditures of most of the provisions included in this compendium.[2]

As defined in the Congressional Budget Act, the concept of tax expenditure refers to the corporation and individual income taxes. Other parts of the Internal Revenue Code--excise taxes, employment taxes, estate and gift taxes--also have exceptions, exclusions, refunds and credits (such as a gasoline tax exemptions for non-highway uses) which are not included here because they are not parts of the income tax.

Administration Fiscal Year 1997 Tax Expenditure Budget

There are several differences between the tax expenditures shown in this publication and the tax expenditure budget found in the Administration's FY97 budget document. In some cases tax expenditures are combined in one list, but not in the other.

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms:

---

[2]For a discussion of the conceptual problems involved in defining tax expenditures, see *The Budget of the United States Government, Fiscal Year 1995, Analytical Perspectives*, "Tax Expenditures," pp. 61-87.

(1) exclusions, exemptions, and deductions, which reduce taxable income;

(2) preferential tax rates, which apply lower rates to part or all of a taxpayer's income;

(3) credits, which are subtracted from taxes as ordinarily computed;

(4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's tax rate. A tax credit is subtracted directly from the tax liability that would otherwise be due; thus the amount of tax reduction is the amount of the credit--which does not depend on the marginal tax rate. (See Appendix A for further explanation.)

Order of Presentation

The tax expenditures are presented in an order which generally parallels the budget functional categories used in the congressional budget, *i.e.*, tax expenditures related to "national defense" are listed first, and those related to "international affairs" are listed next. In a few instances, two or three closely related tax expenditures derived from the same Internal Revenue Code provision have been combined in a single summary to avoid repetitive references even though the tax expenditures are related to different functional categories. This parallel format is consistent with the requirement of section 301(d)(6) of the Budget Act, which requires the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports to present the estimated levels of tax expenditures "by major functional categories."

Impact (Including Distribution)

The impact section includes information on the direct effect of the provisions and, where available, the distributional effect across individuals. Unless otherwise specified, distributional tables showing the share of the tax expenditure received by income class are calculated from data in the Joint

Committee on Taxation's committee print on tax expenditures for 1997-2001. This distribution uses an expanded income concept that is composed of adjusted gross income (AGI), plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employee share of FICA tax, (4) worker's compensation, (5) nontaxable social security benefits, (6) insurance value of Medicare benefits, (7) corporate income tax liability passed on to shareholders, (8) alternative minimum tax preferences, and (9) excluded income of U.S. citizens abroad.

The following table shows the distribution of returns by income class, for comparison with those tax expenditure distributions:

Distribution by Income Class of Tax Returns at 1998 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	14.8
$10 to $20	18.8
$20 to $30	15.2
$30 to $40	12.1
$40 to $50	9.3
$50 to $75	14.5
$75 to $100	7.5
$100 to $200	6.3
$200 and over	1.6

These estimates were made for nine tax expenditures. For other tax expenditures, a distributional estimate or information on distributional impact is provided, when such information could be obtained.

Many tax expenditures are corporate and thus do not directly affect the taxes of individuals. Most analyses of capital income taxation suggest that such taxes are likely to be borne by capital given reasonable behavioral assumptions.[3] Capital income is heavily concentrated in the upper-income

[3]See Jane G. Gravelle, *Corporate Tax Integration: Issues and Options*, Library of Congress, Congressional Research Service Report 91-482, June 14, 1991, pp. 31-39.

levels. For example, the Congressional Budget Office[4] reports that 40 percent of capital income is received by the top one percent of the population, 60 percent is received by the top 5 percent, and 67 percent is received by the top 10 percent, and 76 percent is received by the top 20 percent. The distribution across the first four quintiles is 1, 6, 7, and 10 percent. Corporate tax expenditures would, therefore, tend to benefit higher-income individuals.

Rationale

Each tax expenditure item contains a brief statement of the rationale for the adoption of the expenditure, where it is known. They are the principal rationales publicly given at the time the provisions were enacted. The rationale also chronicles subsequent major changes in the provisions and the reasons for the changes.[5]

Assessment

The assessment section summarizes the arguments for and against the tax expenditures and the issues they raise. These issues include effects on economic efficiency, on fairness and equity, and on simplicity and tax administration. Further information can be found in the bibliographic citations.

Estimating Tax Expenditures

The revenue losses for all the listed tax expenditures are those estimated by the Joint Committee on Taxation.

In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same. In using the tax expenditure estimates, several points should be noted.

---

[4]U.S. Congress, Congressional Budget Office. *Estimates of Federal Tax Liabilities by Income Category and Family Type for 1995 and 1999*, May 1998, p. 30.

[5]Major tax legislation is referred to by year or title. For public law numbers, see Louis Alan Talley, *A Concise History of U.S. Federal Taxation*, Library of Congress, Congressional Research Service Report 90-295 E, June 14, 1990.

First, in some cases, if two or more items were eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items. Thus, the arithmetical sum of all tax expenditures (reported below) may be different from the actual revenue consequences of eliminating all tax expenditures.

Second, the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts.

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until some time after enactment. Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

These tax expenditure estimating considerations are, however, similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income-security program are computed separately. However, if one program, such as veterans pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments.

Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be fully reflected until several years later because the termination of benefits is usually only for new recipients, with persons already receiving benefits continued under "grandfather" provisions.

All revenue loss estimates are based upon the tax law enacted as of December 31, 1996. All estimates have been rounded to the nearest $0.1 billion.

Sum of Tax Expenditure Items by Type of Taxpayer, Fiscal Years 1999-2001

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	492.6	90.2	582.8
2000	511.2	93.5	604.7
2001	529.7	95.3	625.0

2002	550.4	97.2	647.6
2003	571.8	99.0	670.8

Note: These totals are the mathematical sum of the estimated fiscal year effect of each of the tax expenditure items included in this publication. The limitations on the use of the totals are explained in the text. Source: Computed from data supplied by the Joint Committee on Taxation.

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EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES PERSONNEL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.0	-	2.0
2000	2.0	-	2.0
2001	2.0	-	2.0
2002	2.1	-	2.1
2003	2.1	-	2.1

Authorization

Sections 112 and 134[6], and court decisions [see *Jones v. United States*, 60 Ct. Cl. 552 (1925)].

Description

Military personnel are provided with a variety of in-kind benefits (or cash payments given in lieu of such benefits) that are not taxed. These benefits include medical and dental benefits, group term life insurance, professional education and dependent education, moving and storage, premiums for survivor and retirement protection plans, subsistence allowances, uniform allowances, housing allowances, overseas cost-of-living allowances, evacuation allowances, family separation allowances, travel for consecutive overseas tours, emergency assistance, family counseling and defense counsel, burial and death services, travel of dependents to a burial site, and a number of less significant items. Other benefits include certain combat-zone compensation and combat-related benefits. In addition, any

[6]The word "Section" denotes a section of the Internal Revenue Code of 1986, as amended, unless otherwise noted.

member of the armed forces who dies while in active service in a combat zone or as a result of wounds, disease, or injury incurred while in service is excused from all tax liability. Any unpaid tax due at the date of the member's death (including interest, additions to the tax, and additional amounts) is abated. If collected, such amounts are credited or refunded as an overpayment. (Medical benefits for dependents are discussed subsequently under the Health function.)

Impact

Many military benefits qualify for tax exclusion. That is to say, the value of the benefit (or cash payment made in lieu of the benefit) is not included in gross income. Since these exclusions are not counted in income, the tax savings are a percentage of the amount excluded, dependent upon the marginal tax bracket of the recipient.

An individual in the 15-percent tax bracket (Federal tax law's lowest tax bracket) would not pay taxes equal to $15 for each $100 excluded. Likewise, an individual in the 39.6-percent tax bracket (Federal law's highest tax bracket) would not pay taxes of $39.60 for each $100 excluded. Hence, the same exclusion can be worth different amounts to different military personnel, depending on their marginal tax bracket. By providing military compensation in a form not subject to tax, the benefits have greater value for members of the armed services with high income than for those with low income.

Rationale

In 1925, the United States Court of Claims in *Jones v. United States*, 60 Ct. Cl. 552 (1925), drew a distinction between the pay and allowances provided military personnel. The court found that housing and housing allowances were reimbursements similar to other non-taxable expenses authorized for the executive and legislative branches.

Prior to this court decision, the Treasury Department had held that the rental value of quarters, the value of subsistence, and monetary commutations were to be included in taxable income. This view was supported by an earlier income tax law, the Act of August 27, 1894, (later ruled unconstitutional by the Courts) which provided a two- percent tax "on all salaries of officers, or payments to persons in the civil, military, naval, or other employment of the United States."

The principle of exemption of armed forces benefits and allowances evolved from the precedent set by *Jones v. United States*, through subsequent statutes, regulations, or long-standing administrative practices.

The Tax Reform Act of 1986 (P.L. 99-514) consolidated these rules so that taxpayers and the Internal Revenue Service could clearly understand and administer the tax law consistent with fringe benefit treatment enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369).

For some benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime (as in the use of combat pay provisions); other allowances were apparently based on the belief that certain types of benefits were not strictly compensatory, but rather intrinsic elements in the military structure.

Assessment

Some military benefits are akin to the "for the convenience of the employer" benefits provided by private enterprise, such as the allowances for housing, subsistence, payment for moving and storage expenses, overseas cost-of-living allowances, and uniforms. Other benefits are equivalent to employer-provided fringe benefits such as medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits.

Some see the provision of compensation in a tax-exempt form as an unfair substitute for additional taxable compensation. The tax benefits that flow from an exclusion do provide the greatest benefits to high- rather than low-income military personnel. Administrative difficulties and complications could be encountered in taxing some military benefits and allowances that currently have exempt status; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. By eliminating exclusions and adjusting military pay scales accordingly, a result might be to simplify decision-making about military pay levels and make "actual" salary more apparent and satisfying to armed forces personnel. However, elimination of the tax exclusions could also lead service members to think their benefits were being cut, or provide an excuse in the "simplification" process to actually cut benefits, affecting recruiting and retention negatively.

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EXCLUSION OF MILITARY DISABILITY BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	-	0.1
2000	0.1	-	0.1
2001	0.1	-	0.1
2002	0.1	-	0.1
2003	0.1	-	0.1

Authorization

Section 104(a)(4) and 104(b).

Description

Members of the armed forces on or before September 24, 1975, are eligible for tax exclusion of disability pay. The payment from the Department of Defense is based either on the percentage-of-disability or years-of-service methods.

In the case of the percentage-of-disability method, the pension is the percentage of disability multiplied by the terminal monthly basic pay. These disability pensions are excluded from gross income.

In the years-of-service method, the terminal monthly basic pay is multiplied by the number of service years times 2.5. Only that portion that would have been paid under the percentage-of-disability method is excluded.

Members of the United States armed forces joining after September 24, 1975, and who retire on disability, may exclude from gross income Department of Defense disability payments equivalent to disability payments they could have received from the Veterans Administration. Otherwise,

Department of Defense disability pensions may be excluded only if the disability is directly attributable to a combat-related injury.

Impact

Disability pension payments that are exempt from tax provide more net income than taxable pension benefits at the same level. The tax benefit of this provision increases as the marginal tax rate increases, and is greater for higher-income individuals.

Rationale

Typically, the Acts which provided for disability pensions for American veterans also provided that these payments would be excluded from individual income tax. In 1942, the provision was broadened to include disability pensions furnished by other countries (many Americans had joined the Canadian armed forces). It was argued that disability payments, whether provided by the United States or by Canadian governments, were made for essentially the same reasons and that a veteran's disability benefits were similar to compensation for injuries and sickness, which at that time was already excludable from income under Internal Revenue Code provisions.

In 1976, the exclusion was repealed, except in certain instances. Congress sought to eliminate abuses by armed forces personnel who were classified as disabled shortly before becoming eligible for retirement in order to obtain tax-exempt treatment for their pension benefits. After retiring from military service, some individuals would earn income from other employment while receiving tax-free military disability benefits. Since present armed forces personnel may have joined or continued their service because of the expectation of tax-exempt disability benefits, Congress deemed it equitable to limit changes in the tax treatment of disability payments to future personnel.

Assessment

The exclusion of disability benefits paid by the federal government alters the distribution of net payments to favor higher income individuals. If individuals had no other outside income, distribution could be altered either by changing the structure of disability benefits or by changing the tax treatment.

The exclusion causes the true cost of providing for military personnel to be understated in the budget. Under present rules, however, most of these tax benefits do not accrue to new members of the armed forces, and the

benefit will eventually be confined to a small group, barring a major military engagement which produces substantial combat-related disabilities.

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EXCLUSION OF INCOME EARNED ABROAD BY U.S. CITIZENS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.9	-	1.9
2000	2.0	-	2.0
2001	2.2	-	2.2
2002	2.3	-	2.3
2003	2.5	-	2.5

Authorization

Section 911.

Description

U.S. citizens are generally subject to U.S. taxes on their foreign- as well as domestic-source income. However, section 911 of the tax code permits U.S. citizens who live and work abroad an exclusion of wage and salary income from taxable income. The amount that can be excluded was $70,000 for 1997, but beginning in 1998 the exclusion is scheduled to increase by $2,000 annually to $80,000 in 2002. The exclusion is also scheduled to be indexed for U.S. inflation, beginning in 2008.

Qualifying individuals can also exclude certain expenditures for overseas housing. (Foreign tax credits, however, cannot be claimed for foreign taxes paid on excluded income.) To qualify for either exclusion, a person must be a U.S. citizen, must have their tax home in a foreign country, and must either be a bona fide resident of a foreign country or have lived abroad for at least 330 days of any 12 consecutive months. Qualified income must be "earned" income rather than investment income. If a person qualifies for the exclusion for only part of the tax year, only part of the exclusion can be claimed. The housing exclusion is designed to approximate the extra housing costs of

living abroad; it is equal to the excess of actual foreign housing costs over 16 percent of the salary for a Federal employee at the GS-14, step 1 level. While a taxpayer can claim both the housing and the income exclusion, the combined exclusions cannot exceed total foreign earned income, including housing allowances.

Impact

The exclusion's impact depends partly on whether foreign taxes paid are higher or lower than U.S. taxes. If an expatriate pays high foreign taxes, the exclusion has little importance; the U.S. person can use foreign tax credits to offset any U.S. taxes in any case. For expatriates who pay little or no foreign taxes, however, the exclusion reduces or eliminates U.S. taxes. Available data suggest that U.S. citizens who work abroad have higher real incomes, on average, than persons working in the United States. Thus, where it does reduce taxes the exclusion reduces tax progressivity.

The exclusion's effect on horizontal equity is more complicated. Because foreign countries have costs of living that differ from that of the United States, the tax liabilities of U.S. persons working abroad differ from the tax burdens of persons with identical real incomes living in the United States. A person working in a high-cost country needs a higher nominal income to match the real income of a person in the United States; an expatriate in a low-cost country needs a lower nominal income. Since tax brackets, exemptions, and the standard deduction are expressed in terms of nominal dollars, persons living in low-cost countries generally have lower tax burdens than persons with identical real incomes living in the United States. Similarly, if not for the foreign earned income exclusion, U.S. citizens working in high-cost countries would pay higher taxes than their U.S. counterparts.

Because the maximum income exclusion is not linked to the actual cost of living, the provision overcompensates for the cost of living abroad in some cases. Indeed, some have argued that because the tax code does not take into account variations in living costs within the United States, the appropriate equity comparison is between expatriates and a person living in the highest cost area within the United States. In this case, the likelihood that the exclusion reduces rather than improves horizontal equity is increased.

Rationale

The Revenue Act of 1926 provided an unlimited exclusion of earned income for persons residing abroad for an entire tax year. Supporters of the exclusion argued that the provision would bolster U.S. trade performance, since it would provide tax relief to U.S. expatriates engaged in trade promotion.

The subsequent history of the exclusion shows a continuing attempt by policymakers to find a balance between the provision's perceived beneficial effects on U.S. trade and economic performance and perceptions of tax equity. In 1962, the Kennedy Administration recommended eliminating the exclusion in some cases and scaling it back in others in order to "support the general principles of equity and neutrality in the taxation of U.S. citizens at home and abroad." The final version of the Revenue Act of 1962 simply capped the exclusion in all cases at $20,000. The Tax Reform Act of 1976 pared the exclusion further (to $15,000), again for reasons of tax equity.

However, the Foreign Earned Income Act of 1978 completely revamped the exclusion so that the 1976 provisions never went into effect. The 1978 Act sought to provide tax relief more closely tied to the actual costs of living abroad. It replaced the single exclusion with a set of separate deductions that were linked to various components of the cost of living abroad, such as the excess cost of living in general, excess housing expenses, schooling expenses, and home-leave expenses.

In 1981, however, the emphasis again shifted to the perceived beneficial effects of encouraging U.S. employment abroad; the Economic Recovery Tax Act (ERTA) provided a large flat exclusion and a separate housing exclusion. ERTA's income exclusion was $75,000 for 1982, but was to increase to $95,000 by 1986. However, concern about the revenue consequences of the increased exclusion led Congress to temporarily freeze the exclusion at $80,000 under the Deficit Reduction Act of 1984; annual $5,000 increases were to resume in 1988. In 1986, as part of its general program of broadening the tax base, the Tax Reform Act fixed the exclusion at the $70,000 level. The Taxpayer Relief Act of 1997 provided the gradual increase of the exclusion to $80,000 by 2002, as well as indexing for U.S. inflation, beginning in 2008.

Assessment

The foreign earned income exclusion has the effect of increasing the number of Americans working overseas in countries where foreign taxes are low. This effect differs across countries. As noted above, without section 911 or a similar provision, U.S. taxes would generally be high and employment abroad would be discouraged in countries where living costs are high. While the flat $70,000 exclusion eases this distortion in the case of some countries, it also overcompensates in others, thereby introducing new distortions.

The foreign earned income exclusion has been defended on the grounds that it helps U.S. exports; it is argued that U.S. persons working abroad play an important role in promoting the sale of U.S. goods abroad. The impact of the provision is uncertain. If employment of U.S. labor abroad is a

complement to investment by U.S. firms abroad--for example, if U.S. multinationals depend on expertise that can only be provided by U.S. managers or technicians--then it is possible that the exclusion has the indirect effect of increasing flows of U.S. capital abroad.

The increased flow of investment abroad, in turn, could trigger exchange-rate adjustments that would increase U.S. net exports. On the other hand, if the exclusion's increase in U.S. employment overseas is not accompanied by larger flows of investment, it is likely that exchange rate adjustments negate any possible effect section 911 has on net exports. Moreover, there is no obvious economic rationale for promoting exports.

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EXCLUSION OF CERTAIN ALLOWANCES FOR FEDERAL EMPLOYEES ABROAD

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	-	0.2
2000	0.2	-	0.2
2001	0.2	-	0.2
2002	0.2	-	0.2
2003	0.2	-	0.2

Authorization

Section 912.

Description

U.S. Federal civilian employees who work abroad are allowed to exclude from income certain special allowances that are generally linked to the cost of living. They are not eligible for the $70,000 foreign earned income exclusion. (Like other U.S. citizens, they are subject to U.S. taxes and can credit foreign taxes against their U.S. taxes. Federal employees are, however, usually exempt from foreign taxes).

Specifically, section 912 excludes certain amounts received under the Foreign Service Act of 1980, the Central Intelligence Act of 1949, the Overseas Differentials and Allowances Act, and the Administrative Expenses Act of 1946. The allowances are primarily for the general cost of living abroad, housing, education, and travel. Special allowances for hardship posts are not eligible. Section 912 also excludes cost-of-living allowances received by Federal employees stationed in U.S. possessions, Hawaii, and Alaska. In addition, travel, housing, food, clothing, and certain other allowances received by members of the Peace Corps are excluded.

Impact

Federal employees abroad may receive a significant portion of their compensation in the form of housing allowances, cost-of-living differentials, and other allowances. Section 912 can thus reduce taxes significantly. Since the available data suggest real incomes for Federal workers abroad are generally higher than real incomes in the United States, section 912 probably reduces the tax system's progressivity.

Section 912's impact on horizontal equity (the equal treatment of equals) is more ambiguous. Without it or a similar provision, Federal employees in high-cost countries would likely pay higher taxes than persons in the United States with identical real incomes, because the higher nominal incomes necessary to offset higher living costs would place these employee stationed abroad in a higher tax bracket and would reduce the value of personal exemptions and the standard deduction.

The complete exemption of cost-of-living allowances, however, probably overcompensates for this effect. It is thus uncertain whether the relative treatment of Federal workers abroad and their U.S. counterparts is more or less uneven with section 912.

Some have argued that because no tax relief is provided for persons in high cost areas in the United States, horizontal equity requires only that persons abroad be taxed no more heavily than a person in the highest-cost U.S. area. It might also be argued that the cost of living exclusion for employees in Alaska and Hawaii violates horizontal equity, since private-sector persons in those areas do not receive a tax exclusion for cost-of-living allowances.

Rationale

Section 912's exclusions were first enacted with the Revenue Act of 1943. The costs of living abroad were apparently rising, and Congress determined that because the allowances merely offset the extra costs of working abroad and since overseas personnel were engaged in "highly important" duties, the Government should bear the full burden of the excess living costs, including any taxes that would otherwise be imposed on cost-of-living allowances.

The Foreign Service Act of 1946 expanded the list of excluded allowances beyond cost-of-living allowances to include housing, travel, and certain other allowances. In 1960, exemptions were further expanded to include allowances received under the Central Intelligence Agency Act and in 1961 certain allowances received by Peace Corps members were added.

Assessment

The benefit is largest for employees who receive a large part of their incomes as cost-of-living, housing, education, or other allowances. Beyond this, the effects of the exclusions are uncertain. For example, it might be argued that because the Federal Government bears the cost of the exclusion in terms of foregone tax revenues, the measure does not change the Government's demand for personnel abroad and has little impact on the Government's work force overseas.

On the other hand, it could be argued that an agency that employs a person who claims the exclusion does not bear the exclusion's full cost. While the provision's revenue cost may reduce Government outlays in general (particularly in this era of continuing budget deficits) an agency that employs a citizen abroad probably does not register a cut in its budget equal to the full amount of tax revenue loss that the employee generates. If this is true, section 912 may enable agencies to employ additional U.S. citizens abroad.

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EXCLUSION OF INCOME OF FOREIGN SALES CORPORATIONS (FSCs)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	1.8	1.8
2000	-	1.9	1.9
2001	-	2.0	2.0
2002	-	2.1	2.1
2003	-	2.2	2.2

Authorization

Sections 921-927 and 991-997.

Description

The tax code's Foreign Sales Corporation (FSC) provisions permit U.S. exporters to exempt a portion of their export income from U.S. taxation. Enacted in 1984, FSC largely replaces the Domestic International Sales Corporation (DISC) provisions that provided exporters an indefinite tax deferral for part of their export income.

To qualify for the FSC benefit, exports must be sold through specially defined corporations (FSCs) that are organized in a qualifying foreign country or U.S. possession and that meet certain other requirements designed to ensure a minimal presence in a foreign location.

One way the FSC provisions can work is for a U.S. exporting firm to form a subsidiary corporation that qualifies as a FSC. A portion of the FSC's own export income is exempt from taxes, and the FSC can pass on the tax savings to its parent because domestic corporations are allowed a 100-percent dividends-received deduction for income distributed from a FSC.

Alternatively, a FSC can sell tax-favored exports on a commission basis. The FSC foreign presence requirements are relaxed in the case of relatively small exporters. Alternatively, a small exporter can choose to sell its exports through a DISC. Unlike under prior law, however, firms that use the present-law version of DISCs are assessed an interest charge on their deferred taxes.

Impact

FSC's tax exemption for exports increases the after-tax return on investment in export-producing property. In the long run, however, the burden of the corporate income tax (and the benefit of corporate tax exemptions) probably spreads far beyond corporate stockholders to owners of capital in general.

Thus the FSC benefit is probably shared by U.S. capital in general, and probably disproportionately benefits upper-income individuals. To the extent that the FSC exemption results in lower prices for U.S. exports, a part of the FSC benefit probably accrues to foreign consumers of U.S. products.

Rationale

The DISC benefit that preceded FSC was enacted with the Revenue Act of 1971. The provision was intended to increase U.S. exports. DISC was also designed to provide a tax incentive for firms to locate their operations in the United States rather than abroad, and thus provided a counterweight to the tax code's deferral tax incentive to invest abroad.

DISC was subsequently modified by The Tax Reduction Act of 1975, which placed restrictions on the benefit for the export of products in short domestic supply. The Tax Reform Act of 1976 implemented changes designed to improve DISC's cost-effectiveness by linking the tax benefit with increases in a firm's exports. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the DISC benefit slightly as part of the Act's general concern with raising tax revenue and improving tax equity.

A number of major U.S. trading partners voiced objections to DISC almost from its inception, arguing that the provision was an export subsidy and so violated the General Agreement on Tariffs and Trade (GATT), a multilateral trade agreement to which the United States is signatory.

In response to the complaints, the Deficit Reduction Act of 1984 largely replaced DISC with FSC, which contains a number of features (including its foreign-presence requirements) designed to ensure GATT legality. Despite the differences between DISC and FSC, the size of FSC's tax exemption approximates the benefit that was available under DISC's indefinite tax

deferral. Indeed, in 1998 the European Union lodged a complaint against FSC with the World Trade Organization (WTO). Meanwhile, the basic structure of FSC has remained essentially unchanged since 1984. However, the Omnibus Budget Reconciliation Act of 1993 denied the FSC benefit to exports of raw lumber and the Taxpayer Relief Act of 1997 extended the benefit to certain types of software exports that were previously not eligible.

Assessment

Because FSC increases the after-tax return from investment in exporting, it poses a tax incentive to export. FSCs supporters argue that the provision indeed boosts U.S. exports and thus has a beneficial effect on U.S. employment.

Economic analysis, however, suggests that FSC's effects are not what might be expected from a provision designed to improve U.S. trade performance. For example, FSC triggers exchange-rate adjustments that ensure that U.S. imports expand along with any increase FSC might cause in exports; it therefore probably produces no improvement in the U.S. balance of trade.

Indeed, to the extent that FSC increases the Federal budget deficit, it may actually expand the U.S. trade deficit. In addition, FSC probably reduces U.S. economic welfare by interfering in the efficient allocation of the economy's resources and by transferring part of its tax benefit to foreign consumers.

The size of the FSC benefit for individual firms varies, depending on the method an exporter uses to allocate income to its FSC subsidiary. Under the current rules, a corporation that exports can effectively exempt at least 15 percent, and up to 30 percent, of export income from taxes.

It should be noted, however, that some firms may be able to exempt a larger share of their exports from taxes by another tax benefit--the so-called "export source rule" instead of FSC. Recent estimates place the tax revenue loss from the export source rule at about four times that of FSC.

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DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	1.3	1.3
2000	-	1.4	1.4
2001	-	1.4	1.4
2002	-	1.5	1.5
2003	-	1.6	1.6

Authorization

Sections 11(d), 882, and 951-964.

Description

The United States taxes firms incorporated in the United States on their worldwide income but taxes foreign-chartered corporations only on their U.S.-source income. Thus, when a U.S. firm earns foreign-source income through a foreign subsidiary, U.S. taxes apply to the income only when it is repatriated to the U.S. parent firm as dividends or other income; the income is exempt from U.S. taxes as long as it remains in the hands of the foreign subsidiary. At the time the foreign income is repatriated, the U.S. parent corporation can credit foreign taxes the subsidiary has paid on the remitted income against U.S. taxes, subject to certain limitations. Because the deferral principle permits U.S. firms to delay any residual U.S. taxes that may be due after foreign tax credits, it provides a tax benefit for firms that invest in countries with low tax rates.

Subpart F of the Internal Revenue Code (sections 951-964) provides an exception to the general deferral principle. Under its provisions, certain types of income earned by foreign corporations controlled by U.S. shareholders is deemed to be distributed whether or not it actually is, and

U.S. taxes are assessed on a current basis rather than deferred. Income subject to Subpart F is generally income related to passive investment rather than income from active business operations. Also, certain types of sales, services, and other income whose geographic source is relatively easily shifted is included in Subpart F.

Impact

Deferral provides an incentive for U.S. firms to invest in active business operations in low-tax foreign countries rather than the United States, and thus probably reduces the stock of capital located in the United States. Because the U.S. capital-labor ratio is therefore probably lower than it otherwise would be and U.S. labor has less capital with which to work, deferral likely reduces the general U.S. wage level. At the same time, U.S. capital and foreign labor probably gain from deferral.

Rationale

Deferral has been part of the U.S. tax system since the origin of the corporate income tax in 1909. While deferral was subject to little debate in its early years, it later became controversial. In 1962, the Kennedy Administration proposed a substantial scaling-back of deferral in order to reduce outflows of U.S. capital. Congress, however, was concerned about the potential effect of such a step on the position of U.S. multinationals *vis a vis* firms from other countries and on U.S exports. Instead of repealing deferral, the Subpart F provisions were adopted in 1962, and were aimed at taxpayers who used deferral to accumulate funds in so-called "tax haven" countries. (Hence, Subpart F's concern with income whose source can be easily manipulated.)

In 1975, Congress again considered eliminating deferral, and in 1978 President Carter proposed its repeal, but on both occasions the provision was left essentially intact. Subpart F, however, was broadened by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, and the Omnibus Reconciliation Act of 1993 (OBRA93). OBRA93 added section 956A to the tax code, which expanded Subpart F to include foreign earnings that firms retain abroad and invest in passive assets beyond a certain threshold.

In recent years, however, the trend has been incremental restrictions of Subpart F and expansions of deferral. For example, the Small Business Job Protection Act of 1996 repealed section 956A. And the omnibus budget bill enacted in 1998 (P.L. 105-277) extended a temporary exemption from Subpart F for financial services income.

Assessment

The U.S. method of taxing overseas investment, with its worldwide taxation of branch income, limited foreign tax credit, and the deferral principle, can pose either a disincentive, an incentive, or be neutral towards investment abroad, depending on the form and location of the investment. For its part, deferral provides an incentive to invest in countries with tax rates that are lower than those of the United States.

Defenders of deferral argue that the provision is necessary to allow U.S. multinationals to compete with firms from foreign countries; they also maintain that the provision boosts U.S. exports. However, economic theory suggests that a tax incentive such as deferral does not promote the efficient allocation of investment. Rather, capital is allocated most efficiently--and world economic welfare is maximized--when taxes are neutral and do not distort the distribution of investment between the United States and abroad. Economic theory also holds that while world welfare may be maximized by neutral taxes, the economic welfare of the United States would be maximized by a policy that goes beyond neutrality and poses a disincentive for U.S. investment abroad.

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INVENTORY PROPERTY SALES SOURCE RULE EXCEPTION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	3.9	3.9
2000	-	4.0	4.0
2001	-	4.1	4.1
2002	-	4.2	4.2
2003	-	4.3	4.3

Authorization

Sections 861, 862, 863, and 865.

Description

The tax code's rules governing the source of inventory sales interact with its foreign tax credit provisions in a way that can effectively exempt a portion of a firm's export income from U.S. taxation.

In general, the United States taxes U.S. corporations on their worldwide income. The United States also permits firms to credit foreign taxes they pay against U.S. taxes they would otherwise owe.

Foreign taxes, however, are only permitted to offset the portion of U.S. taxes due on foreign-source income. Foreign taxes that exceed this limitation are not creditable and become so-called "excess credits." It is here that the source of income becomes important: firms that have excess foreign tax credits can use these credits to reduce U.S. taxes if they can shift income from the U.S. to the foreign operation. This treatment effectively exempts such income from U.S. taxes.

The tax code contains a set of rules for determining the source ("sourcing") of various items of income and deduction. In the case of sales

of personal property, gross income is generally sourced on the basis of the residence of the seller. U.S. exports covered by this general rule thus generate U.S.--rather than foreign--source income.

The tax code provides an important exception, however, in the case of sales of inventory property. Inventory that is purchased and then resold is governed by the so-called "title passage" rule: the income is sourced in the country where the sale occurs. Since the country of title passage is generally quite flexible, sales governed by the title passage rules can easily be arranged so that the income they produce is sourced abroad.

Inventory that is both manufactured and sold by the taxpayer is treated as having a divided source. Unless an independent factory price can be established for such property, half of the income it produces is assigned a U.S. source and half is governed by the title passage rule. As a result of the special rules for inventory, up to 50 percent of the combined income from export manufacture and sale can be effectively exempted from U.S. taxes. A complete tax exemption can apply to export income that is solely from sales activity.

Impact

When a taxpayer with excess foreign credits is able to allocate an item of income to foreign rather than domestic sources, the amount of foreign taxes that can be credited is increased and the effect is identical to a tax exemption for a like amount of income. The effective exemption that the source rule provides for inventory property thus increases the after-tax return on investment in exporting. In the long run, however, the burden of the corporate income tax (and the benefit of corporate tax exemptions) probably spreads beyond corporate stockholders to owners of capital in general.

Thus, the source-rule benefit is probably shared by U.S. capital in general, and therefore probably disproportionately benefits upper-income individuals. To the extent that the rule results in lower prices for U.S. exports, a part of the benefit probably accrues to foreign consumers of U.S. products.

Rationale

The tax code has contained rules governing the source of income since the foreign tax credit limitation was first enacted as part of the Revenue Act of 1921. Under the 1921 provisions, the title passage rule applied to sales of personal property in general; income from exports was thus generally assigned a foreign source if title passage occurred abroad. In the particular case of property both manufactured and sold by the taxpayer, income was treated then, as now, as having a divided source.

The source rules remained essentially unchanged until the advent of tax reform in the 1980s. In 1986, the Tax Reform Act's statutory tax rate reduction was expected to increase the number of firms with excess foreign tax credit positions and thus increase the incentive to use the title passage rule to source income abroad.

Congress was also concerned that the source of income be the location where the underlying economic activity occurs. The Tax Reform Act of 1986 thus provided that income from the sale of personal property was generally to be sourced according to the residence of the seller. Sales of property by U.S. persons or firms were to have a U.S. source.

Congress was also concerned, however, that the new residence rule would create difficulties for U.S. businesses engaged in international trade. The Act thus made an exception for inventory property, and retained the title passage rule for purchased-and-resold items and the divided-source rule for goods manufactured and sold by the taxpayer.

More recently, the Omnibus Budget Reconciliation Act of 1993 repealed the source rule exception for exports of raw timber.

Assessment

Like other tax benefits for exporting, the inventory source-rule exception probably increases exports. At the same time, however, exchange rate adjustments probably ensure that imports increase also. Thus, while the source rule probably increases the volume of U.S. trade, it probably does not improve the U.S. trade balance. Indeed, to the extent that the source rule increases the Federal budget deficit, the provision may actually expand the U.S. trade deficit by generating inflows of foreign capital and their accompanying exchange rate effects. In addition, the source-rule exception probably reduces U.S. economic welfare by transferring part of its tax benefit to foreign consumers.

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DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	1.3	1.3
2000	-	1.4	1.4
2001	-	1.4	1.4
2002	-	1.5	1.5
2003	-	1.6	1.6

Authorization

Sections 953 and 954.

Description

Under the U.S. method of taxing overseas investment, income earned abroad by foreign-chartered subsidiary corporations that are owned by U.S. investors or firms is generally not taxed if it is reinvested abroad. Instead, a tax benefit known as "deferral" applies: U.S. taxes on the income are postponed until the income is repatriated to the U.S. parent as dividends or other income.

The deferral benefit is circumscribed by several tax code provisions; the broadest in scope is provided by the tax code's Subpart F. Under Subpart F, certain types of income earned by certain types of foreign subsidiaries is taxed by the United States on a current basis, even if the income is not actually remitted to the firm's U.S. owners. Foreign corporations potentially subject to Subpart F are termed Controlled Foreign Corporations (CFCs); they are firms that are more than 50% owned by U.S. stockholders, each of whom own at least 10% of the CFC's stock. Subpart F subjects each 10% shareholder to U.S. tax on some (but not all) types of income earned by the CFC. In general, the types of income subject to Subpart F are income from a CFC's passive investment — for example, interest, dividends, and gains

from the sale of stock and securities — and a variety of types of income whose geographic source is thought to be easily manipulated.

Ordinarily, income from banking and insurance could in some cases be included in Subpart F. Much of banking income, for example, consists of interest; investment income of insurance companies could also ordinarily be taxed as passive income under Subpart F. Certain insurance income is also explicitly included in Subpart F, including income from the insurance of risks located outside a CFC's country of incorporation. However, Congress enacted a temporary exception from Subpart F for income derived in the active conduct of a banking, financing, or similar business by a CFC predominantly engaged in such a business. Congress also enacted a temporary exception for investment income of an insurance company earned on risks located within its country of incorporation.

In short, Subpart F is an exception to the deferral tax benefit, and the tax expenditure at hand is an exception to Subpart F itself for a range of certain financial services income. The exception applies to taxable years of CFCs beginning in 1999, and the taxable years of their U.S. shareholders within which such tax years end.

Impact

The temporary exceptions pose an incentive in certain cases for firms to invest abroad; in this regard its effect is parallel to that of the more general deferral principle, which the exception restores in the case of certain banking and insurance income.

The provision only poses an incentive to invest in countries with tax rates lower than those of the United States; in other countries, the high foreign tax rates generally negate the U.S. tax benefit provided by deferral. In addition, the provision is moot (and provides no incentive) even in low-tax countries for U.S. firms that pay foreign taxes at high rates on other banking and insurance income. In such cases, the firms have sufficient foreign tax credits to offset U.S. taxes that would be due in the absence of deferral. (In the case of banking and insurance income, creditable foreign taxes must have been paid with respect to other banking and insurance income. This may accentuate the importance of the exception to Subpart F.)

Rationale

Subpart F itself was enacted in 1962 as an effort to curtail the use of tax havens by U.S. investors who sought to accumulate funds in countries with low tax rates — hence Subpart F's emphasis on passive income and income whose source can be manipulated. The exception for banking and insurance was likewise in the original 1962 legislation (though not in precisely the same form as the current version). The stated rationale for the exception was that

interest, dividends, and like income were not thought to be "passive" income in the hands of banking and insurance firms.

The exceptions for banking and insurance was removed as part of the broad Tax Reform Act of 1986 (Public Law 99-514). In removing the exception (along with several others), Congress believed they enabled firms to locate income in tax haven countries that have little "substantive economic relation" to the income. As passed by Congress, the Taxpayer Relief Act of 1997 (Public Law 105-34) generally restored the exceptions with minor modifications. In making the restoration, Congress expressed concern that without them, Subpart F extended to income that was neither passive nor easily movable. However, the Act provided for only a temporary restoration, applicable to 1998. Additionally, the Joint Committee on Taxation identified the exceptions' restoration as a provision susceptible to line-item veto under the provisions of the 1996 Line-Item Veto Act because of its applicability to only a few taxpaying entities, and President Clinton subsequently vetoed the exceptions' restoration. The Supreme Court, however, ruled the line-item veto to be unconstitutional, thus making the temporary restoration effective for 1998, as enacted.

The banking and insurance exceptions to Subpart F were extended with a few modifications for an additional year by the Tax and Trade Relief Extension Act of 1998. (The Act is part of Public Law 105-277, the omnibus budget bill passed in October, 1998.) The modifications include one generally designed to require that firms using the exceptions conduct "substantial activity" with respect to the financial service business in question. The extension applies to tax years of Controlled Foreign Corporations beginning in 1999 and the tax year of CFC owners within which such CFC tax years end.

Assessment

Subpart F attempts to deny the benefits of tax deferral to income that is passive in nature or that is easily movable. It has been argued that the competitive concerns of U.S. firms are not as much an issue in such cases as they are with direct overseas investment. Such income is also thought to be easy to locate artificially in tax haven countries with low tax rates. But banks and insurance firms present an almost insoluble technical problem; the types of income generated by passive investment and income whose source is easily manipulated are also the types of income financial firms earn in the course of their active business. The choice confronting policymakers, then, is whether to establish an approximation that is fiscally conservative or one that places most emphasis on protecting active business income from Subpart F. The exceptions' repeal by the Tax Reform Act of 1986 appeared to do the former, while the recent restoration of the exceptions appears to do the latter.

It should be noted that traditional economic theory questions the merits of the deferral tax benefit itself. Its tax incentive for investment abroad generally results in an allocation of investment capital that is inefficient from the point of view of both the capital exporting country (in this case the United States) and the world economy in general. Economic theory instead recommends a policy known as "capital export neutrality" under which marginal investments face the same tax burden at home and abroad. From that vantage, then, the exceptions to Subpart F likewise impair efficiency.

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TAX CREDIT FOR QUALIFIED RESEARCH EXPENDITURES

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	1.6	1.6
2000	-	0.9	0.9
2001	-	0.5	0.5
2002	-	0.3	0.3
2003	-	0.1	0.1

*This provision will expire in May of 1999; its annual cost if maintained is about $2.2 billion.

Authorization

Section 30.

Description

A nonrefundable, 20-percent income tax credit is allowed for certain research expenditures paid or incurred in carrying on a trade or business of the taxpayer. The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified base research expenditures. The base is computed by multiplying a fixed ratio, average research expenditures divided by gross receipts in 1984-1988, by average gross receipts for the past four years. The base amount must be at least half of current expenditures. Start-up corporations are assigned an initial fixed ratio of 0.03 of gross receipts, which is gradually converted into the same type of ratio as allowed ongoing firms.

Firms may also elect an alternative three-tiered fixed ratio with a lower credit rate: a credit of 1.5 percent for the extent to which current expenditures exceed a base amount reflecting a ratio of one percent but less

than 1.5 percent; a credit rate of 2.2 percent for the extent to which they fall between 1.5 percent and 2 percent; and a credit rate of 2.75 percent of the excess if a base reflecting a ratio above 2 percent.

The credit provision adopts the definition of research used for purposes of the special deduction rules under section 174, but subject to certain exclusions. The amount of the section 174 deduction is reduced by the amount of the credit (the "basis adjustment").

Research expenditures eligible for the incremental credit consist of

(1) in-house expenditures by the taxpayer for research wages and supplies used in research;

(2) certain time-sharing costs for computers used in research, and

(3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf (75 percent if paid to certain non-profit consortia).

If the taxpayer is a corporation, cash expenditures (including grants or contributions) paid for university basic research in excess of a fixed based are eligible for the credit. Expenditures are reduced by any reduction in other contributions to universities compared to the base period (adjusted by inflation).

Impact

The credit has the effect of reducing the net cost to a business of incurring qualified research expenditures in excess of its research expenditures in a base period. Because of the basis adjustment, a corporate firm saves about 13.2 percent of the cost, since it loses the deduction for twenty percent of eligible expenditures (i.e., 13.2 = 20-.34*.20). Because an increase in sales causes a loss of future credits, the R&D credit also imposes a slight tax on sales.

The credit does not provide a benefit to some firms whose research expenditures are declining relative to gross receipts. Firms can, however, benefit from the credit when their level of research activities and other activities (in constant dollars) remains the same because the latest four years' gross receipts are not corrected for inflation. Firms with rapidly growing research expenditures receive larger benefits, but no more than 50 percent of otherwise qualifying current year expenditures can be eligible for the credit, even if the base period amount is less than 50 percent of current expenditures.

Individuals to whom the credit is properly allocable from a partnership or other business may use the credit in a particular year only to offset the amount of tax attributable to that portion of the individual's taxable income derived from that business. For example, an individual cannot use pass-throughs of the credit from a research partnership to offset tax on income from the other sources.

The credit largely accrues to corporations and its direct tax benefits accrue largely to higher-income individuals (see discussion in the Introduction).

Rationale

Section 30 was enacted as part of the Economic Recovery Tax Act of 1981. At that time the credit rate was 25 percent, there was no basis adjustment, and the base was the average of the past three years of expenditures. The reason cited was that a substantial tax credit for incremental research expenditures was needed to overcome the reluctance of many ongoing companies to bear the significant costs of staffing and supplies, and certain equipment expenses such as computer charges, which must be incurred to initiate or expand research programs in a trade or business.

The original credit was scheduled to expire after 1985, in order to allow an evaluation of its effect. The credit was extended (retroactively by the Tax Reform Act of 1986) through 1988. In the Technical and Miscellaneous Revenue Act of 1988, it was extended another year and a half basis adjustment (deductions reduced by half the credit) enacted.

The Omnibus Reconciliation Act of 1989 extended it for another year, and allowed the base to increase in pace with gross receipts rather than research expenditures, increasing the incentive at the margin. It also allowed the credit to apply to R&D associated with a prospective as well as a current line of business and provided for the full basis adjustment. The Omnibus Reconciliation Act of 1989 extended the credit for another year and Tax Extension Act of 1991 extended it through June 1992. The Omnibus Budget Reconciliation Act of 1993 extended the credit through June, 1995. The Small Business Job Production Act of 1996 reinstated the credit retroactively to July 1, 1996 and extended it through May 31, 1997, leaving a one-year gap in coverage. This revision also introduced the three-tiered alternative credit and allowed 75 percent of amounts paid to a non-profit consortium to be eligible. The Taxpayer Relief Act of 1997 extended the credit through June, 1998; the omnibus budget bill passed in 1998 (P.L. 105-277) extended the credit to the period July, 1998 through June, 1999.

Assessment

There is widespread agreement that investment in research and development is under-provided in a market economy, since firms cannot obtain the full return from their investment (due to appropriation of the innovation by other firms). There is some evidence that the social returns to R&D are very high. These observations suggest a strong case for subsidizing R&D investments, since they are more profitable to society than most other investments.

Despite these strong reasons to support the credit, there are several criticisms. It is not clear that a tax subsidy is the best means of subsidizing R&D since an open-ended subsidy cannot target those investments that are most desirable socially. Moreover, it is difficult in practice to ensure that firms are properly identifying research and experimental costs.

One criticism of the credit is that the continual expiration and restoration interferes with planning and that a decision should be made as to whether to retain the credit on a permanent basis.

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EXPENSING OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	1.9	1.9
2000	-	2.4	2.4
2001	-	2.7	2.7
2002	-	2.8	2.8
2003	-	3.0	3.0

Authorization

Section 174.

Description

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new consumer product or improve a production process, must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered through depreciation or amortization deductions over the useful life of the asset, or on a disposition or abandonment of the asset.

Under section 174, however, a taxpayer may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with the taxpayer's trade or business. In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months. Treasury regulations define expenditures eligible for the deduction elections as "research and development costs in the experimental or laboratory sense."

Expenditures for the acquisition or improvement of land, or expenditures for the acquisition or improvement of depreciable or depletable property to be used in connection with research, are not eligible for the deduction elections. However, research expenditures which may be expensed or amortized under section 174 include depreciation (cost recovery) or depletion allowances with respect to depreciable or depletable property used for research. Expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, are not eligible for section 174 elections.

The amount of deduction allowed under section 174 is reduced by the amount, if any, of the credit provided under section 30 for certain incremental research or experimental expenditures.

Impact

The accelerated deduction allowed for research expenditures operates, as does accelerated capital cost recovery, to defer tax liability.

For example, if a corporation incurs expenditures of $1 million in the taxable year for research wages, supplies, and depreciation allowances, the corporation may currently deduct that amount from its taxable income, producing a cash flow (at a 34-percent marginal tax rate) of $340,000. The value to the corporation of current expense treatment is the amount by which the present value of the immediate deduction exceeds (for example) the present value of periodic deductions which otherwise could be taken over the useful life of the asset, such as a patent, resulting from the research expenditures. Expensing is, in fact, equivalent to eliminating tax entirely: the after-tax and pre-tax return on the investment are the same.

The direct beneficiaries of this provision are businesses that undertake research. Mainly, these are large manufacturing corporations or high-technology firms. As a corporate tax deduction, benefits accrue to higher-income individuals (see discussion in the Introduction).

Rationale

Section 174 was enacted as part of the Internal Revenue Code of 1954. The purposes cited for the provision were to encourage research expenditures and to eliminate difficulties and uncertainties under prior law in distinguishing trade or business expenditures from research expenditures.

Assessment

There is relatively little controversy over this provision. It simplifies tax compliance, since it is difficult to isolate expenditures that are associated with R&D or to assign useful lives to them. In addition, there is widespread agreement that investment in research and development is under-provided in a market economy, since firms cannot obtain the full return from their investment (due to appropriation of the innovation by other firms). There is some evidence that the social returns to R&D are very high.

These observations suggest a strong case for subsidizing R&D investments, but not necessarily a tax benefit, which does not precisely target those investments with the largest spillover effects.

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EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels
1999	([1])	([1])	0.4	([1])	0.4	([1])
2000	([1])	([1])	0.4	([1])	0.4	([1])
2001	([1])	([1])	0.4	([1])	0.4	([1])
2002	([1])	([1])	0.5	([1])	0.5	([1])
2003	([1])	([1])	0.5	([1])	0.5	([1])

[(1)]Less than $50 million.

Authorization

Section 263(c), 291, 616-617, 57(2), and 1254.

Description

Firms engaged in production of oil, gas, or geothermal energy are permitted to expense (to deduct in the year paid or incurred) rather than capitalize (*i.e.*, recover such costs through depletion or depreciation) certain intangible drilling and development costs (IDCs). This is an exception to general tax rules.

Amounts paid for fuel, labor, repairs to drilling equipment materials, hauling, supplies, and preparing the site for the production of oil, gas, or geothermal energy are IDCs. Amounts paid for casings, valves, pipelines, and other tangible equipment cannot be expensed, but must be capitalized, recovered either through depletion or depreciation.

The option to expense IDCs applies to domestic properties; IDCs on foreign properties must be either amortized (deducted in equal amounts) over 10 years or added to the adjusted cost basis and recovered through depletion or depreciation. An integrated oil company, generally a producer that is not an independent producer, can only expense 70 percent of the IDCs--the remaining 30 percent must be amortized over a five-year period. Dry hole costs for either domestic or foreign properties are expensed.

For integrated producers, the excess of expensed IDCs over the capitalized value is a tax preference item that is subject to the alternative minimum tax to the extent that it exceeds 65 percent of the net income from the property. Independent producers include only 60 percent of their IDCs as a tax preference item. Instead of expensing, a taxpayer may choose to amortize over a 10-year period and avoid the alternative minimum tax. Prior to 1993, an independent producer's intangible drilling costs were subject to the alternative minimum tax, and they were allowed a special "energy deduction" for 100 percent of certain IDCs, subject to some limitations.

Impact

IDCs and other intangible exploration and development costs represent a major portion of the costs of finding and developing a mineral reserve. In the case of oil and gas, which historically accounted for 99 percent of the revenue loss from this provision, IDCs typically account for between 75 and 90 percent of the costs of creating a mineral asset.

Historically, expensing of IDCs was a major tax subsidy for the oil and gas industry, and, combined with other tax subsidies such as the depletion allowance, reduced effective tax rates significantly below tax rates on other industries. These subsidies provided incentives to increase investment, exploration, and output, especially of oil and gas.

Oil and gas output, for example, rose from 16 percent of total energy production in 1920 to 71.1 percent of total in 1970 (the peak year). The cutbacks in expensing, reductions in income tax rates, and the contraction in the oil and gas industry have reduced the value of this subsidy.

Moreover, the alternative minimum tax, and introduction of new excise taxes, have raised effective tax rates for oil and gas, although the subsidy still keeps effective marginal tax rates on oil and gas (especially for independent producers) below the marginal effective tax rates on other industries in most cases.

These taxes arguably contributed to the decline in domestic oil exploration and production, which recently dropped to a 30-year low, but the major

cause of these declines is probably the decline in oil prices, which have in recent years, in real terms, been at historically low levels.

Unlike percentage depletion, this tax expenditure is largely claimed by integrated oil and gas producers. The at-risk, recapture, and minimum tax restrictions that have since been placed on the use of the provision have primarily limited the ability of high-income taxpayers to shelter their income from taxation through investment in mineral exploration.

Rationale

Expensing of IDCs was originally established in a 1916 Treasury regulation (T.D. 45, article 223), with the rationale that such costs were ordinary operating expenses.

In 1931, a court ruled that IDCs were capital costs, but permitted expensing, arguing that the 15-year precedent gave the regulation the force of a statute. In 1942, Treasury recommended that expensing be repealed, but the Congress did not take action. A 1945 court decision invalidated expensing, but the Congress upheld it (on the basis that it reduced uncertainty and stimulated mineral exploration) and codified it as section 263(c) in 1954.

Continuation of expensing has been based on the need to stimulate exploratory drilling, which could increase domestic oil reserves, reduce imported petroleum, and enhance energy security.

The Tax Reform Act of 1976 added expensing of IDCs as a tax preference item subject to the minimum tax. Expensing of IDCs for geothermal wells was added by the Energy Tax Act of 1978. The Tax Equity and Fiscal Responsibility Act of 1982 limited expensing for integrated oil companies to 85 percent; the remaining 15 percent of IDCs had to be amortized over 3 years.

The Deficit Reduction Act of 1984 limited expensing for integrated producers to 80 percent. This was further limited to 70 percent by the Tax Reform Act of 1986, which also repealed expensing on foreign properties.

In 1990, a special energy deduction was introduced, against the alternative minimum tax, for a portion of the IDCs and other oil and gas industry tax preference items. For independent producers the Energy Policy Act of 1992 limited the amount of IDCs subject to the alternative minimum tax to 60 percent, and suspended the special energy deduction through 1998.

Assessment

IDCs are generally recognized to be capital costs which, according to standard economic principles, should be recovered using depletion (cost depletion adjusted for inflation). Lease bonuses and other exploratory costs (survey costs, geological and geophysical costs) are properly treated as capital costs, although they may be recovered through percentage rather than cost depletion.

Immediate expensing of IDCs provides a tax subsidy for capital invested in the mineral industry, especially for oil and gas producers, with a relatively larger subsidy for independents.

By expensing rather than capitalizing these costs, taxes on income are effectively set to zero. As a capital subsidy, however, expensing is inefficient because it makes investment decisions based on tax considerations rather than inherent economic considerations.

There is little economic justification for this nonneutral tax treatment of IDCs. The depressed state of oil and gas drilling activity in the United States is largely attributable to recent declines in oil prices, although cutbacks in IDCs and other factors have probably played a role.

To the extent that IDCs stimulate drilling of successful wells, they reduce dependence on imported oil in the short run, but contribute to a faster depletion of the Nation's resources. Arguments have been made over the years to justify expensing on grounds of unusual risks, national security, uniqueness of oil as a commodity, the industry's lack of access to capital, and protection of small producers.

Volatile oil prices make oil and gas investments very risky, but this would not necessarily justify expensing. The corporate income tax does have efficiency distortions, but income tax integration may be a more appropriate policy to address this issue. An alternative approach to enhancing energy security is through an oil stockpile program such as the Strategic Petroleum Reserve.

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EXCESS OF PERCENTAGE OVER COST DEPLETION: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In billions of dollars]

	Individuals		Corporations		Total	
Fiscal year	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels
1999	0.1	0.1	0.4	0.2	0.5	0.3
2000	0.1	0.1	0.4	0.2	0.5	0.3
2001	0.1	0.1	0.4	0.2	0.5	0.3
2002	0.1	0.1	0.4	0.2	0.5	0.3
2003	0.1	0.1	0.4	0.2	0.5	0.3

Authorization

Sections 611, 612, 613, 613A, and 291.

Description

Firms that extract oil, gas, or other minerals are permitted a deduction to recover their capital investment in the mineral reserve, which depreciates due to the physical and economic depletion of the reserve as the mineral is recovered (section 611). There are two methods of calculating this deduction: cost depletion and percentage depletion. Cost depletion allows for the recovery of the actual capital investment--the costs of discovering, purchasing, and developing a mineral reserve--over the period during which the reserve produces income.

Each year, the taxpayer deducts a portion of the adjusted basis (original capital investment less previous deductions) equal to the fraction of the estimated remaining recoverable reserves that have been extracted and sold. Under this method, the total deductions cannot exceed the original capital investment.

Under percentage depletion, the deduction for recovery of capital investment is a fixed percentage of the "gross income"--*i.e.*, sales revenue--from the sale of the mineral. Under this method, total deductions may, and typically do, exceed the capital invested.

Section 613 states that mineral producers must claim the higher of cost or percentage depletion. The percentage depletion rate for oil and gas is 15 percent and is allowed only for independent producers and royalty owners--those producing less than 50,000 barrels per day--and only up to 1,000 barrels of oil output, or its equivalent in gas, per day. In 1990, a higher depletion rate for marginal wells--oil from stripper wells, and heavy oil--was enacted. This rate starts at 15 percent, and increases by one percentage point for each $1 that the price of oil for the previous calendar years falls below $20 per barrel (subject to a maximum rate of 25 percent).

The percentage depletion allowance is available for many other types of fuel minerals, at rates ranging from 10 percent (coal, lignite) to 22 percent (uranium). The rate for regulated natural gas and gas sold under a fixed contract is 22 percent; the rate for geopressured methane gas is 10 percent. Oil shale and geothermal deposits qualify for a 15-percent allowance.

Percentage depletion for oil and gas is limited to the lesser of 100 percent of the taxable income from each property before the depletion allowance, or 65 percent of the taxable income from all properties for each producer. For ten years beginning on January 1, 1998 and ending December 31, 1999, the 100-percent taxable income limitation is suspended for marginal wells. Since 1990, transferred properties have been eligible for percentage depletion. Percentage depletion for coal and other fuels is limited to 50 of the taxable income from the property. Under code section 291, percentage depletion on coal mined by corporations is reduced by 20 percent. Prior to 1993, a special "energy deduction" was available to independent oil and gas producers and royalty owners for percentage depletion, subject to certain limitations.

Impact

Historically, generous depletion allowances and other tax benefits reduced effective tax rates in the fuel minerals industry significantly below tax rates on other industries, which provided incentives to increase investment, exploration, and output, especially oil and gas. Oil and gas output, for example, rose from 16 percent of total energy production in 1920 to 71.1 percent of in 1970 (the peak year).

The combination of this subsidy and the deduction of intangible drilling and other costs represented a significant boon to mineral producers who were eligible for both. Three-quarters of the original investment can be "written

off" immediately, and then a portion of gross revenues can be written off for the life of the investment. It was possible for cumulative depletion allowances to total many times the amount of the original investment.

The 1975 repeal of percentage depletion for the major integrated oil companies means that only about 1/4 of total oil and gas production benefits from the subsidy. The reduction in the rate of depletion from 27.5 to 15 percent means that independents benefit from it much less than they used to. In addition, cutbacks in other tax benefits, and the introduction of excise taxes have raised effective tax rates in the mineral industries, although independent oil and gas producers continue to be favored.

Undoubtedly, these cutbacks in percentage depletion contributed to the decline in domestic oil production, which peaked in 1970 and recently dropped to a 30-year low. Percentage depletion for other mineral deposits was unaffected by the 1975 legislation. Nevertheless, half of the percent revenue loss is a result, in an average year, of oil and gas depletion. The value of this expenditure to the taxpayer is the amount of tax savings that results from using the percentage depletion method instead of the cost depletion method.

Percentage depletion has little, if any, effect on oil prices, which are determined in the world oil market. It may bid up the price of drilling and mining rights.

Rationale

Provisions for a mineral depletion allowance based on the value of the mine were made under a 1912 Treasury Department regulation (T.D. 1742) but were never implemented. A court case resulted in the enactment, as part of the Tariff Act of 1913, of a "reasonable allowance for depletion" not to exceed five percent of the value of mineral output. Treasury regulation No. 33 limited total deductions to the original capital investment.

This system was in effect from 1913 to 1918, although in the Revenue Act of 1916, depletion was restricted to no more than the total value of output, and in the aggregate no more than capital originally invested or fair market value on March 1, 1913 (the latter so that appreciation occurring before enactment of income taxes would not be taxed).

The 1916 depletion law marked the first time that the tax laws mentioned oil and gas specifically. On the grounds that the newer discoveries that contributed to the war effort were treated less favorably, discovery value depletion was enacted in 1918. Discovery depletion, which was in effect through 1926, allowed deductions in excess of capital investment because it was based on the market value of the deposit after discovery. Congress viewed oil and gas as a strategic mineral, essential to national security, and

wanted to stimulate the wartime supply of oil and gas, compensate producers for the high risks of prospecting, and relieve the tax burdens of small-scale producers.

In 1921, because of concern with the size of the allowances, discovery depletion was limited to net income; it was further limited to 50 percent of net income in 1924. Due to the administrative complexity and arbitrariness, and due to its tendency to establish high discovery values, which tended to overstate depletion deductions, discovery value depletion was replaced in 1926 by the percentage depletion allowance, at the rate of 27.5 percent.

In 1932, percentage depletion was extended to coal and most other minerals. In 1950, President Truman recommended that the depletion rate be reduced to 15 percent, but Congress disagreed. In 1969, the top depletion rates were reduced from 27.5 to 22 percent, and in 1970 the allowance was made subject to the minimum tax.

The Tax Reduction Act of 1975 eliminated the percentage depletion allowance for major oil and gas companies and reduced the rate for independents to 15 percent for 1984 and beyond. This was in response to the first energy crisis of 1973-74, which caused oil prices to rise sharply. The continuation of percentage depletion for independents was justified by the Congress on grounds that independents had more difficulty in raising capital than the majors, that their profits were smaller, and that they could not compete with the majors.

The Tax Equity and Fiscal Responsibility Act of 1982 limited the allowance for coal and iron ore. The Tax Reform Act of 1986 denied percentage depletion for lease bonuses, advance royalties, or other payments unrelated to actual oil and gas production.

The Omnibus Budget and Reconciliation Act of 1990 introduced the higher depletion rates on marginal production, raised the net income limitation from 50 to 100 percent, and made the allowance available to transferred properties. These liberalizations were based on energy security arguments. The Energy Policy Act of 1992 repealed the minimum tax on percentage depletion and suspended the special energy deduction through 1998. The Taxpayer Relief Act of 1997 suspended the 100-percent taxable income limitation for marginal wells for two years.

Assessment

Standard accounting and economic principles state that the appropriate method of capital recovery in the mineral industry is cost depletion adjusted for inflation. The percentage depletion allowance permits independent oil and gas producers, and other mineral producers, to continue to claim a deduction even after all the investment costs of acquiring and developing the

property have been recovered. Thus it is a mineral production subsidy rather than an investment subsidy.

As a production subsidy, however, percentage depletion is inefficient, encouraging excessive development of existing properties over exploration for new ones. This tax treatment contrasts with capital subsidies such as accelerated depreciation for non-mineral assets. Although accelerated depreciation may lower effective tax rates by speeding up tax benefits, these assets cannot claim depreciation deductions in excess of investment.

Percentage depletion for oil and gas subsidizes independents that are primarily engaged in exploration and production. To the extent that it stimulates oil production, it reduces dependence on imported oil in the short run, but it contributes to a faster depletion of the Nation's resources in the long run, which increases oil import dependence. Arguments have been made over the years to justify percentage depletion on grounds of unusual risks, the distortions in the corporate income tax, national security, uniqueness of oil as a commodity, the industry's lack of access to capital, and to protect small producers.

Volatile oil prices make oil and gas investments more risky, but this would not necessarily justify percentage depletion or other tax subsidies. The corporate income tax does have efficiency distortions, but income tax integration is a more appropriate policy to address this problem.

An alternative approach to enhancing energy security is through an oil stockpile program such as the Strategic Petroleum Reserve.

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CREDIT FOR ENHANCED OIL RECOVERY COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 43.

Description

Section 43 provides for a 15-percent income tax credit for the costs of recovering domestic oil by a qualified "enhanced-oil-recovery" (EOR) method. Qualifying methods apply fluids, gases, and other chemicals into the oil reservoir, and use heat to extract oil that is too viscous to be extracted by conventional primary and secondary waterflooding techniques.

Nine tertiary recovery methods listed by Department of Energy in section 212.78(c) of their June 1979 regulations qualify for the tax credit: miscible fluid displacement, steam-drive injection, microemulsion flooding, *in-situ* combustion, polymer-augmented water flooding, cyclic steam injection, alkaline (or caustic) flooding, carbonated water flooding, and immiscible carbon dioxide gas displacement. Another technique, immiscible non-hydrocarbon gas displacement, was added as well.

Qualifying EOR costs include the cost of equipment, intangible drilling and development costs (*i.e.*, labor, supplies and repairs), and the costs of the injectants.

The EOR credit is phased out ratably, over a $6-per-barrel range, for oil prices above $28 (the $28 threshold is adjusted for inflation). The EOR credit may not be greater than taxpayer's net income tax in excess of 25 percent of net regular tax liability above $25,000, or the tentative minimum tax. The EOR credit is claimed as part of the general business credit.

The cost of the property that may otherwise be deducted is reduced by the amount of the credit. Alternative fuel production credits attributable to the property are also reduced by the EOR credit.

Impact

Conventional oil recovery methods typically succeed in extracting only one-third to one-half of a reservoir's oil. Some of the remaining oil can be extracted by unconventional methods, such as EOR methods, but these methods are currently uneconomic at prices below about $28-30 per barrel. The EOR credit reduces the cost of producing oil from older reservoirs relative to the cost of producing oil from new reservoirs. Given that oil prices are not expected to rise above the $28-per-barrel reference price (adjusted for inflation) in the near future, the credit should be fully available.

Rationale

The EOR credit was enacted as part of the Omnibus Budget and Reconciliation Act of 1990, to increase the domestic supply of oil, to reduce the demand for imported oil, to make the United States less dependent upon Persian Gulf producers and other unstable foreign oil producers, and to enhance the energy security of the United States. Another motive for this provision may have been to help the oil and gas industry, which had, at the time, not fully recovered from the 1986 oil price collapse.

Assessment

Oil production in the United States, which peaked in 1970 and recently dropped to a thirty-year low, has been declining at the rate of about four percent per year. Foreign oil supplies now account for over half of U.S. oil demand. The United States, once the world's leading oil producer and exporter, has been depleting its oil reservoirs and is now the high marginal cost oil producer.

United States production of oil by EOR methods increased during the 1980s; between 1990 and 1992 it increased by nearly 14 percent. At present

EOR methods yield nearly 3/4 of 1 million barrels per day of oil production. It is estimated, however, that between 250 and 350 billion barrels of oil remain in abandoned reservoirs, significantly more than the known reserves of oil recoverable by primary and secondary methods. Further, it is estimated that 10 percent of that oil is known recoverable reserves that can be produced with current EOR techniques if the financial incentives were there.

The incentive effect of the EOR credit should, in time, increase the recovery of this oil, which would increase the domestic supply of oil and tend to reduce the level of imported oil.

It is unlikely, however, to reverse the long-term slide in domestic production and growing dependence on imports. The United States is more dependent on imported oil, but is less vulnerable to supply disruptions and oil price shocks, due to the stockpiling of oil under the Strategic Petroleum Reserve, the weakened market power of OPEC, and the increased competitiveness in world oil markets. Increased domestic oil production lessens short-term dependency but it encourages long-term dependency as domestic resources are depleted. EOR oil is more expensive to recover than conventional oil but it is a relatively inexpensive way to add additional oil reserves.

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TAX CREDIT FOR PRODUCTION OF NON-CONVENTIONAL FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	1.0	1.3
2000	0.3	1.0	1.3
2001	0.3	1.0	1.3
2002	0.3	1.0	1.3
2003	0.2	0.8	1.0

Authorization

Section 29.

Description

Section 29 provides for a production tax credit of $3 per barrel of oil-equivalent (in 1979 dollars) for certain types of liquid and gaseous fuels produced from alternative energy sources. This credit is also known as the non-conventional fuels credit, or more simply, the "section 29 credit." The full credit is available if oil prices fall below $23.50 per barrel (in 1979 dollars); the credit is phased out as oil prices rise from $23.50 to $29.50 (in 1979 dollars).

Both the credit and the phase-out range are adjusted for inflation since 1979. Currently, the credit is over $6.00 per barrel of liquid fuels and over $1.00 per thousand cubic feet (MCF) for gaseous fuels, and the phase-out range for oil prices is from about $40 to $50 per barrel. With recent per-barrel oil prices in the low $20s, the credit is now, and is expected to be in the near future, fully in effect.

Qualifying fuels include oil produced from shale or tar sands, synthetic fuels (either liquid, gaseous, or solid) produced from coal, and gas produced

from either geopressurized brine, Devonian shale, tight formations, or biomass, and coalbed methane (a colorless and odorless natural gas that permeates coal seams and that is virtually identical to conventional natural gas).

For most qualifying fuels, the production tax credit is available through December 31, 2002, provided that the facilities were placed in service (or wells drilled) by December 31, 1992. For gas produced from biomass, and synthetic fuels produced from coal or lignite, the credit is available through December 31, 2007, provided that the facility is placed in service (or well drilled) before July 1, 1998 pursuant to a binding contract entered into before January 1, 1997.

The section 29 credit is offset by benefits from Government grants, subsidized or tax-exempt financing, energy investment credits, and the enhanced oil recovery tax credit. Finally, the credit is nonrefundable and it is limited to the excess of a taxpayer's regular tax over several tax credits and the tentative minimum tax.

Impact

The production tax credit lowers the marginal cost of producing the qualifying alternative fuels, and increases the supply of those fuels, causing a substitution of the alternative fuels for the more conventional petroleum fuels, a reduction in the demand for petroleum, and a reduction in imported petroleum (the marginal source of oil).

The credit's effects have, generally, not been sufficient to offset the disincentive effects of low and unstable oil prices, the high cost of alternative fuels production, and taxpayers' unawareness of the availability of the new credit. Consequently, there has been little if any increase in the production of alternative fuels since 1980 with the possible exception of coalbed methane.

In the case of coalbed methane the combined effect of the $1.00 per MCF tax credit (which was at times 100% of natural gas prices) and declining production costs (due to technological advances in drilling and production techniques) was sufficient to offset the decline in oil and natural gas prices, and the resulting decline in domestic conventional natural gas production.

Production of coalbed methane has increased from 0.1 billion MCF in 1980 to over 800 billion MCF in 1994, a large part of it in response to the production tax credits, and virtually all of it at the expense of conventional gas production. The credit for coalbed methane benefits largely oil and gas producers, both independent producers and major integrated oil companies.

Rationale

The original concept for the alternative fuels production tax credit goes back to an amendment by Senator Talmadge to H.R. 5263 (95th Congress), the Senate's version of the Energy Tax Act of 1978 (P.L. 95-618), one of five public laws in President Carter's National Energy Plan. H.R. 5263 provided for a $3.00 per barrel tax credit or equivalent, but only for production of shale oil, gas from geopressurized brine, and gas from tight rock formations.

The final version of the Energy Tax Act did not include the production tax credit. The original concept was resuscitated in 1979 by Senator Talmadge as S. 847 and S. 848, which became part of the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223).

The purpose of the credits was to provide incentives for the private sector to increase the development of alternative domestic energy resources because of concern over oil import dependence and national security. The specific event that triggered support for the credits in 1980 was the 1979-80 war between Iran and Iraq, which caused petroleum supply shortages and sharp increases in energy prices.

The latter "placed-in-service" rule has been amended several times in recent years. The original 1980 windfall profit tax law established a placed-in-service deadline of December 31, 1989. This was extended by one year to December 31 1990 by the Technical and Miscellaneous Revenue Act of 1988. That deadline was extended to December 31, 1991 as part OBRA, the Omnibus Budget Reconciliation Act of 1990. The Energy Policy Act of 1992 extended coverage for biomass and fuels produced from coal for facilities through 1997 and extended the credit on production from these facilities through 2007. The Small Business Jobs Protection Act of 1996 (P.L. 104-188) further extended the placed-in-service rule by an additional eighteen months.

Assessment

The credit has significantly reduced the cost and stimulated the supply of unconventional gases--particularly of coalbed methane from coal seams not likely to be mined for coal in the foreseeable future. Virtually all of the added gas output has substituted for domestic conventional natural gas rather than for imported petroleum, meaning that the credit has basically not achieved its underlying energy policy objective of enhancing energy security. Further, economists see little justification for such a credit on grounds of allocative efficiency, distributional equity, or macroeconomic stability. From an economic perspective, the credits compound distortions in the energy markets, rather than correcting for preexisting distortions due to pollution, oil import dependence, “excessive” market risk, and other factors. Such

distortions may be addressed by other policies: pollution and other environmental externalities may be dealt with by differential taxes positively related to the external cost: excessive dependence on imported petroleum and vulnerability to embargoes and price shocks suggest either an oil import tax or a petroleum stockpile such as the Strategic Petroleum Reserve.

The credit is projected to reduce federal revenues by $6.5 billion over the next five years, making the budget deficit higher than it would otherwise be, and reducing tax system progressivity. The credit has not encouraged the collection of coalbed methane from active coal mines, which continues to be vented and which contributes a potent greenhouse gas linked to possible global warming.

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TAX CREDITS FOR ALCOHOL FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	([1])	([1])
2000	-	([1])	([1])
2001	-	([1])	([1])
2002	-	([1])	([1])
2003	-	([1])	([1])

([1])Less than $50 million.

Authorization

Section 38, 40, 87.

Description

There are three income tax credits for alcohol-based motor fuels: the alcohol mixtures credit, the pure alcohol fuel credit, and the small ethanol producer credit.

The alcohol mixture (or blender's) credit and the pure alcohol fuel credit is 54 cents per gallon of ethanol (60 cents for methanol) of at least 190 proof, and 40 cents for each gallon of alcohol between 150 and 190 proof (45 cents for methanol). No credit is available for alcohol that is less than 150 proof. The 54-cent credit is reduced to 53 cents for the period 2001-2002, 52 cents for 2003-2004, and 51 cents for 2005-2007. The alcohol mixtures credit is typically available to the blender, and the pure alcohol credit is typically available to the retail seller.

The small ethanol producer credit is 10 cents per gallon of ethanol produced, used, or sold for use as a transportation fuel. This credit is limited

to 15 million gallons of annual alcohol production for each small producer, defined as one with a production capacity of under 30 million gallons.

The alcohol fuels tax credits apply to biomass ethanol (alcohol from renewable resources such as vegetative matter), and to methanol derived from biomass, including wood. Alcohol derived from petroleum, natural gas, or coal (including peat) does not qualify for the credits. This limitation excludes most economically feasible methanol, which is derived primarily from natural gas. About 95 percent of current biomass ethanol production is derived from corn.

A 1990 IRS ruling allowed mixtures of gasoline and ETBE (Ethyl Tertiary Butyl Ether) to qualify for the 54-cent blender's credit. ETBE is a compound that results from a chemical reaction between ethanol (which must be produced from renewables under this ruling) and isobutylene. ETBE is technically feasible as a substitute for ethanol or MTBE (Methyl Tertiary Butyl Ether) as a source of oxygen in gasoline regulated under the Clean Air Act.

In lieu of the blender's credit, fuel ethanol blenders may claim the 5.4¢ excise-tax exemption, provided under IRC sections 4041 and 4081 for blends of ethanol and any liquid motor fuel. The 5.4-cent exemption is equivalent to 54 cents per gallon of alcohol.

The alcohol fuels tax credit is a component of the general business credit and is limited to the taxpayer's net income tax in excess of the greater of (a) 25 percent of regular tax liability above $25,000, or (b) the tentative minimum tax. Any unused credits may be carried forward 15 years or back 3 years. Credits must also be included as income under section 87.

All three of the alcohol tax credits expire on January 1, 2008, or in the event that the Highway Trust Fund component of the gasoline tax expires.

Impact

Consumption of ethanol motor fuel, most of which is a gasoline blend, has increased from about 40 million gallons in 1979 to over one billion gallons. Gasohol accounts for about 8 percent of the transportation fuels market. This increase is likely due to the Federal excise tax exemption, the excise tax exemptions at the State and local level, and to the high oil prices in the late 1970s and early 1980s, rather than to the alcohol fuels tax credits.

Due to restrictions on taking the credit against only portions of income tax liability, and the inclusion of the credit itself in income, blenders prefer to use the excise tax exemption.

Allowing ETBE to qualify for the blender's tax credit is projected to stimulate the production of ethanol for use as an oxygen source for reformulated gasoline, and thus to reduce the production and importation of MTBE, an alternate oxygen source made from natural gas. If this occurs, it would increase the share of US corn crop allocated to ethanol production above the current 4-5 percent. It would also increase Federal revenue losses from the alcohol fuels credits, which heretofore have been negligible due to blender's use of the exemption over the credit.

Rationale

The alcohol fuels tax credits were intended to complement the excise-tax exemptions for alcohol fuels enacted in 1978. These exemptions provided the maximum tax benefit when the gasohol mixture was 90% gasoline and 10% alcohol. Recent tax law changes have provided a prorated exemption to blends of 7.7 percent and 5.7 percent alcohol.

The Congress wanted the credits to provide incentives for the production and use of alcohol fuels in mixtures that contained less than 10 percent alcohol. The Congress also wanted to give tax-exempt users (such as farmers) an incentive to use alcohol fuel mixtures instead of tax-exempt gasoline and diesel.

Both the credits and excise-tax exemptions were enacted to encourage the substitution of alcohol fuels produced from renewables for gasoline and diesel. The underlying policy objective is, as with most other energy tax incentives, to reduce reliance on imported petroleum and to contribute to energy independence. In addition, the Congress wanted to help support farm incomes by finding another market for corn, sugar, and other agricultural products that are the basic raw materials for alcohol production.

The alcohol fuels mixture credit and the pure alcohol fuels credit were enacted as part of the Crude Oil Windfall Profit Tax of 1980 (P.L.96-223), at the rate of 40 cents per gallon for alcohol that was 190 proof or more, and 30 cents per gallon for alcohol between 150 and 190 proof. The credits were increased in 1982 and 1984.

The Omnibus Reconciliation Act of 1990 reduced the credits to 54 cents and 40 cents and introduced the new 10-cent-per-gallon small ethanol producer credit.

The Senate version of the Comprehensive National Energy Policy Act of 1992 (H.R. 776) proposed that the credit offset fifty percent of the minimum tax, but this was not part of the final law. The Transportation Equity Act for the 21st Century (P.L. 105-178) reduces the 54-cent credit to 51 cents as described above.

Assessment

The alcohol fuels tax credits were enacted to lower the cost of producing and marketing ethanol fuels that would otherwise not be competitive. They target one specific alternative fuel over many others--such as methanol, liquified petroleum gas, compressed natural gas, or electricity--that could theoretically substitute for gasoline and diesel. Alcohol fuel is not only higher priced, but also requires substantial energy to produce, thereby diminishing the net overall conservation effect.

To the extent that the credits induce a substitution of domestically produced ethanol for petroleum fuels they would reduce petroleum imports and provide some environmental gains, although not necessarily more than other alternative fuels. But it is likely the excise tax exemptions rather than the credits that have provided these effects so far.

At 54 cents per gallon of alcohol, the subsidy is $23 per barrel of oil displaced, which is equal to the current domestic oil price. Providing tax subsidies for one type of fuel over others could distort market decisions and engender an inefficient allocation of resources, even if doing so produces some energy security and environmental benefits.

Substantial losses in Federal tax revenue, and additional economic distortions in fuels markets, are likely to result in the future if there is increased production of ETBE in place of its lower-cost alternative, MTBE. This substitution would reduce imports of MTBE and improve the trade balance, but would not reduce petroleum imports (which is the underlying goal of the credits) since MTBE is made primarily from natural gas.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT INDUSTRIAL DEVELOPMENT BONDS FOR ENERGY PRODUCTION FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	0.1	0.2
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	0.1	([1])	0.1
2003	0.1	([1])	0.1

([1])Less than $50 million.

Authorization

Sections 103, 141, 142, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance the construction of certain energy facilities is tax exempt. These energy facility bonds are classified as private-activity bonds, rather than as governmental bonds, because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

These bonds may be issued to finance the construction of hydroelectric generating facilities at dam sites constructed prior to March 18, 1979, or at sites without dams that require no impoundment of water. Bonds may also be issued to finance solid waste disposal facilities that produce electric energy.

These exempt facility bonds generally are subject to the State private-activity bond annual volume cap. Bonds issued for government-owned solid waste disposal facilities are not, however, subject to the volume cap.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to provide the services of energy facilities at lower cost.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the energy facilities, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The Crude Oil Windfall Profits Tax Act of 1980 used tax credits to encourage the private sector to invest in renewable energy sources. Because State and local governments pay no Federal income tax, Congress in this Act authorized governmental entities to use tax-exempt bonds to reduce the cost of investing in hydroelectric generating facilities.

The portion of the facility eligible for tax-exempt financing ranged from 100 percent for 25-megawatt facilities to zero percent for 125-megawatt facilities.

The definition of solid waste plants eligible for tax-exempt financing was expanded by the 1980 Act because the Treasury regulations then existing denied such financing to many of the most technologically efficient methods of converting waste to energy. This expansion of eligibility included plants that generated steam or produced alcohol. Tax exemption for steam generation and alcohol production facilities bonds were eliminated by the 1986 Tax Act.

Assessment

Any decision about changing the status of these two eligible private activities should consider the Nation's need for renewable energy sources to replace fossil fuels, and the importance of solid waste disposal in contributing to environmental goals.

If the case to be made for subsidy of these activities is found persuasive, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for energy facilities have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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EXCLUSION OF ENERGY CONSERVATION SUBSIDIES PROVIDED BY PUBLIC UTILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 136.

Description

Gross income does not include the value of any subsidy provided (directly or indirectly) by a public utility to a customer for the purchase or installation of any energy conservation measure.

Impact

The exclusion reduces the cost of programs financed by utilities to conserve energy, since, absent such provisions, the value of the subsidy would be included in gross income and subject to tax. Depending on the tax rate, the tax saving could be as much as one-third the value of the subsidy.

Rationale

This provision was adopted as part of the Energy Policy Act of 1992 (P.L. 102-486), to encourage residential customers of public utilities to participate in energy conservation programs. In addition, for subsidies received after 1994, the exclusion of an energy conservation measure undertaken with respect to business property was limited to 15 percent of the value of the subsidy received after 1996 (40 percent for 1995, and 50 percent for 1996).

An exclusion for residential customers had previously been in the law. The Solar Energy and Energy Conservation Act of 1980 amended the National Energy Conservation Act of 1978 to provide that these payments were excluded. This provision expired in mid-1989. The Small Business Job Protection Act of 1996 (P.L. 104-188) repealed the partial exclusion with respect to business property, effective on January 1, 1997, unless pursuant to a binding contract in effect on September 13, 1995.

Assessment

Generally, allowing special tax benefits for certain types of investment or consumption results in a misallocation of resources.

Such a program might be justified on the grounds of conservation, if consumption of energy resulted in negative effects on society, such as pollution. In general, however, it is more efficient to directly tax energy fuels than to subsidize a particular method of achieving conservation.

There may also be a market failure in tenant occupied homes, if the tenant pays for electricity separately. In that case, the landlord may have little incentive to undertake conservation expenditures.

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TAX CREDIT FOR INVESTMENTS IN SOLAR AND GEOTHERMAL ENERGY FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Sections 46 and 48.

Description

Sections 46 and 48 provide for a 10-percent income-tax credit for business investment in solar and geothermal energy equipment. Solar equipment is defined as equipment that generates electricity directly (photovoltaic systems), or that heats, cools, or provides hot water in a building, and equipment that provides solar process heat. Geothermal equipment includes equipment used to produce, distribute, or use energy from a natural underground deposit of hot water, heat, and steam (such as the Geysers of California).

The credits for solar and geothermal equipment are what remain of the business energy tax credits enacted under the Energy Tax Act of 1978, and they are the sole exception to the repeal of the investment tax credits under the Tax Reform Act of 1986.

Impact

The energy tax credits lower the cost of, and increase the rate of return to, investing in solar and geothermal equipment, whose return is typically much lower than conventional energy equipment. Currently low oil prices are unlikely to make private investments in solar and geothermal economic even with a 10-percent credit, although recent technological innovations have reduced the costs of solar technologies.

Even during the early 1980s, when oil prices were high and effective tax rates on these types of equipment were sometimes negative (due to the combined effect of the energy tax credits, the regular 10 percent investment tax credit, and accelerated depreciation) business investment in these technologies was negligible. It is not clear how much these credits encourage additional investment as opposed to subsidizing investment that would have been made anyway.

The number of solar collector manufacturers, and their shipments of collectors reached a peak in the early 1980s--commensurate with the peak in oil prices--and declined thereafter. Shipments of medium-temperature collectors remained high through 1985, declining sharply thereafter. In addition to the 1986 drop in oil prices, this was probably due to the termination of the residential solar credit, which was not reinstated, rather than termination of the business solar credits, which were reinstated.

Most solar collectors are used in heating water and pools in residences. Business applications of solar equipment are still quite insignificant, except for public utilities, which use them to generate electricity. However, public utilities do not qualify for the credit. Very little energy in the United States is generated from solar equipment--about 0.075 quadrillion Btu's in 1996, which was one percent of renewable energy consumption and 0.08 percent of total consumption.

Electricity generated from geothermal deposits, which generated four times as much energy as solar equipment in 1990, increased rapidly from the onset of the energy crisis in 1973 to the collapse of oil prices in 1986, and declined slightly since 1987. Even so, it accounts for 5 percent of the renewable energy consumed from renewable sources, and 0.4 percent of total U.S. energy consumed in 1996. Most of it is generated by electric utilities, which do not qualify for the tax credit.

Rationale

The business energy tax credits were part of the Energy Tax Act of 1978, which was one of five public laws enacted as part of President Carter's National Energy Plan. The rationale behind the credits was primarily to reduce United States consumption of oil and natural gas by encouraging the

commercialization of renewable energy technologies, to reduce dependence on imported oil and enhance national security.

Under the original 1978 law, which also provided for tax credits for solar and geothermal equipment used in residences, several other types of equipment qualified for the tax credits: shale oil equipment, recycling equipment, wind equipment, synthetic fuels equipment, and others. For some types of equipment, the credits expired on December 31, 1982, for others the Crude Oil Windfall Profit Tax Act of 1980 extended the credits through 1985.

The 1980 Act extended the credit for solar and geothermal equipment, raised their credit rates from 10 to 15 percent, repealed the refundability of the credit for solar and wind energy equipment, and extended the credit beyond 1985 for certain long-term projects. The Tax Reform Act of 1986 retroactively extended the credits for solar, geothermal, ocean thermal, and biomass equipment through 1988, at declining rates.

The Miscellaneous Revenue Act of 1988 extended the solar, geothermal, and biomass credits at their 1988 rates--ocean thermal was not extended. The Omnibus Budget and Reconciliation Act of 1989 extended the credits for solar and geothermal, and reinstated the credit for ocean thermal equipment, through December, 31 1991. The credit for biomass equipment was not extended. The Tax Extension Act of 1991 extended the credits for solar and geothermal through June 30, 1992. The Energy Policy Act of 1992 made the credits, which now apply only to solar and geothermal equipment, permanent.

Assessment

The business energy tax credits encourage investments in technologies that rely on clean, abundant, renewable energy as substitutes for conventional fossil-fuel technologies that pollute the environment and contribute to dependence on imported oil. The major policy question, however, is the cost--in terms of lost Federal tax revenue and in terms of the distortions to the allocation of resources--in relation to the small quantities of fossil fuels savings and environmental gains.

The credits lose much Federal tax revenue in relation to the small amounts of fossil energy they save. They also subsidize two specific technologies, at the expense of others that might have more "bang for the buck." The high capital costs for alternative energy technologies, and market uncertainty, are not evidence of energy market failure.

The environmental problems associated with production and consumption of fossil fuels may also be addressed with emissions taxes or emissions trading rights (as in the Clean Air Act).

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TAX CREDITS FOR ELECTRICITY PRODUCTION FROM WIND AND BIOMASS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	([1])	0.1
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	0.1	([1])	0.1
2003	0.1	([1])	0.1

([1])Less than $50 million.

Authorization

Section 45.

Description

Taxpayers are allowed a 1.5-cent credit in 1992 dollars (adjusted for inflation) per kilowatt hour for electricity produced from qualified wind energy or "closed-loop" biomass. The electricity must be produced from a facility owned by a taxpayer and it must be sold to an unrelated third party. The credit is allowed for the first ten years of production from a new facility.

Closed-loop biomass involves the use of plant matter, where plants are grown solely as fuel to produce electricity. Use of waste materials such as scrap wood or agricultural/municipal waste) or timber does not qualify for the credit.

The credit is phased out as the average annual contract price of electricity from the renewable source, the reference price, rises over a 3-cent range from 8 cents to 11 cents per kilowatt. These amounts have been adjusted for inflation since 1992. For 1997, the reference price for wind is 6.4 cents per kilowatt hour; the reference price for biomass is 0 cents per kilowatt

hour. Thus, the full inflation-adjusted credit of 1.6 cents per kilowatt hour for 1997 is available.

The credit cannot be received by a facility that has received the business energy credit or investment credit and is reduced proportionally if government subsidies (including tax-exempt bonds) are used.

The credit applies to electricity produced by facilities placed in service after 1992 and before July 1, 1999, for biomass, and after 1993 and before July 1, 1999, for wind. However, the credit is available for ten years beginning on the date the facility was first placed in service.

Impact

This tax benefit is a production incentive; it encourages use of wind and biomass to generate electricity. The phase-out is designed to remove the subsidy when the price of electricity becomes sufficiently high that a subsidy is no longer needed. President Clinton's FY 1999 budget proposal would have extended this tax credit by five years. This provision, which is part of the President's approach to global climate change, was not adopted.

Rationale

This provision was adopted as part of the Energy Policy Act of 1992. Its purpose was to encourage the development and utilization of electric generating technologies that use specified renewable energy resources, as opposed to conventional fossil fuels.

Assessment

Generally, allowing special tax credits and deductions for certain types of investment or consumption results in a misallocation of resources. This provision might be justified, however, on the basis of reducing pollution. An alternative way to reduce pollution is by directly taxing emissions, and allowing individuals to choose the optimal response. In some cases, however, such an approach is not administratively feasible.

The provision might also be justified on the grounds of reducing dependence on imported oil (although alternative approaches, such as stockpiling, are available).

The modest revenue costs associated with the provision suggest that the impact will be small as well.

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EXCESS OF PERCENTAGE OVER COST DEPLETION: NONFUEL MINERALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	0.2	0.3
2000	0.1	0.2	0.3
2001	0.1	0.2	0.3
2002	0.1	0.2	0.3
2003	0.1	0.2	0.3

Authorization

Sections 611, 612, 613, and 291.

Description

Firms that extract minerals, ores, and metals from mines are permitted a deduction to recover their capital investment, which depreciates due to the physical and economic depletion of the reserve as the mineral is recovered (section 611).

There are two methods of calculating this deduction: cost depletion, and percentage depletion. Cost depletion allows for the recovery of the actual capital investment--the costs of discovering, purchasing, and developing a mineral reserve--over the period during which the reserve produces income.--

Each year, the taxpayer deducts a portion of the adjusted basis (original capital investment less previous deductions) equal to the fraction of the estimated remaining recoverable reserves that have been extracted and sold. Under this method, the total deductions cannot exceed the original capital investment.

Under percentage depletion, the deduction for recovery of capital investment is a fixed percentage of the "gross income"--*i.e.*, sales revenue--from the sale of the mineral. Under this method, total deductions typically exceed the capital invested.

Section 613 states that mineral producers must claim the higher of cost or percentage depletion. The percentage depletion allowance is available for many types of minerals, at rates ranging from 5 percent (for clay, sand, gravel, stone, etc.) to 22 percent (for sulphur, uranium, asbestos, lead, etc.).

Metal mines generally qualify for a 14-percent depletion, except for gold, silver, copper, and iron ore, which qualify for a 15-percent depletion. The percentage depletion rate for foreign mines is generally 14 percent.

Percentage depletion is limited to 50 percent of the net income from the property (100 percent in the case of oil and gas wells). For corporate taxpayers, section 291 reduces the percentage depletion allowance for iron ore by 20 percent. Allowances in excess of cost basis are treated as a preference item and taxed under the alternative minimum tax.

Impact

Historically, generous depletion allowances and other tax benefits reduced effective tax rates in the minerals industries significantly below tax rates on other industries, providing incentives to increase investment, exploration, and output, especially for oil and gas. It is possible for cumulative depletion allowances to total many times the amount of the original investment.

Issues of principal concern are the extent to which percentage depletion:

(1) decreases the price of qualifying minerals, and therefore encourages their consumption;

(2) bids up the price of exploration and mining rights; and

(3) encourages the development of new deposits and increases production.

Most analyses of percentage depletion have focused on the oil and gas industry, which--before the 1975 repeal of percentage depletion for major oil companies--accounted for the bulk of percentage depletion.

There has been relatively little analysis of the effect of percentage depletion on other industries. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers is

dependent on a number of factors, including the statutory percentage depletion rate, income tax rates, and the effect of the net income limitation.

Rationale

Provisions for a depletion allowance based on the value of the mine were made under a 1912 Treasury Department regulation (T.D. 1742), but this was never effectuated.

A court case resulted in the enactment, as part of the Tariff Act of 1913, of a "reasonable allowance for depletion" not to exceed five percent of the value of output. This statute did not limit total deductions; Treasury regulation No. 33 limited total deductions to the original capital investment.

This system was in effect from 1913 to 1918, although in the Revenue Act of 1916, depletion was restricted to no more than the total value of output, and, in the aggregate, to no more than capital originally invested or fair market value on March 1, 1913 (the latter so that appreciation occurring before enactment of income taxes would not be taxed).

On the grounds that the newer mineral discoveries that contributed to the war effort were treated less favorably, discovery value depletion was enacted in 1918. Discovery depletion, which was in effect through 1926, allowed deductions in excess of capital investment because it was based on the market value of the deposit after discovery. In 1921, because of concern with the size of the allowances, discovery depletion was limited to net income; it was further limited to 50 percent of net income in 1924.

For oil and gas, discovery value depletion was replaced in 1926 by the percentage depletion allowance, at the rate of 27.5 percent. This was due to the administrative complexity and arbitrariness, and due to its tendency to establish high discovery values, which tended to overstated depletion deductions.

For other minerals, discovery value depletion continued until 1932, at which time it was replaced by percentage depletion at the following rates: 23 percent for sulphur, 15 percent for metal mines, and 5 percent for coal.

From 1932 to 1950, percentage depletion was extended to most other minerals. In 1950, President Truman recommended a reduction in the top depletion rates to 15 percent, but Congress disagreed. The Revenue Act of 1951 raised the allowance for coal to 10 percent and granted it to more minerals.

In 1954, still more minerals were granted the allowance, and foreign mines were granted a lower rate. In 1969, the top depletion rates were reduced and the allowance was made subject to the minimum tax. The Tax

Equity and Fiscal Responsibility Act of 1982 reduced the allowance for corporations that mined coal and iron ore by 15 percent. The Tax Reform Act of 1986 raised the cutback in corporate allowances for coal and iron ore from 15 to 20 percent.

The House version of H.R. 776, The Comprehensive National Energy Policy Act of 1992, proposed to repeal percentage depletion for mercury, asbestos, uranium, and lead, but this was eliminated in conference.

Assessment

Standard accounting and economic principles state that the appropriate method of capital recovery in the mineral industry is cost depletion adjusted for inflation. The percentage depletion allowance permits mineral producers to continue to claim a deduction even after all the investment costs of acquiring and developing the property have been recovered. Thus it is a mineral production subsidy rather than an investment subsidy.

As a production subsidy, however, percentage depletion is inefficient, encouraging excessive development of existing properties rather than exploration of new one. Although accelerated depreciation for non-mineral assets may lower effective tax rates by speeding up tax benefits, these assets cannot claim depreciation deductions in excess of investment.

However, arguments have been made to justify percentage depletion on grounds of unusual risks, the distortions in the corporate income tax, national security, and to protect domestic producers. Mineral price volatility alone does not necessarily justify percentage depletion.

The corporate income tax does have efficiency distortions, but income tax integration is the appropriate policy. Percentage depletion may not be the most efficient way to increase mineral output.

Percentage depletion may also have adverse environmental consequences, encouraging the use of raw materials rather than recycled substitutes.

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EXPENSING OF MULTIPERIOD TIMBER-GROWING COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	0.1	0.1
2000	([1])	0.1	0.1
2001	([1])	0.2	0.2
2002	([1])	0.2	0.2
2003	([1])	0.2	0.2

([1])Less than $50 million.

Authorization

Sections 162, 263(d)(1).

Description

Most of the production costs of maintaining a timber stand after it is established are expensed (deducted when incurred), rather than capitalized (reducing gain when the timber is sold). These costs include indirect carrying costs (*e.g.*, interest and property taxes) as well as costs of disease and pest control and brush clearing. Other costs, such as the costs of planting the stand, are capitalized. In most other industries, such indirect costs are capitalized under the uniform capitalization rules.

Impact

By allowing the deduction of expenses when incurred, the effective tax rate on investments in these indirect costs is zero. This provision lowers the effective tax rate on timber growing in general. The extent of the effect of tax provisions on the timber industry is in some dispute. Most of the benefit goes to corporations, and thus is likely to benefit higher-income individuals (see discussion in introduction).

Rationale

The original ability to expense indirect costs of timber growing was apparently part of a general perception that these costs were maintenance costs, and thus deductible as ordinary costs of a trade or business. There were a series of revenue rulings and court cases over the years distinguishing between what expenses might be deductible and what expenses might be capitalized (*e.g.*, I. T. 1610 in 1923, an income tax unit ruling), Mim. 6030 in 1946 (a mimeographed letter ruling), Revenue Ruling 55-412 in 1955, and Revenue Ruling 66-18 in 1966).

The Tax Reform Act of 1986 included uniform capitalization rules which required indirect expenses of this nature to be capitalized in most cases. Several exception were provided, including timber. There is no specific reason given for exempting timber *per se*, but the general reason given for exceptions to the uniform capitalization rules is that they are cases were application "might be unduly burdensome."

Assessment

The tax benefit provides a forgiveness of tax on the return to part of the investment in timber growing. Absent any general benefits to society, the effect is to misallocate resources, which causes a welfare loss. Timber growing might, however, provide benefits to society in general (externalities) that are not captured by investors, because of the aesthetic, recreational, and environmental benefits of timber stands. But the tax approach must be weighed against direct subsidies and direct ownership of timber lands by the government to accomplish these objectives.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT SEWAGE, WATER, AND HAZARDOUS WASTE FACILITIES BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.4	0.2	0.6
2000	0.5	0.2	0.7
2001	0.5	0.2	0.7
2002	0.5	0.2	0.7
2003	0.5	0.2	0.7

Authorization

Sections 103, 141, 142, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance the construction of sewage facilities, facilities for the furnishing of water, and facilities for the disposal of hazardous waste is tax exempt.

Some of these bonds are classified as private-activity bonds rather than as governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

The bonds for these facilities are subject to the State private-activity bond annual volume cap.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to finance the facilities at reduced interest rates.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the sewage, water, and hazardous waste facilities, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Prior to 1968, no restriction was placed on the ability of State and local governments to issue tax-exempt bonds to finance sewage, water, and hazardous waste facilities. Although the Revenue and Expenditure Control Act of 1968 imposed tests that would have restricted issuance of these bonds, it provided a specific exception for sewage and water (allowing continued unrestricted issuance).

Water-furnishing facilities must be made available to the general public (including electric utility and other businesses), and must be either operated by a governmental unit or have their rates approved or established by a governmental unit.

The hazardous waste exception was adopted by the Tax Reform Act of 1986. The portion of a hazardous waste facility that can be financed with tax-exempt bonds cannot exceed the portion of the facility to be used by entities other than the owner or operator of the facility. In other words, a hazardous waste producer cannot use tax-exempt bonds to finance a facility to treat its own wastes.

Assessment

Some of the benefits from investing in these environmentally oriented activities are enjoyed by society as a whole, and some of them accrue to people outside the political boundaries of State and local governments. It is expected that these activities are provided in inadequate amounts by the private and State-local sectors. Providing a Federal subsidy encourages greater sewage, water, and hazardous waste control investment.

Because a portion of the cost is paid by taxpayers rather than by the entities producing the hazardous waste or environmental pollution, the

producers of the pollution are encouraged to maintain too high a level of output. The Nation seems uncertain about the desirability of subsidizing such private investments in the environment. The Tax Reform Act of 1986 terminated the general eligibility of private industry's pollution control investment for tax-exempt financing.

If a case can be made for subsidy of these activities, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for these activities have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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TAX CREDIT FOR REHABILITATION OF HISTORIC STRUCTURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	0.3	0.4
2000	0.1	0.4	0.5
2001	0.1	0.4	0.5
2002	0.1	0.4	0.5
2003	0.1	0.4	0.5

Authorization

Section 47.

Description

Expenditures on certified structures qualify for a 20 percent tax credit if used to substantially rehabilitate historic structures for use as residential rental or commercial property. The basis (cost for purposes of depreciation) of the building is reduced by the credit.

The amount of the credit that can be offset against unrelated income is limited to the equivalent of $25,000 in deductions under the passive loss restriction rules.

Certified historic structures are either individually registered in the National Register of Historic Places or are structures certified by the Secretary of the Interior as having historic significance and located in a registered historic district. The State Historic Preservation Office reviews applications and forwards recommendations for designation to the Interior Department.

Impact

The credit reduces the taxpayer's cost of preservation projects. Prior to tax reform in 1986, historic preservation projects had become a popular tax shelter with rapid growth. The limits on credits under the passive loss restrictions limit the use of this investment as a tax shelter.

Rationale

Rapid depreciation (over five years) of these investments was adopted in 1976 as an incentive in response to declining usefulness of older buildings and designed to promote stability and economic vitality to deteriorating areas through rehabilitating and preserving historic structures and neighborhoods. Achievement of this goal was thought dependent upon enlistment of private funds in the preservation movement.

Partly in a move toward simplification and partly to add counterbalance to new provisions for accelerated cost recovery, the tax incentives were changed to a tax credit in 1981 and made part of a set of credits for rehabilitating older buildings (varying by type or age).

The credit amount was reduced in 1986 because the rate was deemed too high when compared with the new lower tax rates, and a reduction from a three- to a two-tiered rehabilitation rate credit was adopted. A higher credit rate was allowed for preservation of historic structures than for rehabilitations of older qualified buildings first placed in service prior to 1936.

Assessment

Owners of historic buildings are encouraged to renovate them through the use of the 20 percent tax credit available for substantial rehabilitation expenditures approved by the Department of the Interior. Opponents of the credit note that investments are allocated to historic buildings that would not be profitable projects without the credit, resulting in economic inefficiency. Proponents argue that investors fail to consider external benefits (preservation of social and aesthetic values) which are desirable for society at large.

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SPECIAL RULES FOR MINING RECLAMATION RESERVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1]) Less than $50 million.

Authorization

Section 468.

Description

Firms are generally not allowed to deduct a future expense until "economic performance" occurs--that is, until the service it pays for is performed and the expense is actually paid. Electing taxpayers may, however, deduct the current-value equivalent of certain estimated future reclamation and closing costs for mining and solid waste disposal sites.

For Federal income tax purposes, the amounts deducted prior to economic performance are deemed to earn interest at a specified interest rate. When the reclamation has been completed, any excess of the amounts deducted plus deemed accrued interest over the actual reclamation or closing costs is taxed as ordinary income.

Impact

Section 468 permits reclamation and closing costs to be deducted at the time of the mining or waste disposal activity that gives rise to the costs. Absent this provision, the costs would not be deductible until the reclamation or closing actually occurs and the costs are paid. Any excess amount deducted in advance (plus deemed accrued interest) is taxed at the time of reclamation or closing.

Rationale

This provision was adopted in 1984. Proponents argued that allowing current deduction of mine reclamation and similar expenses is necessary to encourage reclamation, and to prevent the adverse economic effect on mining companies that might result from applying the general tax rules regarding deduction of future costs.

Assessment

Reclamation and closing costs for mines and waste disposal sites that are not incurred concurrently with production from the facilities are capital expenditures. Unlike ordinary capital expenditures, however, these outlays are made at the end of an investment project rather than at the beginning.

Despite this difference, amortizing (writing off) these capital costs over the project life is appropriate from an economic perspective. This amortization parallels depreciation of up-front capital costs. The tax code does not provide systematic recognition of such end-of-project capital costs. Hence they are treated under special provisions that provide exceptions to the normal rule of denying deduction until economic performance.

It is debatable, however, whether such exceptions should be regarded as tax expenditures. The tax code provides essentially similar treatment for nuclear power plant decommissioning costs, for example, which are also end-of-project capital costs, but in that case the treatment is not counted as a tax expenditure.

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EXCLUSION OF CONTRIBUTIONS IN AID OF CONSTRUCTION FOR WATER AND SEWER UTILITIES

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	([1])	([1])
2000	-	([1])	([1])
2001	-	([1])	([1])
2002	-	([1])	([1])
2003	-	([1])	([1])

([1])Less than $50 million.

Authorization

Section 118(c),(d).

Description

Contributions in aid of construction are charges paid by utility customers, usually builders or developers, to cover the cost of installing facilities to service housing subdivisions, industrial parks, manufacturing plants, etc. In some cases, the builder/developer transfers completed facilities to the utility rather than paying cash to the utility to finance construction of the facilities.

Qualifying contributions in aid of construction received by regulated water and sewage disposal utilities which provide services to the general public in their service areas are not included in the utilities' gross income if the contributions are spent for the construction of the facilities within 2 years after receipt of the contributions. Service charges for starting or stopping services do not qualify as nontaxable capital contributions. Assets purchased with (or received as) qualifying contributions have no basis

(hence, cannot be depreciated by the utility) and may not be included in the utility's ratebase for ratemaking purposes.

Impact

Prior to the Tax Reform Act of 1986, the special treatment described above applied to contributions in aid of construction received by regulated utilities that provide steam, electric energy, gas, water, or sewage disposal services. This treatment effectively exempted the services provided by facilities financed by contributions in aid of construction from taxation. The treatment was repealed by the Tax Reform Act.

Repeal of the special treatment resulted in increases in the amounts utilities charge their customers as contributions in aid of construction. Prior to the Tax Reform Act, a utility would charge its customers an amount equal to the cost of installing a facility. After the Tax Reform Act, utilities had to charge an amount equal to the cost of the facility plus an amount to cover the tax on the contribution in aid of construction. This parallels the pricing of most other business services, for which companies must charge customers the actual cost of providing the service plus an amount to cover the tax on the income.

The higher cost associated with contributions in aid of construction as a result of the change in the Tax Reform Act led to complaints from utility customers and proposals to reverse the change. The special treatment of contributions in aid of construction was reinstated -- but only for water and sewage utilities -- in the Small Business Job Protection Act of 1996. As a result of this reinstatement, water and sewage utility charges for contributions in aid of construction are lower than they would be if the contributions were still taxable. The charge now covers only the cost of the financed facility; there is no markup to cover taxes on the charge.

To the extent that the lower charges to builders and developers for contributions in aid of construction are passed on to ultimate consumers through lower prices, the benefit from this special tax treatment accrues to consumers. If some of the subsidy is retained by the builders and developers because competitive forces do not require it to be passed forward in lower prices, then the special tax treatment also benefits the owners of these firms.

Rationale

The stated reason for reinstating the special treatment of contributions in aid of construction for water and sewage utilities was concern that the changes made by the Tax Reform Act of 1986 may have inhibited the

development of certain communities and the modernization of water and sewage facilities.

Assessment

The contribution in aid of construction tax treatment allows the utility to write off or expense the cost of the financed capital facility in the year it is put in place rather than depreciating it over its useful life. This treatment, in effect, exempts the services provided by the facility from taxation and thereby provides a special subsidy. Absent a public policy justification, such subsidies distort prices and undermine economic efficiency.

In repealing the special tax treatment of contributions in aid of construction in the Tax Reform Act of 1986, the Congress determined that there was no public policy justification for continuing the subsidy. In reinstating the special tax treatment for water and sewage utilities in the Small Business Job Protection Act of 1996, the Congress determined that there was a public policy justification for providing the subsidy to these particular utilities.

Selected Bibliography

Committee on Finance, *Small Business Job Protection Act of 1996*, Report 104-281, U.S. Senate, 104th Congress, 2d Session, June 18, 1996, p. 136-37.

Conference Report, *Small Business Job Protection Act of 1996*, Report 104-737, U.S. House of Representatives, 104th Congress, 2d Session, August 1, 1996, p. 158-60.

Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, Joint Committee Print, JCS-10-87, May 4, 1987, p. 544-47.

Agriculture

EXCLUSION OF COST-SHARING PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 126.

Description

There are a number of programs under which both the Federal and State Governments make payments to taxpayers which represent a share of the cost of certain improvements made to the land. These programs generally relate to improvements which further conservation, protect the environment, improve forests, or provide habitats for wildlife. Under Section 126, the grants received under certain of these programs are excluded from the recipient's gross income.

To qualify for the exclusion, the payment must be made primarily for the purpose of conserving soil and water resources or protecting the environment, and the payment must not produce a substantial increase in the annual income from the property with respect to which the payment was made.

Impact

The exclusion of these grants and payments from tax provides a general incentive for various conservation and land improvement projects that might not otherwise be undertaken.

Rationale

The income tax exclusion for certain cost-sharing payments was part of the tax changes made under the Revenue Act of 1978. The rationale for this change was that in the absence of an exclusion many of these conservation projects would not be undertaken. In addition, since the grants are spent by the taxpayer on conservation projects, the taxpayer would not necessarily have the additional funds needed to pay the tax on the grants if they were not excluded from taxable income.

Assessment

The partial exclusion of certain cost-sharing payments is based on the premise that the improvements financed by these grants benefit both the general public and the individual landowner. The portion of the value of the improvement financed by grant payments attributable to public benefit should be excluded from the recipient's gross income while that portion of the value primarily benefitting the landowner (private benefit) is properly taxable to the recipient of the payment.

The problem with this tax treatment is that there is no way to identify the true value of the public benefit. In those cases where the exclusion of cost-sharing payment is insufficient to cover the value of the public benefit, the project probably would not be undertaken.

On the other hand, on those projects that are undertaken the exclusion of the cost-sharing payment probably exceeds the value of the public benefit and hence, provides a subsidy primarily benefitting the landowner.

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Taylor, Jack. *Farm Tax Issues in the 105th Congress*. Congressional Research Service Report 97-929 E. Washington, DC: October 1998.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978*.

--, Senate Committee on Finance. *Technical Corrections Act of 1979*, 96th Congress, 1st session. December 13, 1979, pp. 79-81.

EXCLUSION OF CANCELLATION OF INDEBTEDNESS INCOME OF FARMERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1		0.1
2000	0.1	-	0.1
2001	0.1	-	0.1
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Sections 108 and 1017.

Description

This provision allows farmers who are solvent to treat the income arising from the cancellation of certain indebtedness as if they were insolvent taxpayers. Under this provision, income that would normally be subject to tax, the cancellation of a debt, would be excluded from tax if the discharged debt was "qualified farm debt" discharged or canceled by a "qualified person."

To qualify, farm debt must meet two tests: it must be incurred directly from the operation of a farming business, and at least 50 percent of the taxpayer's previous three years of gross receipts must come from farming.

To qualify, those canceling the qualified farm debt must participate regularly in the business of lending money, cannot be related to the taxpayer who is excluding the debt, cannot be a person from whom the taxpayer acquired property securing the debt, or cannot be a person who received any

fees or commissions associated with acquiring the property securing the debt. Qualified persons include federal, state, and local governments.

The amount of canceled debt that can be excluded from tax cannot exceed the sum of adjusted tax attributes and adjusted basis of qualified property. Any canceled debt that exceeds this amount must be included in gross income. Tax attributes include net operating losses, general business credit carryovers, capital losses, minimum tax credits, passive activity loss and credit carryovers, and foreign tax credit carryovers. Qualified property includes business (depreciable) property and investment (including farmland) property.

Taxpayers can elect to reduce the basis of their property before reducing any other tax benefits.

Impact

This exclusion allows solvent farmers to defer the tax on the income resulting from the cancellation of a debt. This tax benefit is not available to other taxpayers unless they are insolvent.

Rationale

The exclusion for the cancellation of qualified farm indebtedness was enacted as part of the Tax Reform Act of 1986. At the time, the intended purpose of the provision was to avoid tax problems that might arise from other legislative initiatives designed to alleviate the credit crisis in the farm sector.

For instance, Congress was concerned that pending legislation providing Federal guarantees for lenders participating in farm-loan write-downs would cause some farmers to recognize large amounts of income when farm loans were canceled. As a result, these farmers might be forced to sell their farmland to pay the taxes on the canceled debt. This tax provision was adopted to mitigate that problem.

Assessment

The exclusion of cancellation of qualified farm income indebtedness does not constitute a forgiveness of tax but rather a deferral of tax. By electing to offset the canceled debt through reductions in the basis of property, a taxpayer can postpone the tax that would have been owed on the canceled debt until the basis reductions are recaptured when the property is sold or through reduced depreciation in the future. Since money has a time value (a dollar today is more valuable than a dollar in the future), however, the

deferral of tax provides a benefit in that it effectively lowers the tax rate on the income realized from the discharge of indebtedness.

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Taylor, Jack. *Farm Tax Issues in the 105th Congress*. Congressional Research Service Report 97-929 E. Washington, DC: October 1998.

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CASH ACCOUNTING FOR AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.5	([1])	0.5
2000	0.7	([1])	0.7
2001	0.8	([1])	0.8
2002	0.8	([1])	0.8
2003	0.8	([1])	0.8

([1])Less than $50 million.

Authorization

Sections 162, 175, 180, 447, 461, 464, and 465.

Description

Most farm businesses (with the exception of certain farm corporations and partnerships or any tax shelter operation) may use the cash method of tax accounting to deduct costs attributable to goods held for sale and in inventory at the end of the tax year. These businesses are also allowed to expense some costs of developing assets that will produce income in future years. Both of these rules thus allow deductions to be claimed before the income associated with the deductions is realized.

Costs that may be deducted before income attributable to them is realized include livestock feed and the expenses of planting crops for succeeding year's harvest. Costs that otherwise would be considered capital expenditures but that may be deducted immediately by farmers include certain soil and water conservation expenses, costs associated with raising dairy and breeding cattle, and fertilizer and soil conditioner costs.

Impact

For income tax purposes, the cash method of accounting is less burdensome than the accrual method of accounting and also provides benefits in that it allows taxes to be deferred into the future. Farmers who use the cash method of accounting and the special expensing provisions receive tax benefits not available to taxpayers required to use the accrual method of accounting.

Rationale

The Revenue Act of 1916 established that a taxpayer may compute income for tax purposes using the same accounting methods used to compute income for business purposes. At the time, because accounting methods were less sophisticated and the typical farming operation was small, the regulations were apparently adopted to simplify record keeping for farmers.

Specific regulations relating to soil and water conservation expenditures were adopted in the Internal Revenue Code of 1954. Provisions governing the treatment of fertilizer costs were added in 1960.

The Tax Reform Act of 1976 required that certain farm corporations and some tax shelter operations use the accrual method of accounting rather than cash accounting. The Tax Reform Act of 1986 further limited the use of cash accounting by farm corporations and tax shelters and repealed the expensing rules for certain land clearing operations. The Act also limited the use of cash accounting for assets that had preproductive periods longer than two years. These restrictions, however, were later repealed by the Technical and Miscellaneous Revenue Act of 1988.

Assessment

The effect of deducting costs before the associated income is realized understates income in the year of deduction and overstates income in the year of realization. The net result is that tax liability is deferred which results in an underassessment of tax. In addition, in certain instances when the income is finally taxed, it may be taxed at preferential capital gains rates.

Selected Bibliography

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Agriculture

INCOME AVERAGING FOR FARMERS

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 1301.

Description

For taxable years beginning after December 31, 1997, taxpayers have the option to calculate their current year income tax by averaging over the prior 3-year period, all or a portion of their income from farming. The taxpayer can designate all or a part of his current year income from farming as "elected farm income". The taxpayer then allocates 1/3 of the "elected farm income" to each of the prior 3 taxable years.

The current year income tax for a taxpayer making this election is calculated by taking the sum of his current year tax calculated without including the "elected farm income" and the extra tax in each of the three previous years that results from including 1/3 of the current year's "elected farm income."

"Elected farm income" can include the gain on the sale of farm assets with the exception of the gain on the sale of land.

Impact

This provision provides tax relief primarily to taxpayers whose main source of income derives from agricultural production. It allows these taxpayers to exert some control over their taxable incomes and hence, their tax liabilities in those years that they experience fluctuations in their incomes.

Rationale

Income averaging for farmers was enacted as part of the Taxpayer Relief Act of 1997. Congress believes that the income from farming can fluctuate dramatically from year to year and that these fluctuations are outside the control of the taxpayers. To address this problem, Congress felt that taxpayers who derive their income from agriculture should be allowed an election to average farm income and mitigate the adverse tax consequences of fluctuating incomes under a progressive tax structure.

Assessment

Under an income tax system with progressive tax rates and an annual assessment of tax, the total tax assessment on an income that fluctuates from year to year will be greater than the tax levied on an equal amount of income that is received in equal annual installments. Under pre-1986 income tax law, income averaging provisions were designed to help avoid the over assessment of tax that might occur under a progressive tax when a taxpayer's income fluctuated from year to year. These pre-1986 tax provisions were especially popular with farmers who, due to market or weather conditions, might experience significant fluctuations in their annual incomes.

The Tax Reform Act of 1986 repealed income averaging. At the time, it was argued that the reduction in the number of tax brackets and the level of marginal tax rates reduced the need for income averaging. Farmers argued that even though the tax brackets had been widened and tax rates reduced, the fluctuations in their incomes could be so dramatic that without averaging they would be subject to an inappropriately high level of income taxation.

As marginal income tax rates were increased in 1990 and 1993, Congress became more receptive to the arguments for income averaging and reinstated limited averaging in the Taxpayer Relief Act of 1997. Under this Act, income averaging for farmers was a temporary provision and was to expire after January 1, 2001. The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 made income averaging for farmers permanent.

It appears, however, that the current income averaging provisions fall short of the economic ideal on several fronts. For instance, from an economic perspective the source of income fluctuations should not matter when deciding whether or not income averaging is needed. Hence, limiting averaging to farm income may appear unfair to other taxpayers such as artists and writers who also may have significant fluctuations in their annual incomes.

A more significant theoretical problem is that these provisions only allow for upward income averaging. Under a theoretically correct income tax, income averaging would be available for downward fluctuations in income as well as upward fluctuations. Downward income averaging would mean that taxpayers who experienced major reductions in their annual incomes would also qualify for income averaging. This would allow them to mitigate sharp reductions in their current year incomes by reducing their current year taxes to reflect taxes that had already been prepaid in previous years when their incomes were higher.

Selected Bibliography

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FIVE-YEAR CARRYBACK FOR FARM NET OPERATING LOSSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	([1])	0.1
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

Authorization

Section 172.

Description

A net operating loss, the amount by which business and certain other expenses exceed income for the year, may be carried forward and deducted from other income for 20 years following the loss year. It may, at the taxpayer's election, instead be carried back to earlier years in which there was positive income. For most taxpayers, the carryback period is limited to the previous 2 years, although small businesses in federally declared disaster areas may carry losses back 3 years. However, losses attributed to a farming business (as defined in section 263A(e)(4))may be carried back 5 years.

Impact

For businesses that have paid taxes within the allowed carryback period, making use of the carryback rather than the carryforward option for operating losses means receiving an immediate refund rather than waiting for a future tax reduction. Although the special 5-year carryback applies only to losses incurred in a farming business, the losses may be used to

offset taxes paid on any type of income. Thus the beneficiaries of this provision are farmers who have either been profitable in the past or who have had non-farm income on which they paid taxes.

Rationale

Some provision for deducting net operation losses from income in other years has been an integral part of the income tax system from its inception. The current general rules (20-year carryforwards and 2-year carrybacks) date from the "Taxpayer Relief Act of 1997," P.L. 105-34, which shortened the carryback period from 3 to 2 years (except for farmers and small businessmen in federally declared disaster areas, which remained at 3 years).

The 5-year carryback for farm losses was enacted as a part of the "Omnibus Consolidated and Emergency Supplemental Appropriations Act," P.L. 105-277. The committee reports state that a special provision for farmers was considered appropriate because of the exceptional volatility of farm income.

Assessment

In an ideal income tax system, the government would refund taxes in loss years with the same alacrity that it collects them in profit years, and a carryback of losses would not be considered a deviation from the normal tax structure. Since the current system is less than ideal in many ways, however, it is difficult to say whether the loss carryover rules bring it closer to or move it further away from the ideal.

The special rule for farmers is intended to compensate for the excessive fluctuations in income farmers are said to experience. This justification is offered for many of the tax benefits farmers are allowed, but it is not actually based on evidence that farmers experience annual income fluctuations greater than other small businessmen. The farm losses may offset taxes on non-farm income, so some of the benefit will accrue to persons whose income is not primarily from farming.

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U.S. House, Committee on Ways and Means. *Taxpayer Relief Act of 1998*. 105th Congress, 2nd session, September 23, 1998, pp. 57-59.

EXEMPTION OF CREDIT UNION INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	0.9	0.9
2000	-	0.9	0.9
2001	-	1.0	1.0
2002	-	1.0	1.0
2003	-	1.1	1.1

Authorization

Section 501(c)(14) of the Internal Revenue Code of 1986 and section 122 of the Federal Credit Union Act, as amended (12 U.S.C. sec. 1768).

Description

Credit unions without capital stock and organized and operated for mutual purposes and without profit are not subject to Federal income tax.

Impact

Credit unions are the only depository institutions which are exempt from Federal income taxes. If this exemption is repealed, both Federally chartered and State chartered credit unions would become liable for payment of Federal corporate income taxes on their retained earnings but not on earnings distributed to depositors.

For a given addition to retained earnings, this tax exemption permits credit unions to pay members higher dividends and charge members lower interest rates on loans. Over the past twenty years, this tax exemption may

have contributed to the more rapid growth of credit unions compared to other depository institutions.

Opponents of credit union taxation emphasize that credit unions provide many services free or below cost in order to assist low-income members. These services include small loans, financial counseling, and low-balance share drafts. They argue that the taxation of credit unions would create pressure to eliminate these subsidized services. But whether or not consumer access to basic depository services is a significant problem is disputed.

Rationale

Credit unions have never been subject to the Federal income tax. Initially, they were included in the provision that exempted domestic building and loan associations--whose business was at one time confined to lending to members--and nonprofit cooperative banks operated for mutual purposes. The exemption for mutual banks and savings and loan institutions was removed in 1951, but credit unions retained their exemption. No specific reason was given for continuing the exemption of credit unions.

In 1978, the Carter Administration proposed that the taxation of credit unions be phased in over a five-year period. In 1984, a report of the Department of the Treasury to the President proposed that the tax exemption of credit unions be repealed. In 1985, the Reagan Administration proposed the taxation of credit unions with over $5 million in gross assets. In the budget for fiscal year 1993, the Bush Administration proposed that the tax exemption for credit unions with assets in excess of $50 million be repealed.

Assessment

Supporters of the credit union exemption emphasize the uniqueness of credit unions compared to other depository institutions. Credit unions are nonprofit financial cooperatives organized by people with a common bond which is a unifying characteristic among members that distinguishes them from the general public.

Credit unions are directed by volunteers for the purpose of serving their members. Consequently, the exemption's supporters maintain that credit unions are member-driven while other depository institutions are profit-driven. Furthermore, supporters argue that credit unions are subject to certain regulatory constraints not required of other depository institutions and that these constraints reduce the competitiveness of credit unions. For example, credit unions may lend only to members.

Proponents of taxation argue that deregulation has caused extensive competition among all depository institutions, including credit unions and that the tax exemption gives credit unions an unwarranted advantage. Proponents of taxation argue that depository institutions should have a level playing field in order for market forces to allocate resources efficiently.

Selected Bibliography

Bickley, James M. *Should Credit Unions be Taxed?* Library of Congress, Congressional Research Service Report No. 97-548 E. Washington, DC: May 15, 1997.

U.S. Congress, Congressional Budget Office. *Reducing the Deficit: Spending and Revenue Options*. Washington, DC: U.S. Government Printing Office, March 1997, p. 384.

U.S. General Accounting Office. *Credit Unions: Reforms for Ensuring Future Soundness*. Washington, DC: July 1991, pp. 299-309.

EXCLUSION OF INVESTMENT INCOME ON LIFE INSURANCE AND ANNUITY CONTRACTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.3	22.6	23.9
2000	1.3	23.3	24.6
2001	1.4	24.0	25.4
2002	1.4	24.8	26.2
2003	1.5	25.6	27.1

Authorization

Section 72, 101, 7702, 7702A.

Description

The premiums life insurance companies collect are invested and the investment return used to help pay benefits. Amounts not paid as benefits may be paid as policy dividends or made available to the policyholders as cash surrender values or loan values.

This investment income (also called "inside build-up") is generally not taxed to the policyholders as it accumulates (and it is not usually taxed at the company level, either). For most policies, amounts paid as death benefits are not taxed at all, and amounts paid as dividends or withdrawn as cash values are taxed only when they exceed total premiums paid for the policy, allowing the cost of the insurance protection to be paid for in part by the tax-free investment income.

Annuity policies are also free from tax on the accumulating investment income, but annuities are taxed on their investment component when paid.

Life insurance policies must meet tests designed to limit the tax-free accumulation of income. If they accumulate investment income very much faster than is needed to fund the promised benefits, the income will be attributed to the owner of the policy and taxed currently. If the owner of any life insurance policy is a corporation, the investment income is included in alternative minimum taxable income.

Impact

The effect of the interest exclusion on life insurance savings allows personal insurance to be partly purchased with tax-free interest income. Although the interest earned is not currently paid to the policyholder, it is used to cover at least part of the cost of the insurance coverage, and it may be received in cash if the policy is terminated. In spite of recent limitations on the amount of income that can accumulate tax-free in a contract, the tax-free interest income benefit can be substantial.

The tax deferral for interest credited to annuity contracts allows taxpayers to save for retirement in a tax-deferred environment without restriction on the amount that can be invested for these purposes. Although the amounts invested in an annuity are not deductible by the taxpayer, as are contributions to qualified pension plans or some IRAs, the tax deferral on the income credited to such investments represents significant tax benefits for the taxpayer.

These provisions thus offer preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies and annuity contracts. Because middle-income taxpayers are the major purchasers of this insurance, they are the primary beneficiaries of the provision. Higher-income taxpayers who are not seeking insurance protection can generally obtain better after-tax yields from tax-exempt State and local obligations or tax-deferred capital gains.

Rationale

The exclusion of death benefits paid on life insurance dates back to the 1913 tax law. While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests, which also were excluded from the tax base.

The nontaxable status of the life insurance inside build-up and the tax deferral on annuity investment income also dates from 1913. Floor discussions of the bill made it clear that inside build-up was not taxable, and that amounts received during the life of the insured would be taxed only

when they exceeded the investment in the contract (premiums paid), although these provisions were not explicitly included in the law.

These rules were to some extent based on the general tax principle of constructive receipt. The interest income was not viewed as actually belonging to the policyholders because they would have to give up the insurance protection or the annuity guarantees to obtain the interest.

The inside build-up in several kinds of insurance products was made taxable to the policy owners in recent years. (Corporate-owned policies were included under the minimum tax in the Tax Reform Act of 1986. Policies with too large an investment component were made taxable on inside build-up or on distributions in the Deficit Reduction Act of 1984, and the Technical and Miscellaneous Revenue Act of 1988.) This suggests that the Congress no longer finds completely persuasive the exclusion rationale based on the constructive receipt doctrine.

Assessment

The tax treatment of policy income combined with the tax treatment of life insurance company reserves (see "Special Treatment of Life Insurance Company Reserves," below) makes investments in life insurance policies virtually tax-free. This distorts investors' decisions by encouraging them to choose life insurance over competing savings vehicles such as bank accounts, mutual funds, or bonds. The result could be too much invested in life insurance and excessive use of life insurance protection.

There is some evidence, however, that people underestimate the financial loss their deaths could cause and so tend to be underinsured. If this is the case, some encouragement of the purchase of life insurance might be warranted. There is no evidence of the degree of encouragement required or of the efficacy of providing that encouragement through tax exemption.

The practical difficulties of taxing inside build-up to the policy owners and the desire not to add to the distress of heirs by taxing death benefits have discouraged many tax reform proposals covering life insurance. Taxing at the company level as a proxy for individual income taxation has been a suggested alternative.

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SMALL LIFE INSURANCE COMPANY TAXABLE INCOME ADJUSTMENT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	--	0.1	0.1
2000	--	0.1	0.1
2001	--	0.1	0.1
2002	--	0.1	0.1
2003	--	0.1	0.1

Authorization

Section 806.

Description

Small life insurance companies are allowed a special deduction not available to other taxpayers. The amount of the deduction is 60 percent of so much of otherwise taxable income from insurance operations for a taxable year that does not exceed $3 million, reduced by 15 percent of the excess of otherwise taxable income over $3 million.

Thus, the deduction phases out as a company's taxable insurance income computed without this deduction increases from $3 million to $15 million. A company with otherwise taxable insurance income over $15 million is not entitled to a small life insurance company deduction.

The small life insurance company deduction is allowed only to companies with gross assets of less than $500 million. Generally, consolidated group tests are used in applying the taxable income and gross asset standards.

Impact

The small life insurance company deduction reduces the tax rate for "small" life insurance companies. (The industry is characterized by very large companies, so assets of up to $500 million and taxable incomes of up to $15 million can still be considered relatively small.) A company eligible for the maximum small company deduction of $1.8 million is, in effect, taxed at a rate of 13.6 percent instead of the regular 34 percent corporate rate.

These companies may be either investor-owned stock companies or policyholder-owned mutual companies, so it is difficult to determine the distribution of benefits. It is possible that competitive pressures would cause the benefits to be passed on to life insurance policyholders in general.

Rationale

This provision was added in the massive revision of life insurance company taxation included in the Deficit Reduction Act of 1984 (P.L. 98-369). The justification given is that, although "the Congress believed that, without this provision, the Act provided for the proper reflection of taxable income," the Congress was also concerned about a sudden sharp increase in the companies' taxes. A companion provision, reducing taxes an arbitrary amount for all life insurance companies, was repealed in the Tax Reform Act of 1986, but the deduction for small companies was retained.

Assessment

Reducing taxes on business income based on the size of the business does not serve the equity purpose of basing taxes on the ability to pay them, since it is the *owners* of the business (or the customers, employees, or other individuals) who bear the burden of the business's taxes (and their ability to pay is not determined by the size of the business).

It distorts the efficient allocation of resources, since it offers a cost advantage based on size and not economic performance. Nor does this tax reduction serve any simplification purpose, since it requires an additional set of computations and some complex rules to keep it from being abused. It may serve to help newer companies to become established and build up the reserves State law requires of insurance companies.

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SPECIAL TREATMENT OF LIFE INSURANCE COMPANY RESERVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	--	1.3	1.3
2000	--	1.4	1.4
2001	--	1.4	1.4
2002	--	1.5	1.5
2003	--	1.5	1.5

Authorization

Section 803(a)(2), 805(a)(2), 807.

Description

Most businesses calculate taxable income by deducting expenses when the business becomes liable for paying them. Life insurance companies, however, are allowed to deduct additions to reserves for future liabilities under insurance policies, offsetting current income with future expenses.

Impact

Reserves are accounts recorded in the liabilities section of balance sheets to indicate a claim against assets for future expenses. When additions to the reserve accounts are allowed as deductions in computing taxable income, it allows an amount of tax-free (or tax-deferred) income to be used to purchase assets. Amounts are added to reserves from both premium income and the investment income earned by the invested assets, so reserve accounting shelters both premium and investment income from tax.

A large part of the reserves of life insurance companies is credited to individual policyholders, to whom the investment income is not taxed either (see "Exclusion of Investment Income on Life Insurance and Annuity Contracts," above).

The nature of the life insurance industry suggests that a reduction in its corporate taxes would go primarily to policyholders. Thus the beneficiaries of this tax expenditure are probably not the owners of capital in general (see Introduction) but rather those who invest in life insurance products in particular.

Rationale

The first modern corporate income tax enacted in 1909 provided that insurance companies could deduct additions to reserves required by law, and some form of reserve deduction has been allowed ever since.

Originally, the accounting rules of most regulated industries were adopted for tax purposes, and reserve accounting was required by all State insurance regulations. The many different methods of taxing insurance companies tried since 1909 all allowed some form of reserve accounting.

Before the Deficit Reduction Act of 1984, which set the current rules for taxing life insurance companies, reserves were those required by State law and generally computed by State regulatory rules. The Congress, concluding that the conservative regulatory rules allowed a significant overstatement of deductions, set rules for tax reserves that specified what types of reserves would be allowed and what discount rates would be used.

Assessment

Reserve accounting allows the deduction from current income of expenses relating to the future. This is the standard method of accounting for insurance regulatory purposes, where the primary goal is to assure that a company will be able to pay its promised benefits and the understatement of current income is regarded as simply being conservative.

Under the income tax, however, the understatement of current income gives a tax advantage. Combined with virtual tax exemption of life insurance product income at the individual level, this tax advantage makes life insurance a far more attractive investment vehicle than it would otherwise be and leads to the overpurchase of insurance and overinvestment in insurance products.

One often-proposed solution would retain reserve accounting but limit the deduction to amounts actually credited to the accounts of specific

policyholders, who would then be taxable on the additions to their accounts. This would assure that all premium and investment income not used to pay current expenses was taxed at either the company or individual level, more in line with the tax treatment of banks, mutual funds, and other competitors of the life insurance industry.

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DEDUCTION OF UNPAID LOSS RESERVES FOR PROPERTY AND CASUALTY INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	--	3.3	3.3
2000	--	3.4	3.4
2001	--	3.4	3.4
2002	--	3.5	3.5
2003	--	3.5	3.5

Authorization

Section 832(b)(5), 846.

Description

Most businesses calculate taxable income by deducting expenses when the business becomes liable for paying them. Property and casualty insurance companies, however, are allowed to deduct the discounted value of estimated losses they will be required to pay in the future under insurance policies currently in force, including claims in dispute. This allows them to deduct future expenses from current income and thereby defer tax liability.

Impact

The allowance of a deduction for unpaid losses of a property or casualty insurer differs from the treatment of other taxpayers in two important respects. First, insurers may estimate not only the amount of liabilities they have incurred but also the existence of the liability itself. Second, the company may deduct an unpaid loss even though it is contesting

the liability. An ordinary accrual-method taxpayer generally may not deduct the amount of a contested liability.

The net effect of these differences is to permit insurers to accelerate the deduction of losses claimed relative to the timing of those deductions under the generally applicable rules.

Competition in the property and casualty insurance industry would cause most of this reduction in corporate taxes to go to the benefit of the purchasers of insurance, including other businesses, homeowners, and private property owners.

Rationale

The first modern corporate income tax enacted in 1909 provided that insurance companies could deduct additions to reserves required by law, and some form of loss-reserve deduction has been allowed ever since. Originally, the accounting rules of most regulated industries were adopted for tax purposes, and reserve accounting was required by all State insurance regulations.

Before the Tax Reform Act of 1986, property and casualty insurance company reserves for unpaid losses were simply the undiscounted amount expected to be paid eventually, as generally required or allowed by State law. The Congress, concluding that the conservative regulatory rules allowed an overstatement of loss reserve deductions, required that loss reserves be discounted for tax purposes.

Assessment

Reserve accounting allows the deduction from current income of expenses relating to the future. This is the standard method of accounting for insurance regulatory purposes, where the primary goal is assuring that a company will be able to pay its policyholders and the possible understatement of current income is not regarded as a problem.

But the understatement of current income gives an income tax advantage, which is the basis for calling this item a tax expenditure.

An argument can be made, however, that deducting additions to a properly discounted reserve for losses that have already occurred and that can be estimated with reasonable certainty does not distort economic income. Since the insurance industry is based on being able to estimate its future payments from current policies, measuring current income could appropriately take into account the known future payments. From this perspective, only those additions to reserves that exceed expected losses (as

perhaps those for contested liabilities) would properly be considered a tax expenditure.

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SPECIAL DEDUCTION FOR BLUE CROSS AND BLUE SHIELD COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	--	0.4	0.4
2000	--	0.4	0.4
2001	--	0.4	0.4
2002	--	0.4	0.4
2003	--	0.3	0.3

Authorization

Section 833.

Description

Blue Cross and Blue Shield and similar minor health insurance providers in existence on August 16, 1986, and other nonprofit health insurers that meet strict community-service standards, are subject to tax as property and casualty insurance companies, but are allowed a special deduction (for regular tax purposes only) of up to 25 percent of the excess of the year's health-related claims and expenses over their accumulated surplus at the beginning of the year. The deduction is limited to net taxable income for the year and is not allowed in computing the alternative minimum tax. These organizations are also allowed a full deduction for unearned premiums, unlike other property and casualty insurance companies.

Impact

The special deduction exempts from the regular corporate tax of up to 35 percent enough taxable income each year to maintain reserves equal to

25 percent of the year's health-related payouts (three month's worth). Since the deduction is not allowed for the alternative minimum tax, however, the income is subject to tax at the minimum tax rate of 20 percent. The Blue Cross/Blue Shield organizations are not investor owned, so the reduced taxes benefit either their subscribers or all health insurance purchasers (in reduced premiums), their managers and employees (in increased wages and/or discretionary funds), or affiliated hospitals and physicians (in increased fees).

Rationale

The Blue Cross/Blue Shield plans were first subjected to tax in the Tax Reform Act of 1986, which also provided for the special deduction described above. The "Blues" had been ruled tax-exempt by Internal Revenue regulations since their inception in the 1920s, apparently because they were regarded as community service organizations. The special tax deduction was given them in 1986 partly in recognition of their continuing (but much more limited) role in providing community-rated health insurance.

Assessment

Most of the health insurance written by Blue Cross and Blue Shield plans is in the form of group policies indistinguishable in price and coverage from those offered by commercial insurers. Some of the plans have accumulated enough surplus to purchase unrelated businesses, many receive a substantial part of their income from administering Medicare or self-insurance plans of other companies, and some have argued that their tax preferences have benefitted their managers and their affiliated hospitals and physicians more than their communities.

They do, however, retain in their charters a commitment to offer individual policies not available elsewhere. Some continue to offer policies with premiums based on community payout experience ("community rated"). Their former tax exemption and their current reduced tax rates presumably serve to subsidize these community activities.

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DEDUCTION FOR MORTGAGE INTEREST ON OWNER-OCCUPIED RESIDENCES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	48.5	-	48.5
2000	50.4	-	50.4
2001	52.4	-	52.4
2002	54.5	-	54.5
2003	56.8	-	56.8

Authorization

Section 163(h).

Description

A taxpayer may take an itemized deduction for "qualified residence interest," which includes interest paid on a mortgage secured by a principal residence and a second residence. The underlying mortgage loans can represent acquisition indebtedness of up to $1 million, plus home equity indebtedness of up to $100,000.

Impact

The deduction is considered a tax expenditure because homeowners are allowed to deduct their mortgage interest even though the implicit rental income from the home (comparable to the income they could earn if the home were rented to someone else) is not subject to tax.

Renters and the owners of rental property do not receive a comparable benefit. Renters may not deduct any portion of their rent under the Federal

income tax. Landlords may deduct mortgage interest paid for rental property, but they are subject to tax on the rental income.

For taxpayers who can itemize, the home mortgage interest deduction encourages home ownership by reducing the cost of owning compared with renting. It also encourages them to spend more on housing (measured before the income tax offset), and to borrow more than they would in the absence of the deduction.

The mortgage interest deduction primarily benefits middle- and upper-income households. Higher-income taxpayers are more likely to itemize deductions. As with any deduction, a dollar of mortgage interest deduction is worth more the higher the taxpayer's marginal tax rate.

Higher-income households also tend to have larger mortgage interest deductions because they can afford to spend more on housing and can qualify to borrow more. The home equity loan provision favors taxpayers who have been able to pay down their acquisition indebtedness and whose homes have appreciated in value.

Distribution by Income Class of the Tax Expenditure for Mortgage Interest, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.3
$20 to $30	1.0
$30 to $40	2.6
$40 to $50	4.8
$50 to $75	16.3
$75 to $100	21.3
$100 to $200	33.5
$200 and over	20.1

Rationale

The income tax code instituted in 1913 contained a deduction for all interest paid, with no distinction between interest payments made for business, personal, living, or family expenses. There is no evidence in the legislative history that the interest deduction was intended to encourage home ownership or to stimulate the housing industry at that time. In 1913 most interest payments represented business expenses. Home mortgages and other consumer borrowing were much less prevalent than in later years.

Prior to the Tax Reform Act of 1986 (TRA86), there were no restrictions on either the dollar amount of mortgage interest deduction or the number of homes on which the deduction could be claimed. The limits placed on the mortgage interest deduction in 1986 and 1987 were part of the effort to limit the deduction for personal interest.

Under the provisions of TRA86, for home mortgage loans settled on or after August 16, 1986, mortgage interest could be deducted only on a loan amount up to the purchase price of the home, plus any improvements, and on debt secured by the home but used for qualified medical and educational expense. This was an effort to restrict tax-deductible borrowing of home equity in excess of the original purchase price of the home. The interest deduction was also restricted to mortgage debt on a first and second home.

The Omnibus Budget Reconciliation Act of 1987 placed new dollar limits on the mortgage debt incurred after October 13, 1987, upon which interest payments could be deducted. An upper limit of $1 million ($500,000 for married filing separately) was placed on the combined "acquisition indebtedness" for a principal or second residence. Acquisition indebtedness includes any debt incurred to buy, build, or substantially improve the residence(s). The ceiling on acquisition indebtedness for any residence is reduced down to zero as the mortgage balance is paid down, and can only be increased if the amount borrowed is used for improvements.

The TRA86 exception for qualified medical and educational expenses was replaced by the explicit provision for home equity indebtedness: in addition to interest on acquisition indebtedness, interest can be deducted on loan amounts up to $100,000 ($50,000 for married filing separately) for other debt secured by a principal or second residence, such as a home equity loan, line of credit, or second mortgage. The sum of the acquisition indebtedness and home equity debt cannot exceed the fair market value of the home(s). There is no restriction on the purposes for which home equity indebtedness can be used.

Mortgage interest is one of several deductions subject to the phaseout on itemized deductions for taxpayers whose AGI exceeds the applicable threshold amount--$124,500 in 1998, indexed for inflation. (This phaseout was instituted for tax years 1991 through 1995 by the Omnibus Budget Reconciliation Act of 1990 and made permanent by the Omnibus Budget Reconciliation Act of 1993.)

Assessment

Major justifications for the mortgage interest deduction have been the desire to encourage homeownership and to stimulate residential construction. Homeownership is alleged to encourage neighborhood

stability, promote civic responsibility, and improve the maintenance of residential buildings. Homeownership is also viewed as a mechanism to encourage families to save and invest in what for many will be their major financial asset.

A major criticism of the mortgage interest deduction has been its distribution of tax benefits in favor of higher-income taxpayers. It is unlikely that a housing subsidy program that gave far larger amounts to high income compared with low income households would be enacted if it were proposed as a direct expenditure program.

The preferential tax treatment of owner-occupied housing relative to other assets is also criticized for encouraging households to invest more in housing and less in other investments that might contribute more to increasing the Nation's productivity and output.

Efforts to limit the deduction of some forms of interest more than others must deal with taxpayers' ability to substitute one form of borrowing for another. For those who can make use of it, the home equity interest deduction can substitute for the deductions phased out by TRA86 for consumer interest and investment interest in excess of investment income. This alternative is not available to renters or to homeowners with little equity buildup.

Analysts have pointed out that the rate of homeownership in the United States is not significantly higher than in countries such as Canada that do not provide a mortgage interest deduction under their income tax. The value of the U.S. deduction may be at least partly capitalized into higher prices at the middle and upper end of the housing market.

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DEDUCTION FOR PROPERTY TAXES ON OWNER-OCCUPIED RESIDENCES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	17.8	-	17.8
2000	18.4	-	18.4
2001	19.1	-	19.1
2002	19.7	-	19.7
2003	20.3	-	20.3

Authorization

Section 164.

Description

Taxpayers may claim an itemized deduction for property taxes paid on owner-occupied residences.

Impact

The deductibility of property taxes on owner-occupied residences provides a subsidy both to home ownership and to the financing of State and local governments. Like the deduction for home mortgage interest, the Federal deduction for real property (real estate) taxes reduces the cost of home ownership relative to renting.

Renters may not deduct any portion of their rent under the Federal income tax. Landlords may deduct the property tax they pay on a rental property but are taxed on the rental income.

Homeowners may deduct the property taxes but are not subject to income tax on the imputed rental value of the dwelling. For itemizing homeowners, the deduction lowers the net price of State and local public services financed by the property tax and raises their after-Federal-tax income.

Like all personal deductions, the property tax deduction provides uneven tax savings per dollar of deduction. The tax savings are higher for those with higher marginal tax rates, and those homeowners who do not itemize deductions receive no direct tax savings.

Higher-income groups are more likely to itemize property taxes and to receive larger average benefits per itemizing return. Consequently, the tax expenditure benefits of the property tax deduction are concentrated in the upper-income groups.

Distribution by Income Class of the Tax Expenditure for Property Taxes, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.3
$20 to $30	1.2
$30 to $40	2.9
$40 to $50	4.8
$50 to $75	16.2
$75 to $100	20.8
$100 to $200	32.7
$200 and over	21.2

Rationale

Under the original 1913 Federal income tax law all Federal, State, and local taxes were deductible, except those assessed against local benefits (for improvements which tend to increase the value of the property), for individuals as well as businesses.

A major rationale was that tax payments reduce disposable income in a mandatory way and thus should be deducted when determining a taxpayer's ability to pay the Federal income tax.

Over the years, the Congress has gradually eliminated the deductibility of certain taxes under the individual income tax, unless they are business-

related. Deductions were eliminated for Federal income taxes in 1917, for estate and gift taxes in 1934, and for excise and import taxes in 1943, for State and local excise taxes on cigarettes and alcohol and fees such as drivers' and motor vehicle licenses in 1964, for excise taxes on gasoline and other motor fuels in 1978, and for sales taxes in 1986.

The major remaining deductions are for State and local income, real property, and personal property taxes. State and local taxes are among several deductions subject to the phaseout on itemized deductions for taxpayers whose AGI exceeds the applicable threshold amount--$124,500 in 1998, indexed for inflation. (This phaseout was instituted for tax years 1991 through 1995 by the Omnibus Budget Reconciliation Act of 1990 and made permanent by the Omnibus Budget Reconciliation Act of 1993.)

Assessment

Proponents argue that the deduction for State and local taxes is a way of promoting fiscal federalism by helping State and local governments to raise revenues from their own taxpayers. Itemizers receive an offset for their deductible State and local taxes in the form of lower Federal income taxes. Deductibility thus helps to equalize total Federal-State-local tax burdens across the country: itemizers in high-tax States and local jurisdictions pay somewhat lower Federal taxes as a result of their higher deductions, and vice versa.

By allowing property taxes to be deducted in the same way as State and local income and personal property taxes, the Federal Government avoids interfering in State and local decisions about which of these taxes to rely on. The property tax is particularly important as a source of revenue for local governments and school districts.

The property tax deduction is not a cost-efficient way to provide Federal aid to State and local governments in general, or to target aid on particular needs, compared with direct aid. The deduction works indirectly to increase taxpayers' willingness to support higher State and local taxes by reducing the net price of those taxes and increasing their income after Federal taxes.

The same tax expenditure subsidy is available to property taxpayers regardless of whether the money is spent on quasi-private benefits enjoyed by the taxpayers or redistributive public services, or whether they live in exclusive high-income jurisdictions or heterogeneous cities encompassing a low-income population. The property-tax-limitation movements of the 1970s and 1980s, and State and local governments' increased reliance on non-deductible sales and excise taxes and user fees during the 1980s and 1990s, suggest that other forces can outweigh the advantage of the property tax deduction.

Two separate lines of argument are offered by critics to support the case that the deduction for real property taxes should be restricted. One is that a large portion of local property taxes may be paying for services and facilities that are essentially private benefits being provided through the public sector. Similar services often are financed by non-deductible fees and user charges paid to local government authorities or to private community associations (*e.g.*, for water and sewer services or trash removal).

Another argument is that if imputed income from owner-occupied housing is not subject to tax, then associated expenses, such as mortgage interest and property taxes, should not be deductible.

Like the mortgage interest deduction, the value of the property tax deduction may be capitalized to some degree into higher prices for the type of housing bought by taxpayers who can itemize. Consequently, restricting the deduction for property taxes could lower the price of housing purchased by middle- and upper-income taxpayers, at least in the short run.

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EXCLUSION OF CAPITAL GAINS ON SALES OF PRINCIPAL RESIDENCES

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	5.8	-	5.8
2000	6.0	-	6.0
2001	6.2	-	6.2
2002	6.4	-	6.4
2003	6.6	-	6.6

Authorization

Sections 121 an 1034.

Description

A taxpayer may exclude from federal income tax up to $250,000 of capital gain ($500,000 in the case of married taxpayers filing joint returns) from the sale or exchange of their principal residence. To qualify the taxpayer must have owned and occupied the residence for at least two of the previous five years. The exclusion is limited to one sale every two years. Special rules apply in the case of sales necessitated by changes in employment, health and other circumstances.

Impact

Excluding the capital gains on the sale of principal residences from tax benefits primarily middle- and upper-income taxpayers. At the same time, however, this provision avoids putting an additional tax burden on

taxpayers, regardless of their income levels, who have to sell their homes because of changes in family status, employment, or health. It also provides tax benefits to elderly taxpayers who sell their homes and move to less expensive housing during their retirement years. This provision simplifies income tax administration and record keeping.

Rationale

Capital gains arising from the sale of a taxpayer's principal residence has long received preferential tax treatment. The Revenue Act of 1951 introduced the concept of deferring the tax on the capital gain from the sale of a principal residence if the proceeds of the sale were used to buy another residence of equal or greater value. This deferral principal was supplemented in 1964 by the introduction of the tax provision that allowed elderly taxpayers a one-time exclusion from tax for some of the capital gain derived from the sale of their principal residence. Over time, the one-time exclusion provision had been modified such that all taxpayers aged 55 and older were allowed a one-time exclusion for up to $125,000 gain from the sale of their principal residence.

By 1997, Congress had concluded that these two provisions had created significant complexities for the average taxpayer with regard to the sale of their principal residence. To comply with tax regulations, taxpayers had to keep detailed records of the financial expenditures associated with their home ownership. Taxpayers had to differentiate between those expenditures that affected the basis of the property and those that were merely for maintenance or repairs. In many instances these records had to be kept for decades.

In addition to record keeping problems, Congress believed that the prior law rules promoted an inefficient use of taxpayer's resources. Because deferral of tax required the purchase of a new residence of equal or greater value, prior law may have encouraged taxpayers to purchase more expensive homes than they otherwise would have.

Finally, Congress believed that prior law may have discouraged some elderly taxpayers from selling their homes to avoid possible tax consequences. Elderly taxpayers who had already used their one-time exclusion and those who might have realized a gain in excess of $125,000, may have held on to their homes longer than they otherwise would have.

Assessment

This exclusion from income taxation gives homeownership a competitive advantage over other types of investments, since the capital gains from investments in other assets are generally taxed when the assets are sold.

Moreover, when combined with other provisions in the tax code such as the deductibility of home mortgage interest, homeownership is an especially attractive investment. As a result, savings are diverted out of other forms of investment and into housing.

On the other hand, many see the exclusion on the sale of a principal residence as justifiable because the tax law does not allow the deduction of personal capital losses, because much of the profit from the sale of a personal residence can represent only inflationary gains, and because the purchase of a principal residence is less of a profit-motivated decision than other types of investments.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR OWNER-OCCUPIED HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.4	0.6	2.0
2000	1.5	0.6	2.1
2001	1.5	0.6	2.1
2002	1.6	0.7	2.3
2003	1.7	0.7	2.4

Authorization

Sections 103, 141, 143, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds issued to provide mortgages at below-market interest rates on owner-occupied principal residences of first-time homebuyers is tax exempt. The issuer of mortgage bonds typically uses bond proceeds to purchase mortgages made by a private lender. The homeowners make their monthly payments to the private lender, which passes them through as payments to the bondholders.

These mortgage revenue bonds (MRBs) are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Numerous limitations have been imposed on State and local MRB programs, among them restrictions on the purchase prices of the houses that

can be financed, on the income of the homebuyers, and on the portion of the bond proceeds that must be expended for mortgages in targeted (lower income) areas.

A portion of capital gains on an MRB-financed home sold within ten years must be rebated to the Treasury. Housing agencies may trade in bond authority for authority to issue equivalent amounts of mortgage credit certificates (MCCs). MCCs take the form of nonrefundable tax credits for interest paid on qualifying home mortgages.

MRBs are subject to the private-activity bond annual volume cap that is equal to the greater of $50 per State resident or $150 million through 2002, and will gradually rise to the greater of $70 per resident of $210 millions by 2006. Housing agencies must compete for cap allocations with bond proposals for all other private-activities subject to the volume cap.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to offer mortgages on owner-occupied housing at reduced mortgage interest rates.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and homeowners, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The first MRBs were issued without any Federal restrictions during the high-interest-rate period of the late 1970s. State and local officials expected reduced mortgage interest rates to increase the incidence of homeownership. The Mortgage Subsidy Bond Tax Act of 1980 imposed several targeting requirements, most importantly restricting the use of MRBs to lower-income first-time purchasers. The annual volume of bonds issued by governmental units within a State was capped, and the amount of arbitrage profits (the difference between the interest rate on the bonds and the higher mortgage rate charged to the home purchaser) was limited to one percentage point.

Depending upon the state of the housing market, targeting restrictions have been relaxed and tightened over the decade of the 1980s. MRBs were

included under the unified volume cap on private-activity bonds by the Tax Reform Act of 1986.

MRBs had long been an "expiring tax provision" with a sunset date. MRBs first were scheduled to sunset on December 31, 1983, by the Mortgage Subsidy Bond Tax Act of 1980. Additional sunset dates have been adopted five times when Congress has decided to extend MRB eligibility for a temporary period. The Omnibus Budget Reconciliation Act of 1993 made MRBs a permanent provision.

Assessment

Income, tenure status, and house-price-targeting provisions imposed on MRBs make them more likely to achieve the goal of increased homeownership than many other housing tax subsidies that make no targeting effort, such as is the case for the mortgage-interest deduction. Nonetheless, it has been suggested that most of the mortgage revenue bond subsidy goes to families that would have been homeowners even if the subsidy were not available.

If a case is to be made for this subsidy, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, MRBs have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR RENTAL HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.7	0.3	1.0
2000	0.8	0.3	1.1
2001	0.8	0.3	1.1
2002	0.8	0.3	1.1
2003	0.8	0.3	1.1

Authorization

Sections 103, 141, 142, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance the construction of multifamily residential rental housing units for low- and moderate-income families is tax exempt. These rental housing bonds are classified as private-activity bonds rather than as governmental bonds because a substantial portion of their benefits accrues to individuals or business, rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

These residential rental housing bonds are subject to the State private-activity bond annual volume cap. Several requirements have been imposed on these projects, primarily on the share of the rental units that must be occupied by low-income families and the length of time over which the income restriction must be satisfied.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to offer residential rental housing units at reduced rates. Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and renters, and for estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Before 1968 no restriction was placed on the ability of State and local governments to issue tax-exempt bonds to finance multifamily rental housing. Although the Revenue and Expenditure Control Act of 1968 imposed tests that would have restricted issuance of these bond issues, it provided a specific exception for multifamily residential rental housing (allowing continued unrestricted issuance).

Most States issue these bonds in conjunction with the Leased Housing Program under Section 8 of the United States Housing Act of 1937. The Tax Reform Act of 1986 restricted eligibility for tax-exempt financing to projects satisfying one of two income-targeting requirements: 40 percent or more of the units must be occupied by tenants whose incomes are 60 percent or less of the area median gross income, or 20 percent or more of the units are occupied by tenants whose incomes are 50 percent or less of the area median gross income. The Tax Reform Act of 1986 subjected these bonds to the State volume cap on private-activity bonds.

Assessment

This exception was provided because it was believed that subsidized housing for low- and moderate-income families provided benefits to the Nation, and provided equitable treatment for families unable to take advantage of the substantial tax incentives available to those able to invest in owner-occupied housing.

Even if a case can be made for subsidy due to State and local underinvestment in residential rental housing, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for rental housing have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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DEPRECIATION OF RENTAL HOUSING IN EXCESS OF ALTERNATIVE DEPRECIATION SYSTEM

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.6	0.2	1.8
2000	1.6	0.2	1.8
2001	1.6	0.2	1.8
2002	1.6	0.2	1.8
2003	1.7	0.2	1.9

Authorization

Sections 167 and 168.

Description

Taxpayers are allowed to deduct the costs of acquiring depreciable assets (assets that wear out or become obsolete over a period of years) as depreciation deductions. The tax code currently allows new rental housing to be written off over 27.5 years, using a "straight line" method where equal amounts are deducted in each period. This rule was adopted in 1986. There is also a prescribed 40-year write-off period for rental housing under the alternative minimum tax (also based on a straight-line method).

The tax expenditure measures the revenue loss from current depreciation deductions in excess of the deductions that would have been allowed under this longer 40-year period. The current revenue effects also reflect different write-off methods and lives prior to the 1986 revisions, since many buildings pre-dating that time are still being depreciated.

Prior to 1981, taxpayers were generally offered the choice of using the straight-line method or accelerated methods of depreciation, such as double-declining balance and sum-of-years digits, in which greater amounts are

deducted in the early years. (Used buildings with a life of twenty years or more were restricted to 125-percent declining balance methods). The period of time over which deductions were taken varied with the taxpayer's circumstances.

Beginning in 1981, the tax law prescribed specific write-offs which amounted to accelerated depreciation over periods varying from 15 to 19 years. Since 1986, all depreciation on residential buildings has been on a straight-line basis over 27.5 years.

Example: Suppose a building with a basis of $10,000 was subject to depreciation over 27.5 years. Depreciation allowances would be constant at 1/27.5 x $10,000 = $364. For a 40-year life the write-off would be $250 per year. The tax expenditure in the first year would be measured as the difference between the tax savings of deducting $364 or $250, or $114.

Impact

Because depreciation methods faster than straight-line allow for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, and because shorter useful lives allow quicker recovery, accelerated depreciation results in a deferral of tax liability.

It is a tax expenditure to the extent it is faster than economic (*i.e.*, actual) depreciation, and evidence indicates that the economic decline rate for residential buildings is much slower than that reflected in tax depreciation methods.

The direct benefits of accelerated depreciation accrue to owners of rental housing. Benefits to capital income tend to concentrate in the higher-income classes (see discussion in the Introduction).

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. Tax lives were recommended for assets through "Bulletin F," but taxpayers were also able to use a facts-and- circumstances justification.

A ruling issued in 1946 authorized the use of the 150-percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined

faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well.

By the 1960s, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. The first restriction on depreciation was to curtail the benefits that arose from combining accelerated depreciation with lower capital gains taxes when the building was sold. That is, while taking large deductions reduced the basis of the asset for measuring capital gains, these gains were taxed at the lower capital gains rate rather than the ordinary tax rate.
In 1964, 1969, and 1976 various provisions to "recapture" accelerated depreciation as ordinary income in varying amounts when a building was sold were enacted.

In 1969, depreciation on used rental housing was restricted to 125 percent declining balance depreciation. Low-income housing was exempt from these restrictions.

In the Economic Recovery Tax Act of 1981, residential buildings were assigned specific write-off periods that were roughly equivalent to 175-percent declining balance methods (200 percent for low-income housing) over a 15-year period under the Accelerated Cost Recovery System (ACRS).

These changes were intended as a general stimulus to investment. Taxpayers could elect to use the straight-line method over 15 years, 35 years, or 45 years. (The Deficit Reduction Act of 1984 increased the 15-year life to 18 years; in 1985, it was increased to 19 years.) The recapture provisions would not apply if straight-line methods were originally chosen. The acceleration of depreciation that results from using the shorter recovery period under ACRS was not subject to recapture as accelerated depreciation.

The current treatment was adopted as part of the Tax Reform Act of 1986, which lowered tax rates and broadened the base of the income tax.

Assessment

Evidence suggests that the rate of economic decline of residential structures is much slower than the rates allowed under current law, and this provision causes a lower effective tax rate on such investments than would otherwise be the case. This treatment in turn tends to increase investment in rental housing relative to other assets, although there is considerable debate about how responsive these investments are to tax subsidies.

At the same time, the more rapid depreciation partly offsets the understatement of depreciation due to the use of historical cost-basis

depreciation, assuming inflation is at a rate of five percent or so. Moreover, many other assets are eligible for accelerated depreciation as well.

Much of the previous concern about the role of accelerated depreciation in encouraging tax shelters in rental housing has faded because the current depreciation provisions are less rapid than those previously in place, and because there is a restriction on the deduction of passive losses. (However, the restrictions were eased somewhat in 1993.)

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TAX CREDIT FOR LOW-INCOME HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.3	1.2	3.5
2000	2.6	1.4	4.0
2001	2.8	1.5	4.3
2002	3.1	1.7	4.8
2003	3.4	1.9	5.3

Authorization

Section 42.

Description

A tax credit for a portion of acquisition costs (allowed in equal amounts over ten years) is allowed for low-income housing.

The credit rate is set so that the present value of the tax credit is equal to 70 percent for new construction and 30 percent for housing receiving other Federal benefits (such as tax exempt bond financing), or for substantially rehabilitated existing housing.

The credit is allowed only for the fraction of units serving low-income tenants, which are subject to maximum rent. To qualify, 20 percent of the units in a rental project must be occupied by families with less than 50 percent of area median income, or 40 percent of the units must be occupied by families with less than 60 percent of area median income.

An owner loses entitlement to the credit and is required to pay back a portion of credits already taken if the project is sold or ceases to qualify for low-income use within 15 years.

The credit can only be taken if it is allocated by the State housing authority; there is an annual per-resident limit of $1.25 for total credit

authority. The housing agency must require an enforceable 30-year low-income use (through restrictive covenants), although if a buyer cannot be found after the initial 15-year period, the property can be converted to market use and sold at a controlled price.

The amount of the credit that can be offset against unrelated income is limited to the equivalent of $25,000 in deductions under the passive loss restriction rules.

Impact

This provision substantially reduces the cost of investing in qualified units. Given the spending caps which limit the allocation of property to this use, excess profits to investors might normally be expected. The oversight requirements should prevent this outcome, and direct much of the benefit to qualified tenants of the housing units. Thus, although the direct benefits are received by high-income investors, the actual benefit is likely to accrue to lower- and moderate-income tenants.

Rationale

The tax credit for low-income housing was adopted in the Tax Reform Act of 1986. It replaced a number of other provisions in the law, including accelerated depreciation, five-year amortization of rehabilitation expenditures, expensing of construction-period interest and taxes, and general availability of tax-exempt bond financing.

The initial credit was nine percent a year for ten years for new housing, and four percent per year for ten years for housing receiving other subsidies, and for the acquisition of rehabilitated existing housing. These amounts totaled 90 percent and 40 percent of the cost respectively, but the credit rate is to be set to be the equivalent of 70 percent and 30 percent in present value.

There was a State ceiling per capita of $1.25. Some minor changes were made by the Revenue Bill of 1987, including carryover of credit authority by States. The credit was scheduled to expire at the end of 1989, but was extended by the Omnibus Budget Reconciliation Acts of 1989 (through 1990 with a $0.9375 per capita ceiling).

This 1989 revision also required States to regulate projects more carefully to insure that investors were not earning excessive rates of return. The law also introduced the requirement that new projects have a long-term plan for providing low-income housing, and legislation in 1990 extended the provision through 1991. The Tax Extension Act of 1991 extended the

credit through the first half of 1992. The Omnibus Budget Reconciliation Act of 1993 made the credit permanent.

Assessment

The low-income housing credit is much more targeted to benefiting lower-income individuals than the more general tax provisions it replaced. Moreover, by allowing State authorities to direct use, the credit can be used as part of a general neighborhood revitalization program.

There are, however, a number of criticisms that can be made of the credit (see the Congressional Budget Office study for a more detailed discussion). The credit is unlikely to have a substantial effect on the total supply of low-income housing, based on both micro-economic analysis and some empirical evidence.

There are significant overhead and administrative costs, especially if there are attempts to insure that investors do not earn excess profits. And, in general, some economists would argue that housing vouchers, or direct-income supplements for the low-income, are more direct and fairer methods of providing assistance to lower-income individuals.

Finally, although recapture rules and low-income-use covenants limit the ability of investors to take the credit and then shift use to higher-income purposes, there is an incentive to investors to allow units to deteriorate over time.

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TAX CREDIT FOR FIRST TIME HOMEBUYERS IN THE DISTRICT OF COLUMBIA

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1997	([1])	-	([1])
1998	([1])	-	([1])
1999	([1])	-	([1])
2000	-	-	-
2001	-	-	-

([1])Less than $50 million.

Authorization

Section 1400C.

Description

A credit is allowed for first time homebuyers of a principle residence in the District of Columbia. The maximum credit is $5000 ($2500 for married separate returns), and the credit is phased out for incomes between $70,000 and $90,000 for single taxpayers and $110,000 to $130,000 for joint returns. The credit applies to purchases made after August 5, 1997 and before January 1, 2001.

Impact

The credit will benefit individuals purchasing a home in the District of Columbia. In general, homeowners tend to have higher incomes, but the dollar limit on the credit and the phase-out will cause the benefit to be more concentrated in middle income classes than other homeowner preferences.

The tax benefit will encourage more individuals to move to the District of Columbia and to purchase homes; it may also increase property values slightly.

Rationale

The homebuyer credit was enacted along with a number of other special benefits for the District of Columbia in 1997. These provisions were enacted with the objective of encouraging economic development and attracting new homeowners to the city.

Assessment

Geographically targeted tax provisions should encourage increased employment and income of individuals living and working in specified areas. While the target of most geographically targeted provisions is an improvement in the economic status of lower-income individuals currently living in these areas, it is not clear to what extent these tax subsidies, including the homeowner credit, will succeed in that objective. Since low income individuals do not usually own homes, any benefits from a homeowner subsidy are not likely to be felt directly by the poor. The indirect benefits would also likely be modest.

Another reservation about geographically targeted provisions is that they may make surrounding communities, that may also be poor, worse off by attracting sales away from them.

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REDUCED RATES OF TAX ON LONG-TERM CAPITAL GAINS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	35.1	-	35.1
2000	32.0	-	32.0
2001	33.8	-	33.8
2002	34.9	-	34.9
2003	36.1	-	36.1

Authorization

Sections 11(h), 631, 1201-1256.

Description

Gains on the sale of capital assets held for more than a year are subject to lower tax rates under the individual income tax. Individuals subject to the 15 percent rate pay a 10 percent rate and employees in the 28, 31, 36, and 39.6 percent rate brackets pay a 20 percent rate. Gain arising from prior depreciation deductions is taxed at ordinary rates but with a maximum of 28 percent. Eventually, property held for five years or more will be taxed at 8 percent and 18 percent, rather than 10 percent and 20 percent. The 8 percent rate applies to sales after 2000; the 18 percent rate applies to property *acquired* after 2000 (and, thus, to such property sold after 2005). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than a year, but not inventory.

The tax expenditure is the difference between taxing gains at the lower rates and the statutory rate.

Several special categories of income that are treated as capital gains have been listed separately in previous tax expenditure compendiums: energy (capital gains treatment of coal royalties), natural resources (capital gains treatment of iron ore royalties and timber), and agriculture (gains on farm property including livestock). These items have become smaller, with only a small subsidy limited to individuals.

Impact

Since higher-income individuals receive most capital gains, benefits accrue to high-income taxpayers. Even among these higher-income taxpayers, there would be even more skewing of the benefits to the upper part of that higher-income distribution. For example, according to data presented by the Treasury Department (testimony of Ken Gideon, Deputy Assistant Secretary of Treasury for Tax Policy, March 6, 1990, before the House Ways and Means Committee), of capital gains taxes paid by individuals with economic incomes above $100,000, 70 percent of the tax was paid by individuals with incomes above $200,000. (The economic class of $100,000 and above accounted, in fact, for 72 percent of total capital gains tax paid.)

The primary assets that typically yield capital gains are corporate stock, and business and rental real estate. Corporate stock accounts for from 20 percent to 50 percent of total realized gains, depending on the state of the economy and the stock market. There are also gains from assets such as bonds, partnership interests, owner-occupied housing, timber, and collectibles, but all of these are relatively small as a share of total capital gains.

Rationale

Although the original 1913 Act taxed capital gains at ordinary rates, the 1921 law provided for an alternative flat-rate tax for individuals of 12.5 percent for gain on property acquired for profit or investment. This treatment was to minimize the influence of the high progressive rates on market transactions. The Committee Report noted that these gains are earned over a period of years, but are nevertheless taxed as a lump sum.

Over the years many revisions in this treatment have been made. In 1934, a sliding scale treatment was adopted (where lower rates applied the longer the asset was held). This system was revised in 1938.

In 1942, the sliding scale approach was replaced by a 50-percent exclusion for all but short-term gains (held for less than six months), with

an elective alternative tax rate of 25 percent. The alternative tax affected only individuals in tax brackets above 50 percent.

The 1942 act also extended special capital gains treatment to property used in the trade or business, and introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate then in effect for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime, and that resulting gains should not be taxed at the greatly escalated wartime rates.

Treatment of gain from cutting timber was adopted in 1943, in part to equalize the treatment of those who sold timber as a stand (where income would automatically be considered a capital gain) and those who cut timber. Capital gains treatment for coal royalties was added in 1951 to make the treatment of coal lessors the same as that of timber lessors and to encourage coal production. Similar treatment of iron ore was enacted in 1964 to make the treatment consistent with coal and to encourage production. The 1951 act also specified that livestock was eligible for capital gains, an issue that had been in dispute since 1942.

The alternative tax for individuals was repealed in 1969, and the alternative rate for corporations was reduced to 30 percent. The minimum tax on preference income and the maximum tax offset, enacted in 1969, raised the capital gains rate for some taxpayers.

In 1976 the minimum tax was strengthened, and the holding period lengthened to one year. The effect of these provisions was largely eliminated in 1978, which also introduced a 60-percent exclusion for individuals and lowered the alternative rate for corporations to 28 percent. The alternative corporate tax rate was chosen to apply the same maximum marginal rate to capital gains of corporations as applied to individuals (since the top rate was 70 percent, and the capital gains tax was 40 percent of that rate due to the exclusion).

The Tax Reform Act of 1986, which lowered overall tax rates and provided for only two rate brackets (15 percent and 28 percent), provided that capital gains would be taxed at the same rates as ordinary income. This rate structure included a "bubble" due to phase-out provisions that caused effective marginal tax rates to go from 28 percent to 33 percent and back to 28 percent.

In 1990, this bubble was eliminated, and a 31-percent rate was added to the rate structure. There had, however, been considerable debate over proposals to reduce capital gains taxes. Since the new rate structure would have increased capital gains tax rates for many taxpayers from 28 percent to 31 percent, the separate capital gains rate cap was introduced. The 28 percent rate cap was retained when the 1993 Omnibus Budget

Reconciliation Act added a top rate of 36 percent and a ten percent surcharge on very high incomes, producing a maximum rate of 39.6 percent. The Taxpayer Relief Act of 1997 provided the lower rates currently in place; its objective was to increase saving and risk-taking, and to reduce lock-in. The holding period was increased to 18 months, but cut back to one year in 1998.

Assessment

The original rationale for allowing a capital gains exclusion or alternative tax benefit--the problem of bunching of income under a progressive tax--is relatively unimportant under the current flatter rate structure.

A primary rationale for reducing the tax on capital gains is to mitigate the lock-in effect. Since the tax is paid only on a realization basis, an individual is discouraged from selling an asset. This effect causes individuals to hold a less desirable mix of assets, causing an efficiency loss. This loss could be quite large relative to revenue raised if the realizations response is large.

Some have argued, based on certain statistical studies, that the lock-in effect is, in fact, so large that a tax cut could actually raise revenue. Others have argued that the historical record and other statistical studies do not support this view and that capital gains tax cuts will cause considerable revenue loss. This debate about the realizations response has been a highly controversial issue.

Although there are efficiency gains from reducing lock-in, capital gains taxes can also affect efficiency through other means, primarily through the reallocation of resources between types of investments. Lower capital gains taxes may disproportionately benefit real estate investments, and may cause corporations to retain more earnings than would otherwise be the case, causing efficiency losses. At the same time lower capital gains taxes reduce the distortion that favors corporate debt over equity, which produces an efficiency gain.

Another argument in favor of capital gains relief is that much of gain realized is due to inflation. On the other hand, capital gains benefit from deferral of tax in general, and this deferral can become an exclusion if gains are held until death. Moreover, many other types of capital income (*e.g.*, interest income) are not corrected for inflation.

The particular form of this capital gains tax relief also results in more of a concentration towards higher-income individuals than would be the case with an overall exclusion.

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DEPRECIATION OF BUILDINGS OTHER THAN RENTAL HOUSING IN EXCESS OF ALTERNATIVE DEPRECIATION SYSTEM

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.6	1.9	3.5
2000	1.2	1.5	2.7
2001	1.0	1.2	2.2
2002	0.9	1.2	2.2
2003	0.8	1.1	1.9

Authorization

Section 167 and 168.

Description

Taxpayers are allowed to deduct the costs of acquiring depreciable assets (assets that wear out or become obsolete over a period of years) as depreciation deductions. The tax code currently allows new buildings other than rental housing to be written off over 39 years, using a "straight line" method where equal amounts are deducted in each period. There is also a prescribed 40 year write-off period for these buildings under the alternative minimum tax (also based on a straight-line method).

The tax expenditure measures the revenue loss from current depreciation deductions in excess of the deductions that would have been allowed under this longer 40-year period. The current revenue effects also reflect different write-off methods and lives prior to the 1993 revisions, which set the 39-year life, since many buildings pre-dating that time are still being depreciated.

Prior to 1981, taxpayers were generally offered the choice of using the straight-line method or accelerated methods of depreciation, such as double-declining balance and sum-of-years digits, in which greater amounts are deducted in the early years. Non-residential buildings were restricted in 1969 to 150-percent declining balance (used buildings were restricted to straight-line). The period of time over which deductions were taken varied with the taxpayer's circumstances.

Beginning in 1981, the tax law prescribed specific write-offs which amounted to accelerated depreciation over periods varying from 15 to 19 years. In 1986, all depreciation on nonresidential buildings was on a straight-line basis over 31.5 years, and that period was increased to 39 years in 1993.

Example: Suppose a building with a basis of $10,000 was subject to depreciation over 39 years. Depreciation allowances would be constant at 1/39 x $10,000 = $257. For a 40-year life the write-off would be $250 per year. The tax expenditure in the first year would be measured as the difference between the tax savings of deducting $257 or $250, or $7.

Impact

Because depreciation methods faster than straight-line allow for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, and because shorter useful lives allow quicker recovery, accelerated depreciation results in a deferral of tax liability.

It is a tax expenditure to the extent it is faster than economic (*i.e.*, actual) depreciation, and evidence indicates that the economic decline rate for non-residential buildings is much slower than that reflected in tax depreciation methods.

The direct benefits of accelerated depreciation accrue to owners of buildings, and particularly to corporations. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation. Benefits to capital income tend to concentrate in the higher-income classes (see discussion in the Introduction).

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. Tax lives were recommended for assets through "Bulletin F," but taxpayers were also able to use a facts and circumstances justification.

A ruling issued in 1946 authorized the use of the 150-percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well.

By the 1960s, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. The first restriction on depreciation was to curtail the benefits that arose from combining accelerated depreciation with lower capital gains taxes when the building was sold.

In 1964, 1969, and 1976 various provisions to "recapture" accelerated depreciation as ordinary income in varying amounts when a building was sold were enacted. In 1969, depreciation for nonresidential structures was restricted to 150-percent declining balance methods (straight-line for used buildings).

In the Economic Recovery Tax Act of 1981, buildings were assigned specific write-off periods that were roughly equivalent to 175-percent declining balance methods (200 percent for low-income housing) over a 15-year period under the Accelerated Cost Recovery System (ACRS). These changes were intended as a general stimulus to investment.

Taxpayers could elect to use the straight-line method over 15 years, 35 years, or 45 years. (The Deficit Reduction Act of 1984 increased the 15-year life to 18 years; in 1985, it was increased to 19 years.) The recapture provisions would not apply if straight-line methods were originally chosen. The acceleration of depreciation that results from using the shorter recovery period under ACRS was not subject to recapture as accelerated depreciation.

The current straight-line treatment was adopted as part of the Tax Reform Act of 1986, which lowered tax rates and broadened the base of the income tax. A 31.5-year life was adopted at that time; it was increased to 39 years by the Omnibus Budget Reconciliation Act of 1993.

Assessment

Evidence suggests that the rate of economic decline of rental structures is much slower than the rates allowed under current law, and this provision causes a lower effective tax rate on such investments than would otherwise be the case. This treatment in turn tends to increase investment in nonresidential structures relative to other assets, although there is

considerable debate about how responsive these investments are to tax subsidies.

At the same time, the more rapid depreciation partly offsets the understatement of depreciation due to the use of historical cost basis depreciation, assuming inflation is at a rate of five percent or so. Moreover, many other assets are eligible for accelerated depreciation as well.

Much of the previous concern about the role of accelerated depreciation in encouraging tax shelters in commercial buildings has faded because the current depreciation provisions are less rapid than those previously in place and because there is a restriction on the deduction of passive losses.

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DEPRECIATION ON EQUIPMENT IN EXCESS OF ALTERNATIVE DEPRECIATION SYSTEM

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	6.3	23.7	30.0
2000	6.7	24.8	31.5
2001	6.9	25.3	32.2
2002	6.8	25.7	32.5
2003	6.7	26.1	32.8

Authorization

Section 167 and 168.

Description

Taxpayers are allowed to deduct the cost of acquiring depreciable assets (assets that wear out or become obsolete over a period of years) as depreciation deductions. How quickly the deductions are taken depends on the period of years over which recovery occurs and the method used. Straight-line methods allow equal deductions in each year; accelerated methods, such as declining balance methods, allow larger deductions in the earlier years.

Equipment is currently divided into six categories to be depreciated over 3, 5, 7, 10, 15, and 20 years. Double declining balance depreciation is allowed for all but the last two classes, which are restricted to 150 percent declining balance. A double declining balance method allows twice the straight-line rate to be applied in each year to the remaining undepreciated balance; a 150-percent declining balance rate allows 1.5 times the straight-line rate to be applied in each year to the remaining undepreciated balance.

At some point, the taxpayer can switch to straight-line--write off the remaining undepreciated cost in equal amounts over the remaining life.

The 1986 law also prescribed a depreciation system for the alternative minimum tax, which applies to a broader base. The alternative depreciation system requires recovery over the midpoint of the Asset Depreciation Range, using straight-line depreciation. The Asset Depreciation Range was the set of tax lives specified before 1981 and these lives are longer than the lives allowed under the regular tax system.

This tax expenditure measures the difference between regular tax depreciation and the alternative depreciation system. The tax expenditure also reflects different write-off periods and lives for assets acquired prior to the 1986 provisions. For most of these older assets regular tax depreciation has been completed, so that the effects of these earlier vintages of equipment would be to enter as a revenue gain rather than as a loss.

In the past, taxpayers were generally offered the choice of using the straight-line method or accelerated methods of depreciation such as double-declining balance and sum-of-years digits, in which greater amounts are deducted in the early years. Tax lives varied across different types of equipment under the Asset Depreciation Range System, which prescribed a range of tax lives. Equipment was restricted to 150-percent declining balance by the 1981 Act, which shortened tax lives to five years.

Example: Consider a $10,000 piece of equipment that falls in the five-year class (with double declining balance depreciation) with an eight-year midpoint life. In the first year, depreciation deductions would be 2/5 times $10,000, or $4,000. In the second year, the basis of depreciation is reduced by the previous year's deduction to $6,000, and depreciation would be $2400 (2/5 times $6,000).

Depreciation under the alternative system would be 1/8th in each year, or $1,250. Thus, the tax expenditure in year one would be the difference between $4,000 and $1,250, multiplied by the tax rate. The tax expenditure in year two would be the difference between $2,400 and $1,250 multiplied by the tax rate.

Impact

Because depreciation methods faster than straight-line allow for larger deprecation deductions in the early years of the asset's life and smaller deductions in the later years, and because shorter useful lives allow quicker recovery, accelerated depreciation results in a deferral of tax liability. It is a tax expenditure to the extent it is faster than economic (*i.e.*, actual) depreciation, and evidence indicates that the economic decline rate for equipment is much slower than that reflected in tax depreciation methods.

The direct benefits of accelerated depreciation accrue to owners of assets and particularly to corporations. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation under the alternative minimum tax. Benefits to capital income tend to concentrate in the higher-income classes (see discussion in the Introduction).

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. Tax lives were recommended for assets through "Bulletin F," but taxpayers were also able to use a facts and circumstances justification.

A ruling issued in 1946 authorized the use of the 150-percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double-declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years.

In 1962, new tax lives for equipment assets were prescribed that were shorter than the lives existing at that time. In 1971, the Asset Depreciation Range System was introduced by regulation and confirmed through legislation. This system allowed taxpayers to use lives up to twenty percent shorter or longer than those prescribed by regulation.

In the Economic Recovery Tax Act of 1981, equipment assets were assigned fixed write-off periods which corresponded to 150-percent declining balance over five years (certain assets were assigned three-year lives). These changes were intended as a general stimulus to investment and to simplify the tax law by providing for a single write-off period. The method was eventually to be phased into a 200-percent declining balance method, but the 150-percent method was made permanent by the Tax Equity and Fiscal Responsibility Act of 1982.

The current treatment was adopted as part of the Tax Reform Act of 1986, which lowered tax rates and broadened the base of the income tax.

Assessment

Evidence suggests that the rate of economic decline of equipment is much slower than the rates allowed under current law, and this provision causes a lower effective tax rate on such investments than would otherwise be the case. The effect of these benefits on investment in equipment is uncertain, although more studies find equipment somewhat responsive to tax changes than they do structures. Many other assets also, however, benefit from accelerated depreciation.

The more rapid depreciation roughly offsets the understatement of depreciation due to the use of historical cost basis depreciation, if inflation is at a rate of about five percent or so. Under these circumstances the effective tax rate on equipment is close to the statutory tax rate and the tax rates of most assets are relatively close. If inflation falls, equipment tends to be favored relative to other assets and the tax system causes a misallocation of capital.

Some arguments are made that investment in equipment should be subsidized because it is more "high tech"; conventional economic theory suggests, however, that tax neutrality is more likely to ensure that investment is allocated to its most productive use.

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EXPENSING OF DEPRECIABLE BUSINESS PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	0.5	0.8
2000	0.2	0.5	0.7
2001	0.3	0.7	1.0
2002	0.4	0.7	1.1
2003	0.2	0.5	0.7

Authorization

Section 179.

Description

A taxpayer (other than a trust or estate) may elect, in lieu of capital-cost-recovery deductions, to deduct as an expense up to $18,500 of the cost of qualifying property in the taxable year it is placed in service in 1998. The ceiling will rise to $19,000 in 1999, $20,000 in 2000, $24,000 in 2001, and $25,000 in 2003. In general, qualifying property is equipment acquired, by purchase, for use in a trade or business. The amount that can be expensed is phased out if the taxpayer places more than $200,000 of property in service during the year.

Impact

In the absence of this provision, the cost of depreciable business property would have to be recovered over a period of years beginning with the year it is placed in service. The provision therefore permits the depreciation of relatively small amounts of business property to be substantially

accelerated. Expensing is equivalent to eliminating taxes; the effective tax rate on the investment falls to zero.

Benefits to capital income tend to concentrate in the higher income classes (see discussion in the Introduction).

Rationale

A special deduction for 20 percent of the first $10,000 of investment ($20,000 in the case of a joint return) was enacted in 1959, to provide relief and incentives for small businesses.

The Economic Recovery Act of 1981 substituted first-year expensing to assist small businesses and to simplify depreciation accounting for them. The 1981 law provided for a $5,000 limit, which was to be gradually raised to $10,000 (the full phase-in was delayed by the Deficit Reduction Act of 1984).

Property eligible for expensing was not eligible for the investment tax credit, making the provision of little economic benefit until the repeal of the credit in 1986. In 1993 the President proposed a temporary investment credit for equipment for large firms and a permanent one for small firms. These credits were not adopted, but the $10,000 expensing limit was increased to $17,500. The ceiling was raised (phased in) by the Small Business Job Protection Act of 1996, which imposed an $18,000 limit in 1997, rising to $25,000.

Assessment

This provision simplifies accounting for small businesses whose purchases fall under the limit. It also encourages investment in those businesses.

Although some argue that investment should be encouraged in small businesses because they tend to create more jobs and engage in more innovation than larger firms, evidence on this issue is mixed. Conventional economic analysis indicates that maximum output is produced when all investments are taxed at the same rate.

For firms with expenditures normally above the $17,500 limit, expensing is not an incentive to further investment, nor does it simplify depreciation accounting.

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EXCLUSION OF CAPITAL GAINS AT DEATH
CARRYOVER BASIS OF CAPITAL GAINS ON GIFTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	19.2	-	19.2
2000	20.7	-	20.7
2001	22.2	-	22.2
2002	23.9	-	23.9
2003	25.2	-	25.2

Authorization

Sections 1001, 1002, 1014, 1015, 1023, 1040, 1221, and 1222.

Description

A capital gains tax generally is imposed on the increased value of a capital asset (the difference between sales price and original cost of the asset) when the asset is sold or exchanged. This tax is not, however, imposed on the appreciation in value when ownership of the property is transferred as a result of the death of the owner or as a gift during the lifetime of the owner.

In the case of assets transferred at death, the heir's cost basis in the asset (the amount that he subtracts from sales price to determine gain if the asset is sold in the future) generally is the fair market value as of the date of decedent's death. Thus no income tax is imposed on appreciation occurring before the decedent's death, since the cost basis is increased by the amount of appreciation that has already occurred. In the case of gift transfers, the donee's basis in the property is the same as the donor's (usually the original cost of the asset). Thus, if the donee disposes of the property in a sale or exchange, the capital gains tax will apply to the pre-transfer appreciation.

Tax on the gain is deferred, however, and may be forgiven entirely if the donee in turn passes on the property at death.

Assets transferred at death or by *inter vivos* gifts (gifts between living persons) may be subject to the Federal estate and gift taxes, respectively, based upon their value at the time of transfer.

Impact

The exclusion of capital gains at death is most advantageous to individuals who need not dispose of their assets to achieve financial liquidity. Generally speaking, these individuals tend to be wealthier. The deferral of tax on the appreciation involved combined with the exemption for the appreciation before death is a significant benefit for these investors and their heirs.

Failure to tax capital gains at death encourages lock-in of assets, which in turn means less current turnover of funds available for investment. In deciding whether to change his portfolio, an investor takes into account the higher pre-tax rate of return he might obtain from the new investment, the capital gains tax he might have to pay if he changes his portfolio, and the capital gains tax his heirs might have to pay if he decides not to change his portfolio.

Often an investor in this position decides that, since his heirs will incur no capital gains tax on appreciation that occurs before the investor's death, he should transfer his portfolio unchanged to the next generation. The failure to tax capital gains at death and the deferral of tax tend to benefit high-income individuals (and their heirs) who have assets that yield capital gains.

Some insight into the distributional effects of this tax expenditure may be found by considering the distribution of current payments of capital gains tax. As shown in the Treasury Department's distributional table produced below (based on the testimony of Ken Gideon, Deputy Assistant Secretary for Tax Policy, before the House Ways and Means Committee on March 6, 1990), these taxes are heavily concentrated among high-income individuals.

Of course, the distribution of capital gains taxes could be different from the distribution of taxes not paid because they are passed on at death, but the provision would always accrue largely to higher-income individuals who tend to hold most of the wealth in the country.

Estimated Distribution of Capital Gains Taxes

Income Class	Percentage
less than $10,000	0.6
$10,000-$20,000	1.4
$20,000-$30,000	1.6
$30,000-$50,000	6.1
$50,000-$100,000	16.1
$100,000-$200,000	19.7
Over $200,000	54.5

The primary assets that typically yield capital gains are corporate stock, real estate, and owner-occupied housing.

Rationale

The original rationale for nonrecognition of capital gains on *inter vivos* gifts or transfers at death is not indicated in the legislative history of any of the several interrelated applicable provisions. However, one current justification given for the treatment is that death and *inter vivos* gifts are considered as inappropriate events to result in the recognition of income.

The Tax Reform Act of 1976 provided that the heir's basis in property transferred at death would be determined by reference to the decedent's basis. This carryover basis provision was not permitted to take effect and was repealed in 1980. The primary stated rationale for repeal was the concern that carryover basis created substantial administrative burdens for estates, heirs, and the Treasury Department.

Assessment

Failure to tax gains transferred at death is probably a primary cause of lock-in and its attendant efficiency costs; indeed, without the possibility of passing on gains at death without taxation, the lock-in effect would be greatly reduced.

The lower capital gains taxes that occur because of failure to tax capital gains at death can also affect efficiency through other means, primarily through the reallocation of resources between types of investments. Lower capital gains taxes may disproportionally benefit real estate investments and may cause corporations to retain more earnings than would otherwise be the

case, causing efficiency losses. At the same time, lower capital gains taxes reduce the distortion that favors corporate debt over equity, which produces an efficiency gain.

There are several problems with taxing capital gains at death. There are administrative problems, particularly for assets held for a very long time when heirs do not know the basis. In addition, taxation of capital gains at death would cause liquidity problems for some taxpayers, such as owners of small farms and businesses. Therefore most proposals for taxing capital gains at death would combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of gain to be taxed.

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AMORTIZATION OF BUSINESS START-UP COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	([1])	0.3
2000	0.3	([1])	0.3
2001	0.3	([1])	0.3
2002	0.3	([1])	0.3
2003	0.3	([1])	0.3

([1])Less than $50 million.

Authorization

Section 195.

Description

Costs incurred before the beginning of a business normally are not deductible, because they are not incurred in carrying on a trade or business. These start-up costs normally must be capitalized and added to the taxpayer's basis in the business. Under section 195, a taxpayer may elect to deduct eligible start-up expenditures over a period of not less than 60 months. In the absence of such an election, no deduction is allowed for start-up expenditures.

An expenditure must satisfy two requirements to qualify for this treatment. First, it must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer, or in connection with a
profit-seeking or income-producing activity prior to the day the taxpayer begins an active trade or business. Second, the expenditure must be one that would have been deductible for the taxable year in which it was paid

or incurred, if it had been paid or incurred in connection with the operation of an existing trade or business in the same field as that entered into by the taxpayer.

Impact

The election to amortize business start-up costs encourages the formation of new businesses by permitting the deduction of expenses that would have been deductible by an ongoing business. Without such an election, most of these start-up costs would not be recovered by the taxpayer until the taxpayer sold his interest in the business.

Benefits to capital income tend to concentrate in the higher income classes (see discussion in the Introduction).

Rationale

Before enactment of section 195 in 1980, the question of whether an expense incurred in creating or investigating the creation of a new business was currently deductible or must be capitalized was a source of controversy and litigation between taxpayers and the Internal Revenue Service. Certain business organizational expenditures for the formation of a corporation or partnership could be amortized, on an elective basis, over a period of not less than 60 months (Code sections 248 and 709).

In 1980, Congress added section 195 in order to encourage the creation of new businesses and reduce the controversy and litigation that surrounded the proper income tax classification of start-up expenditures. In 1984, these rules were clarified to reduce any remaining controversy regarding the definition of start-up expenditures.

Assessment

In theory, business organizational costs should be written off over the life of the business. There is, however, a difficulty in determining what that useful life is.

The advantage of this provision in eliminating taxpayer controversy and its small size has made it a provision which has attracted little concern.

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REDUCED RATES ON FIRST $10,000,000 OF CORPORATE TAXABLE INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	4.4	4.4
2000	-	4.4	4.4
2001	-	4.4	4.4
2002	-	4.4	4.4
2003	-	4.5	4.5

Authorization

Section 11.

Description

Corporate taxable income for corporations with less than $10 million of taxable income is subject to tax under a graduated tax rate structure. The tax rate is 15 percent on the first $50,000 of income, 25 percent on the next $25,000, and 34 percent thereafter. An additional 5-percent corporate tax is imposed on a corporation's taxable income in excess of $100,000 until the maximum additional tax is $11,750.

Thus, the benefit of these graduated rates is eliminated for corporations with taxable income in excess of $335,000, who pay a flat average rate of 34 percent. The tax rate on taxable income in excess of $10 million is 35 percent. When taxable income rises above $15 million, a tax of three percent of the excess or $100,000 (whichever is lesser) is imposed. The benefit of the 34 percent (vs. the 35 percent) rate is thus phased out when income reaches $18,333,333.

The graduated rates are not available for personal-service corporations, and there are restrictions to prevent abuse by related corporations. The tax

expenditure is the difference between taxes paid and the tax due if all income were subject to a flat 35 percent tax rate.

Impact

These reduced rates are available to smaller corporations. The phase-out limits the benefits of the graduated rates from 15 to 34 percent to a corporation with taxable income below $335,000. As a result, a corporation with taxable income from $100,000 to $335,000 pays a 39-percent marginal tax rate, which is 5 percent greater than the rate on taxable income just below or above this range. (The average tax, however, is below 34 percent.) A similar notch effect increases the rate to 38 percent in the $15 million to $18.3 million phaseout range.

The graduated rates encourage the use of the corporate structure and allow some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. They also encourage the splitting of operations between sole proprietorships, partnerships, and corporations. Most businesses are not incorporated; only a small fraction of firms are affected by this provision.

This provision is likely to benefit higher-income individuals who are the primary owners of capital (see Introduction for a discussion).

Rationale

In the early years of the corporate income tax, exemptions from tax were allowed in some years. A graduated rate structure was first adopted in 1936. From 1950-1974 there was a "normal" rate on corporate income, and a surtax, with an exemption from surtax for the first $25,000. The purpose was to provide relief for small businesses.

However, many large businesses fragmented their operations into numerous corporations to obtain numerous exemptions from the surtax. Some remedial steps were taken in 1963, and in 1969 legislation was enacted limiting groups of corporations controlled by the same interest to a single surtax exemption.

In 1975, a graduated rate structure with three (and eventually more) rate brackets was adopted. In 1984, a system for phasing out the exemptions was adopted, with exemptions phasing out for taxable incomes between $1 million and $1.405 million; at that time, lower rates applied to incomes up to $100,000.

The present corporate tax rates at the lower level (below $10 million) were enacted in the Tax Reform Act of 1986, which also restricted the

phase-out so that the benefits were phased out between $100,000 and $335,000. The general rationale for the lower rates--to aid small businesses--was reiterated at this time. The lower ceilings on the rates and the quicker phase-out was based on the notion of targeting the benefit more precisely to smaller businesses. The 35-percent rate was added in 1993 largely to raise revenue to reduce the budget deficit.

Assessment

The graduated rates are commonly justified as aids to small businesses. Unlike graduation in the rates of the individual tax, corporate rate graduation cannot be justified based on ability to pay, since owners of small corporations may, in fact, be very well off. In addition, the graduated rates can constitute a form of tax shelter for individuals, who may be able to retain part of income in corporations at lower rates. Thus the aid to small business must be justified on the grounds of efficiency.

Although some arguments are made that investment should be encouraged in small businesses because they tend to create more jobs and engage in more innovation than larger firms, evidence on this issue is mixed. Conventional economic analysis indicates that maximum output is produced when all investments are taxed at the same rate. Moreover, the vast majority of small businesses are not organized in corporate form. The graduated rate structure also adds complexity to the law and discourages investments of firms subject to the higher marginal tax rates of the phase-out range.

The graduated rate structure allows individuals to avoid taxes by diverting and retaining profits into corporations. In addition, it encourages multiple corporations, to maximize the amount of income taxed at low rates, requiring complicated rules to limit this activity.

The lower rates do, however, make it possible for moderate-income owners of businesses to operate in a corporate form without paying heavy taxes. Generally, individuals are free to organize as corporations for legal purposes, but to be taxed as partners under the Subchapter S provisions. There may be some circumstances, however, where such an election is not feasible (*e.g.*, when more than one class of stock is desired) or when taxable corporate status may be desirable (because of rules allowing for fringe benefits).

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PERMANENT EXEMPTION FROM IMPUTED INTEREST RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	([1])	0.2
2000	0.2	([1])	0.2
2001	0.2	([1])	0.2
2002	0.2	([1])	0.2
2003	0.2	([1])	0.2

([1])less than $50 million

Authorization

Section 163(e), 483, 1274, and 1274A.

Description

The failure to report interest as it accrues can allow the deferral of taxes. The tax code generally requires that debt instruments bear a market rate of interest at least equal to the average rate on outstanding Treasury securities of comparable maturity. If an instrument does not, the Internal Revenue Service imputes a market rate to it. The imputed interest must be included as income to the recipient and is deducted by the payer.

There are several exceptions to the general rules for imputing interest on debt instruments. Debt associated with the sale of property when the total sales price is no more than $250,000, the sale of farms or small businesses by individuals when the sales price is no more than $1 million, and the sale of a personal residence, is not subject to the imputation rules at all. Debt instruments for amounts not exceeding an inflation-adjusted maximum

(currently about $3 million), given in exchange for real property, may not have imputed to them an interest rate greater than 9 percent.

This tax expenditure is the revenue loss in the current year from the deferral of taxes caused by these exceptions.

Impact

The exceptions to the imputed interest rules are generally directed at "seller take-back" financing, in which the seller of the property receives a debt instrument (note, mortgage) in return for the property. This is a financing technique often used in selling personal residences or small businesses or farms, especially in periods of tight money and high interest rates, both to facilitate the sales and to provide the sellers with continuing income.

This financing mechanism can also be used, however, to shift taxable income between tax years and thus delay the payment of taxes. When interest is fully taxable but the gain on the sale of the property is taxed at reduced capital gains rates, as in current law, taxes can be eliminated, not just deferred, by characterizing more of a transaction as gain and less as interest (that is, the sales price could be increased and the interest rate decreased).

With only restricted exceptions to the imputation rules, and other recent tax reforms, the provisions now cause only modest revenue losses and have relatively little economic impact.

Rationale

Restrictions were placed on the debt instruments arising from seller-financed transactions beginning with the Revenue Act of 1964, to assure that taxes were not reduced by manipulating the purchase price and stated interest charges. These restrictions still allowed considerable creativity on the part of taxpayers, however, leading ultimately to the much stricter and more comprehensive rules included in the Deficit Reduction Act of 1984.

The 1984 rules were regarded as very detrimental to real estate sales and they were modified almost immediately (temporarily in 1985 [P.L. 98-612] and permanently in 1986 [P.L. 99-121]). The exceptions to the imputed interest rules described above were introduced in 1984 and 1986 (P.L. 99-121) to allow more flexibility in structuring sales of personal residences, small businesses, and farms by the owners, and to avoid the administrative problems that might arise in applying the rules to other smaller sales.

Assessment

The imputed interest and related rules dealing with property-for-debt exchanges were important in restricting unwarranted tax benefits before the Tax Reform Act of 1986 eliminated the capital gains exclusion and lengthened the depreciable lives of buildings.

Under pre-1986 law, the seller of commercial property would prefer a higher sales price with a smaller interest rate on the associated debt, because the gain on the sale was taxed at lower capital gains tax rates. The buyer would at least not object to, and might prefer, the same allocation because it increased the cost of property and the amount of depreciation deductions (*i.e.*, the purchaser could deduct the principal, through depreciation deductions, as well as the interest). It was possible to structure a sale so that both seller and purchaser had more income at the expense of the government.

Under current depreciation rules and low interest rates, this allocation is much less important. In addition, the 9-percent cap on imputed interest for some real estate sales has no effect when market interest rates are below that figure.

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EXPENSING OF MAGAZINE CIRCULATION EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 173.

Description

Publishers of newspapers, magazines, and other periodicals generally are permitted to elect to deduct expenditures to establish, maintain, or increase circulation in the year that the expenditures are made.

Current deductions are permitted under this rule even though certain of the expenditures would otherwise be treated as capital expenditures. Expenditures eligible for current deduction do not include those for the purchase of land or depreciable property or for the purchase of any part of the business of another publisher.

The tax expenditure is the difference between the current deduction of costs and the recovery that would have been allowed if these expenses were capitalized and deducted over a period of time.

Impact

Publishers are permitted a current deduction for circulation expenditures, including some expenditures otherwise considered capital in nature. This treatment speeds up the deduction of costs. Like other primarily corporate tax expenditures, the benefit tends to accrue to high-income individuals (see Introduction for a discussion).

Rationale

The current deduction rule was codified in 1950 to eliminate the problem of distinguishing between expenditures to maintain circulation (which are currently deductible) and those to establish or develop circulation (which otherwise had to be capitalized).

Assessment

Although this provision provides a benefit for certain investment in building up circulation that yields returns in the future, it simplifies the tax law. Without such a general treatment, it would be necessary to distinguish between expenditures for establishing or expanding circulation and those for maintaining circulation.

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Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1986*, Committee Print, 99th Congress, 2nd session. May 4, 1987, p. 445.

SPECIAL RULES FOR MAGAZINE, PAPERBACK BOOK, AND RECORD RETURNS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 458.

Description

In general, if a buyer returns goods to the seller, the seller's income is reduced in the year in which the items are returned. If the goods are returned after the tax year in which the goods were sold, the seller's income for the previous year is not affected.

An exception to the general rule has been granted to publishers and distributors of magazines, paperbacks, and records, who may elect to exclude from gross income for a tax year the income from the sale of goods that are returned after the close of the tax year. The exclusion applies to magazines that are returned within two months and fifteen days after the close of the tax year, and to paperbacks and records that are returned within four months and fifteen days after the close of the tax year.

To be eligible for the special election, a publisher or distributor must be under a legal obligation, at the time of initial sale, to provide a refund or credit for unsold copies.

Impact

Publishers and distributors of magazines, paperbacks, and records who make the special election are not taxed on income from goods that are returned after the close of the tax year. The special election mainly benefits large publishers and distributors.

Rationale

The purpose of the special election for publishers and distributors of magazines, paperbacks, and records is to avoid imposing a tax on accrued income when goods that are sold in one tax year are returned after the close of the year.

The special rule for publishers and distributors of magazines, paperbacks, and records was enacted by the Revenue Act of 1978.

Assessment

For goods returned after the close of a tax year in which they were sold, the special exception allows publishers and distributors to reduce income for the previous year. Therefore, the special election is inconsistent with the general principles of accrual accounting.

The special tax treatment granted to publishers and distributors of magazines, paperbacks, and records is not available to producers and distributors of other goods. On the other hand, publishers and distributors of magazines, paperbacks, and records often sell more copies to wholesalers and retailers than they expect will be sold to consumers.

One reason for the overstocking of inventory is that it is difficult to predict consumer demand for particular titles. Overstocking is also used as a marketing strategy that relies on the conspicuous display of selected titles. Knowing that unsold copies can be returned, wholesalers and retailers are more likely to stock a larger number of titles and to carry more copies of individual titles.

For business purposes, publishers generally set up a reserve account in the amount of estimated returns. Additions to the account reduce business income for the year in which the goods are sold. For tax purposes, the

special election for returns of magazines, paperbacks, and records is similar, but not identical, to the reserve account used for business purposes.

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DEFERRAL OF GAIN ON NON-DEALER INSTALLMENT SALES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.4	0.5	0.9
2000	0.4	0.5	0.9
2001	0.4	0.5	0.9
2002	0.4	0.5	0.9
2003	0.4	0.6	1.0

([1])Less than $50 million.

Authorization

Sections 453 and 453A(b).

Description

An installment sale is a sale of property in which at least one payment will be received in a tax year later than the year in which the sale took place. Some taxpayers are allowed to report some such sales for tax purposes under a special method of accounting, called the installment method, in which the gross profit from the sale is prorated over the years during which the payments are received.

This conveys a tax advantage compared to being taxed in full in the year of the sale, because the taxes that are deferred to future years have a time value (the amount of interest they could earn).

Use of the installment method was once widespread, but it has been severely curtailed in recent years. In current law, it can be used only by persons who do not regularly deal in the property being sold (except sellers

of timeshares and unimproved building lots, who may continue to use it but must pay interest on the deferred taxes).

For sales by nondealers, interest must be paid to the Government on the deferred taxes for any sale in which the sale price is more than $150,000 by any taxpayer with total installment sales arising during the year and outstanding at the end of the year of more than $5,000,000, except sales of farm property and sales of personal use property by individuals. Interest payments offset the value of the tax deferral, so this tax expenditure represents only the revenue loss from those transactions still giving rise to interest-free deferrals.

Impact

Installment sale treatment constitutes a departure from the normal rule that gain is recognized when the sale of property occurs. The deferral of taxation permitted under the installment sale rules essentially furnishes the taxpayer an interest-free loan equal to the amount of tax on the gain that is deferred.

The benefits of deferral are currently restricted to those transactions by nondealers in which the sales price is no more than $150,000 and to the first $5,000,000 of installment sales arising during the year, to sales of personal-use property by individuals, and to sales of farm property. (There are other restrictions on many types of transactions, such as in corporate reorganizations and sales of depreciable assets.)

Thus the primary benefit probably flows to sellers of farms, small businesses, and small real estate investments.

Rationale

The rationale for permitting installment sale treatment of income from disposition of property is to match the time of payment of tax liability with the cash flow generated by the disposition. It has usually been considered unfair, or at least impractical, to attempt to collect the tax when the cash flow is not available, and some form of installment sale reporting has been permitted since at least the Revenue Act of 1921. It has frequently been a source of complexity and controversy, however, and has sometimes been used in tax shelter and tax avoidance schemes.

Installment sale accounting was greatly liberalized and simplified in the Installment Sales Revision Act of 1980 (P.L. 96-471). It was greatly restricted by a complex method of removing some of its tax advantages in the Tax Reform Act of 1986, and it was repealed except for the limited uses described above in the Omnibus Budget Reconciliation Act of 1987

Assessment

The installment sales rules have always been pulled between two opposing goals: taxes should not be avoidable by the way a deal is structured, but they should not be imposed when the money to pay them is not available. Allowing people to postpone taxes simply by taking a note instead of cash in a sale leaves obvious room for tax avoidance.

Trying to collect taxes from taxpayers who do not have the cash to pay is administratively difficult and strikes many as unfair. After having tried many different ways of balancing these goals, lawmakers have settled on a compromise that denies the advantage of the method to taxpayers who would seldom have trouble raising the cash to pay (retailers, dealers in property, investors with large amounts of sales) and continues to permit it to small, nondealer transactions (with "small" rather generously defined).

Present law results in modest revenue losses and probably has little effect on economic incentives.

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COMPLETED CONTRACT RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	0.2	0.2
2000	([1])	0.2	0.2
2001	([1])	0.2	0.2
2002	([1])	0.2	0.2
2003	([1])	0.2	0.2

([1])Less than $50 million

Authorization

Section 460.

Description

Some taxpayers with construction or manufacturing contracts extending for more than one tax year are allowed to report some or all of the profit on the contracts under special accounting rules rather than the normal rules of tax accounting. Many such taxpayers use the "completed contract" method.

A taxpayer using the completed contract method of accounting reports income on a long-term contract only when the contract has been completed. All costs properly allocable to the contract are also deducted when the contract is completed and the income reported, but many indirect costs may be deducted in the year paid or incurred. This mismatching of income and expenses allows a deferral of tax payments
that creates a tax advantage in this type of reporting.

Most taxpayers with long-term contracts are not allowed to use the completed contract method and must capitalize indirect costs and deduct

them only when the income from the contract is reported. There are exceptions, however. Home construction contracts may be reported according to the taxpayer's "normal" method of accounting and allow current deductions for costs that others are required to capitalize.

Other real estate construction contracts may also be subject to these more liberal rules if they are of less than two years duration and the contractor's gross receipts for the past three years have averaged $10 million or less. Contracts entered into before 3/1/86, if still ongoing, may be reported on a completed contract basis, but with full capitalization of costs.

Contracts entered into between 2/28/86 and 7/11/89 and residential construction contracts other than home construction may be reported in part on a completed contract basis, but may require full cost capitalization. This tax expenditure is the revenue loss from deferring the tax on those contracts still allowed to be reported under the more liberal completed contract rules.

Impact

Use of the completed contract rules allows the deferral of taxes through mismatching income and deductions because they allow some costs to be deducted from other income in the year incurred, even though the costs actually relate to the income that will not be reported until the contract's completion, and because economic income accrues to the contractor each year he works on the contract but is not taxed until the year the contract is completed. Tax deferral is the equivalent of an interest-free loan from the Government of the amount of the deferred taxes. Because of the restrictions now placed on the use of the completed contract rules, most of the current tax expenditure relates to real estate construction, especially housing.

Rationale

The completed contract method of accounting for long-term construction contracts was permitted by Internal Revenue regulations since 1918 on the grounds that such contracts involved so many uncertainties that profit or loss was undeterminable until the contract was completed.

In regulations first proposed in 1972 and finally adopted in 1976, the Internal Revenue Service extended the method to certain manufacturing contracts (mostly defense contracts), at the same time tightening the rules as to which costs must be capitalized. Perceived abuses, particularly by defense contractors, led the Congress to question the original rationale for the provision and eventually to a series of ever more restrictive rules. The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) further tightened the rules for cost capitalization.

The Tax Reform Act of 1986 (P.L. 99-514) for the first time codified the rules for long-term contracts and also placed restrictions on the use of the completed contract method. Under this Act, the completed contract method could be used for reporting only 60 percent of the gross income and capitalized costs of a contract, with the other 40 percent reported on the "percentage of completion" method, except that the completed contract method could continue to be used by contractors with average gross receipts of $10 million or less to account for real estate construction contracts of no more than two years duration. It also required more costs to be capitalized, including interest.

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) reduced the share of a taxpayer's long-term contracts that could be reported on a completed contract basis from 60 percent to 30 percent. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) further reduced the percentage from 30 to 10, (except for residential construction contracts, which could continue to use the 30 percent rule) and also provided the exception for home construction contracts.

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) repealed the provision allowing 10 percent to be reported by other than the percentage of completion method, thus repealing the completed contract method except as noted above.

Assessment

Use of the completed contract method of accounting for long-term contracts was once the standard for the construction industry. Extension of the method to defense contractors, however, created a perception of widespread abuse of a tax advantage. The Secretary of the Treasury testified before the Senate Finance Committee in 1982 that "virtually all" defense and aerospace contractors used the method to "substantially reduce" the taxes they would otherwise owe.

The principal justification for the method had always been the uncertainty of the outcome of long-term contracts, an argument that lost a lot of its force when applied to contracts in which the Government bore most of the risk. It was also noted that even large construction companies, who used the method for tax reporting, were seldom so uncertain of the outcome of their contracts that they used it for their own books; their financial statements were almost always presented on a strict accrual accounting basis comparable to other businesses.

Since the use of the completed contract rules is now restricted to a very small segment of the construction industry, it produces only small revenue losses for the Government and probably has little economic impact in most areas. One area where it is still permitted, however, is in the construction

of single-family homes, where it adds some tax advantage to an already heavily tax-favored sector.

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CASH ACCOUNTING, OTHER THAN AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	([1])	0.1
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	0.1	([1])	0.1
2003	0.1	([1])	0.1

([1])Less than $50 million.

Authorization

Sections 446 and 448.

Description

Under the cash method of accounting, income is reported in the year in which it is received and deductions are taken in the year in which expenses are paid. Under the accrual method of accounting, income is generally recognized when it is earned, whether or not it has actually been received. Deductions for expenses are generally allowed in the year in which the costs are actually incurred.

All taxpayers (except some farmers) must use the accrual method of accounting for inventories and for some income and expenses that span tax years (*e.g.*, depreciation and prepaid expenses). Tax shelters, C corporations, partnerships that have C corporations as partners, and certain trusts must use the accrual method of accounting. Individuals and many businesses may use the cash method of accounting, however. The cash method may be used by small businesses, qualified personal service

corporations, and certain farm and timber interests (discussed under "Agriculture" above).

A small business is a business with average annual gross receipts of $5 million or less for the three preceding tax years. Qualified personal service corporations are employee-owned service businesses in the fields of health, law, accounting, engineering, architecture, actuarial science, performing arts, or consulting.

Impact

For tax purposes, most individuals and many businesses use the cash method of accounting because it is less burdensome than the accrual method of accounting. The revenue losses mainly benefit the owners of smaller businesses and professional service corporations of all sizes.

Rationale

Individuals and many businesses are allowed to use the cash method of accounting because it generally requires less record-keeping than other methods of accounting.

According to the Revenue Act of 1916, a taxpayer may compute income for tax purposes using the same accounting method used to compute income for business purposes. The Internal Revenue Code of 1954 allowed taxpayers to use a combination of accounting methods for tax purposes. The Tax Reform Act of 1986 prohibited tax shelters, C corporations, partnerships that have C corporations as partners, and certain trusts from using the cash method of accounting.

Assessment

The choice of accounting methods may affect the amount and timing of a taxpayer's Federal income tax payments. Under the accrual method, income for a given period is more clearly matched with the expenses associated with producing that income. Therefore, the accrual method more clearly reflects a taxpayer's net income for a given period. For business purposes, the accrual method also provides a better indication of a firm's economic performance for a given period.

Under the cash method of accounting, taxpayers have greater control over the timing of receipts and payments. By shifting income or deductions from one tax year to another, taxpayers can defer the payment of income taxes or take advantage of lower tax rates. On the other hand, because of its relative simplicity, the cash method of accounting involves lower costs

of compliance. The cash method is also the method most familiar to the individuals and businesses to whom its use is largely confined.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	0.1	0.3
2000	0.2	0.1	0.3
2001	0.2	0.1	0.3
2002	0.2	0.1	0.3
2003	0.2	0.1	0.3

Authorization

Sections 103, 141, 144, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance business loans of $1 million or less for construction of private manufacturing facilities is tax exempt. These small-issue industrial development bonds (IDBs) are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

The $1 million loan limit may be raised to $10 million ($20 million in certain economically distressed areas) if the aggregate amount of related capital expenditures (including those financed with tax-exempt bond proceeds) made over a six-year period is not expected to exceed $10 million. The bonds are subject to the State private-activity bond annual volume cap.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to offer loans to manufacturing businesses at reduced interest rates.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and business borrowers, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The first bonds for economic development were issued without any Federal restrictions. State and local officials expected that reduced interest rates on business loans would increase investment and jobs in their communities. The Revenue and Expenditure Control Act of 1968 imposed several targeting requirements, limiting the tax exempt bond issue to $1 million and the amount of capital spending on the project to $5 million over a six-year period.

The Revenue Act of 1978 increased the $5 million limit on capital expenditures to $10 million, and to $20 million for projects in certain economically distressed areas.

Several tax acts in the 1970s and early 1980s denied use of the bonds for specific types of business activities. The Deficit Reduction Act of 1984 restricted use of the bonds to manufacturing facilities, and limited any one beneficiary's use to $40 million of outstanding bonds. The annual volume of bonds issued by governmental units within a State first was capped in 1984, and then included by the Tax Reform Act of 1986 under the unified volume cap on private-activity bonds. This cap is equal to the greater of $50 per capita or $150 million through 2002. The Taxpayer Relief Act of 1998 will raise the cap to the greater of $70 per capita or $210 million between 2003 and 2006.

Small-issue IDBs long had been an "expiring tax provision" with a sunset date. IDBs first were scheduled to sunset on December 31, 1986 by the Tax Equity and Fiscal Responsibility Act of 1982. Additional sunset dates have been adopted three times when Congress has decided to extend small-issue IDB eligibility for a temporary period. The Omnibus Budget Reconciliation Act of 1993 made IDBS permanent.

Assessment

It is not clear that the Nation benefits from these bonds. Any increase in investment, jobs, and tax base obtained by communities from their use of these bonds probably is offset by the loss of jobs and tax base elsewhere in the economy.

National benefit would have to come from valuing the relocation of jobs and tax base from one location to another, but the use of the bonds is not targeted to a subset of geographic areas that satisfy explicit Federal criteria such as income level or unemployment rate. Any jurisdiction is eligible to utilize the bonds.

As one of many categories of tax-exempt private-activity bonds, small-issue IDBs have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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DEFERRAL OF GAIN ON LIKE-KIND EXCHANGES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	0.4	0.7
2000	0.3	0.4	0.7
2001	0.3	0.4	0.7
2002	0.3	0.4	0.7
2003	0.3	0.4	0.7

Authorization

Section 1031.

Description

When business or investment property is exchanged for property of a "like kind," no gain or loss is recognized on the exchange and therefore no tax is paid at the time of the exchange on any appreciation. This is in contrast to the general rule that any sale or exchange for money or property is a taxable event.

It is also an exception to the rules allowing tax-free exchanges when the property is "similar or related in service or use," the much stricter standard applied in other areas, such as replacing condemned property (section 1033). The latter is not considered a tax expenditure, but the postponed tax on appreciated property exchanged for "like-kind" property is.

Impact

The like-kind exchange rules have been liberally interpreted by the courts to allow tax-free exchanges of property of the same general type but of very

different quality and use. All real estate, in particular, is considered "like-kind," allowing a retiring farmer from the Midwest to swap farm land for a Florida apartment building tax-free.

The provision is very popular with real estate interests, some of whom specialize in arranging property exchanges. It is useful primarily to persons who wish to alter their real estate holdings without paying tax on their appreciated gain. Stocks and financial instruments are not eligible for this provision, so it is not useful for rearranging financial portfolios.

Rationale

A provision allowing tax-free exchanges of like-kind property was included in the first statutory tax rules for capital gains in the Revenue Act of 1921 and has continued in some form until today. Various restrictions over the years took many kinds of property and exchanges out of its scope, but the rules for real estate, in particular, were broadened over the years by court decisions.

In moves to reduce some of the more egregious uses of the rules, the Deficit Reduction Act of 1984 set time limits on completing exchanges and the Omnibus Budget Reconciliation Act of 1989 outlawed tax-free exchanges between related parties. The general rationale for allowing tax-free exchanges is that the investment in the new property is merely a continuation of the investment in the old.

A tax-policy rationale for going beyond this, to allowing tax-free adjustments of investment holdings to more advantageous positions, does not seem to have been offered. It may be that this was an accidental outgrowth of the original rule.

Assessment

From an economic perspective, the failure to tax appreciation in property values as it occurs defers tax liability and thus offers a tax benefit. (Likewise, the failure to deduct *declines* in value is a tax penalty.) Continuing the "nonrecognition" of gain, and thus the tax deferral, for a longer period by an exchange of properties adds to the tax benefit.

This treatment does, however, both simplify transactions and make it less costly for businesses and investors to replace property. Taxpayers gain further benefit from the loose definition of "like-kind" because they can also switch their property holdings to types they prefer without tax consequences. This might be justified as reducing the inevitable bias a tax on capital gains causes against selling property, but it is difficult to argue

for restricting the relief primarily to those taxpayers engaged in sophisticated real estate transactions.

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EXCEPTION FROM NET OPERATING LOSS LIMITATIONS FOR CORPORATIONS IN BANKRUPTCY PROCEEDINGS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	0.5	0.5
2000	-	0.5	0.5
2001	-	0.5	0.5
2002	-	0.5	0.5
2003	-	0.4	0.4

Authorization

Section 382(l)(5).

Description

In general, net operating losses of corporations may be carried back three years or carried forward fifteen years to offset taxable income in those years. If one corporation acquires another, the tax code has rules to determine whether the acquiring corporation inherits the tax attributes of the acquired corporation, including its net operating loss carryforwards, or whether the tax attributes of the acquired corporation disappear.

The acquiring corporation will inherit the tax attributes of the acquired corporation if the transaction qualifies as a tax-free reorganization. To qualify as a reorganization, the acquired corporation must essentially (or largely) continue in operation but in a different form. The owners of the acquired corporation must become owners of the acquiring corporation, and the business of the acquired corporation must be continued. An example is a merger of one corporation into another by exchanging stock of the acquiring corporation for stock of the acquired corporation.

While net operating loss carryforwards from an acquired corporation may be used to offset taxable income of the acquiring corporation after a reorganization, limitations are imposed. In general, the amount of income of the acquiring corporation that may be offset each year is determined by multiplying the value of the stock of the acquired corporation immediately before the ownership change by a specified long-term interest rate.

The purpose of the limitation is to prevent reorganized corporations from being able to absorb net operating loss carryforwards more rapidly than an approximation of the pace at which the acquired corporation would have absorbed them had it continued in existence.

If certain conditions are met, subsection 382(l)(5) provides an exception to the general limitation on net operating loss carryforwards for cases in which the acquired corporation was in bankruptcy proceedings at the time of the acquisition. In this case (unless the corporation elects otherwise), the limitation on net operating loss carryforwards does not apply. In some cases, however, certain adjustments are made to the amount of loss carryforwards of the acquired corporation that may be used by the successor corporation.

Impact

Section 382(l)(5) allows the use of pre-acquisition net operating loss carryforwards in circumstances in which they could not be used, in most cases, under the general rule.

The general rule determines the amount of the carryforwards which may be used to offset income based on the equity value of the acquired corporation at the time of acquisition. But most corporations in bankruptcy have zero or negative equity value. Hence, absent this exception, their successor corporations would be denied use of any of the carryovers.

Rationale

The rationale for the bankruptcy exception to the limitation on net operating loss carryovers is that the creditors of the acquired corporation who become shareholders in the bankruptcy reorganization may have, in effect, become the owners before the reorganization and borne some of the losses of the bankrupt corporation. In this case, the effective owners of the acquired corporation become owners of the acquiring corporation even though an ownership change appears to have occurred. Limitations are imposed to prevent abusive transactions.

Assessment

While the rationale for the provision is reasonable, the exception is not structured to be fully consistent with the rationale. There is no test to determine what portion, if any, of the preacquisition net operating loss carryforwards was borne by creditors who became shareholders.

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CREDIT FOR EMPLOYER-PAID FICA TAXES ON TIPS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	0.1	0.3
2000	0.2	0.2	0.4
2001	0.3	0.2	0.5
2002	0.3	0.2	0.5
2003	0.3	0.2	0.5

Authorization

Section 45B.

Description

All employee tip income is treated as employer-provided wages for purposes of the Federal Unemployment Tax Act (FUTA) and the Federal Insurance Contributions Act (FICA). For purposes of the minimum wage provisions, the reported tips are treated as employer-provided wages to the extent they do not exceed one-half of the minimum wage rate.

A general business tax credit (Section 38) is provided for food or beverage establishments in an amount equal to the employer's FICA tax obligation attributable to reported tips in excess of those treated as wages for purposes of satisfying the minimum wage provisions of the Fair Labor Standards Act. Tips taken into account are those received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary. A deduction is not permitted for any amount taken into account in determining the credit. Unused FICA credits may not be carried back to any taxable year which ended before the date of enactment.

Impact

The provision lessens the cost to business firms that serve food and beverages for a portion of the employer's portion of their employee's social security taxes. The tax credit operates to reduce tax liability, but not to less than zero because the credit is nonrefundable as a general business credit. However, the credit may be carried back to tax years ending after August 10, 1993 and forward for 15 years.

The direct beneficiaries of this provision are food and beverage operators. Some believe that prior law had the unintended effect of employers discouraging the reporting of all tip income by their employees so as to reduce the employer's social security tax payments. To the extent that tip income is not reported, both income and social security tax revenues are reduced. Current law poses no additional tax burdens on food and beverage operators for complete reporting of tip income. To the extent that tips are reported and social security taxes paid, employees may be eligible for larger payments from the social security system when they retire.

Rationale

The credit for employer paid FICA taxes on tips was first provided by the Omnibus Budget Reconciliation Act of 1993 (P.L. 101-508). The provision was not included in the House bill nor in the Senate's amendment. The provision appeared and was included in the Conference Committee report without a rationale being offered. Popular press reports indicated that the purpose was to soften the impact of the reduction of the deductible amount of business meals from 80 to 50 percent also included in that act.

A provision included in the Small Business Job Protection Act of 1996 (P.L. 104-188) made modifications to the effective date and extended the provision to employees delivering food or beverages. (Prior law provided the credit only for tips earned on the premises of an establishment.) The legislative history of these changes indicates an intent to change the effective date and that the Treasury's interpretation was not consistent with the provision as adopted. The Ways and Means committee report stated that it was appropriate "to apply the credit to all persons who provide food and beverages, whether for consumption on or off the premises."

Assessment

It is generally argued that tip income is earnings and should be treated the same as other forms of compensation. Waiters and waitresses as well as delivery persons are not self-employed individuals and their tip income is part of their total compensation. Thus, tips are seen as a surrogate wage that employers might have to pay in their absence. It is argued that all

employers should share equally in the costs of future benefits their employees will receive under the Social security program.

Because social security taxes are determined with respect to the entire amount of earnings (including tip income), current law in effect provides a benefit only to food and beverage employers whose employees receive part of their compensation in the form of tips. Even other businesses whose employees receive a portion of their compensation in the form of tip income (such as cab drivers, hairdressers, etc.) are barred from use of this tax credit. Thus, the provision violates the principle of horizontal equity. Since all other employers pay social security taxes on the entire earnings of their employees, it may place them at a competitive disadvantage. For example, a carry-out food concern where tipping is not usual pays the full costs of social security taxes while a sit-down diner does not. In effect, a portion of the social security taxes paid by food and beverage employers reduces business income taxes. To the extent business taxes are reduced, funds are taken from federal tax receipts to fund future social security benefits. Thus, taxpayers at large are paying a portion of the social security taxes of those firms using the employer tip tax credit.

The restaurant industry maintains that tip income is not a wage but a gift between their employees and the customers that they serve. They also contend that if the tip income is seen as compensation, then they should be able to count all tip income in determining the minimum wage (current law allows only one-half the minimum wage to be counted from tip income). The industry argues that having to report the tip income of their employees places large administrative costs upon their operations and has shifted the burdens of reporting and collection from the individual to the business.

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DEFERRAL OF GAIN ON INVOLUNTARY CONVERSIONS RESULTING FROM PRESIDENTIALLY-DECLARED DISASTERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 1033(h).

Description

An individual may claim an itemized deduction for unreimbursed personal casualty losses. The amount deductible for personal use property is the lesser of the resulting loss in the fair market value of the property or the taxpayer's adjusted basis in the property. The deduction is limited to the casualty loss minus 10 percent of the taxpayer's adjusted gross income (AGI) and $100 per casualty event. Further, the deduction is reduced by any reimbursement for the damaged property (such as insurance). In cases where the recovery exceeds a taxpayer's basis, a casualty gain occurs and is taxable. When personal property is "involuntarily converted" into cash (insurance proceeds) it is generally taxed unless the proceeds are used to replace the destroyed property with similar property within a specified period.

In contrast, special rules are provided for a taxpayer's principal residence or any of its contents when involuntarily converted (damaged and replaced with insurance proceeds) as a result of a Presidentially declared disaster under the Disaster Relief and Emergency Assistance Act (DREAA).

In the case of unscheduled personal property (property that is not specified but is nonetheless insured), no gain is recognized by reason of the receipt of any insurance proceeds for property which was part of the residence's contents. There is no requirement that the proceeds replace the destroyed property.

The same treatment is not available for other insurance proceeds (i.e., proceeds for scheduled property). However, other insurance proceeds for the principal residence or its contents may be treated as a common pool of funds. If the common pool of funds is used to purchase any property similar or related in service or use to the converted residence (or its contents), the taxpayer may elect to recognize gain only to the extent that the amount of the pool of funds exceeds the cost of the replacement property.

The replacement period for property involuntarily converted and located within the prescribed disaster area under DREAA is increased from two years to four years.

A taxpayer's principal residence is defined in Code section 1034. A single exception to this rule was provided to taxpayers who do not own their residences (i.e. the provision is available to renters).

Impact

The special rule grants some financial assistance to taxpayers who suffer substantial personal property losses and receive insurance proceeds. It shifts part of the loss from the property owner to taxpayers at large. It does appear from revenue loss projections that use of the exclusion for personal property is low. Without the special rule, if the recovery were to exceed a taxpayer's basis then a casualty gain would occur which would be taxable. Thus, benefits from the provision accrue to taxpayers who would have had large casualty gains and the value of the provision would depend on the marginal tax bracket of taxpayers. To the extent of the excluded amount, higher income taxpayers will receive a greater benefit than lower income taxpayers.

Rationale

The special rules for principal residences damaged in Presidentially declared disaster areas were first provided by the Omnibus Budget Reconciliation Act of 1993 (P.L. 101-508). The provision was not included in the House bill nor in the Senate's amendment. The provision appeared and was included in the Conference Committee Report without a rationale offered.

Assessment

A requirement of the special rule is that only property in a Presidentially declared disaster area is eligible for relief. Thus, persons who incur similar losses of their primary residence located outside a disaster area (for example by fire or flood) may not receive the same tax treatment. This violates the principle of horizontal equity: that similarly situated taxpayers bear similar tax burdens.

In support of the provision, it can be argued that it reduces complexity and extensive recordkeeping that would be required in the absence of the special rule. Naturally, it would be difficult to identify and produce records for all personal property lost in a disaster. The rule also reduces significant problems which might result for the Internal Revenue Service during audits.

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DEFERRAL OF TAX ON CAPITAL CONSTRUCTION FUNDS OF SHIPPING COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	0.1	0.1
2000	-	0.1	0.1
2001	-	0.1	0.1
2002	-	0.1	0.1
2003	-	0.1	0.1

Authorization

Section 7518.

Description

U.S. operators of vessels in foreign, Great Lakes, or noncontiguous domestic trade, or in U.S. fisheries, may establish a capital construction fund (CCF) into which they may make certain deposits. Such deposits are deductible from taxable income, and income tax on the earnings of the deposits in the CCF is deferred.

When tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct, acquire, lease, or pay off the indebtedness on a qualifying vessel. A qualifying vessel must be constructed or reconstructed in the United States, and any lease period must be at least five years.

The tax basis of the vessel (usually its cost to the taxpayer), with respect to which the operator's depreciation deductions are computed, is reduced by the amount of such withdrawal. Thus, over the life of the vessel tax depreciation will be reduced, and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation

of the replacement vessel may be deposited into the CCF, the tax deferral may be extended.

Withdrawals for other purposes are taxed at the top tax rate. This rule prevents firms from withdrawing funds in loss years and escaping tax entirely. Funds cannot be left in the account for more than 25 years.

Impact

The allowance of tax deductions for deposits can, if funds are continually rolled over, amount to a complete forgiveness of tax. Even when funds are eventually withdrawn and taxed, there is a substantial deferral of tax that leads to a very low effective tax burden. The provision makes investment in U.S.-constructed ships and registry under the U.S. flag more attractive than it would otherwise be. Despite these benefits, however, there is very little (in some years, no) U.S. participation in the worldwide market supplying large commercial vessels.

The incentive for construction is perhaps less than it would otherwise be, because firms engaged in international shipping have the benefits of deferral of tax through other provisions of the tax law, regardless of where the ship is constructed. This provision is likely to benefit higher-income individuals who are the primary owners of capital (see Introduction for a discussion).

Rationale

The special tax treatment originated to ensure an adequate supply of shipping in the event of war. Although tax subsidies of various types have been in existence since 1936, the coverage of the subsidies was expanded substantially by the Merchant Marine Act of 1970.

Before the Tax Reform Act of 1976 it was unclear whether any investment tax credit was available for eligible vessels financed in whole or in part out of funds withdrawn from a CCF. The 1976 Act specifically provided (as part of the Internal Revenue Code) that a minimum investment credit equal to 50 percent of an amount withdrawn which was to purchase, construct, or reconstruct qualified vessels was available in 1976 and subsequent years.

The Tax Reform Act of 1986 incorporated the deferral provisions directly into the Internal Revenue Code. It also extended benefits to leasing, provided for the minimum 25-year period in the fund, and required payment of the tax at the top rate.

Assessment

The failure to tax income from the services of shipping normally misallocates resources into less efficient uses, although it appears that the effects on U.S. large commercial shipbuilding are relatively small.

There are two possible arguments that could be advanced for maintaining this tax benefit. The first is the national defense argument --that it is important to maintain a shipping and shipbuilding capability in time of war. This justification is in doubt today, since U.S. firms control many vessels registered under the foreign flag and many U.S. allies control a substantial shipping fleet and have substantial ship-building capability.

There is also an argument that subsidizing domestic ship-building and flagging offsets some other subsidies--both shipbuilding subsidies that are granted by other countries, and the deferral provisions of the U.S. tax code that encourage foreign flagging of U.S.-owned vessels. Economic theory suggests, however, that efficiency is not necessarily enhanced by introducing further distortions to counteract existing ones.

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EXCLUSION OF EMPLOYER-PAID TRANSPORTATION BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	3.5	-	3.5
2000	3.6	-	3.6
2001	3.6	-	3.6
2002	3.7	-	3.7
2003	3.7	-	3.7

Authorization

Section 132(f).

Description

Transit passes provided directly by the employer are excludable from income in amounts up to $60 per month. A similar exclusion applies to van pools, although the limit applies to the total of van pool costs and transit passes.

Parking facilities provided by the employer are excludable from income in amounts up to $155 per month. Cash reimbursements are also eligible for exclusion in the case of parking facilities.

The dollar limits are indexed for inflation.

Impact

Exclusion from taxation of transportation fringe benefits provides a subsidy to employment in those businesses and industries in which such fringe benefits are common and feasible. The subsidy provides benefits both to the employees (more are employed and they receive higher compensation) and to their employers (who have lower wage costs).

The parking exclusion is more likely to benefit higher income individuals than the mass transit and van pool subsidies. For those individuals receiving benefits, the savings rise with marginal tax rate.

Rationale

A statutory exclusion for the value of parking was introduced in 1984, along with exclusions for a number of other fringe benefits. In many cases, these practices had been long established and generally had been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income.

Employees clearly receive a benefit from the availability of free or discounted goods or services, but the benefit may not be as great as the full amount of the discount. In enacting these provisions, the Congress also wanted to establish limits on the use of tax-free fringe benefits. Prior to enactment of the provisions, the Treasury Department had been under a congressionally imposed moratorium on issuance of regulations defining the treatment of these fringes. There was a concern that without clear boundaries on use of these fringe benefits, new approaches could emerge that would further erode the tax base and increase inequities among employees in different businesses and industries.

The Comprehensive Energy Policy Act of 1992 placed a dollar ceiling on the exclusion of parking facilities and introduced the exclusions for mass transit facilities and van pools in order to encourage mass commuting, which would in turn reduce traffic congestion and pollution.

Assessment

The exclusion subsidizes employment in those businesses and industries in which transportation fringe benefits are feasible and commonly used. Because the exclusion applies to practices which are common and may be feasible only in some businesses and industries, it creates inequities in tax treatment among different employees and employers.

Subsidies for mass transit and van pools, and for parking when provided primarily for car pools, are methods of encouraging mass commuting and may be beneficial for reducing congestion and pollution. At the same time, all of these subsidies reduce the cost of commuting in general and add to congestion and pollution, unlike other methods of discouraging automobile commuting, such as higher gasoline taxes, or local parking taxes.

One problem with taxing any directly supplied fringe benefit, such as free or reduced parking, is the administrative difficulty in determining fair market value.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR HIGH-SPEED RAIL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million per year.

Authorization

Sections 103, 141, 142, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance the construction of high-speed inter-urban rail facilities is tax exempt. In order to qualify for this exception, high-speed rail facilities must carry passengers (the general public) between metropolitan statistical areas at speeds in excess of 150 miles per hour. Rolling stock is not eligible for tax exemption.

These high-speed rail bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to finance rail facilities at reduced interest rates. Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the high-speed rail facilities, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Prior to 1968, no restriction was placed on the ability of State and local governments to issue tax-exempt bonds to finance privately owned mass commuting facilities. Although the Revenue and Expenditure Control Act of 1968 imposed tests that would have restricted issuance of these bond issues, it provided a specific exception for mass commuting facilities (allowing continued unrestricted issuance).

The Tax Reform Act of 1986 classified mass commuting facility bonds as taxable private-activity bonds. Tax exemption was allowed if the facilities were government owned. The 1986 Act established a more favorable exception for high-speed inter-urban rail facilities, allowing private ownership if the owner agreed only to forego depreciation allowances on the rail property. Twenty-five percent of these bonds were subject to the private-activity bond volume cap, but this restriction was eliminated by the Omnibus Budget Reconciliation Act of 1993.

Assessment

The desirability of allowing these bonds to be eligible for tax-exempt status hinges on one's view of whether the users of such facilities should pay the full cost, or whether sufficient social benefits (such as reduction of congestion costs) exist to justify taxpayer subsidy. Public finance theory suggests that to the extent these facilities provide social benefits, the facilities might be underprovided due to the reluctance of State and local taxpayers to finance benefits for nonresidents.

Even if a case can be made for subsidy due to State and local underinvestment, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for high-speed intercity rail facilities have increased the financing costs of bonds issued for public capital stock and increased the supply of assets

available to individuals and corporations to shelter their income from taxation.

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REGIONAL ECONOMIC DEVELOPMENT INCENTIVES: EMPOWERMENT ZONES, ENTERPRISE COMMUNITIES, INDIAN INVESTMENT INCENTIVES, AND DISTRICT OF COLUMBIA INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	0.4	0.7
2000	0.3	0.4	0.7
2001	0.4	0.4	0.8
2002	0.2	0.4	0.6
2003	0.2	0.3	0.5

([1])Less than $50 million per year.

Authorization

Sections 38(b), 39(d),45A, 168(j), 280C(a), 1391-1397D, 1400-1400B.

Description

The OBRA 1993 tax legislation specified that nine empowerment zones and 95 enterprise communities will be designated to receive special tax benefits. Six of the empowerment zones and 65 of the enterprise communities will be in urban areas; the remainder will be in rural areas. Indian reservations cannot be designated but will receive separate tax subsidies.

Designated areas must satisfy eligibility criteria including poverty rates and population and geographic size limits; they will be eligible for benefits for ten years.

For empowerment zones, the tax incentives include a 20-percent employer wage credit for the first $15,000 of wages for zone residents who work in the zone, $20,000 in expensing of equipment in investment (in

addition to the $17,500 allowed generally) in qualified zone businesses, and expanded tax exempt financing for certain zone facilities, primarily qualified zone businesses.

Enterprise communities receive only the tax exempt financing benefits. Tax exempt bonds for any one community cannot exceed $3 million and bonds for any user cannot exceed $20 million for all zones or communities. Businesses eligible for this financing are subject to limits to target businesses operating primarily within the zones or communities.

Businesses on Indian reservations are eligible for accelerated depreciation and for a credit for 20 percent of the cost of the first $20,000 of wages (and health benefits) paid by the employer to tribal members and their spouses, in excess of payments in 1993. These benefits are available for wages paid, and for property placed in service, for ten years (1994-2003).

In 1997 several tax incentives for the District of Columbia were adopted: a wage tax credit of $3,000 per employee for wages paid to a District resident, tax-exempt bond financing, and additional first-year expensing of equipment. These apply to areas with poverty rates of 20 percent or more. There is also a zero capital gains rate for business sales in areas with 10 percent poverty rates. Most provisions are available through 2003, but the wage credit applies through 2002. (A credit for first-time homebuyers adopted at that time is discussed under the Commerce and Housing heading.)

Impact

Both businesses and employees within the designated areas may benefit from these provisions. Wage credits given to employers can increase the wages of individuals if not constrained by the minimum wage, and these individuals tend to be lower income individuals. If the minimum wage is binding (so that the wage does not change) the effects may show up in increased employment and/or in increased profits to businesses.

Benefits for capital investments may be largely received by business owners initially, although the eventual effects may spread to other parts of the economy. Eligible businesses are likely to be smaller businesses because they must operate within the designated area.

Rationale

These geographically targeted tax provisions were adopted in 1993, although they had been under discussion for some time and had been included in proposed legislation in 1992. Interest in these types of tax subsidies increased after the 1992 Los Angeles riots.

The objective of the subsidies was to revitalize distressed areas through expanded business and employment opportunities, especially for residents of these areas, in order to alleviate social and economic problems, including those associated with drugs and crime.

The number of zones was expanded and the DC tax incentives were adopted in 1997.

Assessment

The geographically targeted tax provisions should encourage increased employment and income of individuals living and working in the zones and increased incentives to businesses working in the zones. The small magnitude of the program may be appropriate to allow time to assess how well such benefits are working; current evidence does not provide clear guidelines.

If the main target of these provisions is an improvement in the economic status of individuals currently living in these geographic areas, it is not clear to what extent these tax subsidies will succeed in that objective. None of the subsidies are given directly to workers; rather they are received by businesses. Capital subsidies may not ultimately benefit workers; indeed, it is possible that they may encourage more capital intensive businesses and make workers worse off. Wage subsidies are more likely than capital subsidies to be effective in benefiting poor zone or community residents. Workers cannot benefit from higher wages due to an employer subsidy, however, if the wage is determined by regulation (the minimum wage) and is already artificially high.

Another reservation about enterprise zones is that they may make surrounding communities, that may also be poor, worse off by attracting businesses away from them. And, in general, questions have been raised about the target efficiency of provisions that target all beneficiaries in a poor area rather than poor beneficiaries in general.

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EXPENSING OF REDEVELOPMENT COSTS IN CERTAIN ENVIRONMENTALLY CONTAMINATED AREAS ("BROWNFIELDS")

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	0.1	0.1
2000	([1])	0.1	0.1
2001	([1])	0.1	0.1
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million per year.

Authorization

Section 198, 280B, and 468, 1221(1), 1245, 1392(b)(4), and 1393(a)(9).

Description

Firms that undertake expenditures to control or abate hazardous substances in a qualified contaminated business property or site in certain targeted empowerment zones and enterprise communities are allowed to expense -- deduct the costs against income in the year incurred -- those expenditures that would otherwise be allocated to capital account. Upon the disposition of the property, the deductions are subject to recapture as ordinary income.

Impact

Immediate expensing provides a tax subsidy for capital invested by businesses, in this case for capital to be used for environment clean up and community development. Frequently, the costs of cleaning up contaminated land and water in abandoned industrial or commercial sites is

a major barrier to redevelopment of that site and of the community in general. By expensing rather than capitalizing these costs, taxes on the income generated by the capital expenditures are effectively set to zero. This should provide a financial incentive to businesses and encourage them to invest in the clean up and redevelopment of "brownfields" -- abandoned old industrial sites and dumps, including properties owned by the federal and subnational governments, that could and would be cleaned up and redeveloped except for the costs and complexities of the environmental contamination.

The provision broadens target areas in distressed urban and rural communities that can attract the capital and enterprises needed to rebuild and redevelop polluted sites. The tax subsidy is thus primarily viewed as an instrument of community development, to develop and revitalize urban and rural areas depressed due to environmental contamination. According to the Environmental Protection Agency there are thousands of such sites (30,000 by some estimates) in the United States. (These sites do not include those on the "superfund list," which are a greater priority because they are even more polluted than brownfields, and which are covered by the Comprehensive Environmental Response Compensation, and Liability Act).
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The tax provision should also greatly simplify tax compliance and facilitate the tax administration process, which was inconsistent owing to the uncertainty in regards to the central question whether environmental remediation costs are ordinary business expenses or capital expenditures.

Rationale

Section 198 was added by the Taxpayer Relief Act of 1997 (P.L. 105-34). Its purpose is threefold: 1) As an economic development policy, its purpose is to encourage the redevelopment and revitalization of depressed communities and properties abandoned due to hazardous waste pollution; 2) As an environmental policy, expensing of environmental remediation costs provides a financial incentive to clean up contaminated waste sites; and 3) As tax policy, expensing of environmental remediation costs establishes clear and consistent rules, and reduces the uncertainty that existed prior to the law's enactment, regarding the appropriate tax treatment of such expenditures.

Assessment

Section 198 specifically treats environmental remediation expenditures, which would otherwise be capitalized, as deductible in the year incurred. Such expenditures are generally recognized to be capital costs which, according to standard economic principles, should be recovered over the

income producing life of the underlying asset. As a capital subsidy, however, expensing is inefficient because it makes investment decisions based on tax considerations rather than inherent economic considerations.

As a community development policy the effectiveness of the tax subsidy is questionable since the main disincentive to development of brownfield sites appears to be not costs but rather the potential liability under current environmental regulation. That is to say the main barrier to development appears to be regulatory rather than financial. Barring such regulatory disincentives, the market system ordinarily creates its own incentives to develop depressed areas, as part of the normal economic cycle of growth, decay, and redevelopment. As an environmental policy this type of capital subsidy is also questionable on efficiency grounds. Many economists believe that expensing is a costly and inefficient way to achieve environmental goals, and that the external costs resulting from environmental pollution are more efficiently addressed by either pollution or waste taxes or tradeable permits.

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INVESTMENT CREDIT FOR REHABILITATION OF STRUCTURES, OTHER THAN HISTORIC STRUCTURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	([1])	([1])	([1])
2003	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 47.

Description

Qualified expenditures made to substantially rehabilitate nonresidential building receive a 10-percent tax credit. Only expenditures on buildings placed in service before 1936 are eligible. Expenditures made during any 24-month period must exceed the greater of $5,000 or the adjusted basis (cost less depreciation taken) of the building.

At least 50 percent of external walls must be retained as external walls, at least 75 percent of the exterior walls must be retained as internal or external walls, and at least 75 percent of the internal structural framework of the building must be retained. The building must not have been moved since 1936.

Impact

These provisions encourage business to renovate rather than relocate. They reduce the cost of rehabilitation and thereby can turn unprofitable rehabilitation into profitable rehabilitation, and can make rehabilitation more profitable than new construction.

Rationale

The Revenue Act of 1978 provided a credit for rehabilitation expenditures made for nonresidential buildings at least 20 years old, in response to concerns over the declining usefulness of older buildings (especially those in older neighborhoods and central cities). The purpose was to promote stability and restore economic vitality to deteriorating areas.

Larger rehabilitation tax credits were enacted in the Economic Recovery Tax Act of 1981; the purpose was to counteract any tendency to encourage firms to relocate and build new plants in response to significantly shortened recovery periods. Concerns were expressed that investment in new structures in new locations does not promote economic recovery if it displaces older structures, and that relocation can cause hardship to workers and their families.

The credit was retained in the Tax Reform Act of 1986 because investors were viewed as failing to consider social and aesthetic values of restoring older structures. The credit amount was reduced because the rate would have been too high when compared with the new lower tax rates.

Assessment

The main criticism of the tax credit is that it allocates investments to restoring older buildings that would not otherwise be profitable, causing economic inefficiency. This allocation may be desirable if there are external benefits to society (*e.g.*, aesthetic benefits) that the firm would not take into account.

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Community and Regional Development

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR PRIVATE AIRPORTS, DOCKS, AND MASS-COMMUTING FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.7	0.3	1.0
2000	0.8	0.3	1.1
2001	0.9	0.3	1.2
2002	0.9	0.4	1.3
2003	1.0	0.4	1.4

Authorization

Sections 103, 141, 142, and 146.

Description

Interest income on State and local bonds used to finance the construction of government-owned airports, docks, wharves, and mass-commuting facilities, such as bus depots and subway stations, is tax exempt. These airport, dock, and wharf bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Because private-activity mass commuting facility bonds are subject to the private-activity bond annual volume cap, currently equal to the greater of $50 per State resident or $150 million, they must compete for cap allocations with bond proposals for all other private activities subject to the volume cap.

Bonds issued for airports, docks, and wharves are not, however, subject to the annual State volume cap on private-activity bonds. The cap is foregone because government ownership requirements restrict the ability of the State or local government to transfer the benefits of the tax exemption to a private operator of the facilities.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low-interest rates enable issuers to provide the services of airport, dock, and wharf facilities at lower cost.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the airport, dock, and wharf facilities, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Prior to 1968, no restriction was placed on the ability of State and local governments to issue tax-exempt bonds to finance privately owned airports, docks, and wharves. Although the Revenue and Expenditure Control Act of 1968 imposed tests that would have restricted issuance of these bond issues, it provided a specific exception for airports, docks, wharves, and mass-commuting facilities (allowing continued unrestricted issuance).

The Deficit Reduction Act of 1984 allowed bonds for non-government-owned airports, docks, wharves, and mass-commuting facilities to be tax exempt, but required the bonds to be subject to a volume cap applied to several private activities. The volume cap did not apply if the facilities were "governmentally owned."

The Tax Reform Act of 1986 allowed tax exemption only if the facilities satisfied government ownership requirements, but excluded the bonds for airports, wharves, and docks from the private-activity bond volume cap. This Act also denied tax exemption for bonds used to finance related facilities such as hotels, retail facilities in excess of the size necessary to serve passengers and employees, and office facilities for nongovernment employees.

The Economic Recovery Tax Act of 1981 extended tax exemption to mass-commuting vehicles (bus, subway car, rail car, or similar equipment) that private owners leased to government-owned mass transit systems. This provision allowed both the vehicle owner and the government transit system to benefit from the tax advantages of tax-exempt interest and accelerated depreciation allowances. The vehicle exemption was scheduled to (and did) sunset on December 31, 1984.

Assessment

State and local governments tend to view these facilities as economic development tools. The desirability of allowing these bonds to be eligible for tax-exempt status hinges on one's view of whether the users of such facilities should pay the full cost, or whether sufficient social benefits exist to justify taxpayer subsidy. Public finance theory suggests that to the extent these facilities provide social benefits that extend beyond the boundaries of the State or local government, the facilities might be underprovided due to the reluctance of State and local taxpayers to finance benefits for nonresidents.

Even if a case can be made for subsidy due to State and local underinvestment, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for airports, docks, and wharves have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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Education, Training, Employment, and Social Services:
Education and Training

TAX CREDITS FOR TUITION FOR POST-SECONDARY EDUCATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	5.6	-	5.6
2000	6.4	-	6.4
2001	6.2	-	6.2
2002	6.2	-	6.2
2003	6.2	-	6.2

Authorization

Section 25A

Description

A Hope Scholarship Credit can be claimed for each student in the family (including the taxpayer, the spouse, or their dependents) for two taxable years for expenses incurred attending a qualified post-secondary education program. Each student's credit is equal to 100 percent of the first $1,000 of qualified tuition and fees and 50 percent of the next $1,000. Tuition and fees financed with scholarships, veterans' education assistance, and other income not included in gross income for tax purposes are not qualified (with the exception of gifts and inheritances).

The Lifetime Learning Credit provides a 20 percent credit for the first $5,000 of qualified tuition and fees (the first $10,000 after 2002) that taxpayers pay for themselves, their spouse, or their dependents. The credit is available for any number of years for any level of postsecondary education.

Both credits are phased out for single taxpayers with modified adjusted gross income over $40,000 ($80,000 for joint return taxpayers). Neither credit is refundable, and the sum of these and other credits is limited to the excess of the taxpayer's regular income tax liability over the minimum tax.

Impact

The cost of investing in postsecondary education is reduced for those recipients whose marginal investment dollar is affected by these credits. Other things equal, these individuals will either increase the amount they invest or participate when they otherwise would not. Thus, some of the federal revenue loss is received by individuals who do not alter their investment decisions.

Rationale

These credits were enacted in the Taxpayer Relief Act of 1997. The intent of the credits is to assist low-and-middle-income families and students in paying for the costs of post-secondary education.

Assessment

Federal subsidy of higher education has three potential economic justifications: a capital market failure; external benefits; and nonneutral federal income tax treatment of physical and human capital. Subsidies that correct these problems are said to provide taxpayers with "social benefits."

Many students find themselves unable to finance their postsecondary education from earnings and personal or family savings. Student mobility and a lack of property to pledge as loan collateral require that commercial lenders charge high interest rates on loans for postsecondary education to reflect their high risk of default. As a result, students often find themselves unable to afford postsecondary loans from the financial sector. By definition, this financial constraint bears more heavily on lower-income groups than on higher-income groups and leads to inequality of opportunity. It is also inefficient because these students on average might be expected to earn a rate of return on postsecondary education loans that is higher than the rate of return earned on the alternative loans made by the financial sector.

This "failure" of the capital markets is attributable to the legal restriction against pledging an individual's future labor supply as loan collateral, that is, against indentured servitude. Since allowing indentured servitude is something modern society rejects, the federal government pursues an alternative strategy to correct this market failure—it provides a guarantee to absorb most of the financial sector's default risk associated with postsecondary loans to students. This financial support is provided through the Federal Family Education Loan Program and the Direct Loan Program. (See the entry “Exclusion of Interest on State and Local Government Student Loan Bonds” for more information.) This guarantee is an entitlement and equalizes the financing cost for some portion of most students' education investment. When combined with Pell Grants for lower-income students, it appears that at least some portion of the capital market failure has been corrected and equality of opportunity has been improved.

Some benefits from postsecondary education may accrue not to the individual being educated, but rather to the members of society at large. These external benefits are not valued by individuals considering educational purchases, causing them to invest less than is optimal for society (even assuming no capital market imperfections). External benefits are variously described as taking the form of better citizenship and increased productivity generated by knowledge.

Other federal and state-local spending subsidies to higher education arguably can be said to be designed to increase external benefits, and total tens of billions of dollars per year.

A third potential justification sometimes advanced for providing subsidies to human capital investment is the possibility that investment in human capital is more heavily taxed than is investment in physical capital. However, the tax on human capital investment appears to be lower than the tax on physical capital.

Potential students induced to enroll in higher education by these credits cause investment in education to increase. But the overall effectiveness of the tax credit depends upon whether the cost of the marginal investment dollar of those already investing in higher education is reduced. For those whose tuition and fees exceed qualified tuition and fees, the credit applies to the last dollar of tuition and fees and the student's price is reduced by 50 percent with the HOPE credit and by 20 percent with the Lifetime Learning Credit. The portion of the credit (and the federal revenue loss) that appears either as an increase in the quantity of education or as higher tuition depends upon the structure of the demand and supply schedules for higher education.

It is clear from the structure of these tax credits that tuition and fee payments will exceed qualified tuition and fees for a large number of students who are eligible for these credits.. These students experience an income effect but no marginal price effect. They enjoy a windfall gain and the federal taxpayer gets no offsetting social benefits in the form of an increased quantity of investment.

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Education, Training, Employment, and Social Services:
Education and Training

DEDUCTION FOR INTEREST ON STUDENT LOANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	-	0.1
2000	0.2	-	0.2
2001	0.2	-	0.2
2002	0.3	-	0.3
2003	0.3	-	0.3

Authorization

Section 221.

Description

Taxpayers may deduct interest paid on qualified education loans in determining their adjusted gross income. This above-the-line deduction is not restricted to itemizers. The deduction is allowed only with respect to interest paid during the first 60 months (whether or not consecutive) in which interest payments are required. The deduction is limited to $1,000 for taxable years beginning in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter. Allowable deductions are phased out for taxpayers with modified adjusted gross incomes between $40,000 and $55,000 ($60,000 to $75,000 in the case of joint returns). These income thresholds are indexed for inflation after 2002. Taxpayers are not eligible for the deduction if they can be claimed as a dependent by another taxpayer.

Qualified education loans are indebtedness incurred solely to pay qualified higher education expenses of taxpayers, their spouse, or their dependents at institutions eligible to participate in federal student aid programs under title IV of the Higher Education Act; these include most colleges and universities and also proprietary schools (for-profit trade and vocational schools). Other eligible institutions are hospitals and health care facilities that conduct internship or residency programs leading to a certificate or degree. At the time the debt is incurred, students must be enrolled (or accepted for enrollment) in a degree, certificate, or other program leading to a recognized educational credential and must carry at least one-half the normal full-time work load. Refinancings are considered to be qualified loans (though the 60-month limitation does not begin again), but loans from related parties are not. Qualified higher education expenses generally equal the cost of attendance

(including tuition, fees, books, equipment, room and board, transportation, etc.) minus scholarships and other education payments excluded from taxes.

Impact

The deduction benefits taxpayers according to their marginal tax rate (see Appendix A). Most education debt is incurred by students, who generally have low tax rates after they leave school and begin loan repayment. However, some debt is incurred by parents who are in higher tax brackets. The annual ceiling on amounts than can be deducted limits the impact for graduates who have large debt.

Rationale

The interest deduction for qualified education loans was authorized by the Taxpayer Relief Act of 1997 as one of a number of tax benefits for postsecondary education. These benefits reflect congressional concern that families are having increasing difficulty paying for college; they also reflect an intention to subsidize middle income families that otherwise do not qualify for much federal student aid. The interest deduction is seen as a way of helping taxpayers repay education loan debt, which has been rising steadily in recent years.

Assessment

The tax deduction can be justified both as a way of encouraging families to finance college by borrowing (which would be supported by theories about investment in human capital) and as a means of easing repayment burdens when graduates begin full-time employment. The deduction may allow some graduates to accept public service jobs that pay low salaries, though their tax savings would not be large. Whether the deduction will affect enrollment decisions is unknown; it might only change the way families finance college costs. The deduction has been criticized for providing a subsidy to all borrowers (aside from those with higher income), even those with little debt, and for doing little to help borrowers who have large loans. It is also unlikely to reduce loan defaults, which generally are related to low income and unemployment.

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EXCLUSION OF EARNINGS OF TRUST ACCOUNTS FOR HIGHER EDUCATION ("EDUCATION IRAs")

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	-	0.3
2000	0.5	-	0.5
2001	0.5	-	0.5
2002	0.6	-	0.6
2003	0.7	-	0.7

Authorization

Section 530.

Description

Education IRAs are trusts or custodial accounts created solely for the purpose of paying qualified higher education expenses of a designated beneficiary. Contributions are limited to $500 annually, subject to a phase out for taxpayers with modified adjusted gross incomes between $95,000 and $110,000 ($150,000 to $160,000 in the case of joint returns). Contributions may be made until the beneficiary turns age 18, but none may be made in a year when a contribution is made to a qualified state tuition program for the same beneficiary. Contributions are not deductible, but account earnings are exempt from taxation and distributions are excluded from gross income if used for tuition, fees, books, supplies, or equipment required for enrollment or attendance at an eligible educational institution. Qualified expenses also include limited amounts for room and board for students who attend at least half time. Eligible institutions are those eligible to participate in federal student aid programs under title IV of the Higher Education Act; these include most colleges and universities and also proprietary schools (for-profit trade and vocational schools). The remaining balance of an education IRA must be distributed within 30 days after the beneficiary reaches age 30.

Distributions are taxed to the beneficiary under section 72 annuity rules: thus, each distribution is treated as consisting of principal, which is not taxed, and earnings, some of which may be taxed depending on the amount of qualified education expenses. The exclusion does not apply to distributions in the year that either the HOPE Scholarship tax credit or the Lifetime Learning tax credit is claimed for the beneficiary.

Distributions included in gross income are subject to a 10 % penalty tax, though the latter is waived in years when either tax credit is claimed.

Impact

The exclusion benefits taxpayers according to their marginal tax rate (see Appendix A). Being students, most beneficiaries are likely to have low tax rates. There are also tax advantages associated with the deferred recognition of account earnings. These benefits are most likely to accrue to children of middle-income families that have the means to save regularly for college. The $500 annual limit on contributions may discourage participation by mutual funds that would enable education IRAs to earn higher rates of return over time than bank accounts.

Rationale

Education IRAs were authorized by the Taxpayer Relief Act of 1997 as one of a number of tax benefits for postsecondary education. These benefits reflect congressional concern that families are having increasing difficulty paying for college. They also reflect an intention to subsidize middle income families that otherwise do not qualify for much federal student aid. Education IRAs are seen as a way of helping families save for college over a number of years.

Assessment

The tax exclusion could be justified both as a way of encouraging families to use their own resources for college expenses and as a means of easing their financing burdens. The exclusion is more generous than the deferral allowed for qualified state tuition programs, though the latter provision has no limit on contributions and no income ceiling on contributors. However, for education IRAs, as for qualified state tuition programs, families that have the wherewithal to save are more likely to benefit. Whether education IRAs will result in families saving additional sums might be doubted. Tax benefits for education IRAs are not related to the student's cost of attendance or other family resources, as is most federal aid. The appropriate treatment for education IRAs under student aid need analysis formulas has yet to be resolved; this might create uncertainty about the optimum approach families should take to saving.

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Rewarding Talent in American Higher Education. Princeton, New Jersey. 1998. chaps. 3-6.

Education, Training, Employment, and Social Services:
Education and Training

EXCLUSION OF INTEREST ON EDUCATION SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 135.

Description

Eligible taxpayers can exclude from their gross income all or part of the interest on U.S. Series EE Savings Bonds if the bonds are used to finance higher education.

A taxpayer must meet certain requirements to qualify for the interest exclusion. The savings bonds must be purchased and owned by persons who are age 24 or over, and must be used to finance higher education for the taxpayer or the taxpayer's spouse or dependents. The bonds must be used for tuition and required fees (less any scholarships, fellowships, and employer-provided educational assistance) at qualified institutions, which include most colleges, universities, and certain vocational schools.

The bonds must be used to pay for higher education in the same year that they are redeemed, must be redeemed by the owner, and must have been issued after 1989.

To qualify for the interest exclusion the bonds must have been purchased by the bond owner or spouse, and the exclusion is not allowed if the bonds are used to pay for enrollment at trade or vocational schools run for profit. The bonds cannot be used to pay for room and board or books.

The interest exclusion is phased out for middle- and upper-income taxpayers. The phaseout ranges are based on a taxpayer's modified adjusted gross income, which is the sum of a taxpayer's adjusted gross income (including the interest from Series EE Bonds), the exclusion for foreign earned income, and the exclusions for income from sources within Puerto Rico and certain U.S. possessions.

The phaseout threshold is adjusted annually for inflation, but the size of the range does not change due to inflation. For 1993, the phaseout range for a married couple filing jointly is $68,250 to $98,250. For single taxpayers and heads of household, it is $45,500 to $60,500. No interest exclusion is allowed for taxpayers with incomes above these ranges. Married couples filing separate tax returns are not eligible for the interest exclusion.

If the total amount of principal and interest on bonds redeemed during a year exceeds the amount of qualified education expenses, the amount of the interest exclusion is reduced proportionately.

Impact

Education Saving Bonds provide lower- and middle-income families with a tax-favored way to save for higher education for their children, and working adults may also save for their own and their spouse's education. Tax benefits of Education Savings Bonds are greater for taxpayers who live in areas with higher State and local income taxes.

Rationale

In recent years, college costs have risen faster than the general rate of inflation and faster than the incomes of many Americans. Education Savings Bonds provide a tax break for eligible taxpayers. The interest exclusion for Education Savings Bonds was created by the Technical Corrections and Miscellaneous Revenue Act of 1988 (P.L. 100-607). The provision was amended by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) and the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508).

Assessment

The benefits of Education Savings Bonds depend on several factors, including how soon taxpayers begin to save, the return on alternative savings plans, a taxpayer's marginal income tax rate, and the burden of State and local income taxes.

For many taxpayers, the after-tax rate of return on Education Savings Bonds is approximately the same as the after-tax rate of return on other Government securities with a similar term. Like other U.S. Government securities, the interest income from Series EE Savings Bonds is exempt from State and local income taxes, and Education Savings Bonds are also exempt from Federal income taxes.

The interest rate on Series EE Bonds held for five years or more is set at 85 percent of the market rate on Treasury securities maturing in five years. Therefore, for taxpayers in the 15-percent tax bracket, the interest exclusion for Education Savings Bonds is offset by the below-market rate of interest.

The tax savings from the exclusion are greater for some taxpayers in the 28 percent tax bracket, but the exclusion is phased out for taxpayers with incomes above a certain level. Nevertheless, Series EE Bonds are a safe way to save and many taxpayers may find it easier to purchase and redeem Series EE Bonds than to buy and sell other government securities.

Further, the yield on Series EE Bonds held for five years or more is not allowed to fall below a minimum interest rate (currently four percent). The minimum interest rate is occasionally above the market interest rate, which makes Series EE Bonds an attractive savings option.

Series EE Bonds held for less than five years earn a below-market rate, based on a fixed graduated scale. Therefore, for taxpayers who are saving for educational expenses that will be incurred in less than five years, other savings plans may offer a better after-tax rate of return. On the other hand, Education Savings Bonds may offer an added incentive for many families to begin saving early for their own and their children's education.

The interest exclusion for Education Savings Bonds is based on a taxpayer's income in the year in which the bonds are redeemed. Therefore, taxpayers must predict their eligibility for the interest exclusion. They must also anticipate the future costs of tuition and fees.

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Education, Training, Employment and Social Services:
Education and Training

DEFERRAL OF TAX ON EARNINGS OF QUALIFIED STATE TUITION PROGRAMS

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	-	0.2
2000	0.2	-	0.2
2001	0.2	-	0.2
2002	0.3	-	0.3
2003	0.4	-	0.4

Authorization

Section 529.

Description

Over 40 States have adopted programs which allow persons to pay in advance or save for college expenses for designated beneficiaries. There are two general types of plans: prepaid tuition contracts and savings accounts for college expenses. Payments usually may be made all at once or over time. Earnings on qualified plans (the excess of tuition benefits over the payments) are included in gross income of the beneficiaries using rules for annuities. Thus, any tax is deferred until benefits are received. Also, the beneficiary (student) would typically have lower tax rates than the contributors.

To be qualified, a State tuition program must receive cash contributions, maintain separate accounting for each beneficiary, and not allow investments to be directed by contributors and beneficiaries. Except in case of a death or disability, programs must have penalties if earnings are not used for tuition, fees, books, supplies, equipment, or room and board.

Impact

A tax deferral is beneficial to taxpayers because it delays the payment of tax (see discussion in Appendix A). The benefit is more likely to accrue to children from higher-income families that have higher tax rates and that have the means to participate in college savings programs. While some programs are open to individuals of any State, in general one must reside in a State with a program in order to benefit from the tax deferral. Tax benefits for savings account plans might be partially offset by additional reductions in student aid.

Rationale

States have established tuition prepayment programs in response to widespread concern about the rising cost of college. The tax status of the first program, the Michigan Education Trust, was the subject of several federal court rulings that left major issues unresolved. Congress eventually clarified most questions in enacting section 529 as part of the Small Business Job Protection Act of 1996.

Assessment

The tax benefit can be justified as easing the financial burden of college expenses for families and encouraging savings for college. The deferral aspect also simplifies the tax treatment of account earnings. However, the benefits are generally limited to better-off individuals in States that have established programs. The programs themselves have been criticized for offering unclear yields (sometimes too high, and sometimes too low, in comparison with other readily-available investments), for creating unfunded State liabilities, and for inappropriately distorting choices in favor of certain colleges. Whether deferral should be restricted to public programs might be questioned.

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Education, Training, Employment, and Social Services:
Education and Training

EXCLUSION OF SCHOLARSHIP AND FELLOWSHIP INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.9	-	0.9
2000	1.0	-	1.0
2001	1.0	-	1.0
2002	1.1	-	1.1
2003	1.2	-	1.2

Authorization

Section 117.

Description

Individuals who are candidates for degrees may exclude qualified scholarships and fellowships from gross income. The exclusion applies only to amounts used for tuition and fees required for enrollment or to amounts used for books, supplies, fees, and equipment required for courses. Amounts used for room, board, and incidental expenses are not excludable. In addition, amounts representing payment for services--teaching, research, or other activities--are not excludable, regardless of when the service is performed or whether it is required of all degree -candidates.

Tuition reductions for employees of educational institutions may also be excluded, provided they do not represent payment for services. The exclusion applies as well to tuition reductions for an employee's spouse and dependent children; in addition, reductions can occur at schools other than where the employee works, provided they are granted by the school attended, not paid by the employing school. More restrictive rules apply to graduate education.

Impact

The exclusion reduces the net cost of education for students who receive financial aid in the form of scholarships or fellowships (including grants awarded on the basis of financial need, such as Pell Grants). The potential benefit is greatest for students at private colleges and universities, where higher tuition charges increase the amount of scholarship or fellowship assistance that might be excluded. For students at public institutions with low tuition charges, the exclusion may apply only to a small portion of a scholarship or fellowship award.

The effect of the exclusion may be negligible for students with little additional income: they could otherwise use their standard deduction or personal exemption to offset scholarship or fellowship income (though their personal exemption would be zero if their parents could claim them as dependents). On the other hand, the exclusion may result in a substantial tax benefit for married students who file joint returns with an employed spouse.

The exclusion of tuition reductions similarly reduces the net cost of education for employees of educational institutions. When teachers and other school employees take reduced-tuition courses, the exclusion provides a tax benefit not available to other taxpayers unless their courses are job-related or included under an employer education assistance plan (section 127). When their spouse or children take reduced-tuition courses, the exclusion provides a unique benefit unavailable to other taxpayers.

Rationale

Section 117 was enacted as part of the Internal Revenue Code of 1954 in order to clarify the tax status of grants to students; previously, they could be excluded only if it could be established that they were gifts. The statute has been amended a number of times: prior to the Tax Reform Act of 1986, for example, the exclusion was also available to individuals who were not candidates for a degree (though it was restricted to $300 a month with a lifetime limit of 36 months); in addition, teaching and other service requirements did not bar use of the exclusion, provided all candidates had such obligations. Language regarding tuition reductions was added by the Deficit Reduction Act of 1984 as part of legislation codifying and establishing boundaries for tax-free fringe benefits; similar provisions had existed in regulations since 1956.

Assessment

The exclusion of scholarship and fellowship income traditionally was justified on the grounds that the awards were analogous to gifts. With the development of grant programs based upon financial need, which today probably account for most awards, justification now rests upon the hardship that taxation would impose.

If the exclusion were abolished, awards could arguably be increased to cover students' additional tax liability, but the likely effect would be that fewer students would get assistance. Scholarships and fellowships

are not the only educational subsidies that receive favorable tax treatment (for example, government support of public colleges is not considered income to the students), and it might be inequitable to tax them without taxing the others.

The exclusion has been criticized on several grounds. It can be unfair to students who pay for college with their own or family earnings; they can neither shield this income from taxation nor deduct their expenses, though they might be eligible for either the Hope Scholarship or Lifetime Learning tax credits. In addition, the exclusion provides greater benefits to taxpayers with higher marginal tax rates. While students themselves generally have low (or even zero) marginal rates, for economic purposes they often are members of families subject to higher rates. Determining what ought to be the proper taxpaying unit for college students complicates assessment of the exclusion.

Whether the exclusion is justified depends in part on broader considerations about the appropriateness of public subsidies for education. In particular, arguments over the exclusion reflect conflicting views about the extent to which college education is a socially desirable investment as opposed to personal consumption.

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Education, Training, Employment, and Social Services:
Education and Training

EXCLUSION OF EMPLOYER-PROVIDED EDUCATION ASSISTANCE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1993	0.2	-	0.2
1994	0.2	-	0.2
1995	0.2	-	0.2
1996	0.2	-	0.2
1997	0.2	-	0.2

Authorization

Section 127.

Description

An employee may exclude from gross income amounts paid by the employer for educational assistance (tuition, fees, books, supplies, etc.) pursuant to a qualified educational assistance program. The annual limit is $5,250. The exclusion amount is available for education required to keep the taxpayer's present job or to maintain or improve skills used in the present job. Payments for graduate level courses are not

This provision expires in May 2000, but may be extended at a future date.

Impact

The exclusion of these benefit payments encourages employer educational assistance payments. (If the education were job-related, the taxpayer may be able to deduct educational expenses as an itemized business deduction.) The value of the exclusion is dependent upon the amount of educational expenses furnished and the marginal tax rate.

This exclusion allows certain employees, who otherwise might be unable to do so, to continue their education. Various studies have indicated that the provision benefits employees in middle income classes; that average payments are small, and that only about 6.5 percent of employees participate.

Rationale

Section 127 was added to the law by the passage of the Revenue Act of 1978, effective through 1983. Prior to enactment, the treatment of employer-provided educational assistance was complex, with a case-by-case determination of whether the employee could deduct the assistance as job-related education.

The provision was extended from the end of 1983 through 1985 by the Education Assistance Programs (P.L. 98-611). The Tax Reform act of 1986 raised the maximum excludable assistance from $5,000 to $5,250 and extended it through 1987. The Technical and Miscellaneous Revenue Act of 1988 reauthorized the exclusion retroactively to January 1, 1989 and extended it through September 30, 1990. The Revenue Reconciliation Act of 1990 extended it through December 31, 1991 and the Tax Extension Act of 1991 through June 30, 1992. The Omnibus Reconciliation Act of 1993 extended the provision retroactively and through December 31, 1994; the Small Business Job Protection Act re-enacted it to run from January 1, 1995 through May 31, 1997; it was extended again by the Taxpayer Relief Act of 1997. Graduate classes were eliminated after June 30, 1996.

Assessment

The availability of employer educational assistance encourages employer investment in human capital which may be inadequate in a market economy because of spillover effects. After nearly a decade little information on use of this exclusion exists. Moreover, since all employers do not provide educational assistance, taxpayers with similar incomes are not treated equally. Employer educational assistance programs are typically offered by large employers.

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Education, Training, Employment, and Social Services:
Education and Training

PARENTAL PERSONAL EXEMPTION FOR STUDENTS AGE 19-23

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.8	-	0.8
2000	0.8	-	0.8
2001	0.9	-	0.9
2002	0.9	-	0.9
2003	0.9	-	0.9

Authorization

Section 151.

Description

Taxpayers may claim dependency exemptions for children 19 through 23 years of age who are full-time students at least 5 months during the year, even if the children have gross income in excess of the personal exemption amount ($2,550 in 1996) and could not normally be claimed. Other standard dependency tests must be met, including provision of one-half of the dependents' support. These dependents cannot claim personal exemptions on their own returns, however, and their standard deduction may be lower. In 1996, with some exceptions, it is limited to the greater of $650 or their earned income, up to a maximum of $4,000 for individuals filing a single return.

Impact

The student dependency exemption generally results in additional tax savings for families with college students. Parents typically have higher income and higher marginal tax rates than their student children (who may not even be taxed); thus, the exemption is worth more if parents claim it. Parents lose some or all of the

student dependency exemption if their adjusted gross income is greater than inflation adjusted threshold for phasing out personal exemptions ($176,950 for joint returns in 1996).

Rationale

The Internal Revenue Code enacted in 1954 first allowed parents to claim dependency exemptions for their children regardless of their gross income, provided they were less than 19 years old or were full-time students for at least 5 months. Under prior law, such exemptions could not be claimed for any child whose gross income exceeded $600. Committee reports for the legislation noted that the prior rule was a hardship for parents with children in school and an inducement for the children to stop work before their earnings reached that level.

Under the 1954 Code, dependents whose exemptions could be claimed by their parents could also claim personal exemptions on their own returns. The Tax Reform Act of 1986 disallowed double exemptions, limiting claims just to the parents.

The Technical and Miscellaneous Revenue Act of 1988 restricted the student dependency exemption to children under the age of 24. Students who are older than 23 can be claimed as dependents only if their gross income is less than the personal exemption amount.

Assessment

The student dependency exemption was created before the development of broad-based Federal student aid programs, and some of its effects might be questioned in light of their objectives. The exemption principally benefits families with higher incomes and the tax savings are not related to the cost of education. In contrast, most Federal student aid is awarded according to financial need formulas that reflect both available family resources and educational cost.

Nonetheless, the original rationale for the student dependency exemption remains valid. If the exemption did not exist, as was the case before 1954, students who earned more than the personal exemption amount would cause their parents to lose a dependency exemption worth hundreds of dollars, depending on the latter's tax bracket. Unless they would earn a lot more money, students who knew of this consequence might stop work at the point their earnings reached the personal exemption amount.

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Education, Training, Employment, and Social Services:
Education and Training

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT STUDENT LOAN BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	0.1	0.3
2000	0.2	0.1	0.3
2001	0.2	0.1	0.3
2002	0.2	0.1	0.3
2003	0.2	0.1	0.3

Authorization

Sections 103, 141, 144, and 146 of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance post-secondary loans to students is tax exempt. These student loan bonds are classified as private-activity bonds rather than as governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

These student loan bonds are subject to the private-activity bond annual volume cap, and must compete for cap allocations with bond proposals for all other private activities subject to the volume cap.

Student loan bonds are integrally related to direct subsidy assistance provided by the Federal Family Education Loan Program that consisted of Stafford loans ("subsidized" and "unsubsidized") and Parent Loans to Undergraduate Students (PLUS).

The Stafford Loan program

(1) provides a guarantee to commercial lenders against loan default;

(2) makes an interest-rate subsidy in the form of a Special Allowance Payment (SAP), which for commercial lenders (banks) fluctuates with the 91-day Treasury bill rate and makes up the difference between the interest rate the student pays and the interest that banks could earn on alternative investments; and

(3) for Stafford "subsidized" loans only, forgoes both accrual and payment of interest and principal while the student is in school and defers repayment for six months after the student leaves school.

(4) for Stafford “unsubsidized” loans, interest is paid while students are in school, so the Federal subsidy is less than on Stafford "subsidized" loans.

PLUS loans are also guaranteed against default, but the maximum interest rates are higher, and interest is paid while students are in school. The interest rates that borrowers pay under the Stafford and PLUS programs are set by law and are the same regardless of whether loan financing comes from taxable or tax-exempt sources.

Thus, tax-exempt borrowing does not provide lower interest rates for borrowers, but it does broaden access to loans by enabling State and local nonprofit authorities to make loans wherever private institutions may be reluctant to do so.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates may increase the availability of student loans, but they do not lower the interest rate to students, since this is set by Federal law. The availability of student loan bond funds helps create a secondary market for student loans made by private lenders in much the same way the Student Loan Marketing Association does.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and student borrowers, and for estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Although the first student loan bonds were issued in the mid-1960s, few states used them in the next ten years. The use of student loan bonds began growing rapidly in the late 1970s because of the combined effect

of three pieces of legislation.

First, the Tax Reform Act of 1976 authorized nonprofit corporations established by State and local governments to issue tax-exempt bonds to acquire guaranteed student loans. It exempted the special allowance payment from tax-code provisions prohibiting arbitrage profits (borrowing at low interest rates and investing the proceeds in assets (*e.g.*, student loans) paying higher interest rates). State authorities could use arbitrage earnings to make or purchase additional student loans or turn them over to the State government or a political subdivision. This provided incentives for State and local governments to establish more student loan authorities.

Second, the Middle Income Student Assistance Act of 1978 made all students, regardless of family income, eligible for interest subsidies on their loans, expanding the demand for loans by students from higher-income families.

Third, legislation in late 1976 raised the ceiling on SAPs and tied them to quarterly changes in the 91-day Treasury bill rate. The Higher Education Technical Amendments of 1979 removed the ceiling, making the program more attractive to commercial banks and other lenders, and increasing the supply of loans.

In 1980, when Congress became aware of the profitability of tax-exempt student loan bond programs, it passed remedial legislation that reduced by one-half the special allowance rate paid on loans originating from the proceeds of tax-exempt bonds.

Subsequently, the Deficit Reduction Act of 1984 mandated a Congressional Budget Office study of the arbitrage treatment of student loan bonds, and required that Treasury enact regulations if Congress failed to respond to the study's recommendations.

Regulations were issued in 1989, effective in 1990, that required Special Allowance Payments to be included in the calculation of arbitrage profits, and that restricted arbitrage profits to 2.0 percentage points in excess of the yield on the student loan bonds. The Tax Reform Act of 1986 allowed student loans to earn 18 months of arbitrage profits on unspent (not loaned) bond proceeds. This special provision expired one-and-a-half years after adoption, and student loans are now subject to the same six-month restriction on arbitrage earnings as other private-activity bonds.

The Tax Reform Act of 1986 also included student loan bonds under the unified volume cap on private-activity bonds.

Assessment

The desirability of allowing these bonds to be eligible for tax-exempt status hinges on one's view of whether students should pay the full cost of their education, or whether sufficient social benefits exist to justify taxpayer subsidy. Students present high credit risk due to their uncertain earning prospects, high mobility, and society's unwillingness to accept human capital as loan collateral (via indentured servitude or slavery). This suggests

there may be insufficient funds available for human, as opposed to physical, capital investments.

Even if a case can be made for subsidy due to underinvestment in human capital, it is not clear that tax-exempt financing is necessary to correct the market failure. The presence of federally subsidized guaranteed and direct loans already addresses the problem. In addition, it is important to recognize the costs that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for student loans have increased the financing costs of bonds issued for public capital stock, and have increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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Education, Training, Employment and Social Services:
Education and Training

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR PRIVATE NONPROFIT EDUCATIONAL FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.7	0.3	1.0
2000	0.8	0.3	1.1
2001	0.9	0.3	1.2
2002	0.9	0.4	1.3
2003	0.9	0.5	1.4

Authorization

Section 103, 141, 145, 146, and 501(c)(3).

Description

Interest income on State and local bonds used to finance the construction of nonprofit educational facilities (usually university and college facilities such as classrooms and dormitories) is tax exempt. These nonprofit organization bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Bonds issued for nonprofit educational facilities are not, however, subject to the State volume cap on private activity bonds. This exclusion probably reflects some belief that the nonprofit bonds have a larger component of benefit to the general public than do many of the other private activities eligible for tax exemption. The bonds are, however, subject to a $150 million cap on the amount of bonds any nonprofit institution can have outstanding.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to finance educational facilities at reduced interest rates. Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the nonprofit educational facilities, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

An early decision of the U.S. Supreme Court predating the enactment of the first Federal income tax, *Dartmouth College v. Woodward* (17 U.S. 518 [1819]), confirmed the legality of government support for charitable organizations that were providing services to the public. The income tax adopted in 1913, in conformance with this principle, exempted from taxation virtually the same organizations now included under Section 501(c)(3). In addition to their tax- exempt status, these institutions were permitted to receive the benefits of tax-exempt bonds. Almost all States have established public authorities to issue tax-exempt bonds for nonprofit educational facilities.

The private-activity bond status of these bonds subjects them to more severe restrictions in some areas, such as arbitrage rebate and advance refunding, than would apply if they were classified as governmental bonds.

Assessment

Efforts have been made to reclassify nonprofit bonds as governmental bonds. Central to this issue is the extent to which nonprofit organizations are fulfilling their public purpose rather than using their tax-exempt status to convert tax subsidies into subsidized goods and services for groups that might receive more critical scrutiny if their subsidy were provided through the spending side of the budget.

As one of many categories of tax-exempt private-activity bonds, nonprofit education bonds have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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Education, Training, Employment and Social Services:
Education and Training

TAX CREDIT FOR HOLDERS OF QUALIFIED EDUCATION BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-		([1])
2000	-	0.1	0.1
2001	-	0.1	0.1
2002	-	0.1	0.1
2003	-	0.1	0.1

([1])Less than $50 million.

Authorization

Section 1397E of the Internal Revenue Code

Description

Holders of qualified zone academy bonds are provided with a credit equal to the dollar value of the bonds held times a credit rate determined by the Secretary of the Treasury. The credit rate is equal to the percentage that will permit the bonds to be issued without discount and without interest cost to the issuer. The maximum maturity of the bonds is that which will set the present value of the obligation to repay the principal equal to 50 percent of the face amount of the bond issue, using as a discount rate the average annual interest rate on tax-exempt bonds issued in the preceding month having a term of at least 10 years. The bonds must be purchased by a bank, insurance company, or a corporation in the business of lending money.

A qualified zone academy must be a public school below the college level. It must be located in an empowerment zone or enterprise community, or have a student body whose eligibility rate for free or reduced-

cost lunches is at least 35 percent. Ninety-five percent of bond proceeds must be used to renovate capital facilities, provide equipment, develop course materials, or train personnel. The academy must operate a special academic program in cooperation with businesses, and private entities must contribute equipment, technical assistance, employee services, or other property worth at least 10 percent of bond proceeds. Four hundred million of these bonds may be issued in both 1998 and 1999, with the $400 million each year allocated among the states in proportion to their share of all individuals below the poverty line.

Impact

The interest income on bonds issued by State and local governments usually is excluded from federal income tax (see the entry "Exclusion of Interest on Public Purpose State and Local Debt"). Such bonds result in the federal government paying a portion (varying around 25 percent) of the issuer's interest costs. Qualified Zone Academy Bonds are structured to have the entire interest cost of the State or local government paid by the federal government in the form of a credit to the bond holders. In that sense, these are not tax-exempt bonds. These bonds are intended to benefit the taxpayers in the poverty areas eligible to issue the bonds. The cost has been capped at $400 million per year. If the school districts in any state do not use their state's allotment of this $400 million, the unused amount is to be added to the state's allotment the following year.

Rationale

The Taxpayer Relief Act of 1997 introduced Qualified Zone Academy Bonds. Some poor school districts were finding it difficult to pass bond referenda to finance new schools or to rehabilitate existing schools. Increasing the size of the existing subsidy provided by tax-exempt bonds from partial to 100 percent federal payment of interest costs was expected to make school investments less expensive and therefore more attractive to taxpayers in these poor districts. The provision is also intended to encourage public/private partnerships, and eligibility depends in part on a school district's ability to attract private contributions that have a present value equal to at least 10 percent of the value of the bond proceeds.

Assessment

. One way to think of this alternative subsidy is that financial institutions can be induced to purchase these bonds if they receive the same after-tax return from the credit that they would from the purchase of tax-exempt bonds. The value of the credit must be included in taxable income, but is then used to reduce regular or alternative minimum tax liability. Assuming the taxpayer is subject to the regular corporate income tax, the credit rate should equal the ratio of the purchaser's foregone market interest rate on tax-exempt bonds divided by one minus the corporate tax rate. For example, if the tax-exempt interest rate is 6 percent and the corporate tax rate is 35 percent, the credit rate would be equal to .06/(1-.35), or about 9.2 percent. Thus, a financial institution purchasing a $1,000 zone academy bond would receive a $92 tax credit for each year it holds the bond.

The zone academy bonds pay 100 percent of interest costs; tax-exempt bonds that are used for financing other public facilities finance only a portion of interest costs. For example, if the taxable rate is 8 percent and the tax-exempt rate is 6 percent, the non-zone bond receives a subsidy equal to two percentage points of the total interest cost, the difference between 8 percent and 6 percent. The zone academy bond receives a subsidy equal to all 8 percentage points of the interest cost. Thus, this provision reduces the price of investing in schools compared to investing in other public services provided by a governmental unit, and other things equal should cause some reallocation of the units budget toward schools. In addition, the entire subsidy (the cost to the federal taxpayer) is received by the issuing government in the form of reduced interest costs, unlike tax-exempt bonds in which part of the federal revenue loss is a windfall gain for some purchasers and does not act to reduce the issuing government's interest cost.

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Education, Training, Employment, and Social Services:
Education and Training

DEDUCTION FOR CHARITABLE CONTRIBUTIONS TO EDUCATIONAL INSTITUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.8	1.0	3.8
2000	2.9	1.1	4.0
2001	3.1	1.2	4.3
2002	3.3	1.4	4.7
2003	3.5	1.5	5.0

Authorization

Section 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations, including scientific, literary, or educational organizations.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI) (30 percent for gifts of capital gain property). For contributions to nonoperating foundations and organizations, deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over the amount of contributions which qualified for the 50 percent deduction ceiling (including carryovers from previous years).

Gifts of capital gain property to these organizations are limited to 20 percent of AGI. A corporation can deduct up to 10 percent of taxable income (with some adjustments).

If a contribution is made in the form of property, the deduction depends on the type of taxpayer (*i.e.*, individual, corporate, etc.), recipient, and purpose.

Taxpayers are required to obtain written substantiation from a donee organization for contributions which exceed $250. This substantiation must be received no later than the date the donor-taxpayer filed the required income tax return. Donee organizations are obligated to furnish the written acknowledgment when requested with sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the federal government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Those individuals who use the standard deduction or who pay no taxes receive no benefit from the provision.

A limitation applies to the itemized deductions of high-income taxpayers. Under this provision, in 1998, otherwise allowable deductions are reduced by three percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $124,500 (adjusted for inflation in future years). The table below provides the distribution of all charitable contributions, not just those for educational organizations.

Distribution by Income Class of the Tax Expenditure for Charitable Contributions, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.5
$20 to $30	1.3
$30 to $40	2.5
$40 to $50	4.0
$50 to $75	14.9
$75 to $100	14.8
$100 to $200	22.1
$200 and over	39.8

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the

sponsor, argued that the high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were generally contributed to charitable organizations.

It was also argued that many colleges would lose students to the military and charitable gifts were needed by educational institutions. Thus the original rationale shows a concern for educational organizations. The deduction was extended to estates and trusts in 1918 and to corporations in 1935.

Assessment

Most economists agree that education produces substantial "spillover" effects benefiting society in general. Examples include a more efficient workforce, lower unemployment rates, lower welfare costs, and less crime. An educated electorate fosters a more responsive and effective government. Since these benefits accrue to society at large, they argue in favor of the government actively promoting education.

Further, proponents argue that the federal government would be forced to assume some activities now provided by educational organizations if the deduction were eliminated. However, public spending might not be allowed to make up all the difference. Also, many believe that the best method of allocating general welfare resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect which varies with the marginal tax rate of the giver. There are a number of studies which find significant behavioral responses, although a recent study by Randolph suggests that such measured responses may largely reflect transitory timing effects.

Types of contributions may vary substantially among income classes. For example, contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to educational institutions.

It has been estimated by the AAFRC Trust for Philanthropy, Inc. that giving to public and private colleges, universities, elementary schools, secondary schools, libraries, and to special scholarship funds, nonprofit trade schools, and other educational facilities amounted to $18.81 billion in calendar year 1996, which represents an estimated 6.8 percent increase (4.1 percent increase when provided in inflation-adjusted terms).

Opponents say that helping educational organizations may not be the best way to spend government money. Opponents further claim that the present system allows wealthy taxpayers to indulge special interests (such as gifts to their alma mater).

To the extent that charitable giving is independent of tax considerations, federal revenues are lost without increasing charitable gifts. It is generally argued that the charitable contributions deduction is difficult to administer and complex for taxpayers to comply with.

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EXCLUSION OF EMPLOYEE MEALS AND LODGING (OTHER THAN MILITARY)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.7	-	0.7
2000	0.8	-	0.8
2001	0.8	-	0.8
2002	0.8	-	0.8
2003	0.9	-	0.9

Authorization

Sections 119 and 132(e)(2).

Description

Employees do not include in income the fair market value of meals furnished by employers if the meals are furnished on the employer's business premises and for the convenience of the employer.

The fair market value of meals provided to an employee at a subsidized eating facility operated by the employer is also excluded from income, if the facility is located on or near the employer's business, and if revenue from the facility equals or exceeds operating costs. In the case of highly compensated employees, certain nondiscrimination requirements are met to obtain this second exclusion.

Section 119 also excludes from an employee's gross income the fair market value of lodging provided by the employer, if the lodging is furnished on business premises for the convenience of the employer, and if the employee is required to accept the lodging as a condition of employment.

Impact

Exclusion from taxation of meals and lodging furnished by an employer provides a subsidy to employment in those occupations or sectors in which such arrangements are common. Live-in housekeepers or apartment resident managers, for instance, may frequently receive lodging and/or meals from their employers. The subsidy provides benefits both to the employees (more are employed and they receive higher pay) and to their employers (who receive the employees' services at lower cost).

Rationale

The convenience-of-the-employer exclusion now set forth in section 119 generally had been reflected in income tax regulations since 1918, presumably in recognition of the fact that in some cases, the fair market value of employer-provided meals and lodging may be difficult to measure.

The specific statutory language in section 119 was adopted in the 1954 Code to clarify the tax status of such benefits by more precisely defining the conditions under which meals and lodging would be treated as tax free.

In enacting the limited exclusion for certain employer-provided eating facilities in the 1984 Act, the Congress recognized that the benefits provided to a particular employee who eats regularly at such a facility might not qualify as a *de minimis* fringe absent another specific statutory exclusion. The record-keeping difficulties involved in identifying which employees ate what meals on particular days, as well as the values and costs for each such meal, led the Congress to conclude that an exclusion should be provided for subsidized eating facilities as defined in section 132(e)(2).

Assessment

The exclusion subsidizes employment in those occupations or sectors in which the provision of meals and/or lodging is common. Both the employees and their employers benefit from the tax exclusion. Under normal market circumstances, more people are employed in these positions and they receive higher pay (after tax). Their employers receive their services at lower cost. Both sides of the transaction benefit because the loss is imposed on the U.S. Treasury in the form of lower tax collections.

Because the exclusion applies to practices common only in a few occupations or sectors, it introduces inequities in tax treatment among different employees and employers.

While some tax benefits are conferred specifically for the purpose of providing a subsidy, this one ostensibly was provided for administrative reasons, and the benefits to employers and employees are side effects. Some observers challenge the rationale for excluding employer-provided meals and lodging on the basis of difficulty in determining their fair market value. They note that a value is placed on these services

under some Federal and many State welfare programs.

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Education, Training, Employment and Social Services:
Employment

EXCLUSION OF BENEFITS PROVIDED UNDER CAFETERIA PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	4.3	-	4.3
2000	4.5	-	4.5
2001	4.9	-	4.9
2002	5.3	-	5.3
2003	5.7	-	5.7

Authorization

Section 125.

Description

Cafeteria plans allow employees to select a mixture of fringe benefits, including some benefits that are not subject to tax. The "menu" for such plans must include both taxable and nontaxable benefits. The tax expenditure measures the loss in revenues from the failure to include the nontaxable cafeteria plan benefits in taxable income.

Taxable benefits that may be offered under a qualified cafeteria plan consist of certain life insurance that is not excludable from gross income, certain vacation pay, or cash.

Nontaxable benefits include any fringe benefit (other than scholarships or fellowships, van-pooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code. These nontaxable benefits include nontaxable employer-provided health and accident benefits, life insurance, and qualified deferred compensation (savings) plans.

A highly compensated participant in a cafeteria plan is taxed on all benefits if the cafeteria plan

discriminates in favor of highly compensated individuals as to eligibility, benefits or contributions. A highly compensated individual includes an officer, a 5-percent shareholder, someone with high earnings, or a spouse or dependent of any of these individuals.

In addition, if more than 25 percent of the total tax-favored benefits provided under a cafeteria plan for a plan year are provided to key employees, these key employees will be taxed on all benefits. A key employee is an individual who is an officer, a 5-percent owner, a 1-percent owner earning more than $150,000, or one of the top 10 employee-owners.

Impact

This provision permits an employer to allow each employee individual flexibility to choose benefits from a menu. The employee does not include the costs of such plans in income, and his tax bill is reduced compared to another employee with a similar total compensation package received solely in cash wages.

Cafeteria plans have been growing rapidly in popularity, and the tax expenditure cost has been growing as well. For example, the percentage of employees at large and medium sized firms eligible for these plans grew from 5 percent in 1986 to 55 percent in 1995.

Although no direct data are available on the distribution of this tax benefit, it is likely to benefit higher-income individuals more than lower-income ones, not only because of the larger tax advantage of receiving tax-free benefits but also because more highly compensated workers tend to be covered by any type of fringe benefit plan.

For example, in 1993 only 8 percent of individuals earning less than $10,000 and 27 percent of individuals earning between $10,000 and $15,000 were covered by retirement plans; the ratio rises until 81 percent of individuals earning over $75,000 are covered.

Participation is likely to be even more concentrated among higher- income individuals due to the elective nature of the benefit. To illustrate from another elective benefit, Individual Retirement Accounts (IRAs), in 1985 only 2 percent of individuals with adjusted gross income below $10,000 and 14 percent with adjusted gross income from $10,000 to $30,000 participated in IRAs. Yet, 57 percent of those with incomes between $50,000 and $75,000 and about 75 percent of those with incomes above $75,000 contributed.

Rationale

Under a provision of the Employee Retirement Income Security Act of 1974 (ERISA), an employer contribution made before January 1, 1977 to a cafeteria plan in existence on June 27, 1974 was required to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. For plans not in existence on June 27, 1974, the employer contribution was required to be included in income

to the extent the employee could have elected taxable benefits.

Under the Tax Reform Act of 1976, these rules applied to employer contributions made before January 1, 1978. The Foreign Earned Income Act of 1978 (Public Law 95-615) extended these rules until the effective date of the Revenue Act of 1978 (*i.e.*, it extended the treatment through 1978 for calendar-year taxpayers).

In the Revenue Act of 1978, the current provision was added to the Code to ensure that rules were provided on a permanent basis, but no specific rationale was provided.

In the Deficit Reduction Act of 1984, the Congress found it appropriate to limit permissible benefits and provide additional reporting requirements. Reports accompanying that legislation note that these additional limitations were needed to prevent further erosion of the income and employment tax bases.

The Tax Reform Act of 1986 imposed stricter anti-discrimination rules (regarding the favoritism towards highly compensated employees) which affected cafeteria plans. There were other minor revisions as well. The anti-discrimination rules were repealed as part of the public debt limit increase in 1989 (P.L. 101-140).

Assessment

Cafeteria plans are more attractive to employees than less flexible benefit packages, since they can choose those best suited to their individual circumstances. Thus cafeteria plans avoid one of the drawbacks of many other fringe benefit plans, which may not provide the most desirable mix of benefits.

There are some problems with these plans, however. Like all fringe benefit plans, this tax treatment leads to different tax burdens for individuals with the same economic income. They also lead employees to over-consume services covered by the plans, such as health care.

And, because they are elective, they may involve greater administrative costs and be subject to adverse selection (only those individuals who are likely to need the benefits of insurance programs will sign up), which increases costs.

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Education, Training, Employment, and Social Services:
Employment

EXCLUSION OF RENTAL ALLOWANCES FOR MINISTERS' HOMES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.4	-	0.4
2000	0.4	-	0.4
2001	0.4	-	0.4
2002	0.4	-	0.4
2003	0.4	-	0.4

Authorization

Section 107.

Description

Under an exclusion available for a "minister of the gospel," gross income does not include

(1) the fair rental value of a church-owned or church-rented home furnished as part of his or her compensation, or

(2) a cash housing/furnishing allowance paid as part of the minister's compensation.

The housing/furnishing allowance may provide funds for rental or purchase of a home, including down payment, mortgage payments, interest, taxes, repairs, furniture payments, garage costs, and utilities.

Ministers receiving cash housing allowances also may claim deductions on their individual income tax returns for mortgage interest and real estate taxes on their residences even though such expenditures were allocable, in whole or in part, to tax-free receipt of the cash housing allowance. While excluded from income

taxes, the fair rental value or cash housing/furnishing allowance is subject to social security payroll taxes.

Impact

As a result of the special exclusion provided for parsonage allowances, ministers receiving such housing allowances pay less tax than other taxpayers with the same or smaller economic incomes. The tax benefit of the exclusion also provides a disproportionately greater benefit to relatively better-paid ministers, by virtue of the higher marginal tax rates applicable to their incomes.

Some ministers may claim income tax deductions for housing costs allocable to the receipt of tax-free allowances.

Rationale

The provision of tax-free housing allowances for ministers was first made a part of the Internal Revenue Code by passage of the Revenue Act of 1921 (P.L. 98 of the 67th Congress), without any stated reason. The original rationale may reflect the difficulty of placing a value on the provision of a church- provided rectory. Since some churches provided rectories to their ministers as part of their compensation, while other churches provided a housing allowance, the Congress may have wished to provide equal tax treatment to both groups. Another suggested rationale is that the provision was provided in recognition of the clergy as an economically deprived group with low incomes.

The Internal Revenue Service reversed a 1962 ruling (Ruling 62-212) in 1983 (Revenue Ruling 83-3) which provided that, to the extent of the tax-free housing allowance, deductions for interest and property taxes may not be itemized. This change was based on the belief that it was unfair to allow tax-free income to be used to generate individual itemized deductions to shelter taxable income.

In the Tax Reform Act of 1986 (P.L. 99-514) the Congress reversed the I.R.S. ruling because the tax treatment had been long-standing, and for fear that the I.R.S. might treat tax-free housing allowances provided to U.S. military personnel similarly.

Assessment

The tax-free parsonage allowances encourage some congregations to structure maximum amounts of tax-free housing allowances into their minister's pay and may thereby distort the compensation package.

The provision is inconsistent with both horizontal and vertical equity principles. Since all taxpayers may not exclude amounts they pay for housing from taxable income, the provision violates horizontal equity principles. For example, a clergyman teaching in an affiliated religious school may exclude the value of his housing allowance whereas a teacher in the same school may not. This example shows how the tax law

provides different tax treatment to two taxpayers whose economic incomes may be similar.

Ministers with higher incomes receive a greater subsidy than lower-income ministers because of their higher marginal tax rates, and those ministers that have church-provided homes do not receive the same benefits as those who purchase their homes and also have the tax deductions for interest and property taxes available to them. Code Section 265 disallows deductions for interest and expenses which relate to tax-exempt income except in the case of military housing allowances and the parsonage allowance.

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Education, Training, Employment, and Social Services:
Employment

EXCLUSION OF MISCELLANEOUS FRINGE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	6.2	-	6.2
2000	6.5	-	6.5
2001	6.9	-	6.9
2002	7.3	-	7.3
2003	7.8	-	7.8

Authorization

Sections 132 and 117(D).

Description

Individuals do not include in income certain miscellaneous fringe benefits provided by employers, including services provided at no additional cost, employee discounts, working condition fringes, *de minimis* fringes, and certain tuition reductions. Special rules apply with respect to certain parking facilities provided to employees and certain on-premises athletic facilities.

These benefits also may be provided to spouses and dependent children of employees, retired and disabled former employees, and widows and widowers of deceased employees. Certain nondiscrimination requirements apply to benefits provided to highly compensated employees.

Impact

Exclusion from taxation of miscellaneous fringe benefits provides a subsidy to employment in those businesses and industries in which such fringe benefits are common and feasible. Employees of retail stores,

for example, may receive discounts on purchases of store merchandise. Such benefits may not be feasible in other industries--for example, for manufacturers of heavy equipment.

The subsidy provides benefits both to the employees (more are employed and they receive higher compensation) and to their employers (who have lower wage costs).

Rationale

This provision was enacted in 1984; the rules affecting transportation benefits were modified in 1992 and 1997. The Congress recognized that in many industries employees receive either free or discount goods and services that the employer sells to the general public. In many cases, these practices had been long established and generally had been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income.

Employees clearly receive a benefit from the availability of free or discounted goods or services, but the benefit may not be as great as the full amount of the discount. Employers may have valid business reasons, other than simply providing compensation, for encouraging employees to use the products they sell to the public. For example, a retail clothing business may want its salespersons to wear its clothing rather than clothing sold by its competitors. As with other fringe benefits, placing a value on the benefit in these cases is difficult.

In enacting these provisions, the Congress also wanted to establish limits on the use of tax-free fringe benefits. Prior to enactment of the provisions, the Treasury Department had been under a congressionally imposed moratorium on issuance of regulations defining the treatment of these fringes. There was a concern that without clear boundaries on use of these fringe benefits, new approaches could emerge that would further erode the tax base and increase inequities among employees in different businesses and industries.

Assessment

The exclusion subsidizes employment in those businesses and industries in which fringe benefits are feasible and commonly used. Both the employees and their employers benefit from the tax exclusion. Under normal market circumstances, more people are employed in these businesses and industries, and they receive higher compensation (after tax). Their employers receive their services at lower cost. Both sides of the transaction benefit because the loss is imposed on the U.S. Treasury in the form of lower tax collections.

Because the exclusion applies to practices which are common and may be feasible only in some businesses and industries, it creates inequities in tax treatment among different employees and employers. For example, consumer-goods retail stores may be able to offer their employees discounts on a wide variety of goods ranging from clothing to hardware, while a manufacturer of aircraft engines cannot give its workers compensation in the form of tax-free discounts on its products.

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Education, Training, Employment and Social Services:
Employment

EXCLUSION OF EMPLOYEE AWARDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	-	0.1
2000	0.1	-	0.1
2001	0.1	-	0.1
2002	0.1	-	0.1
2003	0.1	-	0.1

Authorization

Sections 74(c), 274(j).

Description

Generally, prizes and awards are taxable. Subsection 74(c), however, provides an exclusion for certain awards given to employees for length of service or for safety. To qualify, awards must meet requirements imposed to assure that they are *bona fide* achievement awards and that they do not constitute disguised compensation.

The amount of the exclusion is limited to $400 generally, or up to $1,600 under certain qualified employee achievement award plans which do not discriminate in favor of highly compensated employees. The amount of employee awards which is excluded from gross income is also excluded under the social security tax.

Impact

Sections 74(c) and 274(j) exclude from gross income certain employee awards for length of service and safety achievement that would otherwise be taxable.

Rationale

The exclusion for employee awards was adopted in the Tax Reform Act of 1986. Prior to that Act, with certain exceptions that were complex and difficult to interpret, awards received by employees generally were taxable. The exclusion recognizes a traditional business practice which may have social benefits. Limitations imposed on the exclusion prevent it from becoming a vehicle for significant tax avoidance.

Assessment

If employee awards were taxable, in some cases employees might prefer not to receive an award because of the tax consequences, and some award programs might be terminated. In other cases, the tax on the award would detract from its value to the employee. Since there is probably some social value in encouraging longevity in employment and safety practices on the job, a limited public subsidy for such awards may be justified.

On the other hand, the exclusion subsidizes employment in those businesses that provide length of service and safety awards for their employees, providing a benefit not enjoyed by businesses which do not provide such awards. The limitations imposed on the exclusion keep the special benefit relatively small.

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Education, Training, Employment, and Social Services:
Employment

EXCLUSION OF INCOME EARNED BY VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.5	-	0.5
2000	0.5	-	0.5
2001	0.6	-	0.6
2002	0.6	-	0.6
2003	0.6	-	0.6

Authorization

Sections 419, 419A, and 501(c)(9).

Description

A Voluntary Employees' Beneficiary Association (VEBA), or 501(c)(9) trust, provides life, sickness, accident, and other welfare benefits to its employee members, their dependents, and their beneficiaries. Membership in the organization must be voluntary.

In addition to its tax-exempt status, other tax advantages include the deductibility of employer contributions to fund future benefit payments (within limits). The tax advantages are predicated upon compliance with certain requirements on who may participate, what benefits may be provided, and how the program is administered.

In addition to meeting nondiscrimination requirements of the tax code, most VEBAs are subject to the reporting, disclosure, and fiduciary requirements applicable to "welfare benefit plans" under the Employee Retirement Income Security Act (ERISA).

The VEBA may be subject to unrelated business income tax on some or all of its income if it holds reserves in excess of the limits permitted in Code Sections 419 and 419A, or if it holds a reserve for post-retirement medical benefits.

Impact

In the absence of a VEBA, an employer often provides welfare benefits by directly purchasing life, health, or disability insurance benefits for its employees. Funding these benefits through a VEBA on an insured or self-insured basis provides certain tax advantages to the employer. Subject to the limits in Code Sections 419 and 419A, the employer can deduct its contributions in advance of the time when benefits are actually paid to employee participants. Another economic advantage to an employer is that the VEBA affords a tax-free accumulation (within limits) that reduces the cost of providing the welfare benefits to employees.

Rationale

Tax-favored treatment of VEBAs had its origin in the Revenue Act of 1928. This law permitted an organization to provide payment of life, sickness, accident, or other welfare benefits to its members, provided that the members contributed at least 85 percent of its income and no part of the trusts' earnings inured to the benefit of any private shareholder or individual.

Previously, employee benefit associations providing these types of benefits had attempted unsuccessfully to obtain tax exemption under other Code provisions. Congress, acknowledging that such organizations were common, responded by creating the exemption.

The exemption for VEBAs was expanded in 1942 to allow employers to contribute to the association without violating the 85-percent-of-income requirement. The 85-percent requirement was eliminated completely by the Tax Reform Act of 1969. Since 1986, deductions for contributions have been subject to rules on funded welfare benefit plans under Code Sections 419 and 419A.

Congress considers these costs justifiable if such benefits fulfill important social-policy objectives, such as increasing health insurance coverage among taxpayers who are not highly compensated and who otherwise would not purchase or could not afford such coverage.

However, Congress was concerned that the nondiscrimination rules did not require sufficient coverage of non-highly-compensated employees. As part of the Tax Reform Act of 1986 (TRA86), new rules for welfare benefit plans, particularly health benefit plans and group term life insurance, were added by Section 89 of the Internal Revenue Code. The new rules were complex and met with a substantial amount of resistance. Congress subsequently repealed Section 89 in 1989.

Assessment

VEBAs may be viewed as the welfare benefits complement of pension and profit-sharing plans. VEBAs have become an attractive alternative for sheltering income and providing certain non-pension benefits to employees, because they are not subject to the same restrictions and limitations as pension and profit-sharing plans.

Generally, if a VEBA discriminates in favor of highly compensated employees, it will lose its tax qualification. However, the nondiscrimination rules do not apply in the case of collectively bargained plans where there was good-faith bargaining.

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Education, Training, Employment, and Social Services:
Employment

SPECIAL TAX PROVISIONS FOR EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	0.8	0.8
2000	([1])	0.8	0.8
2001	([1])	0.9	0.9
2002	([1])	0.9	0.9
2003	([1])	0.9	0.9

([1])Less than $50 million.

Authorization

Sections 133, 401(a)(28), 404(a)(9), 404(k), 415(c)(6), 1042, 4975(e)(7), 4978, 4979A

Description

An employee stock ownership plan (ESOP) is a defined-contribution plan that is required to invest primarily in the stock of the sponsoring employer. ESOPs are unique among employee benefit plans in their ability to borrow money to buy stock. An ESOP that has borrowed money to buy stock is a leveraged ESOP. An ESOP that acquires stock through direct employer contributions of cash or stock is a nonleveraged ESOP.

ESOPs are provided with various tax advantages. Employer contributions to an ESOP may be deducted by the employer as a business expense. Contributions to a leveraged ESOP are subject to less restrictive limits than contributions to other qualified employee benefit plans.

An employer may deduct dividends paid on stock held by an ESOP if the dividends are paid to plan participants or if the dividends are used to repay a loan that was used to buy the stock. The deduction for

dividends used to repay a loan is limited to dividends paid on stock acquired with that loan. Employees are not taxed on employer contributions to an ESOP or the earnings on invested funds until they are distributed.

A stockholder in a closely held company may defer recognition of the gain from the sale of stock to an ESOP if, after the sale, the ESOP owns at least 30 percent of the company's stock and the seller reinvests the proceeds from the sale of the stock in a U.S. company.

To qualify for these tax advantages, an ESOP must meet the minimum requirements established in the Internal Revenue Code. Many of these requirements are general requirements that apply to all qualified employee benefit plans. Other requirements apply specifically to ESOPs.

In particular, ESOP participants must be allowed voting rights on stock allocated to their accounts. In the case of publicly traded stock, full voting rights must be passed through to participants. For stock in closely held companies, voting rights must be passed through on all major corporate issues.

Closely held companies must give employees the right to sell distributions of stock to the employer (a put option), at a share price determined by an independent appraiser. An ESOP must allow participants who are approaching retirement to diversify the investment of funds in their accounts.

Impact

The various ESOP tax incentives encourage employee ownership of stock through a qualified employee benefit plan and provide employers with a tax-favored means of financing. The deferral of recognition of the gain from the sale of stock to an ESOP encourages the owners of closely held companies to sell stock to the company's employees. The deduction for dividends paid to ESOP participants encourages the current distribution of dividends.

Various incentives encourage the creation of leveraged ESOPs. Compared to conventional debt financing, both the interest and principal on an ESOP loan are tax-deductible. The deduction for dividends used to make payments on an ESOP loan and the unrestricted deduction for contributions to pay interest encourage employers to repay an ESOP loan more quickly.

According to an analysis of information returns filed with the Internal Revenue Service, most ESOPs are in private companies, and most ESOPs have fewer than 100 participants. But most ESOP participants are employed by public companies and belong to plans with 100 or more participants. Likewise, most ESOP assets are held by plans in public companies and by plans with 100 or more participants.

Rationale

The tax incentives for ESOPs are intended to broaden stock ownership, provide employees with a source of retirement income, and grant employers a tax-favored means of financing.

The Employee Retirement Income Security Act of 1974 (P.L. 93-406) allowed employers to form leveraged ESOPs. The Tax Reduction Act of 1975 established a tax-credit ESOP (called a TRASOP) that allowed employers an additional investment tax credit of one percentage point if they contributed an amount equal to the credit to an ESOP.

The Tax Reform Act of 1976 allowed employers an increased investment tax credit of one-half a percentage point if they contributed an equal amount to an ESOP and the additional contribution was matched by employee contributions.

The Revenue Act of 1978 required ESOPs in publicly traded corporations to provide participants with full voting rights, and required closely held companies to provide employees with voting rights on major corporate issues. The Act required closely held companies to give workers a put option on distributions of stock.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) replaced the investment-based tax credit ESOP with a tax credit based on payroll (called a PAYSOP). The 1981 Act also allowed employers to deduct contributions of up to 25 percent of compensation to pay the principal on an ESOP loan. Contributions used to pay interest on an ESOP loan were excluded from the 25-percent limit.

The Deficit Reduction Act of 1984 (P.L. 98-369) allowed corporations a deduction for dividends on stock held by an ESOP if the dividends were paid to participants. The Act also allowed lenders to exclude from their income 50 percent of the interest they received on loans to an ESOP.

The Act allowed a stockholder in a closely held company to defer recognition of the gain from the sale of stock to an ESOP if the ESOP held at least 30 percent of the company's stock and the owner reinvested the proceeds from the sale in a U.S. company. The Act permitted an ESOP to assume a decedent's estate tax in return for employer stock of equal value.

The Tax Reform Act of 1986 repealed the tax credit ESOP. The Act also extended the deduction for dividends to include dividends used to repay an ESOP loan. The Act permitted an estate to exclude from taxation up to 50 percent of the proceeds from the sale of stock to an ESOP. The Act allowed persons approaching retirement to diversify the investment of assets in their accounts.

The Omnibus Budget Reconciliation Act of 1989 limited the 50-percent interest exclusion to loans made to ESOPs that hold more than 50 percent of a company's stock. The deduction for dividends used to repay an ESOP loan was restricted to dividends paid on shares acquired with that loan. The Act repealed both estate tax provisions: the exclusion allowed an estate for the sale of stock to an ESOP and the provision allowing an ESOP to assume a decedent's estate tax. The Small Business Job Protection Act of 1996 eliminated the provision that allowed a 50% interest income exclusion for bank loans to ESOPs.

Assessment

One of the major objectives of ESOPs is to expand employee stock ownership. The distribution of stock

ownership in ESOP firms is broader than the distribution of stock ownership in the general population.

Some evidence suggests that among firms with ESOPs there is a greater increase in productivity if employees are involved in corporate decision-making. But employee ownership of stock is not a prerequisite for employee participation in decision-making.

ESOPs do not provide participants with the traditional rights of stock ownership. Full vesting depends on a participant's length of service and distributions are generally deferred until a participant separates from service. To provide participants with the full rights of ownership would be consistent with the goal of broader stock ownership, but employees would be able to use employer contributions for reasons other than retirement.

The requirement that ESOPs invest primarily in the stock of the sponsoring employer is consistent with the goal of corporate financing, but it may not be consistent with the goal of providing employees with retirement income. If a firm experiences financial difficulties, the value of its stock and its dividend payments will fall. Because an ESOP is a defined-contribution plan, participants bear the burden of this risk. The partial diversification requirement for employees approaching retirement was enacted in response to this issue.

A leveraged ESOP allows an employer to raise capital to invest in new plant and equipment. But evidence suggests that the majority of leveraged ESOPs involve a change in ownership of a company's stock, and not a net increase in investment.

Although the deduction for dividends used to repay an ESOP loan may encourage an employer to repay a loan more quickly, it may also encourage an employer to substitute dividends for other loan payments.

Because a leveraged ESOP allows an employer to place a large block of stock in friendly hands, leveraged ESOPs have been used to prevent hostile takeovers. In these cases, the main objective is not to broaden employee stock ownership.

ESOPs have been used in combination with other employee benefit plans. A number of employers have adopted plans that combine an ESOP with a 401(k) salary reduction plan. Some employers have combined an ESOP with a 401(h) plan to fund retiree medical benefits

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Education, Training, Employment, and Social Services:
Employment

WORK OPPORTUNITY TAX CREDIT

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	0.3	0.4
2000	([1])	0.2	0.2
2001	([1])	0.1	0.1
2002	([1])	([1])	([1])
2003	-	([1])	([1])

*The tax credit is effective from October 1, 1996, through June 30, 1999.
([1])Less than $50 million.

Authorization

Sections 51 and 52.

Description

The Work Opportunity Tax Credit (WOTC) is available on a nonrefundable basis to for-profit employers who hire individuals from the following groups:

(1) members of families receiving benefits under the Aid to Families with Dependent Children (AFDC) or its successor program (Temporary Assistance for Needy Families, TANF) for a total of any 9 months during the 18-month period ending on the hiring date;

(2) qualified veterans who are members of families receiving benefits under the Food Stamp program for at least a 3-month period ending during the 15-month period ending on the hiring date;

(3) 18-24 year olds who are members of families receiving Food Stamp benefits for the 6-month period

ending on the hiring date, or receiving benefits for at least 3 months of the 5-month period ending on the hiring date in the case of family members no longer eligible for assistance under section 6(o) of the Food Stamp Act of 1977;

(4) high-risk youth (i.e., 18-24 year olds whose principal place of abode is an empowerment zone or an enterprise community);

(5) summer youth (i.e., 16-17 year olds hired for any 90-day period between May 1 and September 15 whose principal place of abode is an empowerment zone or an enterprise community);

(6) economically disadvantaged ex-felons with hiring dates within 1 year of the last date of conviction or release from prison;

(7) vocational rehabilitation referrals (i.e., individuals with physical or mental disabilities that result in substantial handicaps to employment who have been referred to employers upon completion of or while receiving rehabilitative services under the Rehabilitation Act of 1973 or through a program carried out under chapter 31 of title 38, United States Code); and

(8) Supplemental Security Income recipients who have received benefits for any month ending within the 60-day period ending on the hiring date.

During the first year in which a WOTC-eligible person is hired, the employer can claim an income tax credit of 40% of the first $6,000 earned if the worker is retained for at least 400 hours. If the WOTC-eligible hire is retained for 120-399 hours, the subsidy rate is 25%. For summer youth employees, the 25% or 40% subsidy rate is applied against the first $3,000 earned. No credit can be claimed unless the eligible employee remains on the employer's payroll for a minimum of 120 hours.

The maximum amount of the credit to the employer would be $1,500 or $2,400 per worker ($750 or $1,200 per summer-youth hire) for persons retained 120-399 hours or at least 400 hours, respectively. The actual value could be less than these amounts, depending on the employer's tax bracket. An employer's usual deduction for wages must be reduced by the amount of the credit as well. The credit also cannot exceed 90% of an employer's annual income tax liability, although the excess can be carried back 3 years or carried forward 15 years.

Impact

A local Employment Service (ES) office issues a certification of eligibility to an employer who hires a target-group member for whom a "pre-screening notice" has been submitted within 21 days after the individual begins work for the employer. Alternatively, an employer receives a written certification of eligibility from the ES on or before the day the individual begins work for the employer.

According to the ES, 126,113 certifications were issued to employers in FY1997. Almost 60% were for members of the AFDC/TANF group, and another 25% were for members of the 18-24 year old Food Stamp group. Certifications will be more than the number of credits claimed unless all WOTC-eligible hires remain on firms' payrolls for the minimum employment period. Thus, certifications reflect eligibility determinations rather than credits claimed.

Rationale

The WOTC is intended to help low-skilled individuals get jobs in the private sector. The credit is designed to lower the relative cost of hiring target-group members by subsidizing their wages, and hence to increase employers' willingness to hire them despite their presumed low productivity.

A prior tax credit aimed at encouraging firms to hire hard-to-employ individuals, the Targeted Jobs Tax Credit (TJTC), was effective from 1978 through 1994. Although the TJTC was subject to criticism, the Congress believed that the approach could help to increase the employment of disadvantaged workers.

Assessment

After an almost 4-month lapse, the temporary credit was reauthorized retroactive to its expiration date and extended through June 30, 1999. No funds were explicitly included in legislation to conduct an assessment of the WOTC's effectiveness.

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Education, Training, Employment, and Social Services:
Employment

WELFARE TO WORK TAX CREDIT

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	([1])	([1])
2000	([1])	([1])	([1])
2001	([1])	([1])	([1])
2002	-	([1])	([1])
2003	-	([1])	([1])

*The tax credit is effective from January 1, 1998, through June 30, 1999.
([1])Less than $50 million.

Authorization

Sections 51 and 52.

Description

The Welfare to Work Tax Credit (WWTC) is available on a nonrefundable basis to for-profit employers who hire long-term recipients of Temporary Assistance for Needy Families (TANF) benefits. The eligible group is defined as: (1) members of families that have received TANF benefits for at least 18 consecutive months ending on the hiring date; (2) members of families that have received TANF benefits for any 18 months beginning after the credit's enactment (August 5, 1997), if they are hired within 2 years after the date the 18-month total is reached; or (3) members of families that no longer are eligible for TANF assistance after August 5, 1997 because of any federal- or state-imposed time limit, if they are hired within 2 years after the date of benefit cessation.

During the first year in which WWTC-eligible persons are hired, employers can claim an income tax credit

of 35% of the first $10,000 earned. During the second year of their employment, employers can claim an income credit of 50% of the first $10,000 earned. Earnings against which the subsidy rate can be applied include, in addition to gross wages, certain tax-exempt amounts received under accident and health plans as well as under educational or dependent assistance programs. An eligible-hire must remain on an employer's payroll for a minimum of 400 hours or 180 days in order for the credit to be claimed.

The maximum amount of the credit to the employer would be $3,500 per worker in the first year of employment and $5,000 in the second year of employment. The actual value could be less than these amounts, depending on the employer's tax bracket. An employer's usual deduction for wages must be reduced by the amount of the credit as well. The credit also cannot exceed 90% of an employer's annual income tax liability, although the excess can be carried back 3 years or carried forward 15 years. Employers cannot claim both the WOTC and WWTC for the same individuals.

Impact

A local Employment Service (ES) office issues a certification of eligibility to an employer of a target-group member for whom a "pre-screening notice" has been submitted within 21 days after the individual begins work for the employer. Alternatively, an employer receives a written certification of eligibility from the ES on or before the day the individual begins work for the employer.

According to the ES, 25,341 certifications were issued to employers through the first 6 months (January-June 1998) the credit was in effect in FY1998. Certifications will be more than the number of credits claimed unless all eligible-hires remain on firms' payrolls for the minimum employment period. Thus, certifications reflect eligibility determinations rather than credits claimed.

Rationale

The WWTC is one of the initiatives meant to help welfare recipients comply with the work requirements contained in welfare reform legislation (P.L. 104-193). The credit is designed to lower the relative cost of hiring long-term family assistance beneficiaries by subsidizing their wages, and hence to increase private sector employers' willingness to hire them despite their presumed low productivity.

Earlier tax credits aimed at encouraging firms to hire welfare recipients were little used according to empirical studies. Despite criticism of the Work Incentive, Welfare, and Targeted Jobs Tax credits, the Congress believed that the approach could help the employment prospects of long-term family assistance recipients.

Assessment

The temporary credit is effective from January 1, 1998 through June 30, 1999. No funds were explicitly included in legislation to conduct an assessment of the credit's effectiveness.

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Education, Training, Employment, and Social Services:
Social Services

TAX CREDIT FOR CHILDREN UNDER AGE 17

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	19.1	-	19.1
2000	20.0	-	20.0
2001	20.0	-	20.0
2002	19.8	-	19.8
2003	19.5	-	19.5

Authorization

Section 24.

Description

For tax year 1998, families with qualifying children are allowed a credit against their federal income tax of $400 for each qualifying child. For tax years after 1998, the credit increases to $500 per qualifying child.

To qualify for the credit the child must be an individual for whom the taxpayer can claim a dependency exemption. That means the child must be the son, daughter, grandson, granddaughter, stepson, stepdaughter or an eligible foster child of the taxpayer. The child must be under the age of 17 at the close of the calender year in which the taxable year of the taxpayer begins.

For families with 1 or 2 qualifying children, the child tax credit is not refundable. However, it is calculated before the taxpayer calculates his earned income tax credit (EITC). For families with 3 or more qualifying children, the child tax credit is refundable. However, in any given year, the credit cannot exceed: (a) the sum of the taxpayer's regular income tax liability (excluding the EITC) and the taxpayer's share of social security taxes, reduced by (b) his EITC.

The child tax credit is phased out for taxpayers whose adjusted gross incomes (AGIs) exceed certain

thresholds. For married taxpayers filing joint returns, the phase out begins at AGI levels in excess of $110,000, for married couples filing separately the phase out begins at AGI levels in excess of $55,000, and for single individuals filing as either heads of households or as singles the phase out begins at AGI levels in excess of $75,000. The child tax credit is phased out by $50 for each $1000 (or fraction thereof) by which the taxpayer's AGI exceeds the threshold amounts. Neither the child tax credit amount or the phaseout thresholds are indexed for inflation.

Impact

The child tax credit will benefit all families with qualifying children whose incomes fall below the AGI phase out ranges. The benefits of the credit will be limited for some low-income families since the credit is not refundable for families with one or two children. Larger low-income families will see more benefits from the credit since it is refundable when a family has three or more qualifying children.

Distribution by Income Class of the Tax Credit for Children Under Age 17, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.3
$10 to $20	3.2
$20 to $30	10.4
$30 to $40	16.0
$40 to $50	14.1
$50 to $75	30.5
$75 to $100	18.2
$100 to $200	7.5
$200 and over	0.0

Rationale

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997. Congress indicated that the tax structure at that time did not adequately reflect a family's reduced ability to pay as family size increased. The decline in the real value of the personal exemption over time was cited as evidence of the tax system's failure to reflect a family's ability to pay. Congress further believed that the child tax credit would reduce family's tax liabilities, would better recognize the financial responsibilities of child rearing, and promote family values.

Assessment

Historically, the federal income tax has differentiated among families of different size through the combined use of personal exemptions, child care credits, standard deductions, and the earned income tax credit. These provisions were modified over time so that families of differing size would not be subject to federal income tax if their incomes fell below the poverty level.

The child tax credit enacted as part of the Taxpayer Relief Act of 1997, represents a departure from past policy practices because it is not designed primarily as a means of differentiating between low-income families of different size, but rather is designed to provide general tax reductions to middle income families. The empirical evidence, however, suggests that for families in the middle and higher income ranges, the federal tax burden has remained relatively constant over the past 15 years.

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Education, Training, Employment, and Social Services:
Social Services

TAX CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.5	-	2.5
2000	2.5	-	2.5
2001	2.5	-	2.5
2002	2.5	-	2.5
2003	2.5	-	2.5

Authorization

Section 21.

Description

A taxpayer who maintains a household is allowed a nonrefundable tax credit for employment-related expenses incurred for the care of a dependent child (or a disabled dependent or spouse). Employment-related expenses include expenses for household services, day care centers, and other similar types of noninstitutional care which are incurred in order to permit the taxpayer to be gainfully employed. Employment-related expenses are eligible if they are for a dependent under 13, or for a physically or mentally incapacitated spouse or dependent who regularly spends eight hours a day in the taxpayer's household. Dependent care centers must comply with State and local laws and regulations to qualify. The credit is permitted for payments to relatives (who are not dependents) of the taxpayer.

The maximum credit is 30 percent of expenses up to $2,400 ($720) for one child, and up to $4,800 ($1,440) for two or more children. The credit rate is reduced by one percentage point for each $2,000 of adjusted gross income (AGI), or fraction thereof, above $10,000, until the credit rate of 20 percent is reached for taxpayers with AGI incomes above $28,001. Married couples must file a joint return in order to be eligible for the credit.

Impact

The credit benefits qualified taxpayers with sufficient tax liability to take advantage of it, without regard to whether they itemize their deductions. It operates by reducing tax liability, but not to less than zero because the credit is nonrefundable. Thus, the credit does not benefit persons with incomes so low that they have no tax liability.

Because the credit rate phases down from 30 to 20 percent as incomes rises from $10,000 to $28,001, the credit is structured to give the greatest monetary benefit to parents with incomes of $28,001 or less.

Distribution by Income Class of the Tax Expenditure for Child and Dependent Care Services, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	4.1
$20 to $30	15.5
$30 to $40	13.9
$40 to $50	11.8
$50 to $75	26.4
$75 to $100	15.6
$100 to $200	10.7
$200 and over	2.0

Rationale

The deduction for child and dependent care services was first enacted in 1954. The allowance was limited to $600 per year and was phased out for families with income between $4,500 and $5,100. The intent of the provision recognized the similarity of child care expenses to employee business expenses and provided a limited benefit. Some believe compassion and the desire to reduce welfare costs contributed to the enactment of this allowance.

The provision was made more generous in 1964, and was revised and broadened in 1971. Several new justifications in 1971 included encouraging the hiring of domestic workers, encouraging the care of incapacitated persons at home rather than in institutions, providing relief to middle-income taxpayers as well as low-income taxpayers, and providing relief for employment-related expenses of household services as well as for dependent care.

The Tax Reduction Act of 1975 substantially increased the income limits ($18,000 to $35,000) for

taxpayers who could claim the deduction.

In 1976, the deduction was replaced by a nonrefundable credit. Congress believed that such expenses are a cost of earning income for all taxpayers and that it was wrong to deny the benefits to those taking the standard deduction. Also, the tax credit would provide relatively more benefit than the deduction to taxpayers in the lower tax brackets.

The Revenue Act of 1978 provided that the child care credit was available for payments made to relatives. The stated rationale was that, in general, relatives provide better attention and the allowance would help strengthen family ties.

In 1981, the provision was converted into the current sliding-scale credit and increased. The congressional rationale for increasing the maximum amounts was due to substantial increases in costs for child care. The purpose of switching to a sliding-scale credit was to target the increases in the credit toward low- and middle-income taxpayers because the Congress felt that group was in greatest need of relief.

The Family Support Act of 1988 modified the dependent care tax credit. First, the credit is available for care of children under 13 rather than 15. Second, a dollar-for-dollar offset is provided against the amount of expenses eligible for the dependent care credit for amounts excluded under an employer-provided dependent care assistance program. Finally, the act provides that the taxpayer must report on his or her tax return the name, address, and taxpayer identification number of the dependent care provider.

Assessment

An argument for the child care credit is that child care is a cost of earning income; if this is the rationale, however, it can also be argued that the amount should be a deductible expense that is available to all taxpayers.

The issue of whether the credit is progressive or regressive lingers because an examination of distribution tables shows that the greatest federal revenue losses occur at higher rather than lower income levels. The distribution table appearing earlier in this section shows that taxpayers whose incomes are under $20,000 represent taxpayers that generate less than 5 percent of the costs of the credit. Taxpayers in the $50-$75,000 income class represent approximately a quarter of the revenue costs. However, the determination of the dependant care tax credit progressivity cannot be made simply by comparing federal revenue costs from use of credit by low- versus high-income taxpayers. A more appropriate measure is the credit amount relative to the taxpayer's income.

Economic studies show that the dependent care tax credit is progressive except at the lowest income level. Dunbar and Nordhauser found that the credit was progressive during the 1979-1986 period and became more progressive after the legislated changes made in 1981. Gentry and Hagy found regressivity of the credit only

at low income levels and stated that above the bottom quintile the credit is progressive. Further work by Seetharaman and Iyer confirmed that the credit became more progressive after its redesign in 1981. It is generally observed that the credit is regressive at lower income levels primarily because the credit is non-refundable. Thus, the *structure* of the credit (albeit, except at low-income levels) has been found to be progressive.

This finding—in isolation—is not meant to imply that if the credit were made refundable it would solve all of the problems associated with child care for low-income workers. For example, the earned income tax credit is refundable and designed so that payments can be made to the provision's beneficiaries during the tax year. In practice, few receive the payments from the credit until their tax returns are filed the following year. The problems of the earned income credit show the difficulties encountered in designing a transfer mechanism for payment of a refundable child care credit. The truly poor would need such payments in order to make payments to caregivers.

The child and dependent care tax credit has not been adjusted for inflation while other code provisions are adjusted yearly. This lack of inflation adjustment has affected the low-income taxpayers' ability to use the credit. For example, the standard deduction and personal exemption amounts have been increased and are now adjusted for inflation. For tax year 1998, a family of three (husband, wife, and a single child) have no tax liability until adjusted gross income exceeds $15,200. Because the dependent care tax credit has not been adjusted, the credits highest rate (30%) is not available to this family. Even a single mother raising a child cannot qualify for the credit's highest rate (30%) since no tax liability is incurred until her income exceeds $11,650. As a result, no families may use the highest dependent care tax credit rate because no tax liability is incurred at such low income levels. Any child care expenditures made below those income levels would receive no tax benefit at all since the dependent care tax credit is nonrefundable.

Further, the qualifying expenditure amount has not been increased since 1982. Those amounts of $2,400 for a single child and $4,800 for two or more children break down to $46 per week for one child and $92 for two or more children. This is equivalent to $1.15 per hour per child (using a standard 40 hour work-week) and falls far below the federal minimum wage. Poor families rely more on relatives to provide free child care than non-poor families. Since the dependent care tax credit is for formal (paid) care, use of the credit falls for lower income taxpayers.

In order to properly administer the dependent care tax credit, the Internal Revenue Service requires submission of a tax identification number for the provider of care. To claim the credit complicates income tax filing, although the complexity aids in compliance by reducing fraudulent claims. To the extent that payments are made to individual care providers unrelated to the taxpayer, the payments may result in social security tax liability. Finally, particularly in the case of low-income workers who locate care providers from peers, the reporting of income could reduce the careprovider’s welfare benefits.

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Education, Training, Employment, and Social Services:
Social Services

EXCLUSION OF EMPLOYER-PROVIDED CHILD CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.4	-	0.4
2000	0.4	-	0.4
2001	0.5	-	0.5
2002	0.5	-	0.5
2003	0.6	-	0.6

Authorization

Section 129.

Description

Payments by an employer for dependent care assistance provided to an employee are excluded from the employee's income and, thus, not subject to Federal individual income tax. Likewise, such employer expenditures are not counted as wages subject to employment taxes. The maximum exclusion amount is $5,000. The exclusion amount may not exceed the lesser of the earned income of the employee or the earned income of the employee's spouse if married. Amounts paid to the employee's spouse or related individuals are ineligible. For each dollar a taxpayer receives under this program, a reduction of one dollar is made in the maximum expenses which qualify under the dependent care tax credit.

To qualify, such employer assistance must be provided under a plan which meets certain conditions, including eligibility conditions which do not discriminate in favor of principal shareholders, owners, officers, highly compensated individuals or their dependents, and must be available to a broad class of employees. The law provides that reasonable notification of the availability and terms of the program must be made to eligible employees.

Impact

The exclusion provides an incentive for employers to provide, and employees to receive, compensation in the form of dependent-care assistance rather than cash. The assistance is free from income tax, while the cash is subject to it. As is the case with all deductions and exclusions, this benefit is related to the taxpayer's marginal tax rate and thus provides a greater benefit to taxpayers in high tax brackets than those in low tax brackets. To the extent employers provide dependent care assistance rather than increases in salaries or wages, the Social Security Trust Fund and the Unemployment Compensation lose receipts. Because of the lower amounts of earnings reported to Social Security the employee may receive a lower Social security benefit during retirement years.

Rationale

This provision, enacted in the Economic Recovery Tax Act of 1981 (P.L. 97-34), was intended to provide an incentive for employers to become more involved in the provision of dependent care for their employees.

Assessment

The debate over the tax treatment of child care expenses turns on whether the expenses are viewed as personal consumption or business expenses (costs of producing income). Some have noted that the maximum $5,000 exclusion may be an attempt to restrict the personal consumption element for middle and upper income taxpayers.

Since all employers will not provide dependent care benefits, the provision violates horizontal equity principles, in that all taxpayers with similar incomes are not treated equally. Employer dependent-care plans are typically offered by large employers, so that those likely to participate are employees of large firms. Since upper-income taxpayers will receive a greater subsidy than lower-income taxpayers because of their higher tax rate, the tax subsidy is inverse to need.

Nontaxable benefits reduce the tax base, thus contributing to high marginal tax rates on income that remains taxable, since the ultimate effect is a loss of Federal revenues. If employers substitute benefits for wage or salary increases, that affects the Social Security Trust Fund, since benefits are not taxed for Social Security purposes either.

On the positive side, it is generally believed that the availability of dependent care can reduce employee absenteeism and unproductive work time. The exclusion permits employer involvement and encouragement for full participation of women in the work force. The lower after-tax response to child care may not only affect labor force participation but hours of work. Further, it can be expected that the provision affects the

mode of child care by reducing home care and encouraging more formal care such as child care centers. Those employers that may gain most by the provision of dependent-care services are those whose employees are predominantly female, younger, and whose industries have high personnel turnover.

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Education, Training, Employment, and Social Services:
Social Services

EXCLUSION FOR CERTAIN FOSTER CARE PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 131.

Description

A qualified foster care payment is paid to the provider for caring for the foster individual in the foster care provider's home. Such payments (made by a State or political subdivision or by a State-licensed tax exempt child-placement agency) are excluded from the foster care provider's income. The exclusion is limited to payments for no more than five foster care individuals over age 18, but is unlimited for younger children.

"Difficulty of care" payments are compensation approved by the State for additional care necessitated by an individual's physical, mental, or emotional handicap. The exclusion is available for no more than ten individuals under the age of nineteen, and no more than five individuals over the age of eighteen.

Impact

Both foster care payments and "difficulty of care" payments qualify for tax exclusion; cash foster care payments are not included in the gross income of the foster care provider. Since these exclusions are not counted as part of income, the tax savings are a percentage of the amount excluded, depending on the marginal tax bracket of the foster care provider. Thus, the exclusion has greater value for taxpayers with high incomes than for those with lower incomes. In general, those providers who have other income, such as from a spouse's earnings, are those who receive the greatest tax benefit.

Rationale

In 1977 the Internal Revenue Service, in Revenue Ruling 77-280, 1977-2 CB 14, held that payments made by charitable child-placing agencies or governments (such as child welfare agencies) were reimbursements or advances for expenses incurred on behalf of the agencies or governments by the foster parents and therefore not taxable.

In the case of payments made to providers which exceed reimbursed expenses, the Internal Revenue Service ruled that the foster providers were engaged in a trade or business with a profit motive and dollar amounts which exceed reimbursements were taxable income.

The principle of exemption of foster care payments entered the tax law officially with the passage of the Periodic Payments Settlement Act (P.L. 97-473). That 1982 tax act not only codified the tax treatment of foster care payments but also provided an exclusion from taxation for "difficulty of care payments." Such payments are made to foster parents who care for physically, mentally, or emotionally handicapped children.

In the Tax Reform Act of 1986 (P.L. 99-514), the provision was modified to exempt all qualified foster care payments from taxation. This change was made to relieve foster care providers from the detailed record-keeping requirements of prior law. The Congress feared that detailed and complex record-keeping requirements might deter families from accepting foster children or from claiming the full tax exclusion to which they were entitled. This Act also extended the exclusion of foster care payments to adults placed in a taxpayer's home by a government agency.

Assessment

It is generally conceded that the tax law treatment of foster care payments provides administrative convenience for the Internal Revenue Service, and prevents unnecessary accounting and record-keeping burdens for foster care providers. The trade-off is that to the extent foster care providers receive payments over actual expenses incurred, monies which should be taxable as income are provided an exemption from individual income and payroll taxation.

In addition, "difficulty of care" payments resemble the earned income of other occupations, where such

income is taxable. For example, a similarity between the wages paid to staff in a nursing home and "difficulty of care payments" for foster care providers is obvious, since many similar tasks are performed.

Both the General Accounting Office (1989) and James Bell Associates (1993; under contract from the Department of Health and Human Services) have reported a shortage of foster parents. Included among the reasons for this shortage are the low reimbursement rates paid to foster care providers with some providers dropping out of the program because the low payment rates do not cover actual costs. Thus, to the extent that the exclusion promotes participation in the program, it is beneficial from a public policy viewpoint.

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ADOPTION CREDIT AND EMPLOYEE ADOPTION BENEFITS EXCLUSION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.4	-	0.4
2000	0.4	-	0.4
2001	0.4	-	0.4
2002	0.2	-	0.2
2003	0.1	-	0.1

([1])Less than $50 million.

Authorization

Section 23, 137.

Description

The tax code provides a dollar-for-dollar adoption tax credit for adoption expenses and an exclusion of benefits received under employer-sponsored adoption assistance programs; both are capped at $5,000 per child ($6,000 in the case of children with special needs). Adoptions of foreign special needs children are capped at $5,000 per child. Expenses may be incurred over several years. The nonrefundable tax credit may be carried forward five years. Employer-provided adoption assistance must be received under an established employer-sponsored adoption assistance program. Both the tax credit and tax exclusion amounts are reduced for taxpayers with high adjusted gross incomes. For incomes over $75,000, the amounts are reduced by the percentage that the excess over $75,000 is of $40,000, so that the amounts are fully phased out for taxpayers whose income exceeds $115,000.

The tax credit and tax exclusion amounts are available for qualified adoption expenses which include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to a legal

adoption. Qualified domestic adoption expenses paid in one year are not taken into account for tax credit purposes until the following year unless the expenses are incurred in the same year that the adoption is finalized. In the case of expenses for a foreign adoption, eligibility is established and the tax benefits conferred only when the adoption is finalized. The provisions are unavailable for expenditures contrary to state or federal law, a surrogate parenting arrangement, expenses associated with the adoption of a spouse's child, or for those who have attained age 18 unless the adoptee is physically or mentally incapable of self-care.

The Act prohibits double benefits. Thus, if a deduction or credit is taken for the same expenses under other Internal Revenue Code sections or if a grant is accepted under federal, state, or local programs, or amounts are received from an employer's adoption assistance program, then the tax credit would not be available to provide further favorable tax treatment to the extent of receipts.

Married couples are required to file a joint return to be eligible for the credit. The Secretary is permitted to establish, by regulation, procedures to ensure that unmarried taxpayers who adopt a single child and who have qualified adoption expenses have the same dollar limitation as a married couple. The taxpayer is required to furnish the name, age, and social security number for each adopted child. The Internal Revenue Service has stated it is committed to working with the Congress to devise an administrative solution to minimize processing burdens with potential compliance difficulties.

Both the tax credit and exclusion of monies received through employer-provided programs become effective on January 1, 1997. For adoptions of domestic special needs children, the credit is a permanent part of the income tax code. However, the tax credit provision as it applies to non-special needs children sunsets for amounts paid or incurred after December 31, 2001. The tax exclusion for amounts received under an employer program runs from January 1, 1997 until its expiration after December 31, 2001.

Impact

Both the tax credit and employer exclusion will reduce the costs associated with adoptions through lower income taxes for taxpayers whose incomes fall below $115,000. The $5,000 tax credit ($6,000 in the case of a special needs child) will provide a benefit substantially higher than the largest benefit available under prior tax law although the value of the exclusion could be slightly higher or lower, depending on the taxpayer's prior marginal tax rate. Like other tax benefits, the adoption provisions will reduce Federal tax revenues. The revenue losses will stem not only from the larger tax benefit level of the credit but also the ability to carry forward the tax credit for a five-year period.

It appears likely that only large employers will offer adoption assistance programs because of the administrative and accounting costs associated with such plans. Those employees who receive adoption benefits from employer plans will pay less in taxes when compared to another employee with a similar economic income who receives only wages in cash.

The availability of both the adoption tax credit and exclusion may reduce the costs of foster care to the

extent homes are found for children in state programs. While the revenue costs associated with the adoption credit or exclusion is essentially a one-time per child revenue loss, foster care payments may go on for many years.

Rationale

An adoption expense itemized deduction was provided by the Economic Recovery Tax Act of 1981 (P.L. 97-34); it was designed to encourage and reduce the financial burdens for taxpayers who legally adopt children with special needs. The deduction was repealed with passage of the Tax Reform Act of 1986 (P.L. 99-514). The rationale for repeal was based on the belief that the deduction provided the greatest benefit to higher-income taxpayers and that budgetary control over assistance payments could best be handled by agencies with responsibility and expertise in the placement of special needs children. While not implementing a deduction for adoptions, the Congress later reconsidered its position and included in the conference report on the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) a call for a tax deduction "to encourage and facilitate adoption."

The tax credit and employer provided exclusion provisions for adoption expenses were enacted by Congress as part of the Small Business Job Protection Act of 1996 (P.L. 104-188). The Ways and Means Committee indicated the change was made because of the committee's belief that the financial costs associated with the adoption process should not be a barrier to adoptions.

Assessment

While federal tax assistance has been provided in the past for the placement of special needs children, both the new credit and exclusion are more broadly based. The new provisions apply to the vast majority of adoptions—not just adoptions of special needs children.

It appears that the credit and exclusion are designed to provide tax relief to not only lower but also upper moderate income families for the costs associated with adoptions and to encourage families to seek adoptable children. Under this law, taxpayers with adjusted gross incomes of less than $75,000 can receive the full tax exclusion or tax credit as long as they owe sufficient before-credit taxes. The phase-out applies only to those taxpayers whose adjusted gross incomes fall between $75,000 and $115,000—with no tax benefit provided those taxpayers who exceed the $115,000 cap. It would appear that the rationale for the cap is that taxpayers whose incomes exceed $115,000 have the resources for adoption so that the federal government does not need to provide special tax benefits for adoption to be affordable. The phase-out also reduces the revenue costs associated with these provisions.

The tax credit and exclusion are in addition to the direct expenditure program first undertaken in 1986 to replace the tax deduction of that time. However, especially with regards to the carryforward feature of the tax credit, the need for a direct federal assistance program for adopting children with special needs may warrant

re-examination. Under the tax provision's "double benefit" prohibition, the receipt of a grant will offset the tax credit or exclusion. The offset applies in all cases—including those for special needs children. Thus, it can be said that only in special needs adoption cases where a low or moderate income individual receives a grant greater than $5,000 could the benefit from receiving the grant exceed that of the tax credit for the same amount of out-of-pocket expenses.

Some have assumed that tax credits and direct government grants are similar since both may provide benefits at specific dollar levels. However, some argue that tax credits are often preferable to direct government grants because they provide greater freedom of choice to the taxpayer. Such freedoms include the timing of expenditures, the amount to spend, etc., while government programs typically have more definitive rules and regulations. Additionally, in the case of grants, absent a specific tax exemption, a grant may result in taxable income to the recipient.

Use of a tax mechanism does, however, add complexity to the tax system, since the availability of the credit and tax exclusion must be made known to all taxpayers and space on the tax form must be provided (with accompanying instructions). The enactment of these provisions adds to the administrative burdens of the Internal Revenue Service. A criticism of the tax deduction available under prior law was that the Internal Revenue Service had no expertise in adoptions and was therefore not the proper agency to administer a program of federal assistance for adoptions.

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Education, Training, Employment, and Social Services:
Social Services

DEDUCTION FOR CHARITABLE CONTRIBUTIONS, OTHER THAN FOR EDUCATION AND HEALTH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	19.8	1.0	20.8
2000	20.9	1.1	22.0
2001	22.1	1.2	23.3
2002	23.3	1.3	24.7
2003	24.6	1.4	26.0

Authorization

Section 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations: charitable, religious, educational, and scientific organizations, non-profit hospitals, public charities, and federal, state, and local governments.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI) (30 percent for gifts of capital gain property). For contributions to non-operating foundations and organizations, deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over the amount of contributions which qualified for the 50 percent deduction ceiling (including carryovers from previous years).

Gifts of capital gain property to these organizations are limited to 20 percent of AGI. A corporation can deduct up to 10 percent of taxable income (with some adjustments).

If a contribution is made in the form of property, the deduction depends on the type of taxpayer (*i.e.*, individual, corporate, etc.), recipient, and purpose.

Taxpayers are required to obtain written substantiation from a donee organization for contributions which exceed $250. This substantiation must be received no later than the date the donor-taxpayer filed the required income tax return. Donee organizations are obligated to furnish the written acknowledgment when requested with sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the Federal Government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Those individuals who use the standard deduction or who pay no taxes receive no benefit from the provision.

A limitation applies to the itemized deductions of high-income taxpayers. Under this provision, in 1998, otherwise allowable deductions are reduced by three percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $124,500 (adjusted for inflation in future years). The table below provides the distribution of all charitable contributions, including those for education and health.

Distribution by Income Class of the Tax Expenditure for Charitable Contributions, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.5
$20 to $30	1.3
$30 to $40	2.5
$40 to $50	4.0
$50 to $75	14.9
$75 to $100	14.8
$100 to $200	22.1
$200 and over	39.8

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the sponsor, argued that the high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were generally contributed to charitable organizations.

It was also argued that many colleges would lose students to the military and charitable gifts were needed by educational institutions. The deduction was extended to estates and trusts in 1918 and to corporations in 1935.

Assessment

Supporters note that contributions finance socially desirable activities. Further, the federal government would be forced to step in to assume some activities currently provided by charitable, nonprofit organizations if the deduction were eliminated. However, public spending might not be available to make up all of the difference. In addition, many believe that the best method of allocating general welfare resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect which varies with the marginal tax rate of the giver. There are a number of studies which find significant behavioral responses, although a recent study by Randolph suggests that such measured responses may largely reflect transitory timing effects.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. However, the volume of donations to religious organizations is greater than to all other organizations as a group.

Those who support eliminating this deduction note that deductible contributions are made partly with dollars which are public funds. They feel that helping out private charities may not be the optimal way to spend government money.

Opponents further claim that the present system allows wealthy taxpayers to indulge special interests and hobbies. To the extent that charitable giving is independent of tax considerations, federal revenues are lost without having provided any additional incentive for charitable gifts. It is generally argued that the charitable contributions deduction is difficult to administer and complex for taxpayers to comply with.

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Education, Training, Employment, and Social Services:
Social Services

TAX CREDIT FOR DISABLED ACCESS EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	([1])	0.1
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	0.1	([1])	0.1
2003	0.1	([1])	0.1

([1])Less than $50 million.

Authorization

Section 44.

Description

A nonrefundable tax credit equal to 50 percent of eligible access expenditures is provided to small businesses, defined as those with gross receipts of less than $1 million or those with no more than 30 full-time employees. Eligible access expenditures must exceed $250 in costs to be eligible but expenditures which exceed $10,250 are not eligible for the credit.

The credit is included as a general business credit and subject to present law limits. No further deduction or credit is permitted for amounts allowable as a disabled-access credit. No increase in the property's adjusted basis is allowable to the extent of the credit. The credit may not be carried back to tax years before the date of enactment.

Impact

The provision lessens the after-tax cost to small businesses for expenditures to remove architectural, communication, physical, or transportation access barriers for persons with disabilities by providing a tax credit for expenditures (which exceed $250 but are less than $10,250). The tax credit allowed for the costs of qualified expenditures operates to reduce tax liability, but not to less than zero because the credit is nonrefundable.

The value of this tax treatment is twofold. First, a 50-percent credit is greater than the tax rate of small businesses. Thus, a greater reduction in taxes is provided than through immediate expensing of access expenditures. Second, the value to small businesses is increased by the amount which the present value of the tax credit exceeds the present value of periodic deductions which typically could be taken over the useful life of the capital expenditure. The direct beneficiaries of this provision are small businesses that make access expenditures.

Rationale

This tax credit was added to the Code with the passage of the Revenue Reconciliation Act of 1990 (P.L. 101-508). The purpose is to provide financial assistance to small businesses for compliance with the Americans With Disabilities Act of 1990 (P.L. 101-336). For example, that Act requires restaurants, hotels, and department stores that are either newly constructed or renovated to provide facilities that are accessible to persons with disabilities, and calls for removal of existing barriers when readily achievable in facilities previously built.

Assessment

The tax credit may not be the most efficient method for accomplishing the objective because some of the tax benefit will go for expenditures the small business would have made absent the tax benefit and because there is arguably no general economic justification for special treatment of small businesses over large businesses.

The requirements of the Americans With Disabilities Act placed capital expenditure burdens that may be a hardship to small businesses. These rules are designed primarily for social objectives, *i.e.* to accommodate persons with disabilities; thus some subsidy may be justified in this instance.

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Health

EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR MEDICAL CARE, HEALTH INSURANCE PREMIUMS, AND LONG-TERM CARE INSURANCE PREMIUMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	57.9	-	57.9
2000	61.3	-	61.3
2001	65.1	-	65.1
2002	69.2	-	69.2
2003	73.8	-	73.8

Authorization

Sections 105 and 106.

Description

Employees are not taxed on compensation received in the form of employer-paid health care coverage. The exclusion applies to medical benefits provided under either an accident or health plan, and whether the employer self-insures or purchases a third-party insurance contract for a group plan or individual plans. Unlike some other fringe benefits, there are no limits on the dollar amount of the eligible exclusion per employee for medical benefits, with the exception of limits on employer contributions for long-term care insurance.

Impact

The exclusion from taxation of employer contributions to employee health insurance plans benefits all taxpayers who participate in employer-subsidized plans. Beneficiaries may include retirees as well as present

employees, along with their spouses and dependents. Approximately 66 percent of the U.S. population under age 65 receives health coverage through such plans.

Although the tax exclusion benefits a wide range of the population, it provides proportionately greater benefits to taxpayers with higher incomes, both because high-wage employees tend to have larger amounts of employer-paid health insurance and because they are in higher marginal tax brackets.

Nondiscrimination rules apply to plans self-insured by employers, but not to fully insured plans purchased from third-party insurers which can still offer more generous benefits to selected employees (often the company's more highly compensated employees).

Some groups of employees are far less likely to receive health insurance from their employers. These include workers under age 25 [entry says “30--check”], workers in firms with fewer than 25 employees, part-time workers, and workers in certain industries. The least-covered industry groups include agriculture, personal services, construction, retail trade, business and repair services, and entertainment and recreation services. Lower-wage workers are also typically less likely to receive employer-provided health benefits.

The accompanying table presents statistics for 1997 on the pattern of health insurance coverage by family-income group for the entire noninstitutionalized population of the United States under age 65. Income is expressed as a ratio relative to the Federal poverty income level.

The percentage of the income group covered by employment-based health insurance (column 2) climbs dramatically, from 18.3 percent in the group whose income is less than the poverty-income level, to 80.9 percent for people whose family income is 2 or more times the poverty level.

Conversely, the percentage covered by Medicaid or Medicare (column 3) declines from 45.8 percent in the lowest family-income group to 3.3 percent in the highest-income group. The percent uninsured declines from 34.7 percent for those with income below the poverty level, to 11.3 percent for those with income at two or more times the poverty level.

Health Insurance Coverage From Specified Sources, by Family Income Relative to the Federal Poverty Level, 1997
(Percent of U.S. Civilian Noninstitutionalized Population Under Age 65)

		Type of Insurance[b]			
Income Relative to the Poverty Level[a]	Population (in millions)	Employment based[c]	Medicaid or Medicare	Other[d]	Un-insured
Less than 1.0	32.8	18.3	45.8	6.9	34.7
1.0-1.9	20.5	38.6	23.3	10.2	35.6
1.5 to 1.99	21.2	55.7	12.5	11.1	28.4
2.0 or more	162.5	80.8	3.3	11.0	11.3

Total	237.0	66.3%	11.7%	10.3%	18.2%

[a]The poverty threshold for a family of four in 1997 was $16,400. People may have more than one source of health insurance; thus row percentages may total to more than 100.

[b]Group health insurance through employer or union.

[d]Private nongroup health insurance, veterans coverage, or military health care.

Note: Based on Congressional Research Service analysis of data from the March 1997 Current Population Survey (CPS). Source: Smith, Madeleine. *Health Insurance Coverage: Characteristics of the Insured and Uninsured Populations in 1997*. Library of Congress, Congressional Research Service Report No. 96-891 EPW. Washington, DC: updated November, 1998. Table 2, p. 3.

Rationale

The exclusion of compensation for personal injuries or sickness received by individuals through accident or health insurance plans was first provided in the Revenue Act of 1918.

In 1943, the Internal Revenue Service (IRS) ruled that employer contributions to group health insurance policies were not taxable to the employee. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953. Section 106, enacted in 1954, reversed the 1953 ruling. The legislative history of section 106 indicates that its purpose was principally to make uniform the tax treatment of employer contributions to group and individual health insurance plans.

The Revenue Act of 1978 added the nondiscrimination provisions of section 105(h), which provide that the benefits payable to highly compensated employees under a self-insured medical reimbursement plan are taxable if the plan discriminates in favor of the highly compensated employees. The Tax Reform Act of 1986 repealed section 105(h) and, under a new section 89 of the Internal Revenue Code, extended nondiscrimination rules to group health insurance plans. In 1989, P.L. 101-140 repealed section 89 and reinstated the pre-1986 Act rules under section 105(h).

Under provisions of the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191), effective January 1, 1997, employer contributions to the cost of qualified long term care insurance premiums may be treated as a tax-free health benefit to employees. The tax protection for employees does not apply if the long term care benefits are included under a cafeteria plan or flexible spending account (FSA). There are indexed annual dollar limits on the permissible amount of tax-free premium contributions per person, depending upon the age of the insured person. In 1998 these limits range from $210 for individuals age 40 or less, to $2,570 for individuals over age 70.

Assessment

The tax-favored treatment of employer-provided health insurance has been an important factor in encouraging health insurance coverage for a large fraction of workers and their dependents. The tax subsidy distorts the choice in favor of health benefits instead of taxable wages.

The exclusion allows employers to provide their employees with health insurance coverage at lower cost than if they had to pay the employees additional taxable wages sufficient to purchase the same insurance from their after-tax income. Employees may choose more health insurance than they would without the subsidy, in

preference to wages or other taxable compensation.

Measured as a percent of wages and salaries, employer contributions for group health insurance rose from 0.8 percent in 1955, to 1.6 percent in 1965, 3.1 percent in 1975, 5.4 percent in 1985, and reached 8.1 percent in 1993. The percentage dropped to 7.5 percent in 1995, 7.0 percent in 1996, and 6.7 percent in 1997. Many observers believe that the increase in tax-subsidized health insurance coverage has led to excessive use of health care services, which in turn has helped to drive up health care costs.

Workers and their dependents covered by employer-provided health insurance receive a much more generous subsidy from this exclusion than people who purchase health insurance themselves, or than those who pay their own medical expenses and take the medical-expense itemized income tax deduction.

Employer-paid health care is completely excluded from taxable income for all recipients. In contrast, relatively few taxpayers qualify to take advantage of the medical expense deduction: they must be itemizers and must have self-paid medical expenses in excess of 7.5 percent of their adjusted gross income.

Employer-paid plans generally provide low-deductible coverage for basic health care rather than being restricted to catastrophic expenses, as the medical expense deduction. In addition to the income tax benefits, employer-paid health insurance is excluded from payroll taxation.

Various proposals have been offered to limit the amount of health insurance benefits per employee that can be excluded from taxable income. Assigning a taxable value to the health insurance benefits available to a particular employee could be administratively complicated and numerically imprecise, depending on the design of the limit.

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EXCLUSION OF MEDICAL CARE AND CHAMPUS/TRICARE MEDICAL INSURANCE FOR MILITARY DEPENDENTS, RETIREES, AND RETIREE DEPENDENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.5	-	1.5
2000	1.6	-	1.6
2001	1.6	-	1.6
2002	1.6	-	1.6
2003	1.6	-	1.6

Authorization

Sections 112 and 134 and court decisions [see *Jones v. United States*, 60 Ct. Cl. 552 (1925)].

Description

Military personnel are provided with a variety of in-kind benefits (or cash payments given in lieu of such benefits) that are not taxed. Among these benefits are medical and dental benefits, which include dependents as well.

Some military care for dependents is provided directly in military facilities and by military doctors on a space-available basis. There is also a program, the Civilian Health and Medical Program (CHAMPUS), which operates as a health insurance plan for dependents and for retirees and their dependents until they become eligible for Medicare.

Impact

As in the case of the general exclusion for health care benefits, the benefits are greater for higher income

individuals who have higher marginal tax rates.

An individual in the 15-percent tax bracket (Federal tax law's lowest tax bracket) would not pay taxes equal to $15 for each $100 excluded. Likewise, an individual in the 28-percent tax bracket (Federal law's highest tax bracket) would not pay taxes of $28 for each $100 excluded. Hence, the same exclusion can be worth different amounts to different military personnel, depending on their marginal tax bracket. By providing military compensation in a form not subject to tax, the benefits have greater value for members of the armed services with high income than for those with low income.

Rationale

In 1925, the United States Court of Claims in *Jones v. United States*, 60 Ct. Cl. 552 (1925), drew a distinction between the pay and allowances provided military personnel. The court found that housing and housing allowances were reimbursements similar to other non-taxable expenses authorized for the executive and legislative branches.

Prior to this court decision, the Treasury Department had held that the rental value of quarters, the value of subsistence, and monetary commutations were to be included in taxable income. This view was supported by an earlier income tax law, the Act of August 27, 1894, (later ruled unconstitutional by the Courts) which provided a two- percent tax "on all salaries of officers, or payments to persons in the civil, military, naval, or other employment of the United States."

The principle of exemption of armed forces benefits and allowances evolved from the precedent set by *Jones v. United States*, through subsequent statutes, regulations, or long-standing administrative practices.

The Tax Reform Act of 1986 consolidated these rules so that taxpayers and the Internal Revenue Service could clearly understand and administer the tax law consistent with fringe benefit treatment enacted as part of the Deficit Reduction Act of 1984.

These medical benefits would also be excludable in the absence of specific military exclusions through the general rules allowing exclusion of medical payments (Sections 105 and 106).

Assessment

Some military benefits are akin to the "for the convenience of the employer" benefits provided by private enterprise, such as the allowances for housing, subsistence, payment for moving and storage expenses, overseas cost-of-living allowances, and uniforms. Other benefits are similar to employer-provided fringe benefits such as medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits. While the argument can be made that health and dental care for active duty personnel is essential to the military mission, health care for dependents is much more like a fringe benefit.

Many of the issues associated with military health benefits are similar to those of the civilian and private sector benefits discussed above, i.e., the tax benefit encourages individuals to substitute medical care for taxable wages and to consume too much medical care.

There are, however, some unusual aspects to the military benefits. Direct care provided in military facilities

would be difficult to value for tax purposes, and yet may be necessary for dependents accompanying the service member to isolated areas that do not have adequate medical facilities.

In the absence of a general revision in the tax treatment of health benefits, a change in the treatment for military dependents would be likely to require an increase in military pay to maintain the current attractiveness of the military for those individuals with dependents and with adequate income to encounter income tax liability.

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DEDUCTION FOR HEALTH INSURANCE PREMIUMS AND LONG-TERM CARE INSURANCE PREMIUMS BY THE SELF-EMPLOYED

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.0	-	1.0
2000	1.2	-	1.2
2001	1.2	-	1.2
2002	1.5	-	1.5
2003	2.4	-	2.4

Authorization

Section 162(l).

Description

A self-employed individual may deduct a specified percentage of the amount paid for health insurance for a taxable year on behalf of the individual and the individual's spouse and dependents. The applicable percentage was 25 percent from 1987 through 1994, 30 percent for 1995 and 1996, 40 percent for 1997, and 45 percent for 1998. It is scheduled to increase to 60 percent for 1999-2001, 70 percent for 2002, and 100 percent for 2003 and thereafter. The deduction is available to sole proprietors, working partners in a partnership, and employees of an S corporation who own more than 2 percent of the corporation's stock. No deduction is permitted if the self-employed individual is eligible to participate on a subsidized basis in a health plan of an employer of the self-employed individual or the individual's spouse, determined on a monthly basis. The deduction from gross income may not exceed the self-employed individual's earned income from the business in which the insurance plan was established.

The special percentage deduction is treated as an adjustment to income, also known as an above-the-line deduction permitted in calculating adjusted gross income. (The remaining percentage of the health insurance costs—e.g., 40 percent for 1999—can be included with other medical expenses, subject to the 7.5 percent of adjusted gross income [AGI] floor governing the itemized deduction for medical expenses.)

Impact

For tax year 1993, 3.0 million tax returns claimed the deduction for the self-employed. Estimates from 1988 tax data indicate that less than half of the self-employed tax filers in most income classes claimed the health insurance deduction.

The following table shows the percentage distribution of the total deductions claimed by adjusted gross income class for 1995. The distribution of the special health insurance deduction for the self-employed was more concentrated in the higher income classes than the itemized deductions for medical expenses.

The corresponding tax expenditure values, where the deductions would be weighted by the marginal tax rates applicable to the respective income classes, would be even more heavily distributed toward the higher income groups. For self-employed owners of the many small businesses that generate little or no taxable income, the deduction provides little or no tax subsidy.

Distribution by Adjusted Gross Income Class of the Deduction of Medical Insurance Premiums by the Self-employed in 1995

Adjusted Gross Income Class (in thousands of $)	Percentage Distribution of Deductions
Below $10	7.0
$10 to $20	13.3
$20 to $30	12.7
$30 to $40	9.2
$40 to $50	8.3
$50 to $75	14.1
$75 to $100	9.0
$100 to $200	15.0

$200 and over	11.6
Total	100.0

Note: This is *not* a distribution of tax expenditure values. Derived from data in: Internal Revenue Service. *Statistics of Income—1995: Individual Income Tax Returns*. Washington, DC: 1997, p. 44.

Rationale

A 25 percent health insurance deduction for the self-employed was first enacted as a temporary three-year provision by the Tax Reform Act of 1986, effective through December 31, 1989. The Technical and Miscellaneous Revenue Act of 1988 made certain technical corrections to the provision.

The Omnibus Budget Reconciliation Act of 1989 extended the deduction for 9 months (through September 30, 1990) and clarified that the deduction is available to certain S corporation shareholders. The Omnibus Budget Reconciliation Act of 1990 extended the deduction through December 31, 1991. The Tax Extension Act of 1991 extended the deduction through June 30, 1992. The Omnibus Budget Reconciliation Act of 1993 extended the deduction through December 31, 1993.

The deduction remained in abeyance during 1994 while Congress debated major health insurance reform but passed no legislation. Under P.L. 104-5 enacted in April 1995, the deduction was reinstated retroactive to January 1, 1994, and made permanent. The level of the deduction remained at 25 percent for 1994 but was increased to 30 percent effective January 1, 1995.

The Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191) scheduled several further increases in the percentage of their health insurance premiums that self-employed persons are permitted to deduct. From the level of 30 percent effective for 1995 and 1996, the deduction was scheduled to increase to 40 percent for 1997 and rise in increments to 80 percent for 2006 and thereafter.

Also under provisions of P.L. 104-191, effective January 1, 1997, self-employed persons are able to include in the expenditures eligible for their special deduction premiums paid for qualified long-term care insurance. There are indexed annual dollar limits on the permissible amount of tax deductible long-term care premiums per person, depending upon the age of the insured person. For 1998 these limits range from $210 for individuals age 40 or less, to $2,570 for individuals over age 70.

When the deduction was first established in 1986, Congress expressed concern that the disparity in tax treatment of health benefits between the owners of unincorporated businesses and the owners of corporations created inefficient incentives for incorporation. Congress was also aware that health coverage was particularly low among small businesses operated by the self-employed. Congress also expressed the belief that the exclusion for the self-employed should be accompanied by nondiscrimination rules applying to health insurance coverage for employees of the business. The nondiscrimination requirements accompanying the deduction were removed in 1989 by P.L. 101-140, as part of the repeal of section 89 of the Internal Revenue Code, the nondiscrimination rules that had been enacted in 1986 regarding employee benefit plans. The Omnibus appropriations bill in 1998 increased the percentage deductions.

Assessment

The special percentage deduction for the health insurance expenses of self-employed individuals is intended to provide them some portion of the favorable tax treatment for health insurance given to employees covered under an employer-provided health plan. The deduction helps offset the higher insurance costs that typically face small-group or individual insurance plans. On the other hand, the special partial deduction provides the self-employed with a tax subsidy not available to other individuals who pay health insurance premiums on their own. To date only limited evidence has been assembled on how much the original 25 percent deduction encouraged the purchase of health insurance for the formerly uninsured self-employed and their employees.

When the deduction was at 25 or 30 percent, some argued that a deduction closer to 100 percent would help equalize treatment under the tax laws between the employed and self-employed. Those who opposed a 100-percent deduction expressed concern that self-employed individuals would be free to purchase very generous insurance plans with low deductibles or copayments and with extensive service coverage. The 80-percent deduction was viewed as parity with employer-paid plans that require the employee to pay 20 percent of the premium.

Like the other subsidies provided to health insurance by the tax code, the special deduction for the self-employed acts to increase the purchase of health insurance which, in turn, encourages higher expenditures for health care services. Some have proposed capping the amount of insurance that can be subsidized at the level of a standard health benefits package.

Relative to the self-employed, recipients of employer-provided health insurance (including in this respect more than two percent shareholder-employees of S corporations) receive an additional advantage under payroll taxes. Their health benefits are generally not counted in the FICA wage bases for social security and Medicare tax contributions.

In contrast, self-employed sole proprietors and partners cannot deduct their health insurance expenses when calculating their Self-Employment Contributions Act (SECA) taxes. Thus, the overall tax treatment of health insurance benefits still creates a sizeable incentive to work for an employer who provides insurance, rather than to work only for oneself, even with the special percentage deduction for the self-employed.

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DEDUCTION FOR MEDICAL EXPENSES AND LONG-TERM CARE EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	4.2	-	4.2
2000	4.3	-	4.3
2001	4.5	-	4.5
2002	4.7	-	4.7
2003	4.9	-	4.9

Authorization

Section 213.

Description

Unreimbursed medical expenses paid by an individual may be itemized and deducted from income to the extent they exceed 7.5 percent of adjusted gross income (AGI). Expenses eligible for the deduction include amounts paid by the taxpayer on behalf of the taxpayer, spouse, and eligible dependents, for

(1) health insurance premiums, including after-tax employee contributions to employer-sponsored health plans, Medicare Part B premiums, the portion of the premium that does not qualify for the special deduction for the self-employed, and other self-paid premiums;

(2) diagnosis, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, including dental care;

(3) prescription drugs and insulin;

(4) transportation primarily for and essential to medical care; and

(5) lodging away from home primarily for and essential to medical care, up to $50 per night.

Expenses paid for the general improvement of health are not eligible for the deduction unless prescribed by a physician to treat a specific illness.

Impact

For taxpayers who can itemize their deductions, the deduction eases the financial burden of extraordinary medical expenses. These have been viewed as largely involuntary expenses that reduce the taxpayer's ability to pay taxes.

The deduction is not limited to involuntary expenses, however; it also covers some costs of preventive care, rest cures, and other discretionary expenses. Despite the substantial expansion of health insurance coverage in recent years, a significant share of the out-of-pocket medical expenses now deducted is for procedures and care not covered by commonly available insurance policies (such as orthodontia).

Like all deductions, the medical expense deduction produces higher tax savings per dollar of deduction for taxpayers in higher income tax brackets.

Relative to other itemized deductions, a larger percentage of tax expenditure benefits for the medical expense deduction goes to taxpayers in the lower-middle income brackets, for several possible reasons. Lower-income households are less likely to be well insured, either through their employment or through separately purchased insurance. A given dollar amount of medical expenditures represents a larger fraction of their typical income, and thus is more likely to exceed the 7.5-percent-of-AGI floor. If serious medical problems cause taxpayers to lose time from work, their incomes may fall temporarily in the same year that medical expenses are high.

Distribution by Income Class of the Tax Expenditure for Medical Expenses, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.1
$10 to $20	1.3
$20 to $30	4.6
$30 to $40	9.4
$40 to $50	10.8
$50 to $75	24.9
$75 to $100	18.2

$100 to $200	22.2
$200 and over	8.5

Rationale

Since 1942, there have been numerous adjustments to the rules for deducting medical expenses. These alterations have involved the percentage of AGI at which the floor was set, limits on the maximum amount deductible, whether the maximum would be higher for taxpayers aged 65 and over and disabled, whether medicine and drug expenses would be subject to a separate floor, whether health insurance premiums would be subject to the combined floor, and what types of expenses are eligible for the deduction.

Health costs exceeding a given floor were first allowed as a deduction in 1942. The rationale then was to help maintain high standards of public health and to ease the burden of high wartime tax rates.

Originally the deduction was allowed only to the extent that medical expenses exceeded 5 percent of net income (considered to be the average family medical-expense level) and was subject to a $2,500 maximum ($1,250 for a single individual).

In 1948, the maximum deduction was increased to $1,250 times the number of exemptions, with a ceiling of $5,000 for joint returns and $2,500 for other returns. In 1951, the 5 percent floor was removed if the taxpayer or spouse was age 65 or over.

In 1954, when the Internal Revenue Code was substantially revised, the percentage-of-AGI floor was reduced to 3 percent and a 1 percent floor was imposed on drugs and medicines. The maximum deduction was increased to $2,500 per exemption, with a ceiling of $5,000 per individual return and $10,000 for joint and head of household returns.

In 1959 the maximum deduction was increased to $15,000 if a taxpayer was 65 or over and disabled, and $30,000 if the spouse also was. In 1960 the floor was removed on deductions for dependents age 65 or over.

In 1962, the maximum deduction was increased to $5,000 per exemption with a limit of $10,000 for individual returns, $20,000 for joint and head of household returns, and $40,000 for joint returns where both the taxpayer and spouse are 65 or over and disabled.

In 1964 the one-percent floor on medicine and drug expenses was eliminated for those age 65 or older (taxpayer, spouse, or dependent). In 1965, both the three-percent medical expense and one-percent drug floors were reinstated for taxpayers and dependents aged 65 and over. The maximum deduction limitations were removed, and a separate deduction of up to $150 was permitted for one-half of medical insurance premium costs, without regard to the three percent floor.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the floor from three to five percent of adjusted gross income. It eliminated the separate deduction for health insurance payments but permitted them to be combined with other medical expenses.

TEFRA also eliminated the separate one-percent floor for drug costs, made nonprescription drugs ineligible for the deduction, and combined the deduction for prescription drugs and insulin together with other medical expenses.

The Tax Reform Act of 1986 (TRA86) raised the floor under the combined medical expenses deduction from 5 to 7.5 percent of AGI.

The Omnibus Budget Reconciliation Act of 1990 disallowed deductions for the cost of cosmetic surgery, with certain exceptions. The medical expense deduction is exempt from the overall limit on itemized deductions for high-income taxpayers which took effect in 1991.

Provisions of the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191) permit qualified expenditures for long term care to be treated in the same way that health insurance policies and health care expenses are treated under the tax code. Effective January 1, 1997, a taxpayer's unreimbursed out-of-pocket expenditures for long-term care (including premium costs) were allowed as itemized deductions, to the extent they and other unreimbursed medical expenses exceed 7.5 percent of adjusted gross income. There are indexed annual dollar limits on the permissible amount of tax deductible long-term care insurance premiums per person, depending upon the age of the insured person. In 1998 these limits range from $210 for individuals age 40 or less, to $2,570 for individuals over age 70.

Also under P.L. 104-191, amounts received under a qualified long-term care insurance plan (including reimbursements received by, or expenditures on behalf of, the taxpayer) are considered medical expenses and excluded from gross income, subject to a cap. The cap is indexed for inflation; the 1998 figure is $180 per day per person (minus expenses covered by reimbursements and other payments). Insurance payments in excess of the cap that do not offset actual costs incurred for long-term care services are includable in taxable income.

Assessment

Changes in the tax laws during the 1980s substantially reduced the number of tax returns claiming an itemized deduction for medical and dental expenses.

In 1980, 19.5 million returns, 67.2 percent of all itemized returns, claimed the deduction. In 1983, after TEFRA, it was 9.7 million returns, 27.6 percent of itemized returns. In 1995, representative of the years following TRA86, 5.4 million returns, 16.0 percent of itemized returns, claimed the deduction.

The deduction is now more focused on taxpayers with high unreimbursed medical expenses relative to their income during a given year. Taxpayers may be more able to use the deduction if they can bunch large medical expenditures into a single tax year. Unlike the itemized deduction for casualty losses, there is no carryover available for medical deductions that are unusable in a given tax year.

Restricting the deduction reduces the income tax offset available for uninsured medical expenses and should thereby discourage middle- and upper-income taxpayers from remaining uninsured. The current deduction does not actively help many taxpayers purchase insurance, however.

Although health insurance premiums that individuals pay on their own are technically eligible for deduction, in practice few taxpayers are able to claim the deduction. First, relatively few taxpayers are itemizers, particularly in the lower-income groups. Second, even among itemizers, few with health insurance coverage are likely to qualify for the deduction because their unreimbursed medical expenses are unlikely to exceed 7.5 percent of AGI.

Taxpayers with employer-provided health insurance still have a substantial tax advantage over taxpayers

who purchase health insurance on their own or self-insure. Employer-paid health care is fully excluded from taxable income, not subject to any floor or ceiling limit.

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Health

MEDICAL SAVINGS ACCOUNTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	-	0.1
2000	0.2	-	0.2
2001	0.2	-	0.2
2002	0.2	-	0.2
2003	0.2	-	0.2

Authorization

Section 220.

Description

Individuals' contributions to medical savings accounts (MSAs) are deductible from gross income up to an annual limit of 65% of the insurance deductible (75% for policies covering more than one person) or earned income, whichever is less. Employer contributions, held to the same limits, are excluded from income and employment taxes of the employee and from employment taxes of the employer. Individuals cannot make contributions if their employer does. Earnings on account balances are not taxed. Distributions from MSAs are tax-exempt if used to pay for deductible medical expenses other than insurance except for qualified long-term care insurance, health insurance continuation coverage required under federal law, or health insurance when the individual receives unemployment compensation. Other distributions are included in gross income and a 15% penalty is added except in cases of disability, death, or attaining age 65.

Contributions are allowed if individuals are covered by a high- deductible health plan and no other insurance with some exceptions. Plan deductibles must be at least $1,500 (but not more than $2,250) for coverage of one person and at least $3,000 (but not more than $4,500) for more than one. Annual out-of-pocket expenses for allowed costs cannot exceed $3,000 and $5,500, respectively. Individuals must also be self-employed or covered through plans offered by small employers. Eligibility to establish MSAs will be restricted after the number of taxpayers who had contributions to their accounts exceeds certain thresholds (eventually, 750,000) in 1997 through 1999, or after the end of 2000, whichever occurs earlier. Once restricted, MSAs will generally be limited to individuals who previously had contributions to their accounts or who work for participating employers.

Impact

The MSA tax treatment described above is designed to encourage individuals to purchase high-deductible health insurance and maintain a reserve for routine and other unreimbursed health care expenses. Tax benefits are greatest for individuals with high marginal tax rates. MSAs might not appeal to individuals with chronic illnesses, though they do allow more choice among health care providers than managed care plans. One important question affecting participation is what other health plan options individuals have through their employer or in their community. Another is whether individuals can switch without penalty to comprehensive or low deductible health plans if they anticipate needing more medical care.

Initially, MSAs have not attracted many participants. The IRS determined that 41,668 MSA returns were filed or expected to be filed for tax year 1997; of these, only 26,160 were counted for purposes of the threshold (the balance were from previously uninsured taxpayers). The IRS estimates that only 50,152 countable MSAs will be established by the end of tax year.

Rationale

Tax benefits for MSAs were first authorized by the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191). This legislation addressed some of the issues the previous Congress had considered in debating comprehensive health care reform, but it was more modest in scope. MSAs were proposed to retard the growth of health care costs, which have exceed the general rate of inflation for many years. In giving consumers a greater financial stake in purchasing health care, they would reverse a long trend in the United States towards using private insurance and government assistance to pay medical expenses. While third-party payments have a place, reliance on them lowers the effective price of health care and leads to excessive use. High-deductible insurance, by requiring consumers to assume more of the initial costs incurred each year, would encourage more prudent choices. The MSA would provide funds for consumers to pay these expenses (depending on the account balance), to save for future health care needs, or to use for other purposes if they choose.

MSAs were also advanced as a way to preserve a role for health care indemnity insurance. Indemnity insurance reimburses policy holders or providers on a fee-for-service basis, that is, it pays for each service provided by the doctors and other health professionals whom patients select. From the patients' point of view, two attractive characteristics of fee-for-service are the freedom to choose one's doctor with little restriction from insurers and continuity of service when employment changes (i.e., portability). Indemnity insurance was once the dominant form of private health care coverage in the United States, but today it has lost most of its market share to managed care options: health maintenance organizations, preferred provider organizations, and point-of-service plans.

Assessment

MSAs could be an attractive option. They allow individuals to insure against large or catastrophic expenses while covering routine and other minor costs out of their own pocket. They provide more equitable tax treatment to health insurance plans with low or no deductions. Properly designed, they may encourage more prudent health care use and the accumulation of funds for medical emergencies. While some individuals may

incur greater out-of-pocket costs, on average those who elect this form of coverage might reasonably expect to have gradually increasing account balances. What is unclear, however, is whether most individuals will perceive this financial incentive to be large enough to compensate them for the increased risk they must assume.

One issue surrounding MSAs is whether they drive up costs for everyone else. If MSAs primarily attract young, healthy individuals, premiums for other plans are likely to rise since they would disproportionately cover the older and ill. Over time, healthier people in higher cost plans would switch to lower cost plans, raising their premiums but increasing those in higher cost plans even more. If this process continued unchecked, eventually people who most need insurance would be unable to afford it.

MSAs have limits on their capacity to substantially reduce aggregate health care spending, even assuming their widespread adoption and significant induction (price elasticity) effects of insurance. Most health care spending is attributable to costs that exceed the high- deductible levels allowed under the legislation; consumers generally have little control over these expenditures.

Regardless of their impact on aggregate expenditures, MSAs provide more equitable treatment for taxpayers who choose to self-insure more of their health care costs. Employer-paid health insurance is excluded from employees' gross income regardless of the proportion of costs it covers. Employers generally pay 80% of the cost of a plan that has a low deductible ($200 a year) and copayment requirement (20% up to an annual maximum of $1,000). If the plan instead had a high-deductible ($1,500, for example), employees normally would have to pay for the increase in the deductible with after-tax dollars. They would lose a tax benefit for assuming more financial risk. MSAs restore this benefit as long as an account is used for health care expenses. In this respect, MSAs are like flexible spending accounts (FSAs), which also allow taxpayers to pay unreimbursed health care expenses with pre-tax dollars. With FSAs, however, account balances unused at the end of the year must be forfeited.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR PRIVATE NONPROFIT HOSPITAL FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.3	0.5	1.8
2000	1.5	0.6	2.1
2001	1.5	0.6	2.1
2002	1.5	0.7	2.2
2003	1.7	0.7	2.4

Authorization

Section 103, 141, 145, 146, and 501(c)(3) of the Internal Revenue Code of 1986.

Description

Interest income on State and local bonds used to finance the construction of nonprofit hospitals and nursing homes is tax exempt. These bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

These nonprofit hospital bonds are not subject to the State private-activity bond annual volume cap.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to finance hospitals and nursing homes at reduced interest rates. Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the hospitals and nursing

homes, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Pre-dating the enactment of the first Federal income tax, an early decision of the U.S. Supreme Court, *Dartmouth College v. Woodward* (17 U.S. 518 [1819]), confirmed the legality of government support for charitable organizations that were providing services to the public.

The income tax adopted in 1913, in conformance with this principle, exempted from taxation virtually the same organizations now included under Section 501(c)(3). In addition to their tax-exempt status, these institutions were permitted to receive the benefits of tax-exempt bonds.

Almost all States have established public authorities to issue tax-exempt bonds for nonprofit hospitals and nursing homes. Where issuance by public authority is not feasible, Revenue Ruling 63-20 allows nonprofit hospitals to issue tax-exempt bonds "on behalf of" State and local governments.

Prior to enactment of the Revenue and Expenditure Control Act of 1968, States and localities were able to issue bonds to finance construction of capital facilities for private (proprietary or for-profit) hospitals, as well as for public sector and nonprofit hospitals.

After the 1968 Act, tax-exempt bonds for proprietary (for-profit) hospitals had to be issued as small-issue industrial development bonds, which limited the amount for any institution to $5 million over a six-year period. The Revenue Act of 1978 raised this amount to $10 million.

The Tax Equity and Fiscal Responsibility Act of 1982 established a December 31, 1986, sunset date for tax-exempt small-issue IDBs. The Deficit Reduction Act of 1984 extended the sunset date for bonds used to finance manufacturing facilities, but left in place the December 31, 1986 sunset date for nonmanufacturing facilities, thereby ending the practice of using tax-exempt bonds to finance capital facilities of for-profit hospitals and nursing homes.

The private-activity bond status of these bonds subjects them to more severe restrictions in some areas, such as arbitrage rebate and advance refunding, than would apply if they were classified as governmental bonds.

Assessment

Efforts have been made to reclassify nonprofit bonds as governmental bonds. Central to this issue is the extent to which nonprofit organizations are fulfilling their public purpose rather than using their tax-exempt status to convert tax subsidies into subsidized goods and services for groups that might receive more critical scrutiny if their subsidy were provided through the spending side of the budget.

Questions have been raised about the extent to which nonprofit hospitals are fulfilling their charitable purpose, and whether it is justifiable to continue to allow them to enjoy the below-market capital financing rates provided by their unlimited access to tax-exempt bonds.

Even if a case can be made for subsidy of these nonprofit organizations, it is important to recognize the costs

that accrue. As one of many categories of tax-exempt private-activity bonds, bonds issued for these organizations have increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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DEDUCTION FOR CHARITABLE CONTRIBUTIONS TO HEALTH ORGANIZATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.0	0.7	2.7
2000	2.1	0.8	2.9
2001	2.3	0.9	3.2
2002	2.4	1.0	3.4
2003	2.5	1.1	3.6

Authorization

Section 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations, including organizations whose purpose is to provide medical or hospital care, or medical education or research. To be eligible, organizations must be not-for-profit.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI) (30 percent for gifts of capital gain property). For contributions to nonoperating foundations and organizations, deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over the amount of contributions which qualified for the 50-percent deduction ceiling (including carryovers from previous years).

Gifts of capital gain property to these organizations are limited to 20 percent of AGI. A corporation can deduct up to 10 percent of taxable income (with some adjustments).

If a contribution is made in the form of property, the deduction depends on the type of taxpayer (*i.e.*, individual, corporate, etc.), recipient, and purpose.

Taxpayers are required to obtain written substantiation from a donee organization for contributions which

exceed $250. This substantiation must be received no later than the date the donor-taxpayer filed the required income tax return. Donee organizations are obligated to furnish the written acknowledgment when requested with sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the Federal Government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Those individuals who use the standard deduction or who pay no taxes receive no benefit from the provision.

A limitation applies to the itemized deductions of high-income taxpayers. Under this provision, in 1998, otherwise allowable deductions are reduced by three percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $124,500 (adjusted for inflation in future years). The table below provides the distribution of all charitable contributions, not just those to health organizations.

Distribution by Income Class of the Tax Expenditure for Charitable Contributions, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.5
$20 to $30	1.3
$30 to $40	2.5
$40 to $50	4.0
$50 to $75	14.9
$75 to $100	14.8
$100 to $200	22.1
$200 and over	39.8

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the sponsor, argued that the high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were generally contributed to charitable organizations.

It was also argued that many colleges would lose students to the military, and charitable gifts were needed by educational institutions. The deduction was extended to estates and trusts in 1918 and to corporations in 1935.

Assessment

Supporters note that contributions finance desirable activities such as hospital care for the poor. Further, the Federal Government would be forced to step in to assume more of these activities currently provided by health care organizations if the deduction were eliminated; however, public spending might not be available to make up all of the difference. In addition, many believe that the best method of allocating general welfare

resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect which varies with the marginal tax rate of the giver. There are a number of studies which find significant behavioral responses, although a recent study by Randolph suggests that such measured responses may largely reflect transitory timing effects.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than are contributions to health organizations, the arts, and educational institutions, with contributions to other types of organizations falling between these levels.

However, the volume of donations to religious organizations is greater than to all other organizations as a group. It has been estimated by the AAFRC Trust for Philanthropy, Inc. that giving to health care providers and associations amounted to $13.89 billion in 1996. The average increase in giving to health was 7.3 percent between 1966 and 1996. In 1996 giving to health increased 10.4 percent (which represents a 7.5 percent increase when adjusted for inflation).

There has been recent debate concerning the amount of charity care being provided by health care organizations with tax-exempt status. Those who support eliminating charitable deductions note that deductible contributions are made partly with dollars which are public funds. They feel that helping out private charities may not be the optimal way to spend government money.

Opponents further claim that the present system allows wealthy taxpayers to indulge special interests and hobbies. To the extent that charitable giving is independent of tax considerations, Federal revenues are lost without having provided any additional incentive for charitable gifts. It is generally argued that the charitable contributions deduction is difficult to administer and that taxpayers have difficulty complying with it because of complexity.

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Health

TAX CREDIT FOR ORPHAN DRUG RESEARCH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	([1])	([1])
2000	-	([1])	([1])
2001	-	([1])	([1])
2002	-	([1])	([1])
2003	-	([1])	([1])

([1])Less than $50 million.

Authorization

Sections 41(b), 45C, and 280C.

Description

A tax credit is available for 50 percent of the qualified expenses incurred in testing drugs used to treat rare diseases ("orphan" drugs). Eligible diseases defined by the Federal Food, Drug, and Cosmetic Act consist of illnesses affecting fewer than 200,000 persons, or occurring so infrequently that developing a drug used to treat the disease is not economical.

Outlays that qualify are supplies and salaries, but not depreciable property. Expenses that qualify for the orphan drug research credit cannot also qualify for the research expenditure credit. And while qualified testing expenses that count towards the orphan drug credit can generally be deducted in the year incurred ("expensed"), the amount of deductible expenses is reduced by the orphan drug credit.

Impact

The orphan drug tax credit reduces the cost of investment in qualified drug research. Most of this effect is registered by pharmaceutical firms, which account for nearly 80 percent of all orphan drug credits claimed.

In the long run, however, the burden of the corporate income tax (and the benefit from reductions in it) probably spreads far beyond corporate stockholders to owners of capital in general. (See the related discussion in the Introduction.) To the extent that the credit results in the development of orphan drugs, the credit probably also benefits persons with diseases classified as rare.

Rationale

The orphan drug tax credit was first enacted as part of the Orphan Drug Act of 1983. Its purpose was to provide an incentive for firms to develop drugs for diseases that are so rare that there would be little hope of recovering the drug's development costs without Federal support.

The 1983 Act provided two other forms of Government support: grants for the testing of drugs, and a seven-year market exclusivity for orphan drugs approved for use. Under the initial Act, the only test for a drug's eligibility was that there be no reasonable expectation of recovering the costs of development.

This test, however, proved difficult to administer, and in 1984 Public Law 98-551 added the 200,000-person test described above. The tax credit was initially scheduled to expire at the end of 1987, but was subsequently extended by the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1990, the Tax Extension Act of 1991, and the Omnibus Reconciliation Act of 1993. The credit lapsed, but was reinstated by the Small Business Job Protection Act of 1996, and extended by the Taxpayer Relief Act of 1997.

Assessment

As of September, 1992, 494 drugs had qualified as orphans under the 1983 Act; 64 have been approved for the market. Currently, more than 170 drugs have been brought to the market. Supporters of the Act in general view these data as proof that the Act's incentives are accomplishing their goal of developing drugs that would not otherwise be produced.

However, it has been pointed out that a number of drugs developed and marketed under the Orphan Drug Act have proved to be profitable and probably would have been developed without Government support. Supporters of the Act note, however, that it is only with hindsight that these particular drugs are known to be profitable.

Others have criticized the design of the Orphan Drug Act's incentives without questioning the desirability of Government support. For example, it is argued that the current rules permit firms to classify drugs with multiple uses as being useful for only a narrow range of applications, thereby making it easier for the drugs to qualify as orphans.

To the extent that the orphan drug tax credit accomplishes its purpose, it diverts resources from other uses to the development of drugs for rare diseases. This effect presents the most general issue raised by the credit and perhaps the most painful one: is it appropriate to divert resources from uses that benefit many persons to uses that benefit only a few, albeit in a sometimes dramatic way?

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Medicare

EXCLUSION OF UNTAXED MEDICARE BENEFITS: HOSPITAL INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	14.7	-	14.7
2000	15.2	-	15.2
2001	15.9	-	15.9
2002	16.8	-	16.8
2003	17.8	-	17.8

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31.

Description

Part A of Medicare, also known as hospital insurance or HI, pays for certain in-patient hospital care, skilled nursing facility care, home health care, and hospice care for eligible individuals age 65 or over or disabled.

The Medicare Part A program is financed primarily by a Federal Insurance Contributions Act (FICA) payroll tax on wage and salary income and self-employment income (the self-employed pay 2.90 percent), levied at 1.45 percent on both the employee and employer, and paid into a trust fund. There is no cap on taxable earnings. The individual is viewed as contributing during his or her working years in exchange for receiving insurance benefits during his or her retirement years.

The employer portion of the payroll tax is not included in the employee's reportable compensation for tax purposes. In addition, because the Medicare contribution period began relatively recently (in 1966), the expected lifetime value of the hospital insurance benefits exceeds the amount of payroll tax contributions made by, or on behalf of, the current cohort of beneficiaries. The subsidy components of the insurance benefits are not taxable to the beneficiaries.

Impact

All Medicare Part A beneficiaries are considered to receive the same average dollar value of in-kind insurance benefits per year. There is substantial variation among individuals, however, in the portion of those benefits covered by the person's own employee payroll tax contributions and, conversely, the remaining portion considered untaxed benefits.

This depends on the person's taxable earnings history and life expectancy over the benefits period. The untaxed benefits are likely to be larger for persons who became eligible in the earliest years of the Medicare program, who had low taxable wages or who qualified as a spouse with little or no payroll contributions of their own, and who have a long life expectancy. Beyond this, the tax expenditure value of any dollar of untaxed insurance benefits depends upon the beneficiary's marginal income tax rate during retirement.

Rationale

The exclusion of Medicare benefits from income taxation has never been expressly established by statute. The Medicare program was enacted in 1965. An IRS ruling in 1970 (Rev. Rul. 70-341) provided that the benefits under Part A of Medicare are not includable in gross income because they are in the nature of disbursements made in furtherance of the social welfare objectives of the Federal Government.

The ruling also stated that for purposes of determining an individual's gross income under section 61 of the Internal Revenue Code, basic Medicare benefits (Part A) were not legally distinguishable from the monthly social security payments to an individual. A separate ruling (Rev. Rul. 70-217, 1970-1 C.B. 13) had provided for the excludability of these social security or OASDI (old age and survivors insurance and disability insurance) benefits.

Assessment

The tax subsidy for Medicare HI lowers the apparent cost of the provision of hospital care for the elderly. It may, therefore, cause more resources to be devoted to this program than might otherwise be the case.

There are several administrative considerations that make it difficult to reduce this subsidy in a fair way among individuals. Medicare benefits remain untaxed, like most other health insurance benefits. Taxing the value of the health care benefits actually received is not considered a serious option. Expenditures on behalf of individuals who suffer serious illnesses can be very large. Taxing people heavily at the time of their health misfortune is generally not considered fair.

In fact, the typical tax treatment of insurance purchased by individuals (e.g., life and property insurance) is that insurance payouts to cover reimbursable expenses are not considered taxable income. In exchange, however, the premiums paid for non-health insurance are not deductible from the individual's taxable income. One difference here is that the employer's half of the HI payroll tax contribution is free from individual income taxation. This follows the convention for the OASDI social security taxes.

Even if the average annual insurance value of the Medicare HI coverage is used as the standardized measure of benefits, there is a difference in the size of the subsidy depending upon each beneficiary's length and level of annual contributions to the HI trust fund. In general, some of today's cohort of beneficiaries receives a large subsidy simply because their contribution period was short and many married women had no covered earnings.

For middle and high income current beneficiaries, an additional portion of their social security payments is now subject to income taxation, with the associated revenues going to the Medicare HI trust fund. This provision of the Omnibus Budget Reconciliation Act of 1993 (P.L. 101-508), effective in 1994, applies to taxpayers with provisional income greater than adjusted base amounts of $34,000 for unmarried taxpayers or $44,000 for married taxpayers filing joint returns. For these taxpayers, up to 85 percent of their social security benefits can be included in the calculation of their gross income. The same rules apply to railroad retirement tier 1 benefits. In 1995, 13.5 percent of tax returns reporting social security income were affected by the 85 percent inclusion rule. Because the base amounts are not indexed to rise with inflation, over time a growing fraction of beneficiaries is likely to face income taxes on their social security benefits to help pay for Medicare HI.

For future retirees, the portion of the subsidy measured as HI benefits in excess of payroll tax contributions is expected to gradually decrease as the contribution period covers more of their work years. In addition, the removal of the cap on covered earnings for Medicare HI means that today's high wage earners will contribute more during their working years and consequently receive a lower (and possibly negative) subsidy as Medicare beneficiaries in the future.

Prior to 1991, the taxable earnings base for Medicare HI was the same as for social security (OASDI). The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) raised the cap on the maximum amount of employee earnings subject to the Medicare HI tax to $125,000 in 1991, indexed for inflation thereafter; the cap reached $130,200 for 1992 and $135,000 for 1993. The Omnibus Budget Reconciliation Act of 1993 repealed the cap on wages and self-employment income subject to the Medicare HI tax, effective in 1994. All revenues from the HI payroll tax go into the Medicare Hospital Insurance Trust Fund.

These 1990 and 1993 changes in the tax law reflect an effort to increase the financing of Medicare HI in a more progressive way than the standard alternative of raising the HI payroll tax rates on the social security earnings base.

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EXCLUSION OF MEDICARE BENEFITS: SUPPLEMENTARY MEDICAL INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	7.2	-	7.2
2000	8.0	-	8.0
2001	9.1	-	9.1
2002	10.4	-	10.4
2003	11.8	-	11.8

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31.

Description

Part B of Medicare, also known as supplementary medical insurance or SMI, covers certain doctors' services, outpatient services, and other medical services (such as laboratory tests) for persons age 65 and over (or qualifying disabled individuals) who voluntarily elect to pay the required monthly premium ($43.80 per month in 1998, $45.50 per month in 1999). Currently, these premiums cover about 25 percent of the program's costs. The remaining 75 percent is covered by general revenues. The value of the general fund subsidy is not included in the gross income of enrollees for income tax purposes.

Impact

The tax expenditure benefit of the exclusion is in direct proportion to the enrollee's marginal tax rate. Unlike many other tax expenditure items where the underlying dollar amount of the deduction or exclusion can vary widely among individual taxpayers, the dollar value of the Medicare Part B general fund premium subsidy is the same for all enrollees. All enrollees are considered to receive the same average dollar value of in-kind insurance benefits and are charged the same monthly premium. Consequently, they receive the same subsidy measured as the difference between the value of insurance benefits and the premium. The income tax savings are greater, however, for enrollees in higher tax rate brackets. Taxpayers eligible to claim itemized deductions for medical expenses may include the medicare part B premiums they have paid or had deducted from their

monthly social security benefit.

Rationale

The exclusion of Medicare benefits has never been expressly established by statute. An IRS ruling in 1970, Rev. Rul. 70-341, repeats the findings stated in Rev. Rul. 66-216 that benefits under Part B of Medicare are excludable from taxable income under provisions of IRC section 104 as amounts received through accident and health insurance. This reasoning clearly applies to the premium-financed portion of the SMI program, but not equally to the portion financed by the general Treasury.

The exclusion of the subsidized portion of Medicare Part B benefits has been supported by the same argument that Rev. Rul. 70-341 applied explicitly to Part A of Medicare: the benefits are not includible in gross income because they are in the nature of disbursements made in furtherance of the social welfare objectives of the Federal Government.

Assessment

Medicare benefits remained untaxed, like most other privately and publicly financed health insurance benefits.

The Part B premiums were initially intended to cover 50 percent of SMI program costs. Between 1975 and 1983 that share fell to less than 25 percent. For 1984 through 1997 the premiums were set to cover 25 percent of program costs for the aged under successive laws (an exact dollar figure rather than a percentage applied over the 1991-1995 period). The Balanced Budget Act of 1997 (P.L. 105-33) permanently set the Part B premium equal to 25 percent of program costs.

The tax subsidy for Medicare SMI reduces the cost of supplementary medical insurance for retirees and may cause individuals to consume too much health care. Because this transfer is not means-tested, the benefit is received by many higher income individuals and thus differs from other transfer programs.

There are no obvious administrative limitations on including the value of these subsidies in income; they could simply be assigned to individuals and reported as income on their tax return. Such a change could, however, impose a burden on older individuals of moderate means who have little flexibility to adapt to the additional tax.

Legislation reducing the size of the subsidy itself for higher income individuals would accomplish the same effect as taxation. Several proposals advanced during the last several years would effectively raise the Part B premiums for high income enrollees (in some cases to a level that would cover up to 100 percent of average benefits per enrollee). The mechanism would be a recapture through the individual income tax. The associated revenues would be appropriated to the Medicare SMI Trust Fund. The individual could deduct the recapture amount to the same extent as other health insurance premiums. Any employer reimbursement of the recapture amount would be excludable from the recipient's taxable income.

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EXCLUSION OF WORKERS' COMPENSATION BENEFITS (DISABILITY AND SURVIVORS PAYMENTS)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	3.7	-	3.7
2000	3.8	-	3.8
2001	3.9	-	3.9
2002	4.0	-	4.0
2003	4.2	-	4.2

Authorization

Section 104(a)(1).

Description

Workers' compensation benefits to employees in cases of work-related injury, and to survivors in cases of work-related death, are not taxable. However, workers' compensation cash benefits are counted in determining whether social security or railroad retirement benefits are taxed and may lead to taxation of those benefits. Employers finance benefits through insurance or self-insurance arrangements (with no employee contribution), and their costs are treated as a business expense and not taxed.

Benefits are provided as directed by various State and Federal laws and consist of cash earnings-replacement payments, payment of injury-related medical costs, special payments for physical impairment (regardless of lost earnings), and coverage of certain injury or death-related expenses (e.g., burial costs). Employees and survivors receive compensation if the injury or death is work-related; no proof of employer negligence is needed, and workers' compensation is treated as the sole remedy for work-related injury or death.

Cash earnings replacement payments typically are set at two-thirds of lost pre-tax earning capacity, up to legislated maximum amounts. They are provided for both total and partial disability, generally last for the term of the disability, may extend beyond normal retirement age, and are paid as periodic (e.g., monthly) payments or lump-sum settlements.

Impact

Preliminary estimates for 1995 indicate that workers' compensation benefits totaled $40.1 billion, over half of which represented cash payments to injured employees and survivors replacing lost earnings. Varying estiates of workers' compensation costs to employers in 1995 place them at either $56.9 billion (1.8 percent of an estimate of covered payrolls) or $87.6 billion (2.6 percent of a different estimate of covered payrolls).

The Census Bureau's current population survey gives the following profile of those who reported receiving workers' compensation in 1995:

Total family income (including workers' compensation) was below $15,000 for almost 12 percent of recipients, between $15,000 and $30,000 for 36 percent, between $30,000 and $45,000 for 24 percent, and above $45,000 for 39 percent; 6 percent had family income below the Federal poverty thresholds.

Recipients' income (including workers' compensation) was below $15,000 for 31 percent, between $15,000 and $30,000 for 48 percent, between $30,000 and $45,000 for 11 percent, and above $45,000 for 10 percent.

Workers' compensation cash benefits were less than $5,000 for 64 percent of recipients, between $5,000 and $10,000 for 18 percent, between $10,000 and $15,000 for almost 10 percent, and more than $15,000 for 8 percent.

Rationale

This exclusion was first codified in the Revenue Act of 1918. But the committee reports accompanying the Act suggest that workers' compensation payments were not subject to taxation before the 1918 Act. No rationale for the exclusion is found in the legislative history. But it has been maintained that workers' compensation should not be taxed because it is in lieu of court-awarded damages for work-related injury or death that, before enactment of workers' compensation laws (beginning shortly before the 1918 Act), would have been payable under tort law for personal injury or sickness and not taxed.

While the legislative history of the requirement for taxing some social security and railroad retirement benefits shows no rationale for indirectly "taxing" workers' compensation payments through their effect on taxation of social security and railroad retirement benefits, it is argued for on grounds of equity: providing the same tax treatment of disability benefits to those with and without workers' compensation.

Assessment

Exclusion of workers' compensation benefits from taxation increases the value of these benefits to injured employees and survivors, without direct cost to employers, through a tax subsidy. Taxation of workers' compensation would put it on a par with the earned income it replaces and other employer-provided accident and sickness benefits. It also would place the "true" cost of workers' compensation on employers. Unless compensation benefits were increased in response to taxation, employer costs would likely remain unchanged, and it is possible that "marginal" claims would be reduced.

Furthermore, exclusion of workers' compensation payments from taxation is a relatively inefficient subsidy, replacing more income for (and worth more to) those with higher earnings and other taxable income than poorer

households. While States have tried to correct for this with legislated maximum benefits and by calculating payments based on replacement of after-tax income, the maximums provide only a rough adjustment and few jurisdictions have moved to after-tax income replacement.

On the other hand, a case can be made for tax subsidies for workers' compensation because the Federal and State Governments have required provision of this "no-fault" benefit. Moreover, because most workers' compensation benefit levels, especially the legal maximums, have been established knowing there would be no taxes levied, it is likely that taxation of compensation would lead to considerable pressure to increase payments.

If workers' compensation earnings replacement payments were to be subjected to taxation, those with short-term or partial disabilities enabling them to continue working and those with other taxable income would likely be most affected. These groups form the overwhelming majority of beneficiaries. By and large, those who receive only workers' compensation payments, such as totally disabled long-term beneficiaries, would be affected much less.

Some administrative issues would arise in implementing a tax on workers' compensation. Although most workers' compensation awards are made as periodic cash income replacement payments and separate payments for medical and other expenses, a noticeable proportion of the awards are in the form of lump-sum settlements. In some cases, the portion of the settlement attributable to income replacement can be distinguished from that for medical and other costs, in others it cannot. A procedure for pro-rating lump-sum settlements over time would be called for, and, if taxation of compensation were targeted on income replacement payments, some method of identifying them in lump-sum settlements where they are not would have to be devised. In addition, a reporting system would have to be established for insurers (who pay most benefits), State workers' compensation insurance "funds," and self-insured employers (*e.g.*, a new kind of "1099"), and a way of withholding taxes might be needed.

Equity questions also would arise in taxing compensation. Some of the work force is not covered by traditional workers' compensation laws. For example, interstate railroad employees and seafaring workers have a special court remedy that allows them to sue their employer for negligence damages, similar to the system for work-related injury and death benefits that workers' compensation laws replaced for most workers. Their jury-awarded compensation is not taxed. Some workers' compensation awards are made for physical impairment, without regard to lost earnings. Under current tax law, employer-provided accident and sickness benefits generally are taxable, but payments for loss of bodily functions are excludable. Here, equity might call for continuing to exclude those workers' compensation payments that are made for loss of bodily functions as opposed to lost earnings. Finally, States would face a decision on taxing compensation, jurisdictions that use after-tax income replacement would be called on to change, and the current indirect taxation of workers' compensation through taxation of disability benefits would have to be revised or ended.

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EXCLUSION OF SPECIAL BENEFITS FOR DISABLED COAL MINERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	-	0.1
2000	0.1	-	0.1
2001	0.1	-	0.1
2002	0.1	-	0.1
2003	0.1	-	0.1

Authorization

30 U.S.C. 924(c), 104(a)(1), Revenue Ruling 72-400, 1972-2 C.B. 75.

Description

Benefits to coal mine workers or their survivors for total disability or death resulting from coal workers' pneumoconiosis (black lung disease) paid under the Black Lung Benefits Act generally are not taxable; comparable benefits under State workers' compensation laws also are not taxed.

However, as with workers' compensation, certain black lung payments (*part C* benefits, see below) can affect the taxation of social security and railroad retirement disability benefits if a beneficiary receives both black lung and disability payments. Black lung benefits consist of monthly cash payments and payment of black-lung-related medical costs.

There are two distinct programs providing black lung benefits, although the benefits are the same: monthly cash payments and coverage of black-lung-related medical costs. The *part B* program is financed by annual Federal appropriations, and benefits are provided to those who filed claims prior to June 30, 1973 (or December 31, 1973, in the case of survivors). The *part C* program applies to claims filed after the *part B* deadlines; these benefits are paid either by the "responsible" coal mine operator or, in most cases, by the Black Lung Disability Trust Fund (BLDTF).

To pay their obligations, coal mine operators may set up special "self-insurance trusts," contributions to which are tax deductible, or otherwise fund their liability (typically, through insurance arrangements) and avoid

tax for the cost of providing benefits. The BLDTF is financed by an excise tax on coal and borrowing from the Federal Treasury; it also pays the medical costs of *part B* beneficiaries.

Black lung claims must meet the following general conditions: the worker must be totally disabled from, or have died of, pneumoconiosis arising out of coal mine employment. However, there are certain statutory "presumptions" of eligibility, and it is possible for a beneficiary to be working outside the coal industry (although earnings tests apply in some cases). *Part C* payments are considered workers' compensation and, in some instances, affect any social security or railroad retirement disability benefits; *part B* benefits do not.

Impact

Part B cash payments to 127,000 beneficiaries totaled $625 million in fiscal year 1997. However, virtually all recipients are over 65 years old, and this caseload is declining by over 20,000 a year; more than 80 percent of beneficiaries are single widows or other survivors. *Part C* cash payments to some 74,000 beneficiaries totaled approximately $400 million in fiscal year 1997. In addition, almost $100 million in payments for black-lung related medical treatment were made to, or on behalf of, both *part B* and *part C* recipients. Permanently disabled workers make up about 40 percent of *part C* beneficiaries. As with *part B*, the *part C* rolls are declining, but a much slower rate because new claims continue to be approved. In calendar 1998, annual black lung cash payments (under both *part B* and *part C*) range from $5,465 to $10,928, depending on the number of dependents.

Rationale

Part B payments are excluded under the terms of title IV of the original Federal Coal Mine Health and Safety Act of 1969 (now entitled the Black Lung Benefits Act). No specific rationale for this exclusion is found in the legislative history. *Part C* benefits have been excluded because they are considered to be in the nature of workers' compensation under a 1972 revenue ruling and fall under the workers' compensation exclusion of section 104(a)(1).

Assessment

Excluding black lung payments from taxation increases their value to some beneficiaries, those with other taxable income; the payments themselves fall well below Federal income tax thresholds. However, the effect of taxing black lung benefits and the factors to be considered in deciding on their taxation differ between *part B* and *part C* payments.

Part B benefits could be viewed as earnings replacement payments and, thus, appropriate for taxation, as with workers' compensation. However, it would be difficult to argue for their taxation, especially now that practically all recipients are elderly retirees. When *part B* benefits were enacted, the legislative history emphasized that they were not workers' compensation, but rather a "limited form of emergency assistance." They also were seen as a way of compensating for the lack of health and safety protections for coal miners prior to the 1969 Act and the fact that existing workers' compensation systems rarely compensated for black lung disability or death.

Furthermore, it can be maintained that, in effect, taxation of *part B* payments takes back with one hand what

Federal appropriations give with the other, although almost no beneficiaries would likely be affected given their age and retirement status.

A stronger argument can be made for taxing *part C* benefits, and, if workers' compensation were to be made taxable, they would automatically be taxed because their tax-exempt status flows from their treatment as workers' compensation. Taxing *part C* payments would give them the same treatment as the earnings they replace and remove a relatively inefficient governmental subsidy to those with other taxable income (a noticeable proportion of *part C* recipient households, unlike *part B* households), although, because those on the *part C* rolls are aging, the effect of taxing their benefits should decline over time. On the other hand, black lung benefits are legislatively established (a percentage of minimum Federal salaries, not directly reflective of a worker's pre-injury earnings as in workers' compensation) and can be viewed as a special kind of disability or death "grant" that should not be taxed.

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EXCLUSION OF CASH PUBLIC ASSISTANCE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.5	-	0.5
2000	0.5	-	0.5
2001	0.5	-	0.5
2002	0.5	-	0.5
2003	0.5	-	0.5

Authorization

The exclusion of public assistance payments is not specifically authorized by law. However, a number of revenue rulings under section 61 of the Internal Revenue Code, which defines "gross income," have declared specific types of means-tested benefits to be nontaxable.

Description

The Government provides public assistance benefits tax free to individuals either in the form of cash welfare or as in-kind benefits (certain goods and services received free or for an income-scaled charge). Cash payments come from the Federal-State programs of Temporary Assistance for Needy Families (TANF), which replaced Aid to Families with Dependent Children during FY 1997, Supplemental Security Income (SSI) for the aged, blind, or disabled, and State-local programs of General Assistance (GA), known also by other names such as Home Relief.

(In addition, certain payments for foster care of children, including those made on behalf of children eligible for TANF are tax free, as are "difficulty-of-care" payments for foster children. Exclusion of these foster care payments from taxation is required by section 131 of the Internal Revenue Code. They are discussed elsewhere in this report, under "Social Services.")

Traditionally, the tax benefits from in-kind payments have *not* been included in the tax expenditure budget because of the difficulty of determining their value to recipients. (However, the Census Bureau publishes estimates of the value and distribution of major noncash welfare benefits.)

Impact

Exclusion of public assistance cash payments from taxation gives no benefit to the poorest recipients and has scant impact on the incomes of many. This is because welfare payments are relatively low and many recipients have little if any non-transfer cash income. For example, 76 percent of AFDC families in FY 1996 reported having zero other cash income, and AFDC/TANF payments in the first nine months of FY 1997, transition year, averaged $367 monthly per family (three persons), far below the tax threshold. If family cash welfare payments were made taxable, most recipients still would owe no tax.

However, some welfare recipients do benefit from the exclusion of public assistance cash payments. They are persons who receive relatively high cash aid (including aged, blind, and disabled persons enrolled in SSI in States that supplement the basic Federal income guarantee, which is $494 monthly per individual and $741 per couple in 1998) and persons who have earnings for part of the year and public assistance for the rest of the year (and whose actual annual cash income would exceed the taxable threshold if public assistance were not excluded). Public assistance benefits are based on monthly income and thus families whose fortunes improve during the year generally keep welfare benefits received earlier.

The Census Bureau has estimated, on the basis of information collected in the March 1998 Current Population Survey, that in 1997, $35.6 billion was received in means-tested cash transfers from the programs of AFDC/TANF, SSI, GA, and veterans' pensions. Per recipient household, cash payments averaged $4,773. (Note: The Bureau indicates that this estimate may be below actual payments, as there is a tendency for income to be underreported in household surveys.) Veterans' pensions were place in the cash welfare group by the Census Bureau because they are income-tested, but in this tax expenditure report they are discussed elsewhere, under "veterans' benefits and services."

The Census Bureau report (P60-200, Table 12) indicates that 54 percent of these means-tested cash transfers went to the Nation's poorest households, that is, to those in the bottom fifth of the pre-tax money income distribution; 20 percent went to households in the second quintile, 12 percent to the middle quintile, 8 percent to the fourth quintile, and 6 percent to the top quintile. Thus, if cash transfers were made taxable, some households would have to pay higher income taxes.

The Census Bureau's estimate of the 1997 value of major *noncash* means-tested benefits ($53.4 billion) exceeded that of cash aid. The Bureau estimated the fungible value of medicaid at $26 billion ($2,654 on average per recipient household, counting only households where medicaid had a positive value) and the value of noncash aid at from three other major programs (food stamps, rent subsidies, and free or reduced-price school lunches) at $27.4 billion. On average, recipient households received $1,969 from various combinations of the latter programs.

The fungible value approach counts medicaid benefits as income only "to the extent that they free up resources that could have been spent on medical care." Thus, the estimated value of medicaid is zero unless family income exceeds the cost of food and housing requirements. The Bureau sets the income value of food stamps equal to their face value and that of school lunches at their full subsidy value. Income value of housing subsidies is calculated by a complex procedure that is based on the 1985 American Housing Survey.

In the first nine months of FY 1998, TANF benefits were received by a monthly average of about nine million persons in 3.3 million families, but data are not available on the amount of benefits paid. In Fy 1998, a monthly average of 6.3 million persons were expected to receive $27.4 billion in federal SSI benefits (and another 276,000 to receive federally administered SSI supplements paid with state funds. Most of the recipients of cash help also receive some non-cash

Rationale

Revenue rulings generally exclude government transfer payments from income because they have been considered to have the nature of "gifts" in aid of the general welfare. While no specific rationale has been advanced for this exclusion, the reasoning may be that the Congress did not intend to tax with one hand what it gives with the other.

Assessment

Several reasons are advanced for treating means-tested cash payments as taxable income. First, excluding these cash payments results in treating persons with the same cash income differently. Second, removing the exclusion would not harm the poorest because their total cash income still would be below the tax threshold. Third, the Nation's general view of cash welfare has changed. Cash benefits to TANF families now widely are regarded not as "gifts" but as payments that impose obligations on parents to work or prepare for work through schooling or training, and many GA programs require work. Thus, it may no longer be appropriate to treat cash welfare transfers as gifts. (The SSI program imposes no work obligation, but offers a financial reward for work.)

Fourth, the exclusion of cash welfare from taxation increases the work disincentives inherent in need-tested aid. A welfare recipient who goes to work replaces some nontaxable cash with taxable income. This increases his/her potential "marginal tax" rate. (When recipients work, they face reduction in need-tested benefits, and the benefit-loss rate acts like a form of marginal tax rate.)

Fifth, the 1986 decision to tax all unemployment compensation (and the earlier decision to tax a portion of social security benefits of higher income recipients) began a reform, on grounds of equity, for social insurance benefits that should be extended to means-tested cash aid. Sixth, using the tax system to subsidize needy persons without direct spending masks the total cost of aid and is inefficient, benefiting primarily those with other income. Sixth, taxing welfare payments would increase the ability to integrate the tax and transfer system.

Several objections are made to the removal of the tax exemption from means-tested cash transfers. First, cash welfare programs provide guarantees of minimum cash income that presumably represent target levels of disposable income. Making these benefits taxable might reduce disposable income below the targets.

Second, unless the tax threshold were set high enough, some persons deemed needy by their State might be harmed by the change. Third, TANF and SSI minimum income guarantees differ by State, but the Federal tax threshold is uniform for taxpayers with the same filing status and family size. If cash welfare payments were made taxable, the actual effect would vary among the States.

For instance, an aged person whose only cash income was SSI would become subject to 1998 Federal income tax in Alaska and Connecticut, which provide large SSI supplements. But in States with no supplement, or one smaller than $173 monthly, recipients would remain free of the income tax. Although maximum TANF benefits in all States are below tax thresholds, the shortfall varies widely, ranging from $273 monthly in Alaska to $1,076 in Mississippi for the average TANF family, a mother with two children.

Third, if cash welfare were made taxable, it is argued that noncash welfare also should be counted (raising

difficult measurement issues). Further, if noncash means-tested benefits were treated as income, it is argued that noncash income (ranging from employer-paid health insurance to tax deductions for home mortgage interest) also should be counted, raising new problems. Fourth, the public might perceive the change as violating the social safety net, and, thus, object.

Two other issues are raised by the proposal. New administrative machinery would be needed; at the least, welfare offices would have to prepare annual reports (Form 1099) on cash payments made to recipients. Also, States that gear their income tax to the Federal income tax system would be affected by the change.

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NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS PLANS FOR EMPLOYEES AND SELF-EMPLOYED INDIVIDUALS (KEOUGHS)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	80.9	-	80.9
2000	83.4	-	83.4
2001	83.4	-	83.4
2002	83.5	-	83.5
2003	84.1	-	84.1

Authorization

Sections 401-407, 410-418E, and 457.

Description

Employer contributions to qualified pension, profit-sharing, stock-bonus, and annuity plans on behalf of an employee are not taxable to the employee. The employer is allowed a current deduction for these contributions (within limits). Earnings on these contributions are not taxed until distributed.

The employee or the employee's beneficiary is generally taxed on benefits when benefits are distributed. (In some cases, employees make direct contributions to plans that are taxed to them as wages; these previously taxed contributions are not subject to tax when paid as benefits).

A pension, profit-sharing, or stock-bonus plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. In addition, a plan must meet certain requirements, including standards relating to nondiscrimination, vesting, requirements for participation, and survivor benefits. Nondiscrimination rules are designed to prevent the plans from primarily benefitting highly paid, key employees. Vesting refers to the period of employment necessary to obtain non-forfeitable pension rights.

Tax-favored pension plans, referred to as Keogh plans, are also allowed for the self-employed; they account for only a small portion of the cost ($4.8, $5.1, $5.2, $5.4, and $5.7 billion in 1999-2003).

There are two major types of pension plans: defined-benefit plans, where employees are ensured of a certain

benefit on retirement, and defined-contribution plans, where employees have a right to accumulated contributions (and earnings on those contributions).

The tax expenditure is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid by on pensions by those who are currently receiving retirement benefits.

Impact

Pension plan treatment allows an up-front tax benefit by not including contributions in wage income. In addition, earnings on invested contributions are not taxed, although tax is paid on both original contributions and earnings when amounts are paid as benefits. The net effect of these provisions, assuming a constant tax rate, is effectively tax exemption on the return. (That is, the rate of return on the after-tax contributions is equal to the pre-tax rate of return). If tax rates are lower during retirement years than during the years of contribution and accumulation, there is a "negative" tax. (In present value terms, the government loses more than it receives in taxes).

The employees who benefit from this provision consist of taxpayers whose employment is covered by a plan and whose service has been sufficiently continuous for them to qualify for benefits in a company or union-administered plan. The benefit derived from the provision by a particular employee depends upon the level of tax that would have been paid by the employee if the provision were not in effect.

Munnell (1992) reports that pensions as a share of income for households over age 65 constituted 2.5 percent of the lowest quintile of households, 6.2 percent for the second quintile, 13.7 percent for the middle quintile, and approximately twenty percent for the top two quintiles.

There are several reasons that the tax benefit accrues disproportionately to higher-income individuals. First, employees with lower salaries are less likely to be covered by an employer plan. For example, in 1993, only 8 percent of individuals earning less than $10,000 and 27 percent of individuals earning between $10,000 and $15,000 were covered by retirement plans; the ratio rises until 81 percent of individuals earning over $75,000 are covered.

Although some of these differences reflect the correlation between low income and age, the Congressional Budget Office (1987) found differences in coverage to hold across age groups (data are for 1983). For example, in the 45-64 age group, where overall coverage was 63 percent, only 34 percent of employees with incomes under $10,000 were covered, 57 percent with incomes from $10,000 to $15,000 were covered, 71 percent for incomes from $15,000 to $20,000 were covered, and 80 percent or more of the remaining employees were covered.

In addition to lower numbers of lower-income individuals being covered by the plans, the dollar contributions are much larger for higher-income individuals. This disparity occurs not only because of their higher salaries, but also because of the integration of many plans with social security. Under a plan that is integrated with social security, employer-derived social security benefits or contributions are taken into account as if they were provided under the plan in testing whether the plan discriminates in favor of employees who are officers, shareholders, or highly compensated. These integration rules allow a smaller fraction of income to be allocated to pension benefits for lower-wage employees.

Finally, higher-income individuals derive a larger benefit from tax benefits because their tax rates are higher and thus the value of tax reductions are greater.

In addition to differences across incomes, workers are more likely to be covered by pension plans if they work in certain industries, if they are employed by large firms, or if they are unionized.

Rationale

The first income tax law did not address the tax treatment of pensions, but Treasury Decision 2090 in 1914 ruled that pensions paid to employees were deductible to employers. Subsequent regulations also allowed pension contributions to be deductible to employers, with income assigned to various entities (employers, pension trusts, and employees). Earnings were also taxable. The earnings of stock-bonus or profit-sharing plans were exempted in 1921 and the treatment was extended to pension trusts in 1926.

Like many early provisions, the rationale for these early decisions was not clear, since there was no recorded debate. It seems likely that the exemptions may have been adopted in part to deal with technical problems of assigning income. In 1928, deductions for contributions to reserves were allowed.

In 1938, because of concerns about tax abuse (firms making contributions in profitable years and withdrawing them in loss years), restrictions were placed on withdrawals unless all liabilities were paid.

In a major development, in 1942 the first anti-discrimination rules were enacted, although these rules allowed integration with social security. These regulations were designed to prevent the benefits of tax deferral from being concentrated among highly compensated employees. Rules to prevent over-funding (which could allow pension trusts to be used to shelter income) were adopted as well.

Non-tax legislation in the Taft-Hartly Act of 1947 affected collectively bargained multi-employer plans and the Welfare and Pensions Plans Disclosure Act of 1958 added various reporting, disclosure and other requirements.

In 1962, the Self-Employed Individuals Retirement Act allowed self-employed individuals to establish tax-qualified pension plans, known as Keogh (or H.R. 10) plans, which also benefitted from deferral.

Another milestone in the pension area was the Employee Retirement Income Security Act of 1974, which provided minimum standards for participation, vesting, funding, and plan asset management, along with creating the Pension Benefit Guaranty Corporation (PBGC) to provide insurance of benefits. Limits were established on the amount of benefits paid or contributions made to the plan, with both dollar limits and percentage-of-pay limits.

A variety of changes have occurred since this last major revision. In 1978, simplified employee pensions (SEPS) and tax-deferred savings (401(k)) plans were allowed. The limits on SEPS and 401(k)'s were raised in 1981. In 1982, limits on pensions were cut back and made the same for all employer plans, and special rules were established for "top-heavy" plans. The 1982 legislation also eliminated disparities in treatment between corporate and noncorporate (*i.e.*, Keogh) plans, and introduced further restrictions on vesting and coverage.

The Deficit Reduction Act of 1984 maintained lower limits on contributions, and the Retirement Equity Act of that same year revised rules regarding spousal benefits, participation age, and treatment of breaks in service.

In 1986, a variety of changes were enacted, including substantial reductions in the maximum contributions under defined-contribution plans, and a variety of other changes (anti-discrimination rules, vesting, integration rules). In 1987, rules to limit under-funding and over-funding of pensions were adopted. The Small Business Job Protection Act of 1996 made a number of changes to increase access to plans for small firms, including safe-harbor nondiscrimination rules. In 1997, taxes on excess distributions and accumulations were eliminated.

Assessment

To tax defined-benefit plans can be very difficult since it is not always easy to allocate pension accruals to specific employees. It might be particularly difficult to allocate accruals to individuals who are not vested. This complexity would not, however, preclude taxation of trust earnings at some specified rate.

The major economic justification for the favorable tax treatment of pension plans is that they are argued to increase savings and increase retirement security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty.

The incentive to save relies on an individuals realizing tax benefits on savings about which he can make a decision. Since individuals cannot directly control their contributions to plans in many cases (defined-benefit plans), or are subject to a ceiling, the tax incentives to save may not be very powerful, because tax benefits relate to savings that would have taken place in any case. At the same time, pension plans may force saving and retirement income on employees who otherwise would have total savings less than their pension-plan savings. The empirical evidence is mixed, and it is not clear to what extent forced savings is desirable.

There has been some criticism of tax benefits to pension plans, because they are only available to individuals covered by employer plans. Thus they violate the principle of horizontal equity (equal treatment of equals). They have also been criticized for disproportionately benefitting high-income individuals.

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INDIVIDUAL RETIREMENT PLANS (NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	11.4	-	11.4
2000	12.4	-	12.4
2001	13.1	-	13.1
2002	14.2	-	14.2
2003	15.5	-	15.5

Authorization

Sections 219 and 408.

Description

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account (IRA). Earnings are not taxable, although withdrawals from the plan will be taxed upon receipt.

The deduction for contributions is phased out for active participants in a pension plan at adjusted gross incomes of $50,000 to $60,000 for a joint return, and $30,000 to $40,000 for a single return. Phase-out ranges will increase by $1,000 per year, for 4 years (to $54,000 to $64,000 and $34,000 to $44,000 in 2002). Phase-outs will rise to $60,000 to $70,000 and $40,000 to $50,000 in 2004, then by $5,000 per year to $80,000 to $100,000 for married couples in 2007, and $50,000 to $60,000 for singles in 2005. Individuals may choose a backloaded IRA (a Roth IRA) where contributions are not deductible but no tax applies to withdrawals. These benefits are phased out at $150,000 to $160,000 for a joint return and $95,000 to $110,000 for singles. These individuals are still eligible for deferral of tax on earnings, which will not be taxed until withdrawn. Withdrawals from these non-deductible IRAs allow tax-free recovery of original contributions.

The annual deduction limit for IRA contributions is the lesser of $2,000 or 100 percent of compensation. An individual is eligible for the deduction so long as the individual has compensation includable in gross income and has not attained age 70 1/2 before the close of the taxable year.

A married taxpayer who is eligible to set up an IRA is permitted to make deductible contributions up to

$2,000 to an IRA for the benefit of the nonworking spouse.

Distributions made before age 59 1/2 (other than those attributable to disability or death) are subject to an additional 10-percent income tax unless they are rolled over to another IRA or to an employer plan. An exclusion is allowed for up to $10,000 used to purchase a fist home, education expenses, or for distributions after 5 years from a Roth IRA.

If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, then the transaction is treated as a distribution and the usual tax rules for distributions apply. Distributions must begin after age 70 1/2. Contributions may, however, still be made to a Roth IRA after that age.

The tax expenditure estimates reflect the net of tax losses due to failure to tax contributions and current earnings in excess of taxes paid on withdrawals.

Impact

Deductible IRAs allow an up-front tax benefit by deducting contributions along with not taxing earnings, although tax is paid when earnings are withdrawn. The net overall effect of these provisions, assuming a constant tax rate, is the equivalent of tax exemption on the return (as in the case of Roth IRAs). (That is, the individual earns the pre-tax rate of return on his after-tax contribution). If tax rates are lower during retirement years than they were during the years of contribution and accumulation, there is a "negative" tax on the return. Non-deductible IRAs benefit from a postponement of tax rather than an effective forgiveness of taxes, as long as they incur some tax on withdrawal.

IRAs tend to be less focused on higher-income levels than some types of capital tax subsidies, in part because they are capped at a dollar amount. Their benefits do tend, nevertheless, to accrue more heavily to the upper half of the income distribution. This effect occurs in part because of the low participation rates at lower income levels. In 1985, only 2.3 percent of taxpayers with incomes below $10,000 participated and 13.6 percent of taxpayers with incomes of $10,000 to $30,000 participated. Participation rates rose until they equaled about three- quarters at income levels over $75,000. Further, the lower marginal tax rates at lower income levels make the tax benefits less valuable.

The current tax expenditure reflects several types of revenue losses. The first is due to the pre-1987 deductible IRAs, which were available either to all individuals (1982 to 1986) or to individuals with pension plans (1974-1981). The tax expenditure is the foregone taxes on earnings of these IRAs offset by the taxes paid on withdrawal. The distribution table below (based on Stevens and Shaffer (1992) shows the distribution of tax savings from IRA contributions in 1986. This distribution is probably typical of the tax benefits accruing to 1987 IRAs. (The median tax return in 1986 had adjusted gross income of less than $20,000.)

The second is the earning less?? withdrawal??? for those eligible after 1986 through 1997, a distribution less concentrated at higher income levels because of the phase-out. The third cost is for those eligible after 1997 for regular IRAs; this part of the tax expenditure is the foregone taxes on earnings plus up-front deductions, offset by any tax on benefits. In addition, forgone earnings on Roth IRAs would be included. Their distribution falls between the 1986 and 1987 measures. This distribution is also shown in the table below, by applying the same marginal tax rates to the 1987 distribution of IRA deductions [Jane: check the preceding carefully--I'm not sure I could read all your changes correctly--Tom]

A final source is contributions to non--deductible IRAs. This part of the tax expenditure would simply be foregone earnings on these non-deductible IRAs. There is little information about the extent of this activity. These IRAs presumably would be concentrated at the upper end of the income distribution for 1987-1997, since more generous deductible IRAs are available to lower- and moderate-income individuals. Smaller groups of high-income individuals would use these IRAs after 1997.

Estimated Percentage Distribution of IRA Benefits

Income Class	1986	1987
less than $10,000	1.4	1.9
$10,000-$30,000	15.3	28.2
$30,000-$50,000	36.4	44.7
$50,000-$75,000	26.9	12.1
$75,000-$100,000	9.8	5.6
Over $100,000	10.2	6.5

Rationale

The provision for IRAs was enacted in 1974, but it was limited to individuals not covered by pension plans. The purpose of IRAs was to reduce discrimination against these individuals.

In 1976, the benefits of IRAs were extended to a limited degree to the nonworking spouse of an eligible employee. It was thought to be unfair that the nonworking spouse of an employee eligible for an IRA did not have access to a tax-favored retirement program.

In 1981, the deduction limits for all IRAs were increased to the lesser of $2,000 or 100 percent of compensation ($2,250 for spousal IRAs). The 1981 legislation extended the IRA program to employees who are active participants in tax-favored employer plans, and permitted an IRA deduction for qualified voluntary employee contributions to an employer plan.

The current rules limiting IRA deductions for higher-income individuals not covered by pension plans were phased out at $40,000 to $50,000 ($25,000 to $35,000 for singles) as part of the Tax Reform Act of 1986.

Part of the reason for this restriction arose from the requirements for revenue and distributional neutrality. The broadening of the base at higher income levels through restrictions on IRA deductions offset the tax rate reductions. The Taxpayer Relief Act of 1997 increased phase-outs and added Roth IRAs to encourage savings.

Assessment

The tendency of capital income tax relief to benefit higher-income individuals has been reduced in the case of IRAs by the dollar ceiling on the contribution, and by the phase-out of the deductible IRAs as income rises for those not covered by a pension plan. Providing IRA benefits to those not covered by pensions may also be justified as a way of providing more equity between those covered and not covered by an employer plan.

Another economic justification for IRAs is that they are argued to increase savings and increase retirement security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty, and this issue has been the subject of a considerable literature.

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EXCLUSION OF OTHER EMPLOYEE BENEFITS: PREMIUMS ON GROUP TERM LIFE INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.0	-	2.0
2000	2.0	-	2.0
2001	2.1	-	2.1
2002	2.2	-	2.2
2003	2.3	-	2.3

Authorization

Section 79 and L.O. 1014, 2 C.B. 8 (1920).

Description

The cost of group-term life insurance purchased by an employer for an employee is excluded from the employee's gross income to the extent that the insurance is less than $50,000.

If a group-term life insurance plan discriminates in favor of any key employee (generally an individual who is an officer, a five-percent owner, a one-percent owner earning more than $150,000, or one of the top 10 employee-owners), the full cost of the group-term life insurance for any key employee is included in the gross income of the employee.

The cost of an employee's share of group-term life insurance generally is determined on the basis of uniform premiums, computed with respect to five-year age-brackets and provided in a table furnished by the tax authorities. In the case of a discriminatory plan, however, the amount included in income will be measured by the actual cost rather than by the table cost prescribed by the Treasury.

Impact

These insurance plans, in effect, provide additional income to employees. Because the full value of the insurance coverage is not taxable, this income can be provided at less cost to the employer than the gross amount of taxable wages that would have to be paid to an employee to purchase an equal amount of insurance.

Group term life insurance is a significant portion of total life insurance. However, since neither the value of the insurance coverage nor the life insurance proceeds are included in gross income, the value of this fringe benefit is never subject to income tax.

Individuals who are self-employed or who work for an employer without such a plan do not have the advantage of this tax subsidy for life insurance protection. While there is little information on the distributional consequence of this provisions, if the coverage is similar to that of other fringe benefits, higher-income individuals are more likely to be covered by group life insurance.

Rationale

This exclusion was originally allowed, without limitation of coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). The reason for the ruling is unclear, but it may have related to supposed difficulties in valuing the insurance to individual employees, since the value is closely related to age and other mortality factors. Studies later indicated valuation was not a problem.

The $50,000 limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner.

The further limitation on the exclusion available for key employees in discriminatory plans was enacted in 1982, and expanded in 1984 to apply to post-retirement life insurance coverage. In 1986, more restrictive rules regarding anti-discrimination were adopted, but were repealed in the debt limit legislation (P.L. 101-140) of 1989.

Assessment

There may be some justification for encouraging individuals to purchase more life insurance than they would otherwise do on their own. Since society is committed to providing a minimum standard of living for dependent individuals, it may be desirable to subsidize life insurance coverage.

There is, however, no evidence on the extent to which the subsidy increases the amount of insurance rather than substituting for insurance that would be privately purchased. Moreover, by restricting this benefit to employer-provided insurance, the subsidy is only available to certain individuals, depending on their employer, and probably disproportionally benefits high-income individuals. These limitations in coverage may raise questions of both horizontal and vertical equity.

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EXCLUSION OF OTHER EMPLOYEE BENEFITS: PREMIUMS ON ACCIDENT AND DISABILITY INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.2	-	0.2
2000	0.2	-	0.2
2001	0.2	-	0.2
2002	0.2	-	0.2
2003	0.2	-	0.2

Authorization

Sections 105 and 106.

Description

Premiums paid by employers for employee accident and disability insurance plans are not included in the gross income of employees. Although benefit payments to employees generally are taxable, an exclusion is provided for payments related to permanent injuries and computed without regard to the period the employee is absent from work.

Impact

As with term life insurance, since the value of this insurance coverage is not taxable, the employer's cost is less than he would have to pay in wages that are taxable, to confer the same benefit on the employee. Employers thus are encouraged to buy such insurance for employees. Because some proceeds from accident and disability insurance plans, as well as the premiums paid by the employer, are not included in gross income, the value of the fringe benefit is never subject to income tax.

While there is little information on the distributional effects of this provisions, if the coverage is similar to that of other fringe benefits, higher-income individuals are more likely to be covered by accident and disability insurance.

Rationale

This provision was enacted in 1954. Previously, only payments for plans contracted with insurance companies could be excluded from gross income. The committee report indicated this provision equalized the treatment of employer contributions regardless of the form of the plan.

Assessment

Since public programs (social security and workman's compensation) provide a minimum level of disability payments, it is not clear what justification there is for providing a subsidy for additional benefits. Moreover, by restricting this benefit to employer-provided insurance, the subsidy is only available to certain individuals, depending on their employer, and probably disproportionally benefits high-income individuals. These limitations in coverage may raise questions of both horizontal and vertical equity.

The computation of the value of the premiums could, however, be difficult to calculate, especially if they are combined with health plans.

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ADDITIONAL STANDARD DEDUCTION FOR THE BLIND AND THE ELDERLY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	2.0	-	2.0
2000	2.0	-	2.0
2001	2.0	-	2.0
2002	2.1	-	2.1
2003	2.2	-	2.2

Authorization

Section 63(f).

Description

Blind and aged taxpayers are eligible for an added standard deduction of $850 (married or surviving spouse) or $1050 (unmarried individual) for tax year 19989. A couple could receive additional deductions totaling $3,400 if both are blind and elderly. These amounts are adjusted for inflation.

Impact

The additional standard deduction amounts raise the income threshold at which taxpayers begin to pay taxes. The benefit depends on the tax rate of the individual. Most benefits go to taxpayers with incomes under $50,000.

Distribution by Income Class of the Tax Expenditure for the Additional Standard Deduction Amount for the Blind and Elderly at 1996 Tax Rates and 1996 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.1
$10 to $20	2.1
$20 to $30	13.4
$30 to $40	16.6
$40 to $50	22.3
$50 to $75	28.1
$75 to $100	10.3
$100 to $200	6.6
$200 and over	0.6

Rationale

Special tax treatment for the blind first became available under a provision of the Revenue Act of 1943 (P.L. 78-235) which provided a $500 itemized deduction. The deduction's purpose was to help cover the additional expenses directly associated with blindness, such as the hiring of readers and guides. The deduction evolved to a $600 personal exemption in the Revenue Act of 1948 (P.L. 80-471) so that the blind did not forfeit use of the standard deduction and so that the tax benefit could be reflected directly in the withholding tables.

At the same time that the itemized deduction was converted to a personal exemption for the blind, relief was also provided to the elderly by allowing them an extra personal exemption. Relief was provided to the elderly because of a heavy concentration of small incomes in that population, the rise in the cost of living, and to counterbalance changes in the tax system resulting from World War II. It was argued that those who were retired could not adjust to these changes and that a general personal exemption was preferable to piecemeal exclusions for particular types of income received by the elderly.

As the personal and dependency exemption amounts increased over the years, so too did the amount of the additional exemption. The exemption amount increased to $625 in 1970, $675 in 1971, $750 in 1972, $1,000 in 1979, $1,040 in 1985 and $1,080 in 1986.

A comprehensive revision of the Code was enacted in 1986 designed to lead to a fairer, more efficient and simpler tax system. Under a provision in the Tax Reform Act of 1986 (P.L. 99-514) the personal exemptions for age and blindness were replaced by an additional standard deduction amount. This change was made because higher income taxpayers are more likely to itemize and because a personal exemption amount can be used by all taxpayers whereas the additional standard deduction will be used only by those who forego itemizing deductions. Thus, the rationale is to target the benefits to lower and moderate income elderly and blind taxpayers.

Assessment

Advocates of the blind justify special tax treatment based on higher living costs and additional expenses associated with earning income. However, other taxpayers with disabilities (deafness, paralysis, loss of limbs) are not accorded similar treatment and may be in as much need of tax relief. Just as the blind incur special expenses so too do others with different handicapping impairments.

Advocates for the elderly justify special tax treatment based on need, arguing that the elderly face increased living costs primarily due to inflation; medical costs are frequently cited as one example. However, social security benefits are adjusted annually for cost inflation and the federal government has established the Medicare Program.

One notion of fairness is that the tax system should be based on ability-to-pay and that ability is based upon the income of taxpayers—not age or handicapping condition. The additional standard deduction amounts violate horizontal equity principles in that all taxpayers with equal net incomes are not treated equally. The provision also fails the effectiveness test since low-income blind and elderly individuals who already are exempt from tax without the benefit of the additional standard deduction amount receive no benefit but are most in need of financial assistance.

Nor does the provision benefit those blind or elderly taxpayers who itemize deductions (such as those with large medical expenditures in relation to income). Additionally, the value of the additional standard deduction is of greater benefit to taxpayers with a higher rather than lower marginal income tax rate. Alternatives would be a tax credit or a direct grant.

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TAX CREDIT FOR THE ELDERLY AND DISABLED

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	([1])	-	([1])
2000	([1])	-	([1])
2001	([1])	-	([1])
2002	([1])	-	([1])
2003	([1])	-	([1])

([1])Less than $50 million.

Authorization

Section 22.

Description

Individuals who are 65 years of age or older may claim a tax credit equal to 15 percent of their taxable income up to a base amount. The credit is also available to individuals under the age of 65 if they are retired because of a permanent and total disability and have disability income from either a public or private employer based upon that disability. The maximum base amount for a married couple where both spouses are 65 or over is $7,500. When one spouse is 65 or over and the other spouse is under 65 but disabled, the maximum amount is the lesser of $7,500 or $5,000 plus "disability income" (income from wages, or payments in lieu of wages, due to disability).

A maximum base amount of $5,000 is provided for a single taxpayer 65 or over and a married couple where only one spouse is over 65. Where both are under 65 and both are disabled, the maximum base amount is the lesser of $7,500 or total "disability income." When one is disabled but neither is 65 or over or in the case of a single disabled individual under 65, the maximum base amount is the lesser of $5,000 or "disability income." For a married individual filing separately the maximum base amount is $3,750 (the lesser of $3,750 or the "disability income" received if disabled).

The maximum base amount is reduced by certain amounts received as pensions or disability benefits which are excluded from gross income (such as nontaxable pension or annuity income, social security benefits,

railroad retirement, and veterans benefits). Also, a reduction from the maximum base amount is made by one-half of the excess over the following amounts: $7,500 adjusted gross income (AGI) for a single individual, $10,000 for a joint return, or $5,000 for a married individual filing a separate return.

Impact

The maximum credit per individual is $750 (15 percent of $5,000) and $1,125 in the case of a married couple both 65 or over (15 percent of $7,500). Because the base amount is reduced by social security benefits, the primary beneficiaries are persons with disabilities and retirees who are not eligible to receive tax-exempt social security benefits.

Because the provision is a credit, its value to the taxpayer is affected only by the level of benefits and the credit rate, and not by the tax bracket of the taxpayer. However, the adjusted gross income phaseout serves to limit relief to low- and very-moderate-income taxpayers.

Preliminary Distribution by Income Class of the Tax Expenditure for Credit for the Elderly and Disabled at 1992 Tax Rates and 1992 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	24.4
$10 to $20	51.2
$20 to $30	23.2
$30 to $40	1.2
$40 and over	0.0

Rationale

The retirement income credit first enacted with the codification of the Internal Revenue Code of 1954 (P.L. 83-591) was intended to remove the inequity between individuals who received taxable retirement income with those who received tax-exempt social security payments. In 1976, the retirement income credit was redesigned into the tax credit for the elderly.

In the social security Amendments of 1983 (P.L. 98-21), social security benefits were made taxable above certain income levels. In response to this change the tax credit's base amounts were increased to provide some coordination with the level at which social security benefits became taxable. In addition, the credit for the elderly was expanded to include those permanently and totally disabled. This change was designed to provide the same tax relief to aged and disabled taxpayers who do not receive tax-free social security retirement or disability payments.

Assessment

While the tax credit affords some elderly and disabled taxpayers receiving taxable retirement or disability income a measure of comparability with those receiving tax-exempt (or partially tax-exempt) social security benefits, it does so only at low-income levels because of the adjusted gross income phaseout. social security recipients with higher levels of income always continue to receive at least a portion of their social security income tax free. Such is not the case for those who use the tax credit.

The Congress has not reviewed the tax credit to provide appropriate inflation adjustments since 1983. Therefore, tax relief currently provided by the tax credit, lags behind tax relief provided social security recipients. Thus, as social security income continues to increase with the consumer price index (CPI), a greater differential will exist between the value of the tax credit and the portion of social security income that is tax exempt.

The provision has been criticized for being relatively complex, with some taxpayers unaware of its availability.

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DEDUCTIBILITY FOR CASUALTY AND THEFT LOSSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.3	-	0.3
2000	0.3	-	0.3
2001	0.3	-	0.3
2002	0.3	-	0.3
2003	0.4	-	0.4

Authorization

Section 165(c)(3).

Description

An individual may claim an itemized deduction for unreimbursed personal casualty or theft losses in excess of $100 per event and in excess of 10 percent of adjusted gross income (AGI) for combined net losses during the tax year. Eligible losses are those arising from fire, storm, shipwreck, or other casualty, or from theft. The cause of the loss should be considered a sudden, unexpected, and unusual event.

Impact

The deduction grants some financial assistance to taxpayers who suffer substantial casualties and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer and thus serves as a form of government coinsurance. Use of the deduction is low for all income groups. According to IRS statistics for 1994 and 1995, for each AGI class tabulated, 2.0 percent or less of itemized returns claimed the deduction. For 1993, it was 1.0 percent or less.

There is no maximum limit on the casualty loss deduction. If losses exceed the taxpayer's income for the year of the casualty, the excess can be carried back or forward to another year without reapplying the $100 and ten percent floors. A dollar of deductible losses is worth more to taxpayers in higher income tax brackets because of their higher marginal tax rates.

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and non-business-related losses. No rationale was offered then. The Revenue Act of 1964 (P.L. 88-272) placed a $100-per-event floor on the deduction for personal casualty losses, corresponding to the $100 deductible provision common in property insurance coverage at that time. The deduction was intended to be for extraordinary, nonrecurring losses which go beyond the average or usual losses incurred by most taxpayers in day-to-day living. The $100 floor was intended to reduce the number of small and often improper claims, reduce the costs of record keeping and audit, and focus the deduction on extraordinary losses.

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) provided that the itemized deduction for combined nonbusiness casualty and theft losses would be allowed only in excess of 10 percent of the taxpayer's AGI.

The casualty loss deduction is exempt from the overall limit on itemized deductions for high-income taxpayers which took effect in 1991.

Assessment

Critics have pointed out that when uninsured losses are deductible but insurance premiums are not, the income tax discriminates against those who carry insurance and favors those who do not. It similarly discriminates against people who take preventive measures to protect their property but cannot deduct their expenses. No distinction is made between loss items considered basic to maintaining the taxpayer's household and livelihood versus highly discretionary personal consumption. The taxpayer need not replace or repair the item in order to claim a deduction for an unreimbursed loss.

Up through the early 1980s, while tax rates were as high as 70 percent and the floor on the deduction was only $100, high income taxpayers could have a large fraction of their uninsured losses offset by lower income taxes, providing them reason not to purchase insurance. IRS statistics for 1980 show a larger percentage of itemized returns in higher income groups claiming a casualty loss deduction.

The imposition of the 10-percent-of-AGI floor effective in 1983, together with other changes in the tax code during the 1980s, substantially reduced the number of taxpayers claiming the deduction. In 1980, 2.9 million tax returns, equal to 10.2 percent of all itemized returns, claimed a deduction for casualty or theft losses. In 1995, only 152,270 returns, 0.1 percent of all returns and 0.4 percent of all itemized returns, claimed such a deduction.

Use of the casualty and theft loss deduction fluctuates widely from year to year. Deductions have risen substantially for years witnessing a major natural disaster — such as a hurricane, flood, or earthquake. In some years (such as 1989, 1993, and 1994) the increase in deductions is due to a jump in the number of returns claiming the deduction. In other years (such as 1992) it reflects a large increase in the average dollar amount of deductions per return claiming the loss deduction.

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EARNED INCOME CREDIT (EIC)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	4.2	-	4.2
2000	4.3	-	4.3
2001	4.5	-	4.5
1998	4.6	-	4.6
2003	4.7	-	4.7

Note: The figures in the table show the effect of the basic earned income credit on receipts. Outlays for the basic credit are estimated at $21.6 billion in 1997, $22.4 billion in 1998, $23.2 billion in 1999, $24.4 billion in 2000, and $25.4 billion in 2001.

Authorization

Section 32.

Description

Eligible married couples and single individuals can claim a basic earned income tax credit (EITC). To qualify for the credit, a taxpayer must meet certain earned income and adjusted gross income (AGI) limits; those with a qualifying child can receive a larger credit. Earned income includes wages, salaries, tips, and net income from self employment. A qualifying child is a son or daughter, an adopted child, grandchild, stepchild, or foster child. The child must live with the taxpayer for more than half the year (the entire year in the case of a foster child) and be under age 19 (or age 24, if a full-time student) or permanently and totally disabled.

The EITC for 1998 is equal to 34.0 percent of the first $6,680 of earned income for one qualifying child and 40.0 percent of earned income up to $9,390 for two or more qualifying children. In 1998, the maximum basic credit is $2,221 for one qualifying child and $3,756 for two or more qualifying children.

Families with one child and earned income and AGI between $6,680 and $12,260 in 1998 are eligible for the maximum basic credit. Families with two or more children will receive the maximum credit at levels between $9,392 and $12,260. These amounts will be adjusted for inflation.

For 1998, the basic credit is phased out at a rate of 15.98 percent of AGI (or earned income, if greater) above $12,260 for one qualifying child. The phaseout percentage is 21.06 percent for two or more qualifying children.

In 1997, married couples and individuals between 25 and 64 (without children) are eligible for a smaller EITC of 7.65 percent of the first $4,460 (phased out at a 7.65 percent rate between $5,570 and $10,030). The maximum credit is $41. The income thresholds will be adjusted for inflation.

If the credit is greater than a family's Federal income tax, the difference is refunded. Working parents may arrange with their employers to receive the credit in advance through reduced tax withholding. The amount of the credit that offsets the amount of income tax owed is a tax expenditure, while the refundable portion is treated as an outlay.

Impact

The earned income tax credit increases the after-tax income of lower- and moderate-income working couples and individuals, particularly those with children. The credits also provide an incentive to work for those with little or no earned income. The credits raise the after-tax income of many families above the official poverty level of income.

The following table provides estimates of the distribution of the earned income credit by income level. The estimates include the refundable portion of the credit.

Distribution by Income Class of the Tax Expenditure for the Earned Income Credit, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	19.8
$10 to $20	47.6
$20 to $30	26.0
$30 to $40	5.9
$40 to $50	0.5
$50 to $75	0.2
$75 to $100	0.0
$100 to $200	0.0
$200 and over	0.0

Rationale

The earned income credit was enacted by the Tax Reduction Act of 1975 as a temporary refundable credit to offset the effects of the social security tax and rising food and energy costs on lower income workers and to provide a work incentive for parents with little or no earned income.

The credit was extended by the Revenue Adjustment Act of 1975, the Tax Reform Act of 1976, and the Tax Reduction and Simplification Act of 1977. The Revenue Act of 1978 raised the maximum amount of the credit, provided for advance payment of the credit, and made the credit permanent. The 1978 Act also granted the maximum credit to families with incomes in a range above the level at which the credit reaches a maximum amount.

The credit was expanded by both the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986. The 1986 Act also indexed the income thresholds to inflation. The Omnibus Budget Reconciliation Act (OBRA) of 1990 increased the percentage used in calculating the credit, created a limited adjustment for family size, and created the supplemental credit for young children.

OBRA 1993 increased the credit, expanded the family-size adjustment, extended the credit to individuals without children, and repealed the supplemental credit for young children. This significant expansion of the credit reflected the desire to further encourage work and distributive concerns. The Taxpayer Relief Act of 1997 included provisions to increase compliance.

Assessment

The earned income credit raises the after-tax income of several million lower- and moderate-income families, especially those with children. As an income transfer program, the credit increases the progressivity of the Federal individual income tax. In recent years, the credit has also been promoted as an alternative to raising the minimum wage and as a way of improving the ability of families to pay for child care.

The earned income credit creates an incentive to work because, up to the income threshold at which the credit reaches a maximum, the more a parent earns, the greater the amount of the credit. But within the income range over which the credit is phased out, the credit acts as a work disincentive.

While the credit encourages single parents to enter the work force, it discourages the spouse of a working parent from entering the work force. The earned income credit may also discourage marriage. Unlike other income transfer programs, the earned income credit does not fully adjust for differences in family size.

Because of incorrect or incomplete tax return information, or because they do not file, some eligible individuals do not receive the credit. The credit also differs from other transfer payments in that most individuals receive it as an annual lump sum rather than as a monthly benefit. Efforts have been made to remedy this problem by providing advance payments through employers.

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EXCLUSION OF UNTAXED SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	25.4	-	25.4
2000	26.1	-	26.1
2001	27.0	-	27.0
2002	28.0	-	28.0
2003	28.9	-	28.9

Authorization

Sec. 86 I.R.C. 1954 and I.T. 3194, 1938-1 C.B. 114 and I.T. 3229, 1938-2136, as superseded by Rev. Ruling 69-43, 1969-1 C.B. 310; I.T. 3447, 1941-1 C.B. 191, as superseded by Rev. Ruling 70-217, 1970-1 C.B. 12.

Description

In general, the social security and railroad retirement benefits of most recipients are not subject to tax. A portion of social security and certain (tier one) railroad retirement benefits is included in income for taxpayers whose "provisional income" exceeds certain thresholds.

Tier one railroad retirement benefits are those provided by the railroad retirement system that are equivalent to the social security benefit that would be received by the railroad worker were he or she covered by social security. "Provisional income" is adjusted gross income plus one-half the social security benefit and otherwise tax-exempt "interest" income (i.e., interest from tax-exempt bonds). The thresholds below which no social security or tier one benefits are taxable are $25,000 (single), $32,000 (couple filing joint return) and zero (couple filing separately).

The tax on benefits when income exceeds these thresholds depends on the level of the income. If it is between the $25,000 threshold ($32,000 for a couple) and a second-level threshold of $34,000 ($44,000 for a couple), the amount of benefits subject to tax is the lesser of: (1) 50 percent of benefits; or (2) 50 percent of income in excess of the first threshold. If income is above the second threshold, the amount of benefits subject to tax is the lesser of:

(1) 85 percent of benefits or
(2) 85 percent of income above the second threshold, plus
the smaller of (a) $4,500 (single) or $6,000 (couple) or,
(b) 50 percent of benefits.

For couples filing separately, taxable benefits are the lesser of 85 percent of benefits or 85 percent of provisional income.

This tax treatment differs from that of pension benefits, in which all benefits that exceed the amount of the employee's contribution are fully taxable.

The proceeds from taxation of social security and tier one benefits at the 50 percent rate are credited to the social security trust funds and the railroad retirement system, respectively. Proceeds from taxation of social security benefits and tier one benefits at the 85 percent rate are credited to the Hospital Insurance trust fund of Medicare.

Impact

Currently, about 70 percent of social security and railroad retirement tier one recipients pay no tax on their benefits. Clearly the elderly are favored by this exclusion, because they receive most social security and railroad retirement benefits. Middle-income recipients are advantaged because they pay no tax on 100 percent of their benefits, whereas higher-income recipients can exclude only 50 to 15 percent of their benefits. Low-income recipients also pay no tax on 100 percent of their benefits, but as the value of the exclusion depends on their marginal tax rate (which could be zero), they may be either advantaged or disadvantaged relative to middle and high-income recipients.

Also, the dollar value of the exclusion depends upon the amount of the social security benefit and the marginal tax bracket. The distribution of the tax expenditure is shown below.

Distribution by Income Class of Tax Expenditure, Untaxed Social Security, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.1
$10 to $20	6.8
$20 to $30	19.2
$30 to $40	23.6
$40 to $50	22.7
$50 to $75	23.5
$75 to $100	2.4
$100 to $200	1.3
$200 and over	0.5

Rationale

Until 1984, social security benefits were exempt from the Federal income tax. The original exclusion arose from rulings made in 1938 and 1941 by the then Bureau of Internal Revenue (I.T. 3194, I.T. 3447). The reasons underpinning the rulings, although not stated in the rulings themselves, appear to be:

(1) Congress did not intend for social security benefits to be taxed, as implied by the lack of an explicit provision to tax them;

(2) the benefits were intended to be in the form of "gifts" made in aid of the general welfare, not annuities which replace earnings, and therefore were not to be considered as income for tax purposes; and

(3) subjecting benefits to taxation would tend to defeat the underlying purposes of the Social Security Act.

The exclusion of benefits paid under the railroad retirement system was enacted in the Railroad Retirement Act of 1935. The rationale for the exclusion was not separately stated, but is presumed to be similar to that for excluding social security benefits.

For years many program analysts questioned the basis for the rulings on social security and advocated that the treatment of social security benefits for tax purposes be the same as it is for other pension income. Pension benefits are fully taxable except for the proportion of projected lifetime benefits attributable to the worker's contributions. Financial pressures on the social security system in the early 1980s also increased interest in taxing benefits. The 1982 National Commission on social security Reform proposed taxing one-half of social security benefits received by persons whose income exceeded certain amounts and crediting the proceeds to the social security trust funds.

In enacting the 1983 social security Amendments (P.L. 98-21) in March 1983, Congress essentially adopted the Commission's recommendation, but modified it to phase in the tax on benefits gradually, as a person's income rose above threshold amounts. At the same time, it modified the tax treatment of tier one railroad retirement benefits to conform to the treatment of social security benefits.

In his FY 1994 budget, President Clinton proposed that the taxable proportion of social security benefits be increased to 85% effective in 1994, with the proceeds credited to Medicare's Hospital Insurance (HI) trust fund. The Congress approved this proposal as part of the 1993 omnibus budget reconciliation bill (P.L. 103-66), but limited it to recipients whose threshold incomes exceed $34,000 (single) or $44,000 (couple). Benefits taxable as under old (pre-1994) law are limited to $4,500 (single) or $6,000 (couple) because the 50% rate applies only between the first and second tier thresholds (e.g., $34,000 - $25,000 = $9,000 x ½ = $4,500).

Assessment

Principles of horizontal equity (equal treatment of those in equal circumstances) generally support the idea of treating social security and railroad benefits similarly to other sources of retirement income. Horizontal equity suggests that equal income, regardless of source, represents equal ability to pay taxes, and therefore should be equally taxed. Just as the portion of private pensions, IRAs and investment income on which taxes have never been paid is fully taxable, so too should the portion of social security and railroad retirement not attributable to the individual's contributions be fully taxed.

It is estimated that if social security benefits received the same tax treatment as pensions, on average about 95 percent of benefits would be included in taxable income. However, social security benefits vary with individual circumstances, so the proportion applicable to particular recipients also varies. It has been estimated that the lowest proportion of retirement benefits that would be taxable for anyone in the work force today is 85 percent of benefits.

Because of the administrative complexities involved in calculating the proportion of each individual's benefits, and because in theory it would ensure that no one would receive less of an exclusion than entitled to, it has been proposed that the income thresholds be removed, and that a flat 85 percent of social security benefits be included in taxable income.

Removing the exclusion has also been proposed as the most equitable and effective way to implement *de facto* benefit reductions. Taxing benefits fully better aligns them with need, and is seen as an indirect "means test."

Opponents to increased taxation of social security and railroad retirement object on several grounds. First, it obviously would lower many persons' overall income. For many, it would appear to be simply a benefit reduction--a loss of income to those who cannot change past work and savings decisions. The rules would have changed in the middle of the game, with the greatest effect on older workers and current beneficiaries who made retirement and other decisions based on old law, and who may be already living in large part on their social security and railroad retirement.

Some opponents of taxing benefits support the partial exclusion of social security benefits from tax on general philosophical grounds. They believe that, as the country's only national social insurance system, which provides a bedrock level of protection to nearly all workers and their families from loss of income due to the death, retirement, or disability of the worker, social security is special and should be so treated. They object to the analogy between social security and private pension benefits, saying that they serve different purposes.

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EXCLUSION OF VETERANS' BENEFITS AND SERVICES

(1) EXCLUSION OF VETERANS' DISABILITY COMPENSATION
(2) EXCLUSION OF VETERANS' PENSIONS
(3) EXCLUSION OF GI BILL BENEFITS

Estimated Revenue Loss

[in billions of dollars]

	Individuals				
Fiscal Year	Veterans Disability Compen-sation	Veterans Pensions	GI Bill Benefits	Corpora-tions	Total
1999	2.0	0.1	0.1	-	2.2
2000	2.1	0.1	0.1	-	2.3
2001	2.2	0.1	0.1	-	2.4
2002	2.2	0.1	0.1	-	2.4
2003	2.3	0.1	0.1	-	2.5

Authorization

38 U.S.C. §3101.

Description

All benefits administered by the Department of Veterans Affairs are exempt from taxation. Such benefits include those for veterans' disability compensation, veterans' pension payments, and education payments.

Veterans' service–connected disability compensation payments are related to loss in civil-occupations earnings capacity which results from a service-related wound, injury, or disease. Typically, benefits increase with the severity of disability. There are special dependents' allowances. Veterans with a 60- to 90-percent disability may receive compensation at the 100-percent level if unemployable.

Veteran pensions are available to support veterans with a limited income who had at least one day of military

service during a war period and at least 90 days of active duty service. Benefits are paid to veterans over age 65 or to veterans with disabilities unrelated to their military service.

Pension benefits are based on "countable" income (the larger the income, the smaller the pension) with no payments made to veterans whose assets may be used to provide adequate maintenance. For veterans coming on the rolls after December 31, 1978, countable income includes earnings of the veteran, spouse, and dependent children, if any. Veterans who were on the rolls prior to that date may elect coverage under prior law, which excludes from countable income the income of a spouse, among other items.

Veterans' educational assistance is provided under a number of different programs for veterans, servicepersons, and eligible dependents. These programs have varying eligibility requirements and benefits.

Impact

Beneficiaries of all three major veterans' programs pay less tax than other taxpayers with the same or smaller economic incomes. Since these exclusions are not counted as part of income, the tax savings are a percentage of the amount excluded, depending on the marginal tax bracket of the veteran. Thus the exclusion amounts will have greater value for veterans with high incomes than for those with lower incomes.

Rationale

The rationale for excluding veterans' benefits from taxation is not clear. The tax exclusion of benefits was adopted in 1917, during World War I.

Assessment

The exclusion of veterans' benefits alters the distribution of payments and favors higher-income individuals. It is typically argued that the differential that exists between veterans' service-connected disability compensation and the average salary of wage earners reflects the tax-exempt status of their benefits. If veterans' benefits were to become taxable, it would require higher benefit levels to replace lost income.

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EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT BONDS FOR VETERANS' HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	0.1	([1])	0.1
2000	0.1	([1])	0.1
2001	0.1	([1])	0.1
2002	0.1	([1])	0.1
2003	0.1	([1])	0.1

([1])Less than $50 million.

Authorization

Sections 103, 141, 143, and 146 of the Internal Revenue Code of 1986.

Description

Veterans' housing bonds are used to provide mortgages at below-market interest rates on owner-occupied principal residences of homebuyers who are veterans. These veterans' housing bonds are classified as private-activity bonds rather than governmental bonds, because a substantial portion of their benefits accrues to individuals rather than to the general public.

Each State with an approved program is subject to an annual volume cap related to its average veterans' housing bond volume between 1979 and 1985. For further discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low-interest rates enable issuers to offer mortgages on veterans' owner-occupied housing at reduced mortgage interest rates.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and homeowners, and estimates of the distribution of tax-exempt interest income by income class, see the "Impact" discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Veterans' housing bonds were first issued by the States after World War II, when both State and Federal governments enacted programs to provide benefits to veterans as a reward for their service to the Nation.

The Omnibus Budget Reconciliation Act of 1980 required that veterans' housing bonds must be general obligations of the State. The Deficit Reduction Act of 1984 restricted the issuance of these bonds to the five States that had qualified programs in existence prior to June 22, 1984, and limited issuance to each State's average issuance between 1979 and 1984.

Loans were restricted to veterans who served in active duty any time prior to 1977 and whose application for the mortgage financing occurred before the later of 30 years after leaving the service or January 31, 1985, thereby imposing an effective sunset date for the year 2007. Loans were also restricted to principal residences.

Assessment

The need for these bonds has been questioned, because veterans are eligible for numerous other housing subsidies that encourage home ownership and reduce the cost of their housing. As one of many categories of tax-exempt private-activity bonds, veterans' housing bonds have been criticized because they increased the financing costs of bonds issued for public capital stock and increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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General Purpose Fiscal Assistance

EXCLUSION OF INTEREST ON PUBLIC PURPOSE STATE AND LOCAL GOVERNMENT DEBT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	10.4	4.2	14.6
2000	11.7	4.8	16.5
2001	11.9	4.9	16.8
2002	12.8	5.2	18.0
2003	13.8	5.6	19.4

Authorization

Sections 103 and 141 of the Internal Revenue Code of 1986.

Description

Certain obligations of State and local governments qualify as "governmental" bonds. The interest income earned by individual and corporate purchasers of these bonds is excluded from taxable income.

This interest income is not taxed because the bond proceeds generally are used to build capital facilities that are owned and operated by governmental entities and serve the general public interest, such as highways, schools, and government buildings.

These bonds can be issued in unlimited amounts. The revenue loss estimates in the above table for general fiscal assistance are based on the excluded interest income on these governmental bonds.

Other obligations of State and local governments are classified as "private-activity" bonds. The interest income earned by individual and corporate purchasers of these bonds is included in taxable income.

This interest income is taxed because the bond proceeds are believed to provide substantial benefits to private businesses and individuals (in addition to any benefits that may be provided to the general public). Tax exemption is available for a subset of these otherwise taxable private-activity bonds if the proceeds are used to finance an activity included on a list of activities specified in the Code.

However, unlike governmental bonds, these tax-exempt private-activity bonds may not be issued in unlimited amounts. All governmental entities within the State currently are subject to a State volume cap on new issues of these tax-exempt private-activity bonds equal to the greater of $50 per State resident or $150 million. These caps will begin to rise in 2003, until in 2006 they are the greater of $70 per resident of $210 million.

Each activity included in the list of private activities eligible for tax-exempt financing is discussed elsewhere in this document under the private activity's related budget function.

Impact

The distributional impact of this interest exclusion can be viewed from two perspectives: first, the division of tax benefits between State and local governments and bond purchasers; and second, the division of the tax benefits among income classes.

The direct benefits of the exempt interest income from tax-exempt bonds flow to both State and local governments and to the purchasers of the bonds. The exclusion of interest income causes the interest rate on State and local government obligations to be lower than the rate that must be paid on comparable taxable bonds. In effect, the Federal Government pays part of State and local interest costs. For example, if the market rate on tax-exempt bonds is 8 percent when the taxable rate is 10 percent, there is a 2-percentage point interest rate subsidy to State and local governments.

The interest exclusion also raises the after-tax return for some bond purchasers. A taxpayer facing a 20-percent marginal tax rate is equally well off purchasing either the 8-percent tax-exempt bond or the 10-percent taxable bond (both yield an 8-percent after-tax interest rate).

But a taxpayer facing a 30-percent marginal tax rate is better off buying a tax-exempt bond, because the after-tax return on the taxable bond is 7 percent, and on the tax-exempt bond, 8 percent. These "inframarginal" investors receive windfall gains.

The allocation of benefits between the bondholders and State and local governments (and, implicitly, its taxpayer citizens) depends on the spread in interest rates between the tax-exempt and taxable bond market, the share of the tax-exempt bond volume purchased by individuals with marginal tax rates exceeding the market-clearing marginal tax rate, and the range of the marginal tax rate structure.

The reduction of the top income tax rate of bond purchasers from the 70-percent individual rate that prevailed prior to 1981 to the 39.6-percent individual rate that prevails in 1998 has increased substantially the share of the tax benefits going to State and local governments.

The table below provides an estimate of the distribution by income class of tax-exempt interest income (including interest income from both governmental and private-activity bonds).

Over 51 percent of individuals' tax-exempt interest income is earned by returns with adjusted gross income in excess of $100,000, although these returns represent only 3.2 percent of all returns.

Returns below $40,000 earn only 21.2 percent of tax-exempt interest income, although they represent more than 73 percent of all returns.

The revenue loss is even more concentrated in the higher income classes than the interest income because the average marginal tax rate (which determines the value of the tax benefit from the nontaxed interest income) is higher for higher-income classes.

Distribution of Tax-Exempt Interest Income, 1995

Income Class (in thousands of $)	Percentage Distribution
Below $10	4.4
$10 to $20	4.6
$20 to $30	5.0
$30 to $40	5.0
$40 to $50	4.6
$50 to $75	12.4
$75 to $100	9.1
$100 to $200	17.4
$200 and over	37.7

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Rationale

This exemption has been in the income tax laws since 1913, and was based on the belief that the income had constitutional protection from Federal Government taxation. The claim to this constitutional protection was eliminated by the Supreme Court in 1988, *South Carolina v. Baker* (485 U.S. 505, [1988]).

In spite of this loss of protection, many believe the exemption for governmental bonds is still justified on economic grounds, principally as a means of encouraging State and local governments to overcome a tendency to underinvest in public capital formation.

Bond issues whose debt service is supported by State and local tax bases have been left untouched by legislation, with a few exceptions such as arbitrage restrictions, denial of Federal guarantee, and registration. The reason for this is that most of these bonds have been issued for the construction of public capital stock, such as schools, highways, sewer systems, and government buildings.

This has not been the case for revenue bonds without tax-base support and whose debt service is paid from revenue generated by the facilities built with the bond proceeds. These bonds were the subject of almost continual legislative scrutiny, beginning with the Revenue and Expenditure Control Act of 1968 and peaking with a comprehensive overhaul by the Tax Reform Act of 1986.

This legislation focused on curbing issuance of the subset of tax-exempt revenue bonds used to finance the quasi-public investment activities of private businesses and individuals that are characterized as "private-activity" bonds. Each private activity eligible for tax exemption is discussed elsewhere in this document under the private activity's related budget function.

Assessment

This tax expenditure subsidizes the provision of State and local public services. A justification for a Federal subsidy is that it encourages State and local taxpayers to provide public services that also benefit residents of other states, who do not pay State and local taxes but who do pay Federal taxes.

The form of the subsidy has been questioned because it subsidizes one factor of public sector production, capital, and encourages State and local taxpayers to substitute capital for labor in the public production process. This would make sense if any underconsumption of State and local public services was isolated in capital facilities, but there is no evidence that this is the case. Thus, to the extent a subsidy of State and local public service provision is needed to obtain the amount desired by Federal taxpayers, the subsidy probably should not be restricted to capital.

The efficiency of the subsidy, in the sense of the share of the Federal revenue loss that shows up as reduced State and local interest costs rather than as windfall gains for purchasers of the bonds, has also been the subject of considerable concern.

This State and local share of the benefits depends to a great extent on the number of bond purchasers with marginal tax rates higher than the marginal tax rate of the purchaser who clears the market. The share of the subsidy received by State and local governments was improved considerably during the 1980s as the highest statutory marginal income tax rate on individuals was reduced from 70 percent to 31 percent and on corporations from 46 percent to 34 percent. (The highest current rate on individuals is now 39.6 percent; on corporations, 35 percent.)

The open-ended structure of the subsidy affects Federal control of its budget. The amount of the Federal revenue loss on governmental bonds is entirely dependent upon the decisions of State and local officials.

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DEDUCTION OF NONBUSINESS STATE AND LOCAL GOVERNMENT INCOME AND PERSONAL PROPERTY TAXES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	31.2	-	31.2
2000	32.1	-	32.1
2001	33.0	-	33.0
2002	33.9	-	33.9
2003	34.8	-	34.8

Authorization

Section 164 of the Internal Revenue Code of 1986.

Description

State and local income and personal property taxes paid by individuals are deductible from adjusted gross income. Business income and property taxes are deductible as business expenses, but their deduction is not a tax expenditure because deduction is necessary for the proper measurement of business economic income.

Impact

The deduction of State and local individual income and personal property taxes increases the individual's after-Federal-tax income and reduces the individual's after-Federal-tax price of the State and local public services provided with these tax dollars. Some of the benefit goes to the State and local governments (because individuals are willing to pay higher taxes) and some goes to the individual taxpayer.

The distribution of tax expenditures from State and local income and personal property tax deductions is concentrated in the higher income classes. Almost 80 percent of the tax benefits are taken by families with incomes in excess of $75,000. As with any deduction, it is worth more as marginal tax rates increase. Personal property tax deductions are but a small fraction of income tax deductions ($6.2 billion compared to $114 billion in 1995), and are less concentrated in higher income classes.

Distribution by Income Class of Tax Expenditure for State and Local Income and Personal Property Tax Deductions, 1998

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.1
$20 to $30	0.3
$30 to $40	1.0
$40 to $50	2.5
$50 to $75	9.6
$75 to $100	14.9
$100 to $200	28.6
$200 and over	43.1

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Rationale

Deductibility of State and local taxes was adopted in 1913 in order "not to tax a tax" or, to put it another way, to avoid taxing income that was obligated to expenditures over which the taxpayer was felt to have no discretionary control. However, user charges (such as for sewer and water services) and special assessments (such as for sidewalk repairs) were not deductible. Some general-purpose taxes have lost their deductibility.

The Revenue Act of 1964 eliminated deductibility for motor vehicle operators' licenses, and the Revenue Act of 1978 eliminated deductibility of the excise tax on gasoline. These decisions represent congressional concern that differences among States in the legal specification of taxes allowed differential deductibility treatment for taxes that were essentially the same in terms of their economic incidence.

The Tax Reform Act of 1986 eliminated deductibility of sales taxes, partly due to concern that these taxes were estimated and therefore did not perfectly represent reductions of taxable income, and partly due to concerns that some portion of the tax reflects discretionary decisions of State and local taxpayers to consume services through the public sector that might be consumed through private (nondeductible) purchase.

The Omnibus Budget Reconciliation Act of 1990 curtailed the tax benefit from State and local income and real property tax deductions for higher income taxpayers by requiring that itemized deductions be reduced by a percentage of the amount by which adjusted gross income exceeds some threshold amount. This provision was to expire after 1995; the Omnibus Budget Reconciliation Act of 1993 made the provision permanent.

Assessment

Modern theories of the public sector discount the "don't tax a tax" justification for State and local tax deductibility, emphasizing instead that taxes represent citizens' decisions to consume goods and services

collectively. In that sense, State and local taxes are benefit taxes and should be treated the same as expenditures for private consumption--not deductible against Federal taxable income.

Deductibility can also be seen as an integral part of the Federal system of intergovernmental assistance and policy. Modern theories of the public sector also suggest that

(1) deductibility does provide indirect financial assistance for the State and local sector and should result in increased State and local budgets, and

(2) deductibility will influence the choice of State and local tax instruments if deductibility is not provided uniformly.

Deductibility also has the effect of reducing interstate tax competition because it narrows interstate differentials between statutory tax rates.

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General Purpose Fiscal Assistance

TAX CREDIT FOR PUERTO RICO AND POSSESSION INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	-	3.6	3.6
2000	-	3.8	3.8
2001	-	4.0	4.0
2002	-	3.6	3.6
2003	-	3.2	3.2

Authorization

Sections 936, 30A.

Description

In general, corporations chartered in the United States are subject to U.S. taxes on their worldwide income. However, the possessions tax credit provided by section 936 of the Internal Revenue Code permits qualified U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, and other U.S. possessions a tax credit that offsets some or all of their U.S. tax liability on income from business operations and certain types of financial investment in the possessions. The credit has the effect of exempting qualified income taxes at the Federal level. The possessions have generally enacted their own complementary set of tax incentives. However, under the terms of the Small Business Job Protection Act, the Federal credit is scheduled to end after the year 2005.

To qualify for the credit, a firm must derive 80 percent of its gross from the possessions. Also, 75 percent of a qualified corporation's income must be from the active conduct of a business in a possession rather than from passive (financial) investment. The amount of the tax credit is generally equal to a firm's tax liability on possessions-source income subject to a new cap enacted in 1993. After a transition period ending in 1998, the cap would equal 40 percent of the credit a firm could otherwise claim. Alternatively, a firm can choose a cap equal to a specified portion of its wages and depreciation paid in the possessions. (It is likely that the second cap will be most favorable for most firms.)

The Small Business Job Protection Act of 1996 provides for a phaseout of the credit for firms already using

the benefit and denies the credit to new users. The exact pattern of the phaseout depends on which cap a firm has chosen. In any case, the credit ends after 2005.

Impact

The most direct effect of the possessions tax credit is to reduce the cost of qualified investment in Puerto Rico and the Virgin Islands. In addition, changes introduced by the Omnibus Budget Reconciliation Act of 1993 (OBRA93) reduce the effective cost of qualified wages paid in the possessions.

The largest user of the credit has been the pharmaceuticals industry. In 1992, for example, it accounted for 54 percent of all credits claimed under section 936. In the long run, however, the burden of the corporate income tax (and the benefit from reductions in it) probably spreads beyond corporate stockholders to owners of capital in general. Also--particularly since enactment of OBRA93--it is likely that part of the benefit of section 936 is shared by labor in the possessions.

It is probable that the end of the tax benefit will reduce investment in Puerto Rico from what would otherwise occur. This will likely be accompanied by a decline in labor earnings.

Rationale

A Federal tax exemption for firms earning income in the possessions has been in effect since the Revenue Act of 1921, although its precise nature has undergone several changes. However, the credit was not heavily used in Puerto Rico until the years following World War II, when the Puerto Rican Government integrated the Federal tax exemption into its "Operation Bootstrap" development plan; the plan was designed, in part, to attract investment from the mainland United States.

The Tax Reform Act of 1976 implemented several changes designed to strengthen the provision's incentive effect and to tie it more closely to the possessions. The Act also instituted the credit-cum-exemption mechanism that is currently in place. In keeping the essential elements of the tax exemption intact, Congress indicated that the provision's purpose was to keep Puerto Rico and the possessions competitive with low-wage, low-cost foreign countries as a location for investment.

Changes in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed tighter rules on mainland parent firms that used transfers of intangible assets (*e.g.*, patents) to possessions subsidiaries as a means of sheltering mainland-source income from taxes. The Tax Reform Act of 1986 also sought to link the tax credit more tightly to tangible investment in the possessions by increasing the portion of income that must be from active business investment. The Omnibus Budget Reconciliation Act of 1993 scaled back the credit by limiting each firm's maximum credit to a specified portion of wage and depreciation costs incurred in the credit. While the Act's change likely reduced the tax benefit for some firms, the cap's link with wages and depreciation probably increased the incentive for other companies to employ labor and tangible investment in the possessions, thus focusing the credit more tightly on the possessions themselves. When repeal was subsequently proposed, Congress expressed concern about the provision's revenue cost and stated that the benefit is "enjoyed by only the relatively small number of U.S. corporations that operate in the possessions" while the revenue costs is "borne by all U.S. taxpayers."

The possessions tax credit is also intertwined with the issue of Puerto Rico's political status, and whether

Puerto Rico should retain its current Commonwealth status, become a U.S. State, or become independent. The link exists because both independence and statehood may ultimately require repeal of section 936.

Assessment

Because it reduces the cost of investment in Puerto Rico and the Virgin Islands, the possessions tax credit encourages firms to divert investment from the mainland and foreign countries to the possessions. The measure probably played an important role in attracting a large flow of investment to Puerto Rico in the years following World War II. The investment may have, in turn, helped transform Puerto Rico's economy from one based on agriculture to one heavily dependent on manufacturing. The inflow of investment probably also increased the earnings of Puerto Rican labor by increasing the capital/labor ratio in Puerto Rico.

Section 936's supporters maintain that the provision is critical to the well-being of Puerto Rico's economy. However, the credit's critics have pointed out that the current exemption is an incentive to invest rather than a direct incentive to employ labor, and to the extent it increases employment in Puerto Rico, it does so only as a by-product of its increase in investment. In addition, some have questioned the measure's cost-effectiveness, arguing that the measure's cost in terms of foregone tax collections is high compared to the number of jobs the provision creates in Puerto Rico.

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Interest

DEFERRAL OF INTEREST ON SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1999	1.2	-	1.2
2000	1.2	-	1.2
2001	1.2	-	1.2
2002	1.2	-	1.2
2003	1.2	-	1.2

Authorization

Section 454(c) of the Internal Revenue Code of 1992.

Description

Owners of U.S. Treasury Series E and EE savings bonds have the option of either including interest in taxable income as it accrues or excluding interest from taxable income until the bond is redeemed. Furthermore, EE bonds may be exchanged for current income HH savings bonds with the accrued interest deferred until the HH bonds are redeemed. The revenue loss shown above is the tax that would be due on the deferred interest if it were reported and taxed as it accrued.

Impact

The deferral of tax on interest income on savings bonds provides two advantages. First, payment of tax on the interest is deferred, delivering the equivalent of an interest-free loan of the amount of the tax. Second, the taxpayer often is in a lower income bracket when the bonds are redeemed. This is particularly common when the bonds are purchased while the owner is working and redeemed after the owner retires.

Savings bonds appeal to small savers because of such financial features as their small denominations, ease of purchase, and safety. Furthermore, there is currently an annual cash purchase limit of $15,000 per person in terms of issue price. Because poor families save little and do not pay Federal income taxes, the tax deferral of interest on savings bonds primarily benefits middle income families.

Rationale

Prior to 1951, a cash-basis taxpayer generally reported interest on U.S. Treasury original issue discount bonds in the year of redemption or maturity, whichever came first. In 1951, when provision was made to extend Series E bonds past their dates of original maturity, a provision was enacted to allow the taxpayer either to report the interest currently, or at the date of redemption, or upon final maturity. The committee reports indicated that the provision was adopted to facilitate the extension of maturity dates.

On January 1, 1960, the Treasury permitted owners of E bonds to exchange these bonds for current income H bonds with the continued deferment of Federal income taxes on accrued interest until the H bonds were redeemed. The purpose was to encourage the holding of U.S. bonds. This tax provision was carried over to EE bonds and HH bonds.

Assessment

The savings bond program was established to provide small savers with a convenient and safe debt instrument and to lower the cost of borrowing to the taxpayer. The option to defer taxes on interest increases sales of bonds. But there is no empirical study which has determined whether or not the cost savings from increased bond sales more than offset the loss in tax revenue from the accrual.

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Appendix A

FORMS OF TAX EXPENDITURES

EXCLUSIONS, EXEMPTIONS, DEDUCTIONS, CREDITS, PREFERENTIAL RATES, AND DEFERRALS

Tax expenditures may take any of the following forms:

(1) special exclusions, exemptions, and deductions, which reduce taxable income and, thus, result in a lesser amount of tax;

(2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income;

(3) special credits, which are subtracted from taxes as ordinarily computed; and

(4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business).

The corporate income tax eventually reaches an average rate of 35 percent in two steps. Below $10,000,000 taxable income is taxed at graduated rates: 15 percent on the first $50,000, 25 percent on the next $25,000, and 34 percent on the next $25,000. The limited graduation provided in this structure was intended to furnish tax relief to smaller corporations. The value of these graduated rates is phased out, via a 5 percent income additional tax, as income rises above $100,000. Thus the marginal tax rate, the rate on the last dollar, is 34 percent on income from $75,000 to $100,000, 39 percent on taxable income from $100,000 to $335,000, and returns to 34 percent on income from $335,000 to $10,000,000. The rate on taxable income in excess of $10,000,000 is 35 percent, and there is a second phase-out, of the benefit of the 34-percent bracket, when taxable income reaches $15,000,000. An extra tax of three percent of the excess above $15,000,000 is imposed (for a total of 38 percent) until the benefit is recovered, which occurs at $18,333,333 taxable income. Above that, income is taxed at a flat 35 percent rate. Most corporate income is taxed at the 35 percent marginal rate.

Any credits are deducted directly from tax liability. The essentially flat statutory rate of the corporation income tax means there is very little difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry back or carry forward a net

operating loss or credit.

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except exclusions. They then subtract certain deductions (deductions from gross income or "business" deductions) to arrive at adjusted gross income. The taxpayer then has the option of "itemizing" personal deductions or taking the standard deduction. The taxpayer then deducts personal exemptions to arrive at taxable income. A graduated tax rate structure is applied to this taxable income to yield tax liability, and any credits are subtracted to arrive at the net after-credit tax liability.

The graduated tax structure is applied at rates of 15, 28, 31, 36, and 39.6 percent, with brackets varying across types of tax returns. For joint returns, in 1995, rates on taxable income were 15 percent for the first $39,000, 28 percent for amounts from $39,000 to $94,250, 31 percent for incomes from $94,250 to $143,600, 36 percent for taxable incomes of $143,600 to $256,500, and 39.6 percent for amounts over $256,500. These amounts are indexed for inflation. There are also phase-outs of personal exemptions and excess itemized deductions so that marginal tax rates can be higher at very high income levels.

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest from State and local bonds saves $39.60 in tax for every $100 of interest for the taxpayer in the 39.6-percent bracket, whereas for the taxpayer in the 15-percent bracket the saving is only $15. Similarly, the increased standard deduction for persons over age 65 or an itemized deduction for charitable contributions are worth twice as much in tax saving to a taxpayer in the 31-percent bracket as to one in the 15 percent bracket.

In general, the following deductions are itemized, i.e., allowed only if the standard deduction is not taken: medical expenses, specified State and local taxes, interest on nonbusiness debt such as home mortgage payments, casualty losses, certain unreimbursed business expenses of employees, charitable contributions, expenses of investment income, union dues, costs of tax return preparation, uniform costs and political contributions. (Certain of these deductions are subject to floors or ceilings.)

Whether or not a taxpayer minimizes his tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction. Higher income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners often itemize because deductibility of mortgage interest and property taxes leads to larger deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the reduced rates on the first $75,000 of corporate income) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater is the tax relief from the preferential rate.

Credits

A tax credit (such as the dependent care credit) is subtracted directly from the tax liability that would accrue otherwise; thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can (with one exception) only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to absorb the credit. Most tax credits can be carried backward and/or forward for fixed periods, so that a credit which cannot be used in the year in which it first applies can be used to offset tax liabilities in other prescribed years.

The earned income credit is the only tax credit which is now refundable. That is, a qualifying individual will obtain in cash the entire amount of the refundable credit even if it exceeds tax liability.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these, his taxable income is lower than it otherwise would be, and because of the current reduction in his tax base, his current tax liability is reduced. The reduction in his tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed.

Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in his taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (that is, the tax deferred), the value of the interest-free loan--per dollar of tax deferral--depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-free loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.

The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long run estimates at the level of economic activity for the year in question.

Appendix B

RELATIONSHIP BETWEEN TAX EXPENDITURES AND LIMITED TAX BENEFITS SUBJECT TO LINE ITEM VETO

Description

The Line Item Veto Act (P.L. 104-130) enacted in 1996 gives the President the authority to cancel "limited tax benefits." A limited tax benefit is defined as either a provision that loses revenue and that provides a credit, deduction, exclusion or preference to 100 or fewer beneficiaries, or a provision that provides temporary or permanent transition relief to 10 or fewer beneficiaries in any fiscal year.

Items falling under the revenue losing category do not qualify if the provision treats in the same manner all persons in the same industry, engaged in the same activity, owning the same type of property, or issuing the same type of investment instrument.

A transition provision does not qualify if it simply retains current law for binding contracts or is a technical correction to a previous law (that has no revenue effect).

When the beneficiary is a corporation, partnership, association, trust or estate, the stockholders, partners, association members or beneficiaries of the trust or estate are not counted as beneficiaries.

The beneficiary is the taxpayer who is the legal, or statutory, recipient of the benefit.

The Joint Committee on Taxation is responsible for identifying limited tax benefits subject to the line item veto (or indicating that no such benefits exist in a piece of legislation); if no judgment is made, the President can identify such a provision.

The line item veto takes effect on January 1, 1997.

Similarities to Tax Expenditures

Limited tax benefits resemble tax expenditures in some ways, in that they refer to a credit, deduction, exclusion or preference that confers some benefit. Indeed, during the debate about the inclusion of tax provisions in the line item veto legislation, the term "tax expenditures" was frequently invoked. The House initially proposed limiting these provisions to a fixed number of beneficiaries (originally 5, and eventually 100). The Senate bill did not at first include tax provisions, but then included provisions that provided more favorable treatment to a taxpayer or a targeted group of taxpayers.

Such provisions would most likely be considered as tax expenditures, at least conceptually, although they might not be included in the official lists of tax expenditures because of de minimis rules (that is, some provisions that are very small are not included in the tax expenditure budget although they would qualify on conceptual grounds), or they might not be separately identified. This is particularly true in the case of transition rules.

Differences from Tax Expenditures

Most current tax expenditures would probably not qualify as limited tax benefits even if they were newly introduced (the line item veto applies only to newly enacted provisions).

First, many if not most tax expenditures apply to a large number of taxpayers. Provisions benefitting individuals, in particular, would in many cases affect millions of individual taxpayers. Most of these tax expenditures that are large revenue losers are widely used and widely available (e.g. itemized deductions, fringe benefits, exclusions of income transfers).

Provisions that only affect corporations may be more likely to fall under a beneficiary limit; even among these, however, the provisions are generally available for all firms engaged in the same activity.

These observations are consistent with a recent draft analysis of the Joint Committee on Taxation which included examples of provisions already in the law that might have been classified as limited tax benefits had the line item veto provisions been in effect. Some of these provisions have at some time been included in the tax expenditure budget, although they are not currently included (the orphan drug tax credit, which is very small, and an international provision involving the allocation of interest, which has since been repealed). Some provisions modifying current tax expenditures might also have been included. But, in general, tax expenditures, even those that would generally be seen as narrow provisions focusing on a certain limited activity, would probably not have been deemed limited tax benefits for purposes of the line item veto.

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