108th Congress
2d Session

COMMITTEE PRINT

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TAX EXPENDITURES

Compendium of Background Material on Individual Provisions

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

DECEMBER 2004

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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LETTER OF TRANSMITTAL

December 16, 2004

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 150 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 coordinated by Cheri Reidy of the Senate Budget Committee staff. All tax code changes through the end of the 108th 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.

Don Nickles
Chairman

LETTER OF SUBMITTAL

CONGRESSIONAL RESEARCH SERVICE
THE LIBRARY OF CONGRESS
Washington, D.C., December 20, 2004

Honorable Don Nickles
Chairman, Committee on the Budget
U.S. Senate
Washington, DC 20510.

Dear Mr. Chairman:

I am pleased to submit a revision of the December 2002 Committee Print on Tax Expenditures.

As in earlier versions, each entry includes an estimate of each tax expenditure's revenue cost, its legal authorization, a description of the tax provision and its impact, 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 such data are relevant and available. The rationale section contains some detail about the historical development of each provision. The assessment section summarizes major 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, Gary Guenther, Pamela Jackson, Steven Maguire, Nonna Noto, Maxim Shvedov, and Louis A. Talley of the Government and Finance Division; Richard Bourdon, Velma W. Burke, Linda Levine, Robert F. Lyke, Gail McCallion, Neela Ranade, Edward B. Rappaport, and Christine Scott of the Domestic Social Policy Division; and Salvatore Lazzari of the Resources, Science and Industry 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 128 Federal tax provisions currently treated as tax expenditures. They include those listed in Tax Expenditure Budgets prepared for fiscal years 2005-2009 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 2005-2009, 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

References to selected bibliography.

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[1]U.S. Congress, Joint Committee on Taxation. *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, forthcoming. Estimates may be subject to change; see the Joint Committee document for final estimates.

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 2005 Expenditure Budget

There are several differences between the tax expenditures shown in this publication and the tax expenditure budget found in the Administration's FY2005 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 and some of the differences between the Administration and Joint Committee approaches, see *The Budget of the United States Government, Fiscal Year 2005, Analytical Perspectives*, "Tax Expenditures," pp. 285-325. See also Linda Sugin, "What is Happening to the Tax Expenditure Budget?" *Tax Notes*, August 16, 2004, pp. 763-766.

(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 2005-

2009. 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 estimated distribution of returns by income class, for comparison with those tax expenditure distributions:

Distribution by Income Class of Tax Returns at 2004 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	16.8
$10 to $20	14.7
$20 to $30	13.1
$30 to $40	10.9
$40 to $50	8.6
$50 to $75	15.1
$75 to $100	9.0
$100 to $200	9.5
$200 and over	2.3

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 levels. For example, the Congressional Budget Office[4] reports in 2001 that 52 percent of capital income was received by the top 1 percent of the

---

[3]See Jane G. Gravelle, *Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates*, Library of Congress, Congressional Research Service Report RL32517, August 9,2004.

[4]U.S. Congress, Congressional Budget Office. *Effective Federal Tax Rates for 1979-2001*, April 2004, Table 1B.

population, 68 percent was received by the top 5 percent, 75 percent was received by the top 10 percent, and 83 percent was received by the top 20 percent. The distribution across the first four quintiles was 1, 2, 5, and 8 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.

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.

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 through the end of the 108th Congress.

The expenditure table below shows an initial declining amount for corporations. This decline is due to the temporary first year depreciation for equipment enacted in 2002 that expires in 2004 and largely involves a timing shift: a loss of revenue in the short run offset by a long run gain.

Sum of Tax Expenditure Estimates by Type of Taxpayer, Fiscal Years 2005-2009

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	812.3	85.8	898.1
2006	845.4	75.9	921.3
2007	884.4	82.7	967.1
2008	935.6	86.1	1021.7
2009	926.0	91.6	1017.6

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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National Defense

EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES PERSONNEL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	2.9	-	2.9
2006	2.9	-	2.9
2007	3.0	-	3.0
2008	3.1	-	3.1
2009	3.1	-	3.1

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. 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 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.) Families of members of the armed forces receive a $12,000 death gratuity payment for deceased members of the armed forces. The full amount of the death gratuity payment is tax-exempt.

The personal use of an automobile is not excludable as a qualified military benefit.

The rule that the exclusion for qualified scholarships and qualified tuition reductions does not apply to amounts received that represent compensation for services no longer applies in the case of amounts received under the Armed Forces Health Professions Scholarship and Financial Assistance Program or the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program. Recipients of these scholarships are obligated to serve in the military at an armed forces medical facility.

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 10-percent tax bracket (the lowest income tax bracket) would not pay taxes equal to $10 for each $100 excluded. Likewise, an individual in the 35-percent tax bracket (the highest income tax bracket) would not pay taxes of $35 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.

The exclusion of qualified medical scholarships will primarily benefit students, therefore most beneficiaries are likely to have low tax rates. As noted earlier, the tax benefit of an exclusion varies according to the marginal tax rate of the individual.

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). The Assistant Secretary of the Treasury for Tax Policy, Pamela F. Olson, has indicated that because of the uncertainty concerning Treasury's authority to add dependent care assistance programs to the list of qualified military benefits, Treasury would welcome legislation which clarified the law in this area.

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.

The Economic Growth and Tax Reconciliation Relief Act (P.L. 107-16) simplified the definition of earned income by excluding nontaxable employee compensation, which included combat zone pay, from the definition of earned income. The amount of earned income that armed forces members reported for tax purposes was reduced and caused a net loss in tax benefits for some low-income members of the armed forces. The Working Families Tax Relief Act of 2004 (P.L. 108-311) provided that combat pay that was otherwise excluded from gross income could be treated as earned income for the purpose of calculating the earned income tax credit and the child tax credit.

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. If military pay scales were to be adjusted upward, it could increase the retirement income of military 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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National Defense

EXCLUSION OF MILITARY DISABILITY BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	-	0.1
2006	0.1	-	0.1
2007	0.1	-	0.1
2008	0.1	-	0.1
2009	0.1	-	0.1

Authorization

Section 104(a)(4) or (5) 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 from gross income.

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.

Under the Victims of Terrorism Tax Relief Act of 2001 an exclusion from gross income for disability income is extended to any individual (civilian or military) when attributable to a terroristic or military action regardless of where the activity occurs (inside or outside the United States).

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, 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 the 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 those joining after September 24, 1975.

In response to the terrorist attack of September 11, 2001 Congress amended section 104 to exclude from taxation amounts received by *any* individual as disability income when attributable to injuries incurred as a direct result of a terroristic or military action either within or without the United States. It should be noted that one of the targets of the terrorists was the Pentagon.

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.

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DEDUCTION FOR OVERNIGHT-TRAVEL EXPENSES OF NATIONAL GUARD AND RESERVE MEMBERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	-	0.1
2006	0.1	-	0.1
2007	0.1	-	0.1
2008	0.1	-	0.1
2009	0.1	-	0.1

Authorization

26 USC 162.

Description

An above-the-line deduction is available for un-reimbursed overnight travel, meals, and lodging expenses of National Guard and Reserve members. In order to qualify for the provision, he or she must have traveled more than 100 miles away from home and stayed overnight as part of an activity while on official duty. The deduction applies to all amounts paid or incurred in tax years beginning after December 31, 2002. No deduction is generally permitted for commuting expenses to and from drill meetings and the amount of expenses that may be deducted may not exceed the general Federal Government per diem rate applicable to that locale.

This deduction is available to taxpayers regardless of whether they claim the standard deduction or itemize deductions when filing their income tax return. The deduction is not restricted by the overall limitation on itemized deductions.

Impact

The value of the benefit (or cash payment made in lieu of the benefit) is not included in gross income. Since these deductions 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 10-percent tax bracket (Federal tax law's lowest tax bracket) would not pay taxes equal to $10 for each $100 excluded. Likewise, an individual in the 35-percent tax bracket (Federal law's highest tax bracket) would not pay taxes of $35 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.

One of the benefits of an "above-the-line" deduction is that it reduces the taxpayer's adjusted gross income (AGI). As AGI increases, it can cause other tax deductions and credits to be reduced or eliminated. Therefore, deductions that reduce AGI will often provide a greater tax benefit than deductions "below-the-line" that do not reduce AGI.

Rationale

The deduction was authorized by the Military Family Tax Relief Act of 2003 (P.L. 108-121) which expanded tax incentives for military personnel. Under previous law, the expenses could have been deducted as itemized deductions only to the extent that they and other miscellaneous deductions exceeded 2 percent of adjusted gross income. So reservists who did not itemize were not able to deduct these expenses and reservists who did itemize could deduct the expenses only in reduced form.

In enacting the new deduction, Congress identified the increasing role that Reserve and National Guard members fulfill in defending the nation and a heavy reliance on service personnel to participate in national defense. Congress noted that more than 157,000 reservists and National Guard were on active duty status– most assisting in Operation Iraqi Freedom at the time of enactment.

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. The tax deduction can be justified both as a way of providing support to reservists and as a means of easing travel expense burdens.

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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
2005	3.6	-	3.6
2006	3.8	-	3.8
2007	4.0	-	4.0
2008	4.2	-	4.2
2009	4.4	-	4.4

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 (other than Federal employees) who live and work abroad an exclusion of wage and salary income from taxable income. The amount that can be excluded is $80,000 in 2002. The exclusion is scheduled to be indexed for U.S. inflation, beginning in 2008. (Foreign tax credits, however, cannot be claimed for foreign taxes paid on excluded income.)

Qualifying individuals can also exclude certain expenditures for overseas housing. 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. 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 would have 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 relative to domestic U.S. taxes 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
2005	0.5	-	0.5
2006	0.5	-	0.6
2007	0.7	-	0.6
2008	0.6	-	0.7
2009	0.7	-	0.7

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 $80,000 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 for exclusion. 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. U.S. citizens employed abroad in the private sector are permitted to exclude up to $80,000 per year rather than an amount explicitly linked to cost-of-living allowances. Given that flat amount, whether the tax treatment of federal workers is more or less favorable than that of private sector workers depends of the size of the federal workers' cost-of-living allowance.

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 forgone 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, 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 EXTRATERRITORIAL INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	3.1	3.2
2006	0.1	3.9	4.0
2007	([1])	1.9	1.9
2008	([1])	0.1	0.1
2009	([1])	0.1	0.1

([1]) Less than $50 million

Authorization

Sections 114 and 941-2.

Description

Prior to enactment of the American Jobs Creation Act of 2004 (AJCA), the tax code's extraterritorial income (ETI) provisions permitted U.S. exporters to exclude between 15% and 30% of their export income from U.S. tax. The provisions also effectively permit exporters to exclude a certain amount of income from foreign operations from tax – generally, an amount equal to the amount of export income that is excluded. The AJCA, however, provides for the phaseout of the benefit beginning in 2005, with exports permitted to claim 80% of the benefit they could otherwise use in 2005, and 60% in 2006. The ETI benefit is generally not available in 2007 and thereafter.

Repeal of the ETI provisions is intended to resolve a long-running controversy between the United States and the European Union (EU). The

ETI provisions were enacted as a replacement for the Foreign Sales Corporation (FSC) tax benefit for exporting, which (in response to a complaint by the EU) was found by a World Trade Organization (WTO) panel to be in violation of the WTO agreements' strictures against export subsidies. However, WTO panels have also found the ETI provisions to be non-compliant and the WTO authorized the countries of the EU to apply retaliatory tariffs to items imported from the United States. The EU began to phase in its tariffs in March, 2004.

The statutory mechanics of the ETI benefit work by defining "extraterritorial income" and excluding that income from tax. Extraterritorial income, in turn, is generally defined as a specified portion of income from the sale of property produced either within the United States or abroad, with the added proviso that no more than 50% of the value of the property can be attributable to foreign products or to labor performed outside the United States. The part of extraterritorial income that is exempt varies, depending on which of several alternative calculation rules a taxpayer uses; the exemption can be as small as 15% of qualified income or as large as 30%.

For exports, the size of the ET tax benefit is the same as the FSC benefit it replaced. Again, however, the ET exclusion can apply to a certain amount of income from foreign operations where the FSC benefit did not, so the total tax benefit a particular firm can obtain is potentially larger under the ETI exclusion than it was under FSC. Also, to use the FSC benefit exporters were required to sell their goods through specially-defined subsidiary sales corporations (FSCs). A firm can use the ETI benefit by selling its exports directly.

Impact

To the extent the ETI exclusion increases the after-tax return on investment in export-producing property, and to the extent it applies to foreign operations, the exclusion increases the after-tax return to investment abroad. The tax benefit therefore accrues, in part, to owners of firms that export and firms that both export and conduct foreign operations. However, in the long run, the burden of the corporate income tax – and the benefit of corporate tax exclusions – probably spread beyond corporate stockholders to owners of capital in general, including, for example, unincorporated businesses and owner-occupied housing.

The ETI benefit is therefore probably shared by U.S. capital in general. And because capital tends to be owned by upper-income individuals, the distributional effect of the provision probably reduces the progressivity of the tax system. Also, because part of the export benefit is passed on to foreign consumers in the form of lower prices, a part of the ETI benefit probably accrues to foreign consumers of U.S. exports.

Rationale

While the ETI benefit was intended as a WTO-compliant replacement for FSC, FSC itself was enacted as a replacement for another tax benefit that encountered difficulties with U.S. trading partners: the Domestic International Sales Corporation (DISC) provisions. DISC was enacted with the Revenue Act of 1971, and was intended to increase U.S. exports and to pose a tax incentive for firms to locate their operations in the United States rather than abroad. DISC thus was thought to provide a counterweight to the tax code's deferral incentive for overseas investment.

Soon after DISC was enacted, a number of U.S. trading partners – including what was then the European Economic Community, or EEC – charged 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 was signatory. In response to the complaints, the Deficit Reduction Act of 1984 largely replaced DISC with FSC, which contained a number of features designed to ensure GATT-legality. An understanding adopted by the GATT Council had held that a country need not tax economic processes occurring beyond its own borders. With this in mind, the FSC provisions included requirements that the FSC sales subsidiaries be incorporated abroad or in a U.S. possession and likewise conduct certain minimal economic processes overseas.

The countries of the EEC were still not fully satisfied of FSC's GATT-legality. Still, the controversy was generally below the surface until 1998, when what had become the European Union (EU) lodged a complaint with the World Trade Organization (WTO, GATT's successor) arguing that FSC violated the agreements on which the WTO is based. A WTO panel subsequently upheld the EC's position, and under WTO procedures, the United States was required to make its laws WTO-compliant or face either retaliatory tariffs or compensatory payments. As 2000 drew to a close, the United States enacted the FSC Repeal and Extraterritorial Income Exclusion Act containing the ETI exclusion. The European countries, however, maintained that the ETI provisions are themselves not WTO compliant and asked the WTO to rule on the WTO-legality of ET provisions. The EU also asked the WTO to approve retaliatory tariffs, should the ETI regime prove to be non-compliant. In August, 2001, a WTO panel ruled against the ETI provisions, and in January, 2002, the WTO Appellate Body rejected a U.S. appeal. In August, 2002, the WTO set the amount of sanctions that can be applied by the EU at $4 billion. The EU delayed in implementing its tariffs while legislation addressing the controversy was considered by the U.S. Congress. In March, 2004, however, the EU began to phase in its tariffs.

Assessment

Because the ETI exclusion increases the after-tax return from investment in exporting, it poses a tax incentive to export. Its supporters argue that the provision does indeed boost U.S. exports and thus has a beneficial effect on U.S. employment. Economic analysis, however, suggests that the provision's effects are not what might be expected from an export incentive. The ETI exclusion probably triggers exchange-rate adjustments that ensure that U.S. imports expand along with any increase the exclusion might cause in exports; it probably produces little direct improvement in the U.S. balance of trade. Instead, as the provision probably increases both imports and exports, it likely increases the overall level of U.S. trade.

Economic theory suggests that another effect of the ETI exclusion is probably to shift economic welfare from the United States to foreign consumers. This occurs when part of the tax benefit is passed on to foreign consumers in the form of reduced prices for U.S. goods. The provision may also reduce economic efficiency by inducing the United States to trade more than it otherwise would.

As noted above, in addition to exports, the ETI exclusion extends, in part, to income from foreign operations: 50% of the value of qualifying property can be attributable to foreign operations. In principle, this provision may pose an incentive for U.S. firms that export to also establish operations abroad. The incentive may be limited in its effect, however, because it would only apply to U.S. firms that do not have a large volume of foreign tax credits or who find other tax benefits for investing abroad – specifically, ability to defer U.S. tax on foreign income – to be more attractive.

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DEFERRAL OF ACTIVE INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	3.2	3.2
2006	-	3.4	3.4
2007	-	5.8	5.8
2008	-	6.4	6.4
2009	-	7.0	7.0

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

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.

While U.S. tax (less foreign tax credits) generally applies when tax-deferred income is ultimately repatriated to the United States, a provision of the American Jobs Creation Act of 2004 (P.L. 108-357) provides a temporary (one-year) 85% deduction for repatriated dividends. For a corporation subject to the top corporate tax rate of 35%, the deduction has an effect similar to a reduction in the tax rate on repatriations to 5.25%. The deduction applies to a one-year period consisting (at the taxpayer's election) of either the first tax year beginning on or after P.L. 108-357's date of enactment (October 22, 2004) or the taxpayer's last tax year beginning before the date of enactment.

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. Deferral also probably reduces world economic efficiency by distorting the allocation of capital in favor of investment abroad.

The one-year deduction for repatriations enacted in 2004 is likely to encourage some multinational firms to change the timing of dividend repatriations from the future to the near term, as firms choose to remit some dividends during the provision's one-year window rather than during the future year or years when they were originally scheduled to be repatriated. As noted below, however (see the section entitled "assessment"), this scenario likely depends on firms accepting the provision as temporary rather than permanent.

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 Tax Relief Extension Act of 1999 (P.L. 106-170) extended a temporary exemption from Subpart F for financial services income. In 2004, the American Jobs Creation Act relaxed Subpart F in the area of shipping income and provided a one-year temporary tax reduction for income repatriated to U.S. parents from overseas subsidiaries.

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 either pose a disincentive, pose 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.

Supporters of a tax cut for dividend repatriations have argued that the application of U.S. tax to remissions from overseas subsidiaries poses a disincentive for U.S. multinationals to repatriate the earnings of their foreign subsidiaries. The tax on repatriations, it is argued, acts as a toll on dividends remitted to U.S. parent companies, and encourages firms to instead reinvest their earnings abroad. This argument holds that elimination or reduction of the tax may release the stock of unrepatriated earnings bottled up overseas by the repatriation tax and stimulate an increased flow of repatriations. However, economic theory suggests that whether this scenario actually plays out depends heavily on whether the tax cut for repatriations is temporary (as it is with AJCA) or permanent. If permanent, theory indicates that no change in repatriations may occur.

Supporters of the tax cut for repatriations have argued that it will provide a stimulus for the domestic economy, and encourage firms to undertake additional investment within the U.S. economy. Economic theory, however, is skeptical of this outcome, pointing out that firms undertake investment based on the prospective attractiveness of investment opportunities, on the one hand, and the return savers (i.e., stockholders) require of their corporate-sector investments, on the other. An increase in cash flow in the form of larger repatriations would change neither of these factors.

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INVENTORY PROPERTY SALES SOURCE RULE EXCEPTION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	5.9	5.9
2006	-	6.2	6.2
2007	-	6.4	6.4
2008	-	6.3	6.3
2009	-	6.1	6.1

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 CERTAIN FINANCING INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	1.0	1.0
2006	-	1.1	1.1
2007	-	1.7	1.7
2008	-	-	-
2009	-	-	-

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.

The revenue estimates reflect the effects of the temporary provisions allowing a lower tax on repatriation of dividends, discussed under *Deferral of Active Income of Controlled Foreign Corporations*.

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 one year by the Tax and Trade Relief Extension Act of 1998. (The Act was 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 and added a "nexus" requirement under which activities generating eligible income must take place within the CFC's home country. In 1999, Public Law 106-170 extended the provision through 2001. In 2002, Public Law 107-147 extended the provision for five additional years, through 2006. The American Jobs Creation Act of 2004 added rules permitting, in some circumstances, certain qualifying activities to be undertaken by related entities.

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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TREATMENT OF CERTAIN DIVIDENDS OF REGULATED INVESTMENT COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	0.1	([1])	0.1
2007	0.1	([1])	0.1
2008	0.1	([1])	0.1
2009	-	([1])	([1])

([1]) Less than $50 million.

Authorization

Sections 871 and 881.

Description

Regulated investment companies (RICs) are corporations that operate as passthrough entities and are commonly referred to as mutual funds. These firms pay no income tax, but the income is taxed to the investors. When income is favorably treated (such as long term capital gains) a portion of the dividend can be identified as arising from that income source, providing the same treatment as if securities had been held directly.

In the case of foreign investors, who are not generally subject to U.S. tax, the United States imposes a withholding tax at the firm level. This tax is nominally 30% but can be lowered through treaties. However, the minimum tax on dividends is 15%. For direct holdings by foreigners, certain types of

interest (primarily on bank deposits) and certain capital gains are not subject to the withholding tax.

Foreign investors are generally not subject to federal estate taxes, but the estate tax does apply to U.S. holdings.

This provision allows RICs to designate portions of their dividend payments as interest and short term capital gains and also to designate those portions of their assets that reflect underlying property not associated with the United States. Essentially, it allows a direct "look-through" treatment for these assets to achieve the same treatment that would occur if the assets were held directly rather than through a mutual fund. These provisions do not apply in certain cases, including those cases when the foreign shareholder owns 10% or more of the shares, when the country involved does not share information with the United States, and in certain other circumstances.

The provisions are effective after 2004 but expire after 2007.

Impact

This provision lowers the taxes on foreign investors in U.S. mutual funds to the extent the underlying assets qualify for exemption if held directly, for a temporary period.

Rationale

This provision was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357), a bill that repealed the Extraterritorial Income provision that was found to be an unacceptable export subsidy by the World Trade Organization. The purpose was to enhance the ability of firms to compete internationally and to create and preserve manufacturing jobs.

Assessment

The provision should make it easier for foreign persons to invest in the United States, because mutual funds are an easy way, particularly for smaller investors, to make such investments. This provision will extend the benefits of exemption from withholding that apply to certain underlying assets to mutual fund dividends paid to foreigners.

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General Science, Space, and Technology

TAX CREDIT FOR QUALIFIED RESEARCH EXPENDITURES

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	4.8	4.9
2006	0.1	3.0	3.1
2007	([1])	1.5	1.5
2008	([1])	1.0	1.0
2009	([1])	0.4	0.4

*This provision will expire on December 31, 2005; if it is retained in its present form, the credit's annual cost is about $3.5 billion.

([1])Less than $50 million.

Authorization

Section 41.

Description

A non-refundable, 20-percent income tax credit is allowed for certain research expenditures paid or incurred in carrying on the trade or business of a taxpayer. The credit applies only to the taxpayer's qualified research expenditures for a tax year in excess of a base amount. This amount is computed by multiplying a fixed ratio, which for established corporations is research expenditures divided by gross receipts in 1984-1988, by average gross receipts for the past four years. The base amount cannot be less than 50 percent of current research expenditures, and the fixed ratio may not exceed 0.16. Corporations lacking the requisite number of tax years from 1984 to 1988 are assigned an initial fixed ratio of 0.03 during the first five

tax years in which they have both gross receipts and qualified research expenses.

Corporations also have the option of claiming an alternative incremental research tax credit. The credit is equal to the sum of 2.65 percent of a firm's qualified research expenditures above 1 percent but not greater than 1.5 percent of its average gross receipts in the four previous years, 3.2 percent of its qualified research expenditures above 1.5 percent but not greater than 2.0 percent of the same receipts, and 3.75 percent of its qualified research expenditures that exceed 2.0 percent of the same receipts. In general, firms can expect to benefit more from the alternative credit than the regular credit if their qualified research expenditures in the current tax year are slightly above their base amounts under the regular credit.

The definition of research that is eligible for the credit has been a contentious issue since the credit first entered the tax code in July 1981. As it now stands, research must satisfy three criteria in order to qualify for the credit. First, it must relate to activities that can be expensed under section 174, which is to say that the research must be "experimental" in the laboratory sense. Second, the research must be undertaken to discover information that is "technological in nature" and useful in the development of a new or improved product, process, computer software technique, formula, or invention that is to be sold, leased, licensed, or used by the firm performing the research. And third, the research must relate to activities that constitute a process of experimentation whose goal is the development of a product or process with a "new or improved function, performance, or reliability or quality."

Not all spending related to qualified research is eligible for the incremental or alternative credits; qualified spending fits into one of the following categories:

(1) in-house expenditures by the taxpayer for wages, salaries, 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; the share rises to 75 percent if non-profit scientific research consortia perform the research.

The credit does not apply to expenditures for equipment and structures used in qualified research, the fringe benefits of employees involved in this research, and overhead costs related to research (e.g., rent, utility costs, leasing fees, administrative and insurance costs, and property taxes). Nor can it be claimed for research done after the start of commercial production, research aimed at adapting existing products for a specific customer's needs, research that duplicates existing products, surveys, routine testing, research

to modify computer software for internal use, foreign research, research funded by others, and research in the social sciences, arts, or humanities.

If a taxpayer claims a research tax credit and deducts research expenditures under section 174, then the deduction must be reduced by the amount of the credit. This reduction, which is tantamount to a basis adjustment, has the effect of including the credit in a firm's taxable income.

In addition, payments made by C corporations (including grants or contributions) for basic research conducted by universities and non-profit scientific research organizations are eligible for a basic research tax credit. The credit is equal to 20 percent of these payments above a base amount, which is defined as the sum of 1 percent of a taxpayer's in-house and contract research spending in the base period and any excess of its average non-basic research contributions to qualified organizations in the base period, adjusted for increases in the cost of living, over its contributions in the current tax year. Research expenditures used to compute the basic research credit may not also be included in those used to compute the regular or alternative research credits.

The research credit is due to expire on December 31, 2005. It may not be claimed for eligible expenses paid or incurred after June 30, 1995 and before July 1, 1996 because the credit was not in effect during that period and has not been renewed retroactively to cover it.

Impact

The credit has the effect of reducing the net cost to a business of performing qualified research. While the statutory rate of the credit is 20 percent, the actual reduction in cost is much less than 20 percent owing to certain rules governing the computation of the credit. After subtracting the credit from the deduction for research expenditures under section 174, the credit's marginal effective rate falls to 13 percent: [0.20 x (1-0.35)]. In addition, firms whose current ratio of research spending to gross receipts is more than double the ratio during their base periods are subject to the rule that their base amounts equal 50 percent or more of qualified research expenditures in a tax year. For these firms, the marginal effective rate further shrinks to 6.5 percent. Moreover, since an increase in sales relative to qualified research expenditures may cause a loss of future credits, the credit also has the potential to impose a slight tax on sales growth.

Because of its design, the credit does not provide benefits to all firms undertaking qualified research. For instance, it is of no benefit to firms whose research expenditures are declining relative to gross receipts, but it does benefit firms whose research expenditures are increasing relative to gross receipts. Firms with rapidly growing research expenditures relative to receipts receive the largest benefits, but no more than 50 percent of

qualifying expenditures can be eligible for the credit, even if the base amount is less than 50 percent of current expenditures.

Individuals to whom the credit is properly allocated from a partnership or subchapter S corporation may use the credit in a particular year to offset only the tax on their taxable income derived from that business. As a result, an individual cannot use a research credit earned from a partnership or S corporation to offset the tax on income from the other sources.

The credit is claimed mostly by C corporations, while its direct tax benefits accrue largely to higher-income individuals (see discussion in the Introduction).

Rationale

Section 41 was enacted as part of the Economic Recovery Tax Act of 1981. Initially, the credit rate was fixed at 25 percent, there was no basis adjustment, and the base amount was the average of the past three years of research expenditures. A major justification for such a design was that a substantial incremental tax credit was needed to overcome the reluctance of many established companies to bear the significant costs of staffing, supplies, and certain equipment expenses such as computer charges associated with initiating or expanding research programs.

The original credit was supposed to expire at the end of 1985 to give Congress an opportunity to evaluate its effects before deciding whether or not to extend it. It was extended retroactively through 1988 at a reduced rate of 20% by the Tax Reform Act of 1986. The Technical and Miscellaneous Revenue Act of 1988 extended the credit for another year and a half and added a basis adjustment equal to 50 percent of the credit.

The Omnibus Reconciliation Act of 1989 made additional important changes in the credit. Specifically, the act extended the credit through 1990, allowed the base amount to increase in pace with gross receipts rather than research expenditures, allowed the credit to apply to research intended to explore future lines of business as well as to develop current ones, and provided for the full basis adjustment. The Omnibus Reconciliation Act of 1990 extended the credit through the end of 1991, and the Tax Extension Act of 1991 further extended it through June 1992. After the credit expired and was in abeyance for about one year, the Omnibus Budget Reconciliation Act of 1993 retroactively extended it through June 1995. After the credit again expired and lapsed for about one year, the Small Business Job Production Act of 1996 reinstated it retroactively to July 1, 1996 and extended it through May 31, 1997, leaving a one-year gap in coverage that still exists. The act also introduced the three-tiered alternative credit and allowed 75 percent of payments to non-profit research consortia to be eligible for the credit. The Taxpayer Relief Act of 1997 further extended the

credit through June 1998, and the omnibus budget bill passed in 1998 (P.L. 105-277) extended the credit through June 1999. After expiring yet again, the credit was extended to June 30, 2004 by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170). In October 2004, President Bush signed into law a tax bill (the Working Families Tax Relief Act of 2004, P.L. 108-311) that included a provision extending the credit through December 31, 2005.

Assessment

Among economists and policymakers, there is widespread agreement that investment in research and development (R&D) has a profound effect on long-term economic growth through the innovations it spawns. At the same time, it is thought that private R&D investment is bound to be less than optimal in a market economy mainly because many firms besides the ones financing the R&D are likely to capture some of the economic benefits from research. The nature of the direct results of R&D (i.e., new knowledge or knowhow) makes it very difficult for firms investing in R&D to prevent other firms from appropriating some of the returns, even in the presence of patent protection. There is conclusive evidence that over time, the social returns to R&D are much larger than the private returns. These findings suggest that a case can be made on economic grounds for government subsidies to R&D investments. In the absence of government intervention in the market for R&D, the private sector would be likely to invest less in R&D than its potential social returns would warrant. Public subsidies for R&D (e.g., research tax credits) can remedy this market failure, making everyone better off.

Since its enactment in 1981, the research tax credit has provided in excess of $1 billion a year in tax subsidies for business R&D investment. The credit's effectiveness hinges on the sensitivity of this investment to declines in its real after-tax cost. Available evidence suggests that in the 1980s at least, a decline in this cost of one dollar was associated with an increase in business R&D investment of one to two dollars. Nonetheless, because this sensitivity may shift over long periods, it is uncertain if R&D investment remains as responsive today.

Even though the credit can be justified on economic grounds and has proven to be cost-effective in certain periods, it is open to several criticisms. First, a tax subsidy may not be the most efficient way to encourage increased R&D investment, since an open-ended subsidy like the credit does not necessarily target R&D with the greatest social returns. Second, the lack of a clear and widely accepted definition of research that qualifies for the credit increases the likelihood that firms are fraudulently reclassifying some expenses to make them eligible for the credit. Third, the credit's marginal effective rate may be too low to boost business R&D to levels commensurate with its economic benefits. Finally, the credit's lack of permanence is

thought to undermine its effectiveness by heightening the uncertainty surrounding the expected after-tax returns on prospective R&D investments.

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General Science, Space, and Technology

EXPENSING OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	4.0	4.1
2006	0.1	5.5	5.6
2007	0.1	6.3	6.4
2008	0.1	6.4	6.5
2009	0.1	6.3	6.4

Authorization

Section 174.

Description

As a general rule, business expenditures to acquire an asset with a useful life extending beyond a single tax year, such as a machine tool or computer system, must be capitalized and cannot be deducted in the year the expenditures are made or incurred. These costs usually are recovered through depreciation deductions over the useful life of the asset or the sale or abandonment of the asset.

Under section 174, however, a taxpayer may deduct as a current business expense certain research expenditures that are paid or incurred in connection with the taxpayer's trade or business. This treatment is available even though the research expenditures are likely to generate intangible assets (e.g., patents) with a useful life extending beyond a single tax year. Alternatively, a taxpayer may treat these expenditures as deferred expenses and deduct them on a straight-line basis over a period of 60 months or more;

this treatment is know as amortization. Treasury regulations define the expenditures eligible for the deduction as "research and development costs in the experimental or laboratory sense." The regulations also specify that eligible research expenditures include all costs related to "the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property."

Expenditures for the acquisition or improvement of land or for the acquisition or improvement of depreciable or depletable property to be used in connection with research cannot be deducted under section 174. In practice, this means that outlays for structures and equipment used in research and development (R&D) must be recovered over 15 years and 3 years, respectively, using the depreciation schedules allowed under section 167. In addition, expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, may not be deducted under section 174.

The deduction allowed under section 174 is reduced by the amount (if any) of any credit claimed under section 41 for certain increases in research expenditures.

Impact

The expensing of research costs under section 174 has the effect of deferring tax liability, making it the most accelerated form of depreciation.

For example, if a profitable corporation were to spend $1 million on wages and supplies related to R&D in a tax year, it would be able to deduct that amount from its taxable income, producing a cash flow (at a 35-percent marginal tax rate) of $350,000. The value to the corporation of such - treatment is the amount by which the present value of the immediate deduction exceeds the present value of the periodic deductions that otherwise would be taken over the useful life of the asset (such as a patent) resulting from the research expenditures. Expensing is equivalent to taxing the returns to an asset at a marginal effective rate of zero. In other words, under expending, the after-tax and pre-tax return on the investment are the same.

The direct beneficiaries of this provision obviously are firms that undertake research. For the most part, these tend to be large manufacturing corporations engaged in developing, producing, and selling technologically advanced products. As a corporate tax deduction, the benefits of expensing any capital cost accrue mainly to upper-income individuals (see discussion in the Introduction).

Rationale

Section 174 was enacted as part of the Internal Revenue Code of 1954. The legislative history of the act indicates that Congress was pursuing two overriding aims in enacting section 174. One was to encourage firms (especially smaller ones) to invest in R&D; and the second aim was to eliminate the difficulties and uncertainties facing business taxpayers over the depreciation of research expenditures under previous tax law.

Assessment

There appears to be no controversy over the desirability of the provision, reflecting a widespread acceptance of its primary benefits. It simplifies tax compliance and accounting for business taxpayers by eliminating the problems of identifying expenditures associated with R&D and assigning useful lives to any assets created through R&D. Section 174 also stimulates business R&D investment by boosting after-tax returns to such investment and increasing the cash flow of firms engaged in R&D. This benefit addresses the widely held concern that R&D investment is generally inadequate in a market economy, mainly because of the spillover effects of R&D. There is some empirical evidence that the social returns to R&D exceed the private returns.

While these considerations constitute a strong case for subsidizing R&D investments, they do not necessarily argue in favor of a tax preference like section 174. A principal shortcoming with R&D tax subsidies like section 174 is that they do not precisely target those investments with the largest external benefits.

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Energy

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
2005	([1])	([1])	0.5	([1])	0.5	([1])
2006	([1])	([1])	0.4	([1])	0.4	([1])
2007	([1])	([1])	0.4	([1])	0.4	([1])
2008	([1])	([1])	0.5	([1])	0.5	([1])
2009	([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 the exploration and development of oil, gas, or geothermal properties have the option of expensing (deducting in the year paid or incurred) rather than capitalizing (*i.e.*, recovering such costs through depletion or depreciation) certain intangible drilling and development costs (IDCs). Expensing is an exception to general tax rules that provide for the capitalization of costs related to generating income from capital assets. In lieu of expensing, firms have the option of amortizing IDCs over a five-year period. This option may reduce or eliminate the alternative minimum tax on the IDC, which, as discussed below, is a tax preference item.

IDCs are amounts paid by the operator for fuel, labor, repairs to drilling equipment, materials, hauling, and supplies. They are expenditures incident to and necessary for the drilling of wells and preparing a site for the production of oil, gas, or geothermal energy. IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Amounts paid for casings, valves, pipelines, and other tangible equipment that have a salvage value cannot be expensed but must be capitalized, i.e., recovered either through depletion or depreciation. (And as discussed in the subsequent entry on percentage depletion, amounts expended to purchase a property are depleted using either percentage or cost depletion.) Geological and geophysical costs — exploratory costs associated with determining the precise location and potential size of a mineral deposit — are capitalized.

The option to expense IDCs applies to domestic properties, which include certain off-shore wells (essentially those in the territorial waters of the United States.); 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 cost depletion. An integrated oil company, generally a producer that also has refining and marketing operations, can expense only 70% of the IDCs — the remaining 30% must be amortized over a five-year period. Dry hole costs for either domestic or foreign properties may be expensed or capitalized at the discretion of the taxpayer.

For integrated producers, the excess of expensed IDCs over the amortizable value (over a 10-year period) is a tax preference item that is subject to the alternative minimum tax to the extent that it exceeds 65% of the net income from the property. Independent (non-integrated) producers include only 60% of their IDCs as a tax preference item. As noted above, instead of expensing, a taxpayer may choose to amortize IDCs over a five-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% of certain IDCs, subject to some limitations. If an operator has elected to amortize IDCs on a well that proves later to be a dry hole, the operator may deduct such costs as an ordinary loss. The taxpayer is not required to include these costs as an IDC tax preference item in computing
alternative minimum tax. If a property is disposed of prior to its exhaustion, any expensed IDCs are recaptured as ordinary income.

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% of the revenue

loss from this provision, IDCs typically account for between 75% and 90% 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% of total U.S. energy production in 1920 to 71.1% in 1970 (the peak year). Since the early 1970s, domestic crude oil production has fallen substantially. Coupled with reductions in income taxes and increased limits on expensing, the value of this subsidy has been substantially reduced.

Moreover, the alternative minimum tax and additional 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.

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. However, the exemption for working interests in oil and gas from the passive loss limitation rules still creates opportunities for tax shelters in oil and gas investments.

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 endorsed 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 perceived 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%; the remaining 15% of IDCs had to be amortized over 3 years.

The Deficit Reduction Act of 1984 limited expensing for integrated producers to 80% of IDCs. This was further limited to 70% by the Tax Reform Act of 1986, which also repealed expensing of 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% (70% after 1993) and suspended the special energy deduction through 1998. Recent comprehensive energy policy legislation (H.R. 6) has proposed expansion of certain subsidies for oil and gas, including a proposal to amortize geological and geophysical costs over two years.

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 independent producers.

Expensing rather than capitalizing these costs allows taxes on income to be effectively eliminated. As a capital subsidy, however, expensing is economically inefficient because it promotes investment decisions that are based on tax considerations rather than inherent economic considerations.

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 in the long run. 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. For the goal of enhancing energy security, one alternative approach 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]

Fiscal year	Individuals		Corporations		Total	
	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels	Oil and Gas	Other Fuels
2005	(1)	(1)	0.5	(1)	0.5	(1)
2006	(1)	(1)	0.5	(1)	0.5	(1)
2007	(1)	(1)	0.5	(1)	0.5	(1)
2008	(1)	(1)	0.6	(1)	0.6	(1)
2009	(1)	(1)	0.6	(1)	0.6	(1)

(1)Less than $50 million.

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 a mineral reserve, which depreciates due to the physical and economic depletion or exhaustion as the mineral is recovered (section 611). Depletion, like depreciation, is a form of capital recovery: An asset, the mineral reserve itself, is being expended in order to produce income. Under an income tax, such costs are deductible.

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.*, revenue — from the sale of the mineral. Under this method, total deductions typically exceed, despite the limitations, the capital invested to acquire and develop the reserve.

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% and is limited to average daily production of 1,000 barrels of oil, or its equivalent in gas. For producers of both oil and gas, the limit applies on a combined basis. For example, an oil producing company with 2003 oil production of 100,000 barrels, and natural gas production of 1.2 billion cubic feet (the equivalent of 200,000 barrels of oil) has average daily production of 821.92 barrels (300,000 ÷ 365 days). Percentage depletion is not available to large integrated major oil companies — it is available only for independent producers and royalty owners. An independent producer is one that does not have refinery operations that refine more than 50,000 barrels of oil per day, and does not have retail oil and gas operations grossing more than $5 million per year. Beginning in 1990, the percentage depletion rate on production from marginal wells — oil from stripper wells (those producing no more than 15 barrels per day, on average), and heavy oil — was raised. This rate starts at 15% 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%). This higher rate is also limited to independent producers and royalty owners, and for up to 1,000 barrels, determined as before on a combined basis (including non marginal production).

Percentage depletion is limited to 65% of the taxable income from all properties for each producer. A second limitation, the 100% net-income limitation, which applied to each individual property rather than to all the properties, was retroactively suspended for oil and gas production from marginal wells by the Working Families Tax Relief Act of 2004 (H.R. 1308) through December 31, 2005. From 1998-2003, the 100% net-income limitation had also been suspended, but this expired on January 1, 2004. Since 1990, transferred properties have been eligible for percentage depletion. The difference between percentage depletion and cost depletion is considered a subsidy. It was once a tax preference item for purposes of the alternative minimum tax, but this was repealed by the Energy Policy Act of 1992 (P.L. 102-486)

The percentage depletion allowance is available for many other types of fuel minerals, at rates ranging from 10% (coal, lignite) to 22% (uranium). The rate for regulated natural gas and gas sold under a fixed contract is 22%; the rate for geo-pressurized methane gas is 10%. Oil shale and geothermal deposits qualify for a 15% allowance. The net-income limitation to percentage depletion for coal and other fuels is 50%, as compared to 100% for oil and gas. Under code section 291, percentage depletion on coal mined by corporations is reduced by 20% of the excess of percentage over cost depletion.

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 additional incentives to increase investment, exploration, and output, especially of oil and gas. Oil and gas output, for example, rose from 16% of total U.S. energy production in 1920 to 71.1% of 1970 (the peak year).

The combination of this subsidy and the deduction of intangible drilling and other costs (see previous entry) represented a significant boon to mineral producers who were eligible for both. The deduction of intangible drilling costs allows up to three-quarters of the original investment to be "written off" immediately, and under the percentage depletion allowance 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, and declining oil production, means that the value of this tax subsidy has been greatly reduced in the last 30 years. The reduction in the depletion allowance to 15% in 1984 means that independent producers benefit from it much less than they used to, although independents have increased their share of total output, and they qualify for the higher depletion rate on marginal production. Most recently, high oil and gas prices may have raised somewhat the subsidy value of percentage depletion to the independents. In addition, cutbacks in other tax benefits and additional excise taxes have raised effective tax rates in the mineral industries, although independent oil and gas producers continue to be favored. However, the exemption for working interests in oil and gas from the passive loss limitation rules still creates opportunities for tax shelters in oil and gas investments.

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, in an average year

more than half the percent revenue loss is a result 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 by supply and demand 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 a 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 5% 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% of net income in 1924. Due to the administrative complexity and arbitrariness of the method, 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%.

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%, but Congress disagreed. In 1969, the top depletion rates

were reduced from 27.5% to 22%, 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% for 1984 and beyond. This was in response to the Arab oil embargo of 1973-74, which caused oil prices to rise sharply. The continuation of percentage depletion for independents was justified by Congress on the grounds that independents had more difficulty in raising capital than the major integrated oil companies, 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%, 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. The Taxpayer Relief Act of 1997 suspended the 100% taxable income limitation for marginal wells for two years, and further extensions were made by the Ticket to Work and Work Incentives Improvement Act of 1999 and the Job Creation and Worker Assistance Act of 2002. The On Working Families Tax Relief Act of 2004 (H.R. 1308) retroactively suspended the 100% net-income limitation through December 31, 2005.

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 economically inefficient. It incorrectly measures the income of qualifying independent oil and gas producers, and it encourages excessive development of existing properties — the source of the depletion benefit — over exploration for new ones, which will not produce a flow of depletion benefits until actual output results. 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 be used for depreciation deductions in excess of investment.

Percentage depletion for oil and gas subsidizes independent producers 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 protection of 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 from an economic perspective income tax integration would be a more appropriate policy to address this problem.

To address national security concerns, one alternative is an oil stockpile program such as the Strategic Petroleum Reserve.

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Energy

TAX CREDIT FOR ENHANCED RECOVERY COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	0.2	0.3
2006	0.1	0.3	0.4
2007	0.1	0.3	0.4
2008	0.1	0.3	0.4
2009	0.1	0.4	0.5

Authorization

Section 43.

Description

Section 43 provides for a 15% 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 an oil reservoir, and use heat to extract oil that is too viscous to be extracted by conventional primary and secondary water-flooding techniques.

Nine tertiary recovery methods listed by the Department of Energy in section 212.78(c) of its June 1979 regulations qualify for the tax credit: miscible fluid displacement, steam-drive injection, micro-emulsion 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 later.

Qualifying EOR costs include the following costs, which are associated with an EOR project: 1) the costs of tangible equipment — equipment that

would otherwise qualify for depreciation; 2) intangible drilling and development costs (*i.e.*, labor, supplies and repairs); and 3) the costs of the injectants. For purposes of the credit, the costs of the injectants include expenditures related to the use of a tertiary injectant as well as expenditures related to the acquisition (whether produced or acquired by the purchaser) of the tertiary injectant. The project must be located in the United States, and involve the application of sound engineering principles (as certified by a petroleum engineer).

Effective January 1, 2005, the cost of constructing a natural gas processing plant in the Alaska North Slope qualifies for the 15% EOR credit. The plant must be capable of processing at least 2 trillion Btu's of Alaskan natural gas into the natural gas pipeline system every day, and must produce carbon dioxide for reinjection into a producing oil or gas field.

The EOR credit is allowable provided that the average wellhead price of crude oil (using West Texas Intermediate as the reference) in the year before credit is claimed, is below the statutorily established threshold price of $28 (as adjusted for inflation since 1990), in the year the credit is claimed. Thus, with average wellhead oil prices for 2003 ($27.56) below $36.27 ($28 times the inflation adjustment factor of 1.2952 for 2004), the EOR credit is fully available in 2004. The EOR credit is phased out over a $6 range, proportionately as the average wellhead price — this is referred to as the reference price — rises from the inflation-adjusted threshold price plus $6/barrel. Thus, had the price of West Texas intermediate oil been above $36.27 (when the phase-out range would have been $36.27-$42.27), the EOR credit for 2004 would have been reduced by the proportion this excess represented to $6. To illustrate, had oil prices averaged $39.27/barrel in 2003, the EOR credit would have been reduced by 50% [($39.27 - $36.27)/$6].

The EOR credit is nonrefundable, which means that it is limited to the amount of a taxpayer's regular tax liability. In addition, because the EOR credit is claimed as part of the general business credit, it is also subject to those limits, which generally reduce the economic value of the tax credit. Thus, the EOR credit may not be greater than a taxpayer's net income tax in excess of 25% of net regular tax liability above $25,000, or the tentative minimum tax. The cost of the property that may otherwise be deducted as depreciation, depletion, or amortization (as the case may be) is reduced by the amount of the credit. Alternative fuel production credits attributable to the property are also reduced by the EOR credit. Finally, the EOR credit cannot be claimed against the alternative minimum tax.

Impact

Conventional oil recovery methods typically succeed in extracting only about 30% of a reservoir's oil: 10% during the primary recovery stage; 20%

during the subsequent secondary recovery stage. This varies significantly depending on individual field characteristics. Some of the remaining oil can be extracted by unconventional recovery methods, such as EOR methods, but these methods are currently uneconomic at oil prices below about $28-30 per barrel because EOR is more costly than conventional oil recovery. The EOR credit reduces the cost of producing oil from older abandoned reservoirs relative to the cost of producing oil from new reservoirs, and creates an economic incentive to increase production of otherwise abandoned oil, which adds to the domestic supply of oil. About 60% of EOR projects use thermal techniques (these are primarily in California), nearly 40% use gas injection techniques, and less than 1% use chemical techniques.

Rationale

The EOR credit was enacted as part of the Omnibus Budget 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 unreliable 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. The Crude Oil Windfall Profits Tax of 1980 (P.L. 96-223) provided that some EOR costs would be deductible in the year incurred, rather than capitalized; prior to this legislation tax law treatment — whether EOR expenses should be deductible or capitalized — was unclear. The American Jobs Creation Act of 2004 (H.R. 4520) expanded the EOR credit to include Alaskan natural gas processing plant expenses. (Natural gas needs to be treated prior to injection into a pipeline to remove any propane, CO2, sulfur, and other contaminants, which hinder its ability to be transported via pipeline). This expansion was part of a broader package of tax incentives and loan guarantees for a natural gas pipeline from Alaska's North Slope to the Lower 48 states.

Assessment

EOR holds considerable promise for recovering billions of barrels of oil still residing in abandoned oil fields. Oil production in the United States, which peaked in 1970 and has since declined by about 50%, has continued to drop in recent years. 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.

U.S. production of oil by EOR methods has nearly doubled over the last 20 years, growing from about 450,000 barrels per day to nearly 800,000 barrels per day in 2003. At that level, EOR production comprises about 13%

of total domestic production. The smaller percentage decline in EOR oil output relative to conventional oil means that EOR oil output will grow somewhat over the next 10 years as a fraction of total domestic production. It is estimated, however, that nearly 400 billion barrels of oil (nearly half of the estimated total oil reserves in place and more than double cumulative U.S. production since the first oil well was discovered and produced) remain in abandoned reservoirs, significantly more than the known reserves of oil recoverable by conventional primary and secondary methods. Further, it is estimated that 10% of that oil consists of known recoverable reserves that could 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 diminished relative importance of petroleum in the general economy, the weakened market power of the Organization of Petroleum Exporting Countries (OPEC), and increased competitiveness in world oil markets. Increased domestic oil production lessens short-term dependency but encourages long-term dependency as domestic resources are depleted. EOR oil is more expensive to recover than conventional oil but is a relatively inexpensive way to add additional oil reserves.

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Energy

TAX CREDIT FOR PRODUCTION OF NON-CONVENTIONAL FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.2	1.0	1.2
2006	0.3	1.1	1.4
2007	0.3	1.3	1.6
2008	0.1	0.5	0.6
2009	([1])	0.1	0.1

([1]) Less than $50 million

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, gaseous, and solid fuels produced from alternative energy sources, and sold to unrelated parties. 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 above $23.50 (in 1979 dollars) over a $6 range (i.e., the inflation-adjusted $23.50 plus $6).

Both the credit and the phase-out range are adjusted for inflation (multiplied by an inflation adjustment factor) since 1979. With an inflation adjustment factor of 2.1336 (meaning that inflation, as measured by the Gross National Product deflator, has more than doubled since 1979), the credit for 2003 production is $6.40 per barrel of oil equivalent, which is the amount of the qualifying fuel that has a British thermal unit content of 5.8 million. The credit for gaseous fuels is about $1.13 per thousand cubic feet (mcf). The credit for tight sands gas is not indexed to inflation; it is fixed at the 1979 level of $3 per barrel of oil equivalent (about $0.50 per mcf). With the reference price of oil, which was $27.56/barrel for 2003, below the inflation adjustment phase-out threshold oil price of $50.13 for 2003 ($23.50 multiplied by 2.1333), the full credit of $6.40 per barrel of equivalent was available for qualifying fuels.

Qualifying fuels include synthetic fuels (either liquid, gaseous, or solid) produced from coal, and gas produced from either geopressurized brine, Devonian shale, tight formations, or biomass. Synthetic fuels from coal, either liquid, gaseous, or solid, are also qualifying fuels provided that they meet the statutory and regulatory requirement that they undergo a significant chemical transformation, defined as a measurable and reproducible change in the chemical bonding of the initial components. In most cases, producers apply a liquid bonding agent to the coal or coal waste (coal fines), such as diesel fuel emulsions, pine tar, or latex, to produce the solid synthetic fuel. The coke made from coal and used as a feedstock, or raw material, in steel-making operations also qualifies as a synthetic fuel as does the breeze (which are small pieces of coke) and the coke gas (which is produced during the coking process). Depending on the precise Btu content of these synfuels, the section 29 tax credit could be as high as $26/ton or more, which is a significant fraction of the market price of coal. Qualifying fuels must be produced within the United States.

The section 29 credit for gas produced from biomass, and synthetic fuels produced from coal or lignite, is available through December 31, 2007, provided that the facility was placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997. The section 29 credit used to apply to oil produced from shale or tar sands, and coalbed methane (a colorless and odorless natural gas that permeates coal seams and that is virtually identical to conventional natural gas). But for these fuels the credit terminated on December 31, 2002 (and the facilities had to have been placed in service (or wells drilled) by December 31, 1992).

The section 29 credit is offset (reduced) by other types of government subsidies that a taxpayer may benefit from: government grants, subsidized or tax-exempt financing, energy investment credits, and the enhanced oil recovery tax credit that may be claimed with respect to such project. Finally, the credit is nonrefundable and cannot be used to offset a taxpayer's alternative minimum tax liability. Any unused section 29 credits generally may not be carried forward or back to another taxable year. (However, under

the minimum tax section 53, a taxpayer receives a credit for prior-year minimum tax liability to the extent that a section 29 credit is disallowed as a result of the operation of the alternative minimum tax.)

Impact

The production tax credit is intended to reduce the marginal (and average) costs of producing the qualifying alternative fuels so as to be profitable enough to compete with conventional fuels. For those fuels whose cost reductions (and increased rates of return) are sufficiently large, the resulting price effects could encourage a substitution of the alternative fuels for the more conventional fuels. To the extent that these effects stimulate the supply of liquid fuels such as shale oil or heavy oil, the resulting substitution effects lead to a reduction in the demand for petroleum, and a reduction in imported petroleum (the marginal source of oil), which would work toward the credit's original purpose: enhancing energy security.

However, to date, the credits have not stimulated production of fuels, such as shale oil or heavy oil, that would substitute for petroleum. These and other non-conventional fuels are still generally too costly to be profitably produced at current oil prices. With the exception of coalbed methane, tight sands gas, and "synfuels" from coal, the credit's effects have, generally, not been sufficient to offset the disincentive effects of relatively low and unstable oil prices, and the high cost of alternative fuels production. Recently high crude oil prices (over $50/barrel in October 2004) might, if they remain high and stable, render some of the nonconventional petroleum fuels competitive, which might stimulate production even without a tax credit.

The primary supply effects of the section 29 tax credit have been on non-conventional gases, particularly of coalbed methane, tight sands gas, and shale gas. The credit has increased drilling for these gases, and added to total natural gas reserves. In the case of coalbed methane the combined effect of the large tax credit (the credit of $1.00 per mcf was, at times, 100% of natural gas prices) and declining production costs (due to technological advances in drilling and production techniques) has helped boost production from 0.1 billion cubic feet in 1980 to 1.6 trillion cubic feet in 2003. More recently, favorable rulings by the Internal Revenue Service have increased the production of solid "synthetic" fuels from coal, which has increased the supply of these fuels for use as a feedstock in steel-making operations and in electricity generation. The credit for coalbed methane benefits largely oil and gas producers, both independent producers and major integrated oil companies, and coal companies. Many oil and gas companies, such as DTE Energy, Phillips Petroleum, and the Enron Corporation, used section 29 tax credits to help reduce their effective tax rates.

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 United States has a large resource base of unconventional energy resources, including shale oil and unconventional gases such as tight sands gas and coalbed methane. According to the U.S. Geological Survey and the Minerals Management Service, estimated U.S. recoverable reserves of unconventional gases exceed those of any other category of gas, including estimates of conventional reserves, comprising 35% of the total.

The section 29 credit's "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 (P.L. 100-647). That deadline was extended to December 31, 1991, as part of OBRA, the Omnibus Budget Reconciliation Act of 1990 (P.L.101-508). The Energy Policy Act of 1992 (P. L.102-486) extended coverage for facilities for biomass and fuels produced from coal 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. In Rev. Proc. 2001-30 and 2001-34, the Internal Revenue Service implemented regulations that permitted greater production of solid synthetic fuels from coal to qualify for the section 29 credit. Some have questioned the scientific validity of these rules and have christened the process "spray and pray."

A significant expansion and extension of the section 29 tax credit has been proposed as part of comprehensive energy policy legislation (H.R. 6, 108th Congress and various other versions of such legislation.) But, with the exception of the addition of refined coal (which was originally part of the sections of comprehensive energy legislation that would have amended the section 29 credit) to the section 45 renewable electricity tax credit, these

proposals have not been enacted. (A discussion of the section 45 tax credit appears elsewhere in the Energy section of this compendium.)

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, and of tight sands gas and shale gas. Due to recently tight natural gas markets and relatively high prices, these additional supplies might have kept natural gas prices from rising even more. In general, much 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. More recently, additional supplies of domestic unconventional gases may be substituting for imported LNG (liquefied natural gas). Declining conventional natural gas production in Texas, New Mexico, Oklahoma, Louisiana, and the Gulf of Mexico has been partially offset by increases in Colorado and Wyoming, reflecting the growing prominence of unconventional sources such as tight sands, shales, and coalbeds. Unconventional gas production, currently at nearly 5 trillion cubic feet (1/4 of total domestic production), is projected to increase at the fastest rate of any other type of natural gas, largely because of expansion of unconventional gases from the Rocky Mountain region.

Economists see little justification for such a credit on grounds of allocative efficiency, distributional equity, or macroeconomic stability. From an economic perspective, although tax incentives are generally less distortionary than mandates and standards, critics maintain that the section 29 tax credit compounds 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 have led to calls for either an oil import tax or a petroleum stockpile such as the Strategic Petroleum Reserve.

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. Hydraulic fracturing of coal beds, and other environmental effects from the production of coalbed methane and other unconventional gases, is coming under greater scrutiny.

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Energy

TAX CREDITS FOR ALCOHOL AND BIODIESEL FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	([1])	([1])
2006	-	([1])	([1])
2007	-	([1])	([1])
2008	-	([1])	([1])
2009	-	([1])	([1])

([1])Less than $50 million.

Authorization

Section 38, 40, 87, 196, 6426.

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 existing alcohol mixture (or blender's) credit and the pure alcohol fuel credit is 52¢ per gallon of ethanol (60¢ for methanol) of at least 190 proof, and 38.52¢ for each gallon of alcohol between 150 and 190 proof (45¢ for methanol). No credit is available for alcohol that is less than 150 proof. The 52¢ credit is reduced to 51¢ for 2005-2007 (37.78¢ for ethanol between 150 and 190 proof). The alcohol mixtures credit is available to the blender (who typically is either the refiner, wholesale distributor or marketer); the pure (or "neat") alcohol credit may only be claimed by the consumer or retail seller.

Current tax law also provides for a tax exemption that is equivalent to the fuel ethanol tax credits, and which may be claimed in lieu of the tax credits.

For 90/10 mixtures (90% gasoline, 10% ethanol) the exemption is 5.2¢ per gallon of the blend — the blend is taxed at 13.2¢ per gallon, 5.2¢ less than the full rate of 18.4¢ per gallon on gasoline blends. The exemption may also be claimed against the 24.4¢ per gallon tax on diesel blends — the tax rate would be 19.2¢ after the exemption — but very little, if any, of these blends are actually produced. The 5.2¢ exemption is pro-rated for blends of 7.7% and 5.7% ethanol and gasoline, proportions necessary to comply with requirements for oxygenated and reformulated gasolines under the Clean Air Act. The current 5.2¢ exemption, which is equivalent to 52¢ per gallon of ethanol, is generally claimed up front on sales of gasoline loaded onto tanker trucks. Blenders prefer to claim the exemption, rather than the tax credit, because its benefits accrue immediately upon the purchase of the fuels for blending rather than when the tax return is filed. Also, the exemption is not treated as taxable income, whereas the credits have to be reported as taxable income, and are thus taxed.

For fuel ethanol, current law also provides for a production tax credit in the amount of 10¢ per gallon of ethanol produced, and sold for use as a transportation fuel. This credit, called the "small ethanol producer credit," is limited to the first 15 million gallons of annual alcohol production for each small producer, defined as one with a production capacity of under 30 million gallons. This is in addition to any blender's tax credit claimed on the same fuel. The small ethanol producer's tax credit currently does not flow through to the members of a farmers' cooperative, which means that the current system of ethanol incentives effectively is of no benefit to such cooperatives.

A 1990 IRS ruling allowed mixtures of gasoline and ETBE (Ethyl Tertiary Butyl Ether) to qualify for the 52¢ 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 (CAA). Currently, MTBE is the preferred oxygenate, although ethanol is also used in some regions of the United States, particularly in the Midwest. MTBE has, however, recently been linked to groundwater contamination and is banned in some states.

The alcohol fuels tax credits must be included as income, and are taxable, under section 87. Also, the alcohol credits are components of the general business credit and are subject to the limitations and the carry- back and carry-forward rules of that credit. Under tax code section 196, any credit amount that is unused because of these limitations may be claimed as a deduction in the subsequent tax year.

Effective on January 1, 2005, the existing blender's and "neat" alcohol tax credits are part of a reformed system of tax incentives for fuel ethanol called the "volumetric ethanol excise tax credit." This new system will 1)

repeal the exemptions, 2) allow the existing alcohol fuel mixtures credits to be claimed against the full excise taxes, and 3) create two new tax credits for biodiesel: a credit for biodiesel fuel mixtures (blends of biodiesel and petroleum diesel) and a credit for unblended (pure) biodiesel either used or sold at retail by the taxpayer. The biodiesel mixtures credit is 50¢ per gallon of biodiesel made from recycled oils and $1.00 per gallon of biodiesel made from virgin oils — so called "agri"-biodiesel. Currently, no such credit for biodiesel exists under current law, and biodiesel used as a transportation fuel is taxed at the full rate of 24.4¢ per gallon. Thus, effective on January 1, 2005, the reduced rates of excise taxes (i.e., the exemptions) for alcohol-blended fuels are repealed — blenders will pay the full rate of tax on gasoline and diesel purchases (18.4¢ and 24.4¢, respectively) — and claim the respective tax credits on each gallon of ethanol and biodiesel intended to be blended with gasoline and petroleum diesel, respectively. The sum of the tax credits is to be applied against any applicable excise tax liability — either the 18.4¢ per gallon or 24.4¢ per gallon tax on gasoline or diesel, respectively. Taxpayers are to file a claim for a refund of these tax credits, which must be paid within 45 days, after which interest begins to accrue. Both the restructured fuel ethanol tax credits and the new biodiesel tax credits are part of the general business credit and subject to its limits. Also, the taxability of the credits as income would continue to apply; they would also apply to the new biodiesel tax credits.

The provisions restructuring the tax incentives for fuel ethanol and introducing the biodiesel tax credits are effective for fuel produced, sold, or used after December 31, 2004 and before January 1, 2007 for biodiesel and before January 1, 2011, for fuel ethanol. This means that the biodiesel tax credits, and the fuel ethanol blender's tax credits expire on these dates, respectively.

In all cases, 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 either the current (or the restructured) tax credits or the current exemption. Most economically feasible methanol is derived primarily from natural gas; methanol from renewable resources is generally too costly to produce economically. The effect of this is to exclude most of actual methanol production from the tax incentives. However, methanol derived from methane gas produced from landfills is not alcohol produced from natural gas, and is included for credit purposes. About 90% of current biomass ethanol production is derived from corn. Most biodiesel is made from either recycled or virgin vegetable oil, but biodiesel made from animal fats also qualifies for the biodiesel tax credits. Agri-biodiesel is derived from virgin oils including esters derived from corn, soybeans, sunflower seeds, and other agricultural products.

Impact

The fuel ethanol tax subsidies increase the demand for ethanol, which further raise its price (on a before-tax basis) and increase the output of ethanol. After taxes, however, the net price of ethanol to the blender is comparable to the wholesale price of gasoline and to other blending components. Thus, the effect of the subsidies is to create a market for ethanol producers, such as Archer Daniels Midland, who supply the ethanol to the blenders. It should be noted that although ethanol producers do not claim the tax credits, the economic benefit of the subsidies accrues primarily to them. Most of the alcohol fuel produced in the United States is ethanol; about 90% of it is produced from corn, which is the cheapest feedstock. Large quantities of methanol are also produced but almost all of that comes from natural gas and is thus disqualified from the tax credit. Very little methanol is produced from qualifying biomass, as it is too costly.

Production of ethanol as a motor fuel, most of which is a gasoline blend, has increased from about 40 million gallons in 1979 to 1.7 billion gallons in 2001, and to 2.8 billion gallons in 2003. This represents about 2.1% of the gasoline consumption of nearly 133 billion gallons, but at 10%, 7.7%, and 5.7% blends, ethanol is used in a significant fraction of the total gasoline market. The initial growth in ethanol production was mostly due to the federal excise tax exemption, the excise tax exemptions at the state and local level, tariffs on imported ethanol, and to the high oil prices in the late 1970s and early 1980s, rather than to the alcohol fuels tax credits, which have been little used. More recently environmental policy — Clean Air Act requirements for reformulated and oxygenated fuels — and the banning of MTBE have also increased demand for fuel ethanol.

Allowing ETBE to qualify for the blender's tax credit, the banning of MTBE, and the retention of the oxygenate requirement is projected to further 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 the U.S. corn crop allocated to ethanol production above the current 10%. It would also increase federal revenue losses from the alcohol fuels credits, which heretofore have been negligible due to blenders' use of the exemption over the credit.

Under the modified tax incentives, the ethanol blender's tax credits against the excise tax are roughly equivalent to the value of the excise tax exemption on each gallon of ethanol, but the tax restrictions under the general business credit, and the inclusion of the credit itself in income, will reduce the economic value of the tax credits. For biodiesel, however, which had no tax subsidies prior to the restructuring, the new tax credits are potentially of significant economic benefit, even with the requirement that they be taxable income.

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. Subsequent tax law changes have provided a prorated exemption to blends of 7.7% and 5.7% alcohol, so that ethanol used to meet the CAA requirements for reformulated and oxygenated gasolines receives the maximum tax benefit. Under the restructured incentives, these prorated exemptions will no longer be used.

The Congress wanted the credits to provide incentives for the production and use of alcohol fuels in mixtures that contained less than 10% 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. Ethanol-blended gasoline leads to greater reductions in carbon monoxide than does MTBE-blended gasoline. Ethanol-blended gasoline, however, has relatively higher evaporative emissions, as compared with reformulated gasoline with MTBE, which cause increases in the ozone-forming potential of volatile organic compounds, which leads to increased ozone (smog) formation.

Both the credits and excise-tax exemptions were enacted to encourage the substitution of alcohol fuels produced from renewables for petroleum-based gasoline and diesel. The underlying policy objective is, as with many 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. About 1 billion bushels of corn per annum are used to produce fuel ethanol, over 10% of the total corn crop. The increased demand for corn will raise the price of all corn and increase annual income from corn farming by at much as $5 billion or more. The rationale for the biodiesel tax credits is to provide tax incentives to create an environmentally friendly substitute for conventional diesel fuel, while also creating additional markets for farm products.

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¢ per gallon for alcohol that was 190 proof or more, and 30¢ per gallon for alcohol between 150 and 190 proof. The credits were increased in 1982 and 1984. The Omnibus Reconciliation Act of 1990 (P.L. 101-508) reduced the credits to 54¢ and 40¢ and introduced the 10¢ per-gallon small ethanol producer credit. The Transportation Equity Act for the 21st Century (P.L. 105-178) reduced the blender's tax credit from 54¢ credit to its current rate of 52¢, and to 51¢ beginning in 2005.

The American Jobs Creation Act of 2004 (P.L. 108-357) reformed the tax incentives for fuel ethanol, by, in effect, treating the tax credits as if they were payments of excise tax liability. The rationale for the restructuring was to increase revenues for the Highway Trust Fund (HTF). Consumption of fuel ethanol blends results in revenue losses to the HTF in the amount of the 5.2¢ exemption times the quantity of fuel ethanol blends used. In addition, under tax code sections enacted in 1990, 2.5¢ of the taxable portion of the tax (the 13.2¢ for 90/10 fuel ethanol blends) was retained in the general fund. Thus, in total, the HTF loses, under current law, 7.7¢/gallon of fuel ethanol blends (5.2¢ plus 2.5¢). Under the restructured incentives, tax revenue losses accrue to the general fund, rather than the HTF. The American Jobs Creation Act of 2004 also introduced the biodiesel fuel tax credits, and allowed, for the first time, the small ethanol producer's tax credit to flow through to members of a farmer's cooperative.

Assessment

The alcohol fuels tax credits were enacted as part of President Carter's National Energy Program to increase the development and use of a domestic renewable fuel as a substitute for imported petroleum motor fuels, which account for the bulk of petroleum consumption and imports. The subsidies 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, liquefied petroleum gas, compressed natural gas, or electricity — that could theoretically substitute for gasoline and diesel. Alcohol fuel is a more costly fuel or fuel additive, as compared with alternatives such as MTBE, especially when total resource costs, including revenue losses, are factored in. Alcohol fuels also require substantial energy to produce, thereby diminishing the net overall conservation effect.

These incentives originated as energy security measures — reducing dependence on petroleum imports — but their effects in expanding farm incomes (due to the increase in corn demand, and a higher corn price for all corn output) has not been overlooked by policymakers. To the extent that the credits induce a substitution of domestically produced ethanol for petroleum based motor fuels they reduce petroleum imports and provide some environmental gains, although not necessarily more than other alternative fuels. However, the significance of this has been questioned because of the high energy intensity of ethanol production technologies. So far, it is the excise tax exemptions, rather than the credits, that have provided these stimulative effects so far.

At 52¢ per gallon of alcohol, the subsidy is approximately $22 per barrel of oil displaced, which, up until recently, has been similar to the average domestic oil prices (for example, crude oil prices averaged $27.56 in 2003). Tax subsidies are generally an inefficient way of dealing with energy

security or environmental concerns, and this is also the case with the alcohol fuels tax subsidies, which do not directly address the external costs of petroleum motor fuels production, use, and importation. Providing tax subsidies for one type of fuel over others could further 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 ethanol or ETBE in place of its lower-cost alternative, MTBE. This substitution would reduce imports of MTBE and improve the trade balance, and lessen the threat of MTBE groundwater contamination, 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
2005	0.1	0.1	0.2
2006	0.1	0.1	0.2
2007	0.1	0.1	0.2
2008	0.1	0.1	0.2
2009	0.1	0.1	0.2

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 before 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 would likely 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.

Even if a case can be made for a federal subsidy of energy production facilities based on underinvestment at the State and local level, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, those issued for energy production facilities increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the range 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
2005	([1])	-	([1])
2006	([1])	-	([1])
2007	([1])	-	([1])
2008	([1])	-	([1])
2009	([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. An energy conservation measure is any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit.

To the extent that an energy conservation expenditure by a taxpayer qualifies for this exclusion, tax law denies any other tax benefits on the same expenditure, and requires a reduction in the adjusted basis of the property to which the energy conservation devices were added.

Impact

The exclusion reduces the total cost of energy-efficiency devices provided under programs by utilities to conserve energy, since, absent such provisions, the value of the rebates or other incentives provided by the utility would be included in the customer's gross income and subject to tax. Depending on the marginal tax rate of the customer, the tax saving could be as much as one-third the value of the subsidy. While beneficiaries will be primarily residential customers, the exclusion applies to dwelling units and so could also be claimed by businesses that own condominiums, or apartments, for example.

Rationale

An exclusion for residential customers had originally been enacted as part of the National Energy Conservation Policy Act of 1978 (P.L. 95-619). This exclusion was amended by Title V of the Energy Security Act of 1980 (P.L. 96-294), but had expired in mid-1989. The current provision was adopted as part of the Energy Policy Act of 1992 (P.L. 102-486), to encourage residential and business customers of public utilities to participate in energy conservation programs sponsored by the utility. The goal was to enhance the energy efficiency of dwelling units and encourage energy conservation in residential and commercial buildings. 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. In addition, the 1996 amendments dropped a part of section 136 that allowed the exclusion to apply to industrial energy conservation devices and technologies.

Assessment

Utilities sometimes use rebates and other incentives to induce their customers to invest in more energy efficient heating and cooling equipment, and other energy-saving devices. 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 would be more efficient to directly tax energy fuels than to subsidize a particular method of achieving conservation. From an economic perspective, allowing special tax benefits for certain types of investment or consumption results in a misallocation of resources.

There may be a market failure in tenant-occupied homes, if the tenant pays for electricity separately. In rental housing, the tenant and the landlord lack strong financial incentives to invest in energy conservation equipment and materials, even when the benefits clearly outweigh the costs, because the benefits from such conservation may not entirely accrue to the party

undertaking the energy-saving expenditure and effort. Builders and buyers may also lack sufficient information, a problem which is discussed below.

As a general rule, tenants are not going to improve the energy efficiency of a residence that does not belong to them, even if the unit is metered. They might if the rate of return (or payback) is sufficiently large, but most tenants do not occupy rental housing long enough to reap the full benefits of the energy conservation investments. Part of the problem is also that it is not always easy to calculate the energy savings potential (hence rates of return) from the various retrofitting investments. Landlords may not be able to control the energy consumption habits of renters to sufficiently recover the full cost of the energy conservation expenditures, regardless of whether the units are individually metered. If the units are individually metered, then the landlord would not undertake such investments since all the benefits therefrom would accrue to the renters, unless a landlord could charge higher rents on apartments with lower utility costs. If the units are not individually metered, but under centralized control, the benefits of conservation measures may accrue largely to the landlord, but even here the tenants may have sufficient control over energy use to subvert the accrual of any gains to the landlord. In such cases, from the landlord's perspective, it may be easier and cheaper to forego the conservation investments and simply pass on energy costs as part of the rents. Individual metering can be quite costly and while it may reduce some of the distortions, it is not likely to completely eliminate them, because even if the landlord can charge higher rents, he may not be able to recover the costs of energy conservation efforts or investments.

These market failures may lead to underinvestment in conservation measures in rental housing and provide the economic rationale for Internal Revenue Code (IRC) §136. Without such explicit exclusion, such subsidies would be treated as gross income and subject to tax. This exclusion, however, applies both to owner-occupied and to rental housing.

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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
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1]) Less than $50 million.

Authorization

Sections 46 and 48.

Description

Sections 46 and 48 provide for a non-refundable 10% 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, or steam (such as geysers). In the case of geothermal equipment used to generate electricity, only equipment up to the transmission stage qualifies for the credit.

The credits for solar and geothermal equipment are what remain of the business energy tax credits enacted under the Energy Tax Act of 1978. With the reforestation credit and the rehabilitation credit, they are the sole

exceptions to the repeal of the investment tax credits under the Tax Reform Act of 1986.

The business tax credits for solar and geothermal energy are components of the general business credits and are thus subject to the restrictions, limitations, and carryover provisions of that credit.

Investment in renewable energy technologies also qualifies for 5-year amortization, which provides quicker depreciation deductions, and, therefore, lower effective tax rates, than under alternative depreciation guidelines. And beginning on January 1, 2005, electricity generated by solar and geothermal technologies will qualify for the section 45 production tax credit (as described in a separate entry in the Energy section of this compendium). However, if an investment tax credit is claimed under sections 46 and 48, then rules against double-dipping prevent a section 45 production tax credit from being claimed on power generated from the equipment that would receive the investment tax credit.

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 generally much lower due to significantly higher capital costs, as compared to conventional energy equipment. Even with a 10% credit, and the recent technological innovations that have reduced costs, solar, geothermal, and other renewable energy technologies require relatively high and stable real oil prices in order to realize rates of return high enough to justify private investment. However, the quality of, and access to, a geothermal deposit can, in specialized cases, lower the production costs to below the costs of conventional energy. Sustained high real crude oil prices — both in nominal and real terms in 2004 such prices have been the highest since the early 1980s — would render these technologies more competitive.

Even during the early 1980s, when oil prices were higher than today in real terms, 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% 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.

Renewable energy accounted for about 6% of total energy supplies in 2003, with most of that coming from hydroelectric (2.8%) and biomass (2.9%). Together, solar and geothermal energy accounted for less than ½ of 1% of total energy supplies in 2003, again, due primarily to its high cost (and low rates of return) relative to that of conventional forms of energy investments.

Despite this, however, production and use of solar thermal collectors and photovoltaic systems has increased significantly over the last 20 years. 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. Shipments of medium-temperature collectors remained high through 1985, declining sharply thereafter. In addition to the 1986 drop in oil prices, the decline 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. Total shipments of solar thermal collectors in 2003 were 50.3% greater than in 1994, while shipments of photovoltaic cells and modules were 482% greater. The impressive gains in production and use of photovoltaic systems, some of which are exported, has been driven primarily by declines in manufacturing costs, but government policies promoting renewable energy have undoubtedly also played a significant role.

Most solar collectors are used in heating water and pools in residences. Business applications of solar equipment are still quite insignificant; some public utilities use them to generate electricity. However, public utilities do not qualify for the investment credit, although they will qualify for the production tax credit under section 45. Very little energy in the United States is generated from solar equipment — about 0.063 quadrillion Btu's in 2003, which was 1% of renewable energy consumption and 0.06% of total consumption.

Geothermal energy, which generated five times as much electricity as solar equipment in 2003, 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, in 2003 it accounted for 5% of total renewable energy consumed, and 0.3% of total U.S. energy consumed. 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 (P.L. 95-618), 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 U.S.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; others were extended by the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223) through 1985.

The 1980 Act extended the credit for solar and geothermal equipment, raised their credit rates from 10% to 15% , 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 (P.L. 99-514) retroactively extended the credits for solar, geothermal, ocean thermal, and biomass equipment through 1988, at declining rates.

The Miscellaneous Revenue Act of 1988 (P.L. 100-647) extended the solar, geothermal, and biomass credits at their 1988 rates — ocean thermal was not extended. The Omnibus Budget and Reconciliation Act of 1989 (P.L. 101-239) 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 (P.L. 102-227) extended the credits for solar and geothermal through June 30, 1992. The Energy Policy Act of 1992 (P.L. 102-486) made the credits, which now apply only to solar and geothermal equipment, permanent. The American Jobs Creation Act of 2004 (P.L. 108-357) allowed solar, geothermal and other types of renewable energy technologies to qualify for the section 45 electricity production tax credit.

Assessment

The business energy tax credits encourage investments in technologies that rely on clean, abundant, and, in the case of solar energy, unlimited renewable energy as substitutes for conventional fossil-fuel technologies that pollute the environment and contribute to dependence on imported petroleum. A major policy question is the cost — in terms of foregone federal tax revenue and distortions to the allocation of resources — in relation to the relatively small 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 where others arguably might provide greater benefit if they were subsidized instead. The environmental problems associated with production and consumption of fossil fuels can also be addressed with emissions taxes or emissions trading rights (as in the Clean Air Act), rather than with subsidies which are not only costly, but distortionary.

The high capital costs for alternative energy technologies, and market uncertainty, are not evidence of energy market failure, although they do act as barriers to the development and commercialization of these technologies. However, the incentive effects of the investment tax credits might lead to technological innovations that may reduce the costs of the subsidized technologies and make them competitive (or at least, less uneconomical).

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TAX CREDITS FOR ELECTRICITY PRODUCTION FROM WIND, BIOMASS, AND POULTRY WASTE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	0.2	0.3
2006	0.1	0.2	0.3
2007	0.1	0.3	0.4
2008	0.1	0.4	0.5
2009	0.1	0.4	0.5

Authorization

Section 45.

Description

Taxpayers are allowed a 1.5¢ credit, in 1992 dollars, per kilowatt-hour of electricity produced from qualified wind energy, "closed-loop" biomass, poultry waste, open-loop biomass, geothermal, solar, small irrigation power, and municipal solid waste. The latter covers two types of power facilities: either trash combustion facilities that burn trash directly to generate power, or landfill gas facilities that first produce methane, which is then burned to generate electricity. In the case of both types of municipal waste facilities, small irrigation power, and open-loop biomass facilities, the credit, in current dollars, is reduced by half. The electricity must be produced from a facility owned by a taxpayer and it must be sold to an unrelated third party.

In addition, beginning on October 4, 2004 section 45 provides a new tax credit of $4.375/ton, in 1992 dollars, for production of refined coal — not

for the electricity produced from the coal. (The refined coal tax credit was originally part of the proposed expansion of the §29 tax credit under comprehensive energy legislation, which is discussed in a separate entry in the Energy section of this compendium. That legislation has, at this writing, not been enacted).

Closed-loop biomass involves the use of plant matter, where plants are grown solely as fuel to produce electricity, and includes closed-loop biomass that is combined with either coal or open-loop biomass in a co-fired system. Open-loop biomass refers to a variety of waste materials and by-product sources (such as scrap wood or agricultural livestock waste and crop wastes) or timber wastes such as mill and harvesting residues, pre-commercial thinnings, slash, and brush. Poultry waste is defined as poultry manure and litter, but it also includes wood shavings, straw, rice hulls, and other bedding materials for the disposition of manure. Small irrigation power is basically a small (between 150 kilowatts and 5 megawatts of power) hydro-power system without a dam or water impoundment; it uses ditches and canals to generate power. Municipal solid waste is defined with reference to the Solid Waste Disposal Act. This basically includes most types of organic waste or garbage in landfills and municipal biosolids, sludge, and other residues removed by a municipal wastewater treatment facility. Refined coal is defined as a liquid, gaseous, or solid synthetic fuel produced from coal (and lignite) or high carbon fly ash, including such fuel when used as a feedstock. Qualifying coal must emit 20% less sulfur dioxide, and either 20% less mercury or nitrous oxide than comparable coal.

Generally, the credits are available for ten years beginning on the date the facility is first placed into service, which varies by type of qualifying property. However, in the case of open-loop biomass, geothermal energy, solar energy, small irrigation power, landfill gas facilities and trash combustion facilities, the credit is only available for 5 years from the placed-in-service date. Wind facilities must be placed-in-service from December 31, 1993, through December 31, 2005; closed-loop facilities from December 31, 1992, through December 31, 2005; poultry waste facilities from December 31, 1999 through December 31, 2005; open-loop facilities any time up to December 31, 2005 (which means that the credit for open-loop is provided to both new and existing facilities); and refined coal, from October 4, 2004, through December 31, 2008. For all other properties, facilities must be placed-in-service from January 1, 2005, through December 31, 2006.

Both the 1.5¢ electricity credit and the $4.375 coal credit are phased out as reference energy prices exceed certain thresholds. The 1.5¢ electricity credit is phased out as the reference price — the average annual contract price of electricity from the renewable source — rises over a 3¢ range, beginning with an inflation adjusted threshold of 8¢ per kilowatt. These amounts have been adjusted for inflation since 1992. For 1997, the reference price for wind was 6.4¢ per kilowatt hour; the reference price for biomass was 0¢ per kilowatt hour. For the year 2000, the reference prices were 4.95¢

for wind facilities and 0¢ for biomass and poultry waste facilities, respectively. For 2003 the reference price is 3.24¢ for wind facilities and 0¢ for biomass and poultry facilities. Thus, for 2003, the full inflation-adjusted credit of 1.8¢ per kilowatt hour is available. The IRS has announced that the credit for 2004 will remain at 1.8¢.

The $4.375 refined coal credit is phased out as the market price of refined coal exceeds certain threshold levels, which have yet to be determined. The threshold levels are defined by reference to the price of feedstock fuel used to produce the refined coal, which is adjusted for inflation beginning in 2002. Thus, if a producer of refined coal uses Powder River Basin coal as a feedstock, the threshold price is determined by reference to price of that coal; if the producer uses Appalachian coal, the threshold price is determined by reference to prices of Appalachian coal. The $4.375 refined coal credit is also adjusted for inflation since 1992. With an inflation-adjusted factor of 1.223 for 2003, the credit would have been $5.35 per ton had it been available then.

A facility that qualifies for the section 45 credits may also claim other government benefits, whether tax (the business energy credit or investment credit) or otherwise (including tax-exempt bonds). However, in all cases except for co-fired facilities, the section 45 credits are reduced by half — no such reduction is required of co-fired facilities, which means that qualifying systems may "double dip." In all cases, the credit is available to the owner of the facilities that produce the electricity or refined coal. In two exceptions — in the case of open-loop biomass, and co-firing facilities — the lessee operator may also claim the tax credit in lieu of the facility's owner.

The section 45 tax credits are components of the general business credit, and are subject to the rules governing the restrictions and carry-overs of that section of the tax code. Additionally, the section 45 tax credits may be claimed against the alternative minimum tax.

Impact

Both the renewable electricity credit and the new refined coal credits are production incentives — they reduce the marginal and average costs of generating electricity from renewable energy resources, and producing refined coal, as the case may be. The renewable electricity credit was originally intended to encourage the generation of electricity from wind and biomass by making such electricity more competitive with electricity generated from coal and other sources. However, until recently, very little electricity was actually generated from these types of renewable forms of energy.

Lately, wind power has grown fairly rapidly, due in large measure to the incentive effects of the credits, and, more recently, to the high price of

conventional fossil fuels for electricity generation: coal and natural gas. The extension and broadening of the renewable electricity production tax credit will likely support significant growth in generation from wind turbines and biomass co-firing.

In 2003, power from biomass, mostly open-loop types of waste such as waste wood, accounted for 17% of the total power generated from renewable energy, which was predominantly hydroelectric. There is little, if any, electricity generated from closed-loop biomass as it is uneconomic to grow plants exclusively under a "closed-loop" system, but the expansion of the §45 tax credit to "open-loop" biomass, i.e., to various types of agricultural waste and other biomass products, might further increase electricity from this renewable resource. By allowing existing power plants to claim the electricity credit for burning open-loop biomass, significant co-firing of existing facilities is induced. Some coal facilities are able to rapidly convert to co-firing with biomass, while others would take only a couple of years to make the required capital investment for conversion (about $200/kilowatt hour, which is lower than most alternatives).

The credit phase-outs are designed to remove the subsidy when the price of electricity becomes sufficiently high that a subsidy is no longer needed. The tonnage credit for refined coal is also a production tax credit, which reduces the marginal and average costs of producing refined coal as compared with conventional coal for electricity generation.

Rationale

This provision was adopted as part of the Energy Policy Act of 1992 P.L. 102-486). 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. The Ticket to Work and Work Incentive Improvement Act of 1999 (P.L. 106-170) extended the placed-in-service deadline from July 1, 1999, to January 1, 2002. It also added poultry waste as a qualifying energy resource. The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) extended the placed-in-service deadline to January 1, 2004. The Working Families Tax Relief Act of 2004 (P.L. 108-311) extended the placed-in-service dates for wind, closed-loop biomass and poultry waste facilities so that those placed into service after December 31, 2003, would also qualify for the tax credit. The American Jobs Creation Act of 2004 (P.L. 108-357) expanded the renewable electricity credit to open-loop biomass, geothermal, solar, small irrigation power, and municipal solid waste facilities, and created the production tax credit for refined coal. The expansion and liberalization of the section 45 tax credit embodied in the American Jobs Creation Act of 2004 is incorporated into recent comprehensive energy proposals, which have not been adopted.

Assessment

Federal tax policy, and other federal energy policy, has been critical to the development of renewable electricity, particularly wind power. In the late 1970's and 1980's the investment tax credits established under President Carter's National Energy Act (NEA) significantly increased wind power generation capacity. There was a slowdown in capacity in response to the repeal of these investment incentives, and a decline in real oil prices, but a lagged response after the enactment of the §45 production tax credit in 1992. The evidence also suggests that termination of the §45 tax credit to wind power due to the expiration of the placed-in-service date on January 1, 2004, created policy uncertainty, and probably adversely affected (if only temporarily) investment in the technology.

In addition to the §45 production tax credit, two other federal policies have contributed to the development of electricity from wind: PURPA, the Public Utility Regulatory Policies Act of 1978 (P.L. 95-617), and REPI, the renewable energy production incentive. PURPA, which was also enacted as part of President Carter's NEA, requires electric utilities to buy electricity from "qualifying facilities" at the utilities' avoided cost, the cost to the utility to generate or otherwise purchase electricity from another source; it has been one of the most significant laws for the development of wind power, landfill gas, and other renewable energy resources. The REPI, introduced in 1992 as part of the Energy Policy Act, is a financial incentive provided to tax exempt entities — tax exempt utilities (cooperatives), and state and local governments — for electricity generated from certain types of renewable energy resources. The incentive, which is 1.5¢/kWh of electricity generated, is the grant or spending subsidy equivalent of the §45 tax credit available for private taxable businesses.

The electricity production tax credit might be justified on the basis of reducing pollution — generating power from non-polluting energy resources, such as wind, which emit no pollutants. Generally, however, special tax (as well as other types of government) subsidies in one market to address external costs (pollution) created by other markets (the market for conventional fossil fuels) are seen as being inefficient and costly. Also, providing tax credits and deduction for certain types of investment or consumption, even if for environmentally clean energy technologies, depending on other market distortions and failures, may result in a misallocation of resources. An alternative way to reduce pollution is by directly taxing either the emissions, or the conventional energy resources that produce the emissions. Economic theory holds that this would allow the markets to choose the optimal response.

The provision cannot be justified on the grounds of reducing dependence on imported oil since very little renewable electricity substitutes for petroleum — most of it would substitute for either dirty coal and cleaner, but

still polluting, natural gas. (Also, there are more effective and efficient alternatives to address petroleum import dependence, such as stockpiling).

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INCENTIVES FOR SMALL REFINERS TO COMPLY WITH EPA SULFUR REGULATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	([1])	([1])
2006	-	([1])	([1])
2007	-	([1])	([1])
2008	-	([1])	([1])
2009	-	([1])	([1])

([1]) Less than $50 million.

Authorization

Sections 45H and 179B.

Description

Section 45H allows a small refiner to claim a tax credit for the production of low-sulfur diesel fuel in complying with Environmental Protection Agency (EPA) sulfur regulations. The credit is $2.10/barrel of low sulfur diesel fuel produced; it is limited to 25% of the capital costs incurred by the refiner to produce the low sulfur diesel fuel. The 25% limit is phased out proportionately as a refiner's capacity increases from 155,000 to 205,000 barrels per day.

Section 179B allows a small refiner to also claim a current year tax deduction, i.e., expensing, in lieu of depreciation, for up to 75% of the capital costs incurred in producing low-sulfur diesel fuel that is in compliance with EPA sulfur regulations. This incentive is also pro-rated for refining capacity between 155,000 and 205,000 barrels per day.

For both incentives, a small business refiner is a taxpayer who 1) is in the business of refining petroleum products, 2) employs not more than 1,500 employees directly in refining, and 3) has less than 205,000 barrels per day (averaged over the year) of total refining capacity. The incentives took effect retroactively beginning on January 1, 2003.

Impact

The low sulfur diesel tax credit lowers the average and marginal cost of producing low sulfur diesel fuel. Expensing allows capital costs to be deducted fully in the year incurred rather than over the useful life of the asset — the time period in which the asset generates returns. Under the current depreciation system (the Modified Cost Recovery System) refinery assets have a class life of 16 years and a recovery period of — they would otherwise be depreciated over — 10 years. Expensing of capital costs lowers the cost of capital, and increases the rate of return to, investing in refinery equipment for refining low sulfur diesel fuel. The combined effect of these two tax incentives is to increase the supply of low sulfur diesel fuel.

Rationale

Both incentives were introduced as part of the energy tax provisions in comprehensive energy legislation; they were enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357). The incentives compensate small refiners for the costs of complying with EPA's new tougher standards for diesel fuel under the Highway Diesel Fuel Sulfur Control Requirements, which begin to take effect in 2006. All refiners of diesel fuel, including imported diesel, have to comply with the new standards. By reducing production costs and capital costs of domestic refiners that meet the standards, the two tax incentives reduce the probability that small refiners would be forced out of business.

Assessment

Under an income tax system, there would be no production tax credits and the appropriate method of capital cost recovery would require the taxpayer to spread out depreciation deductions for the cost of the asset, based on its economic depreciation, i.e., the rate at which the asset depreciates in value over its useful life. Neither of the tax subsidies correct for market distortions and are intended only to compensate through the tax system for regulatory costs imposed by the EPA. They are thus distortionary. In theory, the distortions resulting from pollution externalities — the damages (health and environmental) resulting from the production and use of high-sulfur diesel fuel — would be more efficiently corrected with a tax on the producer of high-sulfur diesel fuel rather than a subsidy to producers of low-sulfur fuel.

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Energy

DEFERRAL OF GAIN FROM THE DISPOSITION OF ELECTRIC TRANSMISSION PROPERTY TO IMPLEMENT FEDERAL ENERGY REGULATORY COMMISSION RESTRUCTURING POLICY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	2.7	2.7
2006	-	2.1	2.1
2007	-	-0.2	-0.2
2008	-	-1.0	-1.0
2009	-	-1.0	-1.0

Authorization

Section 451.

Description

Section 451 permits taxpayers to elect to recognize any capital gain from the sale of qualifying electricity transmission property to an independent transmission company, pursuant to a Federal Energy Regulatory Commission (FERC) restructuring policy, evenly over eight years beginning with the year of the sale. The sale proceeds must be reinvested in other electricity assets within four years.

Impact

The recognition of gain over eight years, rather than in the year of sale, is a deferral, rather than a complete forgiveness, of tax liability — it is a

delay in the recognition of income, hence in the payment of tax. The economic benefit derives from the reduction in the present value of the tax owed below what the tax would otherwise be if it were required to be recognized in the year of sale.

Rationale

Under restructuring, certain jurisdictions and FERC are considering rules that would require the separate ownership of generation and distribution and transmission assets. However, in the vertically- integrated electric utility industry, investor-owned utilities own and operate a large segment of the nation's transmission infrastructure. The tax provision encourages the sale of transmission assets by vertically integrated electric utilities — the unbundling of electricity assets — to independent system operators or regional transmission organizations, who would own and operate the transmission lines. The provision is intended to improve transmission management and service, and facilitate the formation of competitive electricity markets. Without this incentive, any gain from the forced sale of transmission assets, pursuant to a FERC (or other regulatory body) restructuring policy would be taxed as ordinary income (i.e., at the highest rates) all in the year of sale.

This provision is one of several proposals, including several tax proposals, intended to promote restructuring of the electric utility industry away from the traditional monopoly structure and toward increased competition. The incentive was introduced as part of the energy tax provisions in comprehensive energy legislation; it was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357).

Assessment

The restructuring of the electric power industry would result in significant reorganization of power assets. In particular, it may result in a significant disposition of transmission assets and possibly, depending on the nature of the transaction, trigger an income tax liability and interfere with industry restructuring. Under an income tax system, the sale for cash of business assets subject to depreciation deductions triggers a tax on taxable income in the year of sale to the extent of any gain. Corporations pay capital gains on sales of capital assets, such as shares of other corporations. But gains on the sale of depreciable assets involve other rules. For example, sales of personal property, such as machinery, are taxed partly as capital gains and partly as ordinary income. The overall taxable amount is the difference between the sales price and basis, which is generally the original cost minus accumulated depreciation. That amount is taxed as ordinary income to the extent of previous depreciation allowances (depreciation is "recaptured").

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EXCESS OF PERCENTAGE OVER COST DEPLETION: NONFUEL MINERALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	0.1	0.2
2006	0.1	0.1	0.2
2007	0.1	0.1	0.2
2008	0.1	0.1	0.2
2009	0.1	0.1	0.2

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 % (for clay, sand, gravel, stone, etc.) to 22% (for sulphur, uranium, asbestos, lead, etc.).

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

Percentage depletion is limited to 50% of the net income from the property. For corporate taxpayers, section 291 reduces the percentage depletion allowance for iron ore by 20%. 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% 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%. This was due to the administrative complexity and arbitrariness, and due to its tendency to establish high discovery values, which tended to overstate 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% for sulphur, 15% for metal mines, and 5% 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%, but Congress disagreed. The Revenue Act of 1951 raised the allowance for coal to 10% 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%. The Tax Reform Act of 1986 raised the cutback in corporate allowances for coal and iron ore from 15% to 20%.

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 economically inefficient, encouraging excessive development of existing properties rather than exploration of new ones. 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.

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
2005	([1])	0.2	0.2
2006	([1])	0.2	0.2
2007	([1])	0.2	0.2
2008	([1])	0.2	0.2
2009	([1])	0.2	0.2

([1])Less than $50 million.

Authorization

Sections 162, 194,263(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, although the first $10,000 of reforestation costs may be expensed and the reaminder amortized over 84 months. 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."

The expensing of the first $10,000 of reforestation costs was added in 2004, and replaced an existing reforestation credit. The change was made to simplify the treatment of reforestation costs, and the basic purpose of the incentive is to encourage reforestation.

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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EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS: NONFUEL MINERALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1]) Less than $50 million.

Authorization

Sections 263, 291, 616-617, 56, 1254.

Description

Firms engaged in mining 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 exploration and development (E&D) costs. This is an exception to general tax rules.

In general, mining exploration costs are those costs incurred to ascertain the existence, location, extent, or quality of any potentially commercial deposit of ore or other depletable mineral prior to the development stage of the mine or deposit.

Development costs generally are those incurred for the development of a mine or other natural deposits after the existence of ores in commercially marketable quantities has been determined. Development expenditures

generally include those for construction of shafts and tunnels, and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such costs. Expensing of mine development costs may be taken in addition to percentage depletion, but it subsequently reduces percentage depletion deductions (*i.e.*, is recaptured).

Expensing of E&D costs applies only to domestic properties; E&D costs on foreign properties must be depreciated. The excess of expensing over the capitalized value (amortized over 10 years) is a tax preference item that is subject to the alternative minimum tax.

Impact

E&D costs for non-fuels minerals are not as large a portion of the costs of finding and developing a mineral reserve as is the case for oil and gas, where they typically account for between 75% and 90% of the costs of creating a mineral asset. Expensing of such costs is also less of a benefit than percentage depletion allowances. The Joint Committee on Taxation estimates total tax expenditures from expensing E&D costs at $300 million over the period 2002-2006.

Nevertheless they are a capital expense which otherwise would be depleted over the income-producing life of the mineral reserve. Combined with other tax subsidies, such as percentage depletion, they reduce effective tax rates in the mineral industry below tax rates on other industries, thereby providing incentives to increase investment, exploration, and output. This increases the supply of the mineral and reduces its price.

This tax expenditure is largely claimed by corporate 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 mine development expenditures was enacted in 1951 to encourage mining and reduce ambiguity in its tax treatment. The provision for mine exploration was added in 1966.

Prior to the Tax Reform Act of 1969, a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States (which subsequently reduced percentage depletion benefits), or to deduct up to $100,000 a year with a total not to exceed $400,000 of foreign and domestic exploration expenditures without recapture.

The 1969 act subjected all post-1969 exploration expenditures to recapture. The Tax Equity and Fiscal Responsibility Act of 1982 added mineral exploration and development costs as tax preference items subject to the alternative minimum tax, and limited expensing for corporations to 85%. The Tax Reform Act of 1986 required that all exploration and development expenditures on foreign properties be capitalized.

Assessment

E&D costs are generally recognized to be capital costs which, according to standard accounting and economic principles, should be recovered through 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 E&D costs provides a tax subsidy for capital invested in the mineral industry with a relatively larger subsidy for noncorporate producers.

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

Arguments have been made over the years to justify expensing on the basis of unusual investment risks, the distortions in the corporate income tax, strategic materials and national security, and protection of domestic producers (especially small independents).

Expensing is a costly and inefficient way to increase mineral output and enhance energy security. Expensing may also have adverse environmental consequences by encouraging the development of raw materials as opposed to recycled substitutes.

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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
2005	0.5	0.2	0.7
2006	0.5	0.2	0.7
2007	0.6	0.2	0.8
2008	0.6	0.2	0.8
2009	0.6	0.2	0.8

Authorization

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

Description

Interest income from 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 classified as private activity 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

Many observers suggest that sewage, water, and hazardous waste treatment facilities will be under-provided by state and local governments because the benefit of the facilities extends beyond State and local government boundaries. In addition, there are significant costs, real and perceived, associated with siting an unwanted hazardous waste facility. The federal subsidy through this tax expenditure may encourage increased investment as well as spread the cost to more potential beneficiaries, federal taxpayers.

Alternatively, subsidizing hazardous waste treatment facilities reduces the cost of producing waste if the subsidy is passed through to waste producers. When the cost of producing waste declines, then waste emitters may in turn increase their waste output. Thus, subsidizing waste treatment facilities may actually increase waste production. Recognizing the potential effect of subsidizing private investment in waste treatment, Congress eliminated a general subsidy for private investment in waste and pollution control equipment in the Tax Reform Act of 1986.

Even if a subsidy for sewage, water, and hazardous waste facilities is considered appropriate, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, bonds for these facilities increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest cost on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the range of assets available to individuals and corporations to shelter their income from taxation.

Selected Bibliography

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SPECIAL RULES FOR MINING RECLAMATION RESERVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([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, writing off these capital costs over the project life is appropriate from an economic perspective, paralleling 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. Because the provisions align taxable income and economic incomes closer together, it is debatable whether the exceptions should be regarded as tax expenditures at all.

Selected Bibliography

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SPECIAL TAX RATE FOR NUCLEAR DECOMMISSIONING RESERVE FUND

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	0.4	0.4
2006	-	0.5	0.5
2007	-	0.6	0.6
2008	-	0.7	0.7
2009	-	0.8	0.8

Authorization

Section 468A.

Description

Taxpayers who are responsible for the costs of decommissioning nuclear power plants (e.g., utilities) can elect to create reserve funds to be used to pay for decommissioning. The funds receive special tax treatment: amounts contributed to a reserve fund are deductible in the year made and are not included in the taxpayer's gross income until the year they are distributed, thus effectively postponing tax on the contributed amounts. Amounts actually spent on decommissioning are deductible in the year they are made. The fund's investments, however, are subject to a 20% tax rate – a lower rate than that which applies to most other corporate income. The amount that can be contributed to an account is limited to the lesser of the "cost of service" amount or an amount the Internal Revenue Service (IRS) determines would provide funding for the actual decommissioning costs, when they occur. The "cost of service" amount is the amount charged by utilities to customers as representing decommissioning costs.

Impact

As noted above, amounts contributed to a qualified fund are deductible in the year contributed but are taxed when withdrawn to pay for decommissioning costs. By itself, such treatment would constitute a tax deferral. However, full taxation of the investment earnings of the tax-deferred funds (the treatment that applied before 1992) would offset any benefit from the deferral. Accordingly, taken alone, only current law's reduced tax rate poses a tax benefit.

But an additional issue is whether the favorable tax treatment accorded to the funds simply compensates for other, unfavorable, tax treatment of decommissioning costs. Under current law there is a tax penalty associated with decommissioning because outlays for nuclear decommissioning are not permitted to be deducted until they are actually made. To the extent a taxpayer incurs a liability for those costs in advance of the outlays, this treatment constitutes a tax penalty similar to a reverse tax deferral; accurate treatment would require the costs to be deducted to reflect the loss in value of the plant as the required outlay becomes closer in time.

The likely economic effect of the reduced rates is to encourage outlays on nuclear decommissioning because the tax-saving funds are contingent on making such outlays. At the same time, however, to the extent that decommissioning costs are required by government regulations to be incurred with or without the special tax treatment, the reduced rates pose an incentive to invest in nuclear power plants. The benefit of the favorable tax treatment likely accrues to owners of electric utilities that use nuclear power and to consumers of the electricity they produce.

Rationale

The special decommissioning funds were first enacted by the Deficit Reduction Act of 1984 (Public Law 98-369), but the funds' investment earnings were initially subject to tax at the highest corporate tax rate (46%, at the time). The funds were established because Congress believed that the establishment of segregated reserve funds was a matter of "national importance." At the same time, however, Congress "did not intend that this deduction should lower the taxes paid by the owners...in present value terms," and thus imposed full corporate taxes on funds' investment earnings.

The reduced tax rate was enacted by the Energy Policy Act of 1992 (Public Law 102-486). The rate was reduced to provide "a greater source of funds" for decommissioning expenses. More recently, Congress in 2000 approved a measure that would eliminate the "cost of service" limitation on contributions to funds (leaving intact, however, the limit posed by the IRS determination.) The Clinton Administration proposed a similar measure in

its fiscal year 2001 budget, but the congressional bill was vetoed for reasons not related to decommissioning costs.

Assessment

As noted above, the reduced tax rates may provide a tax benefit linked with amounts contributed to qualified funds. The impact of the resulting tax benefit on economic efficiency depends in part on the effect of non-tax regulations governing decommissioning. Nuclear powerplants that are not appropriately decommissioned might impose external pollution costs on the economy that are not reflected in the market price of nuclear energy. To the extent government regulations require plants to be shut down in a manner that eliminates pollution, this "market failure" may already be corrected and any tax benefit is redundant. To the extent regulations do not require effective decommissioning, the tax benefit may abet economic efficiency by encouraging decommissioning outlays. The equity effect of the tax benefit is distinct from regulatory fixes of pollution. It is likely that decommissioning costs required by regulation are borne by utility owners and consumers of nuclear energy. The tax benefit probably shifts a part of this burden to taxpayers in general. Note also, however, that the reduced rates may simply compensate for the delayed deduction of decommissioning costs.

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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
2005	-	([1])	([1])
2006	-	([1])	([1])
2007	-	([1])	([1])
2008	-	([1])	([1])
2009	-	([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 rate base for rate-making purposes.

Impact

Before the Tax Reform Act of 1986 (TRA86), 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 TRA86 but reinstated by the Small Business Job Protection Act of 1996 for water and sewage facilities only.

Repeal of the special treatment resulted in increases in the amounts utilities charge their customers as contributions in aid of construction. Before TRA86, a utility would charge its customers an amount equal to the cost of installing a facility. After TRA86, 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 TRA86 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 TRA86, 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, Congress determined that there was an adequate public policy justification for providing the subsidy to these particular utilities.

Selected Bibliography

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Agriculture

EXCLUSION OF COST-SHARING PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([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 to be 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, the excess provides a subsidy primarily benefitting the landowner.

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

–, *General Explanation of the Revenue Act of 1978.*

Agriculture

EXCLUSION OF CANCELLATION OF INDEBTEDNESS INCOME OF FARMERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0·1	-	0·1
2006	0.1	-	0·1
2007	0·1	-	0·1
2008	0·1	-	0·1
2009	0·1	-	0·1

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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Agriculture

CASH ACCOUNTING FOR AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.7	0.1	0.8
2006	0.7	0.1	0.8
2007	0.6	0.1	0.7
2008	0.6	0.1	0.7
2009	0.6	0.1	0.7

Authorization

Sections 162, 175, 180, 446, 447, 448, 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 personal 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.

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Agriculture

INCOME AVERAGING FOR FARMERS AND FISHERMEN

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	-	([1])
2006	([1])	-	([1])
2007	([1])	-	([1])
2008	([1])	-	([1])
2009	([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 or commercial fishing. The taxpayer can designate all or a part of his current year income from farming as "elected farm income" or from fishing as "fishing business" income. The taxpayer then allocates 1/3 of the "elected farm income" or "fishing business" 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" or "elected fishing business" 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" or "fishing business" 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.

The tax computed using income averaging for farmers and fisherman does not apply for purposes of computing the regular income tax and subsequent determination of alternative minimum tax liability.

Impact

This provision provides tax relief primarily to taxpayers whose main source of income derives from agricultural production or commercial fishing. 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 believed 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.

The American Jobs Creation Act of 2004 expanded income averaging to include commercial fisherman. It also coordinated income averaging with the individual alternative minimum tax so that the use of income averaging would not cause farmers or fishermen to incur alternative minimum tax liability.

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 or commercial fishing 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.

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FIVE-YEAR CARRYBACK PERIOD FOR NET OPERATING LOSSES ATTRIBUTABLE TO FARMING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1])Less than $50 million.

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. (The Job Creation and Workers Assistance Act of 2002 temporarily extended the net operating loss carryback period to 5 years for losses arising in taxable years ending in 2001 and 2002 for businesses that normally have a 2 or 3 year loss carryback.) Current law, however, permits losses attributed to a farming business (as defined in section 263A(e)(4)) to 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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EXEMPTION OF CREDIT UNION INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	1.4	1.4
2006	-	1.5	1.5
2007	-	1.5	1.5
2008	-	1.6	1.6
2009	-	1.6	1.6

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 exempt from Federal income taxes. If this exemption were 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 20 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. On March 16, 2004, Donald E. Powell, Chairman of the Federal Deposit Insurance Corporation, stated that "credit unions ought to pay taxes."

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.

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EXCLUSION OF INVESTMENT INCOME ON LIFE INSURANCE AND ANNUITY CONTRACTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	25.0	2.4	27.4
2006	25.7	2.5	28.2
2007	26.4	2.6	29.0
2008	27.2	2.6	29.8
2009	27.9	2.7	30.6

Authorization

Sections 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 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. Inside build-up exclusion is one of the key factors contributing to the surge in the number of corporate-owned life insurance (COLI) policies, which are often criticized for being a tax sheltering tool.

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
2005	-	0.1	0.1
2006	-	0.1	0.1
2007	-	0.1	0.1
2008	-	0.1	0.1
2009	-	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
2005	-	1.8	1.8
2006	-	1.9	1.9
2007	-	2.0	2.0
2008	-	2.0	2.0
2009	-	2.1	2.1

Authorization

Sections 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 PROPERTY LOSS RESERVES FOR PROPERTY AND CASUALTY INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	1.5	1.5
2006	-	1.6	1.6
2007	-	1.6	1.6
2008	-	1.6	1.6
2009	-	1.7	1.7

Authorization

Sections 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
2005	-	0.9	0.9
2006	-	0.9	0.9
2007	-	1.0	1.0
2008	-	1.0	1.0
2009	-	1.0	1.0

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 months' 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
2005	72.6	-	72.6
2006	81.1	-	81.1
2007	87.7	-	87.7
2008	93.5	-	93.5
2009	99.4	-	99.4

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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.4
$20 to $30	1.6
$30 to $40	3.1
$40 to $50	5.3
$50 to $75	16.1
$75 to $100	18.2
$100 to $200	33.1
$200 and over	22.0

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.

Before 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 and 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--$142,700 for 2004, 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 assets 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 address the ability of taxpayers 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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Commerce and Housing:
Housing

DEDUCTION FOR PROPERTY TAXES ON OWNER-OCCUPIED RESIDENCES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	19.6	-	19.6
2006	15.0	-	15.0
2007	13.4	-	13.4
2008	13.0	-	13.0
2009	13.2	-	13.2

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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.6
$20 to $30	2.3
$30 to $40	4.1
$40 to $50	6.5
$50 to $75	20.3
$75 to $100	22.0
$100 to $200	36.1
$200 and over	8.0

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.

In 2004, sales tax deductibility was reinstated for the 2004 and 2005 tax years by the "American Jobs Creation Act of 2004," (P.L. 108-357). In contrast to pre-1986 law, State sales and use taxes can only be deducted *in lieu of* State income taxes not in addition to. Taxpayers who itemize and live in States without a personal income tax will benefit the most from the new law.

State and local taxes are among several deductions subject to the phaseout on itemized deductions for taxpayers whose AGI exceeds the applicable threshold amount--$142,700 for 2004, indexed for inflation. (The phaseout is scheduled to gradually phase-out beginning in the 2006 tax year and be completely eliminated beginning with the 2010 tax year.)

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, sales, 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.

Nevertheless, the property tax deduction is not an economically 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 tax payers 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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Commerce and Housing:
Housing

EXCLUSION OF CAPITAL GAINS ON SALES OF PRINCIPAL RESIDENCES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	22.9	-	22.9
2006	23.7	-	23.7
2007	24.6	-	24.6
2008	25.4	-	25.4
2009	26.3	-	26.3

Authorization

Section 121.

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 primarily benefits 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 have 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 was 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, tax free rollovers and the one-time exclusion of $125,000 in gain for elderly taxpayers, 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 taxpayers' 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.

As a result of these concerns, Congress repealed the rollover provisions and the one-time exclusion of $125,000 of gain in the Taxpayer Relief Act of 1997. In their place, Congress enacted the current tax rules which allow a taxpayer to 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.

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.

Viewed from another perspective, 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. Taxing the gain on the sale of a principal residence might also interfere with labor mobility.

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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
2005	0.9	0.3	1.2
2006	0.9	0.4	1.3
2007	1.0	0.4	1.4
2008	1.0	0.4	1.4
2009	1.1	0.4	1.5

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 $80 per State resident or $233.795 million in 2004. The cap has been adjusted for inflation since 2003. 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.

Even if a case can be made for this federal subsidy for homeownership, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, MRBs increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the assets available to individuals and corporations to shelter their income from taxation.

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Commerce and Housing:
Housing

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.2	0.1	0.3
2006	0.2	0.1	0.3
2007	0.2	0.1	0.3
2008	0.2	0.1	0.3
2009	0.2	0.1	0.3

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 that is equal to the greater of $80 per State resident or $233.795 million in 2004. The cap has been adjusted for inflation since 2003. Several additional 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, State and local governments were allowed to issue tax-exempt bonds to finance multifamily rental housing without restriction. The Revenue and Expenditure Control Act of 1968 (RECA 1968) imposed tests that restricted the issuance of these bonds. However, the Act also provided a specific exception which allowed unrestricted issuance for multifamily rental housing.

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 a federal subsidy for multifamily rental housing due to underinvestment at the State and local level, it is important to recognize the potential costs. As one of many categories of tax-exempt

private-activity bonds, those issued for multifamily rental housing increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the 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
2005	3.4	0.4	3.8
2006	3.8	0.4	4.2
2007	4.3	0.5	4.8
2008	4.9	0.5	5.4
2009	5.6	0.6	6.2

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 roughly offsets the understatement of depreciation due to the use of historical cost-basis depreciation, assuming inflation is at a rate of two percent or so. Moreover, many other assets are eligible for accelerated depreciation as well, and the allocation of capital depends on relative treatment.

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
2005	1.4	3.3	4.7
2006	1.5	3.4	4.9
2007	1.5	3.5	5.0
2008	1.6	3.6	5.2
2009	1.7	3.7	5.4

Authorization

Section 42.

Description

The Low Income Housing Tax Credit (LIHTC) was created by the Tax Reform Act of 1986 (P.L. 99-514), providing a tax credit for a portion of the acquisition costs for the provision of low-income rental housing. The credit is claimed by the owner over a period of ten years. 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 projects 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 a maximum rent. To qualify, at least 40% of the units in a rental project must be occupied by families with incomes less than 60% of the area median. (In practice, data show the vast majority of tax credit projects are composed almost entirely of low-income units). Rents in low-income units are restricted to 30% of the 60% of area median income. An owner's required commitment to keep units available for low-income use

was originally 15 years, but the Omnibus Budget Reconciliation Act of 1989 extended this period to 30 years for projects begun after 1989.

The credits are allocated in a competitive process by State housing agencies to developers, most of whom then sell their 10-year stream of tax credits to investors to raise capital for the project. The original law established an annual per-resident limit of $1.25 for the State's total credit authority. Under the Community Renewal Tax Relief Act of 2000 (P.L 106-554), this limit was increased to $1.50 in 2001, $1.75 in 2002, and thereafter, adjusted for inflation ($1.80 for 2004). There is a minimum annual credit amount for small States, also indexed for inflation, currently about $2.1 million for States where the $1.85 per capita formula would yield less. The housing authority must require an enforceable 30-year low-income use (through restrictive covenants), although after the initial 15-year period, an owner may sell the project (at a controlled price) or convert it to market-rate housing if the housing authority is unable to find a buyer, often a nonprofit group, willing to maintain the project as low-income use for the remainder of the 30 year period.

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. The competitive sale of tax credits by developers to investors and the oversight requirements by housing agencies should prevent excess profits from occurring, and direct much of the benefit to qualified tenants of the housing units.

Most tax credits are now purchased by corporations, including banks who are satisfying their requirements under the Community Reinvestment Act, and by the government-sponsored enterprises, Fannie Mae and Freddie Mac, also satisfying their affordable housing lending goals. Freddie Mac reported that its low-income housing tax credit portfolio now exceeds $2 billion (170,000 units).

Rationale

The tax credit for low-income housing was adopted in the Tax Reform Act of 1986 to provide a subsidy directly linked to the addition of rental housing with limited rents for low-income households. It replaced less targeted subsidies 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 credit was scheduled to expire at the end of 1989, but was temporarily extended a number of times until made permanent by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) required States to regulate tax-credit projects more carefully to insure that investors were not earning excessive rates of return and introduced the requirement that new projects have a long-term plan for providing low-income housing. Legislation in 1988, (the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647), in 1989 (noted above), and in 1990 (the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508) made technical and substantive changes to the provision. As noted above, the Community Renewal Tax Relief Act of 2000 increased the annual tax credit allocation limit, indexed it to inflation, and made minor amendments to the program.

Assessment

The low-income housing credit, now giving States the equivalent of nearly $5.5 billion of annual budget authority, is more targeted to benefitting lower-income individuals than the more general tax provisions it replaced. Moreover, by allowing State authorities to direct its use, the credit can be used as part of a general neighborhood revitalization program. The most comprehensive data base of tax credit units, compiled by the Department of Housing and Urban Development (HUD), revised as of May 28, 2004, shows nearly 20,700 projects and more than 1,041,000 new and rehabilitated units have been placed in service between 1987 and 2001. With about 100,000 units now being added each year, the current total is likely in excess of 1.25 million units. The HUD data base of units built from 1995 through 2001 shows nearly two-thirds were newly constructed (although only one-third in the Northeast were new construction), about one-third of the projects had a nonprofit sponsor, nearly one-half of units are located in central cities and about 40% are in metro area suburbs. It is estimated that about 35% of LIHTC properties have tenant-based rental assistance (HUD's Section 8 program, now called the Housing Choice Voucher program). Data also show that LIHTC units are more likely to be located in largely minority- or renter-occupied census tracts or tracts with large proportions of female-headed households, compared to households in general or rental units in general.

Much less is known about the financial aspects of tax credit projects and how much it actually costs to provide an affordable rental unit under this program when all things are considered. Many tax credit projects receive other Federal subsidies, and as noted, more than one-third of tax credit renters receive additional Federal rental assistance. HUD's Federal Housing Administration (FHA) program is insuring an increasing number of tax credit projects. There are reports that some neighborhoods are saturated with tax credit projects and projects targeted to households with 60% of area

median income frequently have as high a vacancy rate as the surrounding unsubsidized market.

There are a number of criticisms that can be made of the credit (see the Congressional Budget Office study in the bibliography below 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. Direct funding by the Federal government to State housing agencies would avoid the cost of the syndication process (the sale of tax credits to investors as "tax shelters.") And, in general, many economists would argue that housing vouchers, or direct-income supplements to the low-income, are more direct and fairer methods of providing assistance to lower-income individuals. However, others argue that because of landlord discrimination against low income people, minorities, and those with young children (and sometimes an unwillingness to get involved in a government program, particularly in tight rental markets), a mix of vouchers and project-based assistance like the tax credit might be necessary.

A study by the Chicago Rehab Network of 1998 audits of Chicago tax credit projects containing 8,704 units found that 73% had no operating reserves and 44% had no replacement reserves, with a significant number of projects likely to face "a future of deferred maintenance, rising vacancies and ever deepening budget shortfalls." A HUD-commissioned study (report dated August 2000) of 39 projects found that 50% of tax credit renters pay more than 30% of their income for rent, 13% paying more than 50% of income.

A looming issue has to do with the projects completed from 1987 through1989 that have 15-year affordability restrictions that began expiring in 2002. There may be as many as 70,000 of these units whose owners could decide to opt out of the low-income rental operations with relative ease. There has been almost no information yet reported on this potential. A report by the Joint Center for Housing Studies at Harvard University and the Neighborhood Reinvestment Corporation on the expiring affordability issue concluded that : "Lack of monitoring or insufficient funds for property repair or purchase will place even properties for which there is an interest in preserving affordability at risk of market conversion, reduced income-targeting, or disinvestment and decline." An increasing amount of tax credits have been and are likely to be used for the preservation of existing affordable housing in the future rather than for new units that add to the overall supply of affordable units.

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TAX CREDIT FOR REHABILITATION OF HISTORIC STRUCTURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	0.2	0.3
2006	0.1	0.3	0.4
2007	0.1	0.3	0.4
2008	0.1	0.3	0.4
2009	0.1	0.3	0.4

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 rehabilitation credit. The costs of acquiring a building or an interest in such a building, such as a leasehold interest, are not considered as qualifying expenditures. The costs of facilities related to an existing building, such as a parking lot, also are not considered as qualifying expenditures. Expenditures incurred by a lessee do not qualify for the credit unless the remaining lease term on the date the rehabilitation is completed is at least as long as the applicable recovery period under the general depreciation rules (generally, 27.5 years for residential property and 39 years for nonresidential property). Straight-line depreciation must be used to qualify for the rehabilitation 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. The ordering rules for the phaseout are provided in Section 469 of the Internal Revenue Code.

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 U.S. Department of Interior.

Impact

The credit reduces the taxpayer's cost of preservation projects. Prior to the Tax Reform Act of 1986 (P.L. 99-514), 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 (amortized over a 60-month period) for capital expenditures incurred in rehabilitation of certified historic structures was adopted as part of the Tax Reform Act of 1976 (P.L. 94-455). In addition, the act provided that in case of a substantially altered or demolished certified historic structure, the amount expended for demolition or any loss sustained on account of the demolition is to be charged to the capital account with respect to the land and not includible in the depreciable basis of a replacement structure. Further, accelerated depreciation methods are prohibited for the replacement structure. These actions were taken because Congress believed the preservation of historic structures and neighborhoods is an important national goal dependent upon the enlistment of private funds in the preservation movement. It was argued that prior law encouraged the demolition and replacement of old buildings instead of their rehabilitation.

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.

In response to tax simplification proposals which noted the numerous limitations and qualifications of the loss limitation rules, ordering rules in the Internal Revenue Code (Section 469) were clarified with the passage of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147).

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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REDUCED RATES OF TAX ON DIVIDENDS AND LONG-TERM CAPITAL GAINS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	57.8	-	57.8
2006	64.2	-	64.2
2007	69.9	-	69.9
2008	78.6	-	78.6
2009	86.3	-	86.3

Authorization

Sections 1(h), 631, 1201-1256.

Description

Dividends on corporate stock and 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 10 or 15 percent rate pay a 5 percent rate and individuals in higher rates pay a 15 percent rate. The 5 percent rate will be zero in 2008. After 2008 the rates will revert to their levels prior to changes in 2003 (see rationale). Gain arising from prior depreciation deductions is taxed at ordinary rates but with a maximum of 28 percent.. 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 taxing them at 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.

To be eligible for the lower dividend rate, stock must be held for 60 days out of the 120 days that begin 60 days before the ex dividend day. Only stock paid by domestic corporations is eligible. For passthrough entities RICs (regulated investment companies, commonly known as mutual funds) and real estate investment trusts (REITs), payments to shareholders are eligible only to the extent they were qualified dividends to the passthrough entities.

Impact

Since higher-income individuals receive most capital gains, benefits accrue to high-income taxpayers. Dividends are also somewhat concentrated among higher income individuals, although not to as great a degree as capital gains. According to Internal Revenue Service statistics for 2001, taxpayers with adjusted gross income over $100,000 accounted for 2 percent of returns, and a third of income, but accounted for 75 percent of capital gains and 42 percent of dividends. The tax savings would be even more concentrated in higher income classes because the differentials between ordinary rates and the special rates are greater.

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 saw introduced a 60-percent exclusion for individuals and a lowering of 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; its objective was to increase saving and risk-taking, and to reduce lock-in. Individuals subject to the 15 percent rate paid a 10 percent rate and individuals in the 28, 31, 36, and 39.6 percent rate brackets paid a 20 percent rate. Gain arising from prior depreciation deductions was taxed at ordinary rates but with a maximum of 28 percent. Eventually, property held for five years or more would be taxed at 8 percent and 18 percent, rather than 10 percent and 20 percent. The 8 percent rate applied to sales after 2000; the 18 percent rate applied to property *acquired* after 2000 (and, thus, to such property sold after 2005). The holding period was increased to 18 months, but cut back to one year in 1998.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 provided for the current lower rates, with a sunset. The stated rationale was to encourage investment and growth, and to reduce the distortions due to higher taxes on dividends, which also encouraged use of debt finance and retention of earnings.

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.

The extension of lower rates to dividends in 2003 significantly reduced the pre-existing incentives to corporations to retain earnings and finance with debt, and reduced the distortion that favors corporate over non-corporate investment. It is not at all clear, however, that the lower tax rates will induce increased saving, if the tax cuts are financed with deficits, another stated objective of the 2003 dividend relief.

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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
2005	42.6	-	42.6
2006	45.4	-	45.4
2007	48.3	-	48.3
2008	51.2	-	51.2
2009	54.1	-	54.1

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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DEFERRAL OF GAIN ON NON-DEALER INSTALLMENT SALES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.5	0.6	1.1
2006	0.5	0.6	1.1
2007	0.5	0.7	1.2
2008	0.5	0.7	1.2
2009	0.6	0.7	1.3

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 sales of this kind 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. Under current law, it can be used only by persons who do not regularly deal in the property being sold (except for the

sellers of farm property, timeshares, and residential building lots who may use the installment method but must pay interest on the deferred taxes). The latest legislative change in 2004 was a provision of the American Jobs Creation Act denying the installment sale treatment to readily tradeable debt.

For sales by non-dealers, interest must be paid to the government on the deferred taxes attributable to the portion of the installment sales that arise during and remain outstanding at the end of the tax year of more than $5,000,000. Transactions where the sales price is less than $150,000 do not count towards the $5,000,000 limit. Interest payments offset the value of tax deferral, so this tax expenditure represents only the revenue loss from those transactions that give 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 non-dealers 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 significantly 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

in the Omnibus Budget Reconciliation Act of 1987. Further restrictions applicable to accrual method taxpayers were enacted in the Work Incentives Improvement Act of 1999 (P.L. 106-170). The 1999 Act prohibited most accrual basis taxpayers from using the installment method of accounting. Concern, however, in the small business community over these changes led to the passage, in December 2000, of the Installment Tax Correction Act of 2000 (P.L. 106-573). The 2000 Act repealed the restrictions on the installment method of accounting imposed by the 1999 Act. The repeal was made retroactive to the date of enactment of the 1999 change.

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 their taxes (retailers, dealers in property, investors with large amounts of sales) and permits its use to small, non-dealer 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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DEFERRAL OF GAIN ON LIKE-KIND EXCHANGES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.5	1.2	1.7
2006	0.5	1.3	1.8
2007	0.5	1.3	1.8
2008	0.5	1.4	1.9
2009	0.5	1.4	1.9

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 or a right to pump water 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.

The most recent legislative change was a provision of the American Jobs Creation Act of 2004 affecting the recognition of a gain on a principal residence acquired in a like-kind exchange.

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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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
2005	1.3	1.4	2.7
2006	0.1	0.9	1.0
2007	0.2	1.2	1.4
2008	0.3	1.6	1.9
2009	0.5	2.1	2.6

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). Improvements required for a new leasehold for a non-residential structure and certain restaurant improvements made at least three years after original construction may be depreciated over 15 years. This provision applies only through 2005.

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 calculated 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 that are 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.

In 2002, certain qualified leasehold improvements in non-residential buildings were made eligible for a temporary bonus depreciation (expiring

after 2004) allowing 30% of the cost to be deducted when incurred. The percentage was increased to 50% in 2003.

The provision allowing a 15-year recovery period for qualified leasehold improvements and restaurant improvements was adopted in 2004 but suspended after 2005.

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 roughly offsets the understatement of depreciation due to the use of historical cost basis depreciation, assuming inflation is at a rate of two percent or so. Moreover, many other assets are eligible for accelerated depreciation as well, and the allocation of capital depends on the relative treatment.

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
2005	2.2	18.8	21.0
2006	-2.2	5.9	3.7
2007	-0.1	10.6	10.5
2008	1.7	15.7	17.4
2009	3.5	20.3	23.8

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 them 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 that are faster than straight-line allow for larger depreciation 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.

A temporary provision allowed a write-off of 30% of the cost in the first year (for 36 months beginning September 10th, 2001), adopted in 2002 as an economic stimulus. The percentage was increased to 50% in 2003.

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 more than offsets the understatement of depreciation due to the use of historical cost basis depreciation, if inflation is at a rate of about two percent or so for most assets. Under these circumstances the effective tax rate on equipment is below the statutory tax rate and the tax rates of most assets are relatively close to the statutory rate. Thus, 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 UNDER SECTION 179 OF DEPRECIABLE BUSINESS PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	2.1	0.5	2.6
2006	3.0	0.7	3.7
2007	2.5	0.6	3.1
2008	-	-0.1	-0.1
2009	-0.9	-0.4	-1.3

Authorization

Section 179.

Description

A business taxpayer (other than a trust or estate) may deduct as a current expense up to $100,000 of the cost of qualifying depreciable property in the tax year when it is placed in service. Under current federal tax law, this treatment is available in 2003 through 2007. The alternative to expensing is to recover the cost over a longer period according to current depreciation schedules. Beginning in 2008 and beyond, the maximum expensing allowance will drop to $25,000. For the most part, qualifying property is new and used machinery, equipment, and computer software purchased for use in a trade or business; software is eligible for expensing only from 2003 through 2007. The amount that can be expensed is subject to two important limitations: a dollar limitation and an income limitation. Under the former, the maximum expensing allowance is reduced, dollar for dollar, by the amount by which the total cost of qualifying property placed in service in a

tax year from 2003 through 2007 exceeds $400,000 (an amount that is also known as the phase-out threshold). Beginning in 2008 and beyond, the threshold will drop to $200,000. As a result, none of the cost of qualifying property may be expensed once the total cost reaches $500,000 in a single tax year. Under the latter, the expensing allowance may not exceed the taxable income a business taxpayer earns from the active conduct of the trade or business in which the qualifying property is used.

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. Thus, the provision accelerates the depreciation of relatively small amounts of business property. Expensing is equivalent to taxing the returns to investment on eligible business assets at a marginal effective tax rate of zero.

In addition, because of the phase-out threshold for the allowance, most of the firms that are able to take advantage of it are relatively small in asset, employment, or revenue size.

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

Rationale

The expensing allowance originated as a special first-year depreciation deduction that was included in the Small Business Tax Revision Act of 1958. The deduction was equal to 20 percent of the first $10,000 of spending ($20,000 in the case of a joint return) on new and used business equipment and machinery with a tax life of six or more years. It was intended to provide tax relief and investment incentives for small firms and to simplify their tax accounting.

The deduction remained intact until the Economic Recovery Tax Act of 1981 (ERTA) replaced it with a maximum expensing allowance of $5,000. ERTA also put in place a timetable for gradually increasing it to $10,000 by 1986 and established an investment tax credit. Depreciable property that was eligible for expensing was not eligible for the investment tax credit. As a result, relatively few firms took advantage of the allowance until the investment tax credit was repealed by the Tax Reform Act of 1986.

Under the Deficit Reduction Act of 1984, the scheduled increase in the maximum allowance to $10,000 was postponed from 1986 to 1990. The allowance reached $10,000 in 1990, as scheduled.

It remained at that amount until 1993, when 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 allowance was increased to $17,500 as of January 1, 1993 by the Omnibus Budget Reconciliation Act of 1993.

With the enactment of the Small Business Job Protection Act of 1996, the size of the allowance embarked on an accelerated upward path. Under the act, it rose to $18,000 in 1997, $18,500 in 1998, $19,000 in 1999, $20,000 in 2000, $24,000 in 2001 and 2002, and $25,000 in 2003 and thereafter.

The maximum allowance would still be $25,000 were it not for the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The act made three important changes in the allowance. First, it raised the maximum amount that could be expensed to $100,000 and the phase-out threshold to $400,000 for 2003 through 2005. Second, JGTRRA indexed both amounts for inflation in 2004 and 2005. Finally, it added off-the-shelf computer software for business use to the list of depreciable assets eligible for expensing in 2003 through 2005.

Under the American Jobs Creation Act of 2004, all the changes in the allowance made by JGTRRA are extended through 2007.

Assessment

The expensing allowance has implications for tax administration and economic efficiency. On the one hand, it simplifies tax accounting for small firms whose purchases fall under the limit. On the other hand, the provision encourages investment in and by those firms in a way that might divert financial capital away from more productive uses.

Although some argue that investment should be encouraged in and by small businesses because they tend to create more jobs and generate more technological 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 on qualifying property normally above the $100,000 limit, expensing offers no incentive to increase investment in these assets, nor does it simplify depreciation accounting.

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AMORTIZATION OF BUSINESS START-UP COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.6	([1])	0.6
2006	0.6	([1])	0.6
2007	0.6	([1])	0.6
2008	0.6	([1])	0.6
2009	0.7	([1])	0.7

([1])Less than $50 million.

Authorization

Section 195.

Description

Costs incurred before the start of a business normally are not deductible because they are not incurred in connection with carrying on an active trade or business. Instead, these start-up costs should be capitalized and added to the taxpayer's basis in the business. Under section 195, however, a business taxpayer may elect to deduct up to $5,000 in eligible start-up expenditures and amortize whatever amount remains over a period of 15 years. In the absence of such an election, no deduction is allowed for start-up expenditures.

Expenditures must satisfy two requirements to qualify for this treatment. First, they must be paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or creating an active trade or business, or engaging in a profit-seeking or income-producing activity in the period before an active trade or business commences. Second, the expenditures must be for costs that would be deductible if they were paid or incurred in connection with an existing trade or business. Excluded from qualifying start-up expenditures are interest payments on debt, tax payments, and spending on research and development that is deductible under section 174.

Impact

The election to deduct and amortize business start-up costs encourages the formation of new businesses by permitting the immediate deduction of expenses that otherwise would not be recovered until the owner sold his or her interest in the business.

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

Rationale

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

Section 195 first entered the federal tax code through the passage of the Miscellaneous Revenue Act of 1980. The original provision allowed business taxpayers to amortize start-up expenditures over a period of not less than 60 months. Start-up expenditures were defined as any expense "paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or creating an active trade or business." In addition, the expense had to be one that would be immediately deductible if paid or incurred in connection with the expansion of an existing trade or business. Congress added section 195 in the hope that it would facilitate the creation

of new businesses and reduce the likelihood of legal disputes over the proper treatment of start-up expenditures for tax purposes.

Despite the rules enacted in 1980, numerous disputes continued to arise over whether certain business start-up costs should be expensed under section 162, capitalized under section 263, or amortized under section 195. In an attempt to diminish the controversy and litigation surrounding the interpretation of section 195, Congress added a provision to the Deficit Reduction Act of 1984 which clarified the definition of start-up expenditures. Specifically, the provision required taxpayers to treat start-up expenditures as deferred expenses, which meant that they were to be capitalized unless a taxpayer elected to amortize them over a period of not less than 60 months. It also broadened the definition of start-up expenditures to include any expenses incurred in connection with an activity engaged in for profit or for the production of income before the day when the active conduct of a trade of business began; the expenses had to be incurred in anticipation of entering the trade or business.

No changes were made in section 195 until the enactment of the American Jobs Creation Act of 2004. The act includes a provision limiting the scope of the amortization of business start-up costs under prior law. Specifically, the provision permits business taxpayers to elect to deduct up to $5,000 in eligible start-up costs in the tax year when their trade or business commences. This amount must be reduced (but not below zero) by the amount by which these costs exceed $50,000. Any remaining amount must be amortized over 15 years, beginning with the month in which the active conduct of the trade or business commences. The definition of start-up costs remains unchanged. In making these modifications to section 195, Congress is pursuing two aims. One is to encourage the formation of new firms that do not require substantial start-up costs by allowing a certain amount of those costs to be deductible in the tax year the firms begins to operate. The second aim is to make the amortization period for start-up costs consistent with that for intangible assets under section 197, which is 15 years.

Assessment

In theory, business start-up costs should be written off over the life of the business. Such an approach, however, does raise the serious problem of determining the useful life of a business at its outset.

Section 195 has two distinct advantages. First, it substantially lowers the likelihood of costly and drawn-out legal disputes involving business

taxpayers and the IRS over the tax treatment of start-up costs. Second, the provision does so at a relatively small revenue cost.

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Commerce and Housing Credit:
Other Business and Commerce

REDUCED RATES ON FIRST $10,000,000 OF CORPORATE TAXABLE INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	3.6	3.6
2006	-	4.6	4.6
2007	-	5.1	5.1
2008	-	5.2	5.2
2009	-	5.2	5.2

Authorization

Section 11.

Description

Corporations with less than $10 million in taxable income are subject to a graduated tax rate structure. Under the existing structure, the tax rate is 15 percent on the first $50,000 of income, 25 percent on the next $25,000, and an average of 34 percent thereafter. To compensate for the benefit from the lower rates, a tax rate of 39 percent is imposed on corporate taxable income between $100,000 and $335,000. Thus, the benefit of these graduated rates vanishes 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 between $335,000 and $10 million is 34 percent. It rises to 35 percent for taxable income from $10 million to $15 million. When taxable income falls between $15 million and $18,333,333, the rate jumps to 38 percent. And a flat rate of 35 percent is imposed on taxable income above $18,333,333. Thus, the benefit of the 34 percent rate is phased out when income reaches $18,333,333.

The graduated rates do not apply to the taxable income of personal-service corporations; instead, it is taxed at a flat rate of 35 percent. In addition, there are restrictions to prevent abuse by related corporations.

The tax expenditure for this provision is the difference between taxes paid and the taxes that would be owed if all taxable corporate income were taxed at a flat 35 percent rate.

Impact

These reduced rates are available mainly to smaller corporations. The phase-out limits the benefits of the graduated rates below 35 percent to corporations with taxable incomes 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 marginal 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 phase-out range of $15 million to $18.3 million.

The graduated rates encourage the use of the corporate form of legal organization and allow some small corporations that might otherwise operate as passthrough entities (e.g., sole proprietorships or partnerships) to provide fringe benefits. They also encourage the splitting of operations between sole proprietorships, partnerships, S corporations and regular C corporations. Most businesses are not incorporated; so 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 the tax were allowed in some years. A graduated rate structure was first adopted in 1936. From 1950 to 1974, corporate income was subject to a "normal tax" and a surtax, and the first $25,000 of income was exempt from the surtax. The intent of the exemption was to provide tax relief for small businesses.

However, this dual structure led many large firms to reorganize their operations into numerous smaller corporations in order to take advantage of the exemption from the surtax. Some steps to remedy this loophole were taken in 1963. But the most important correction came in 1969, when legislation was enacted that limited clusters of corporations controlled by the same interest to a single exemption.

In 1975, a graduated rate structure with three rate brackets was adopted. In 1984, a law was adopted which included a provision phasing out the exemption for taxable incomes between $1 million and $1.405 million. At that time, lower rates applied to incomes up to $100,000.

The present graduated rate structure for corporate taxable income below $10 million materialized under the Tax Reform Act of 1986, which also adjusted the phase-out of the lower rates so that their benefits gradually disappeared between $100,000 and $335,000. By lowering the ceilings on the rates and accelerating the phase-out, Congress was trying to target the benefits of the graduated rate structure more precisely at smaller businesses. Motivated by a desire to reduce a large and growing budget deficit by raising revenue, Congress added the 35-percent corporate tax rate through the Omnibus Budget Reconciliation Act of 1993.

Assessment

The graduated rates are often justified on the grounds that they provide needed aid to small businesses. They assist smaller firms by both lowering their cost of capital for new investments and increasing their cash flow during a period when many of them struggle to survive. But can the graduated rates be justified on economic grounds?

Unlike graduation in the rates of the individual tax, corporate rate graduation cannot be justified on the basis of a firm's ability to pay. This

is because individuals and not corporations end up paying corporate taxes, and the individuals who own small corporations may, in fact, be very well off. In addition, the graduated rates can serve as a tax shelter for small business owners, who may be able to retain part of their income in corporations whose income is taxed at lower rates than the income of the owners. These considerations suggest that tax relief for small business cannot be justified on the grounds of equity.

Can the tax relief be justified on the basis of economic efficiency? Once again, the case is weak. Although some argue that investment in and by small firms should be encouraged because they tend to create more jobs and generate more technological innovation than larger firms, evidence on this issue is decidedly mixed. Conventional economic analysis clearly implies that maximum output is likely to be produced when the returns to all investments are taxed at the same rate. The graduated rate structure discourages investments in and by firms subject to the higher marginal tax rates of the phase-out range. Such a disincentive can distort the allocation of economic resources by diverting the flow of financial capital from its most productive uses. The graduated rates also give large corporations an incentive to operate for tax purposes as multiple smaller units where economies of scale have less of an impact on the returns to investment.

The lower rates do, however, make it possible for owners of businesses in the lower income brackets to operate in a corporate form. Generally, business owners are free to organize their firms as a regular C corporation or some kind of passthrough entity (i.e., sole proprietorship, partnership, limited liability company, or S corporation) for legal purposes. Income earned by passthrough entities is passed on to the owners (whether or not it is distributed) and taxed at individual income tax rates. Depending on the amount, income earned by corporations can be taxed at lower rates than income earned by passthrough entities. Differences between the two rates create opportunities for the sheltering of income in corporations. There may be some circumstances, however, where operating as a passthrough entity is not feasible. For instance, corporate status may be more desirable if more than one class of stock or favorable tax treatment of employee fringe benefits is desired.

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Commerce and Housing:
Other Business and Commerce

PERMANENT EXEMPTION FROM IMPUTED INTEREST RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.3	([1])	0.3
2006	0.3	([1])	0.3
2007	0.3	([1])	0.3
2008	0.4	([1])	0.4
2009	0.4	([1])	0.4

([1])less than $50 million

Authorization

Sections 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 (about $4.3 million or $3.1 million, depending on the kind of the debt instrument), 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
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 173.

Description

In general, publishers of newspapers, magazines, and other periodicals are allowed to deduct (or expense) their expenditures to maintain, establish, or increase circulation in the year when the expenditures are made.

Current deductions of these expenditures are permitted even though expenditures to establish or increase circulation would normally be considered capital expenditures under section 263. Expenditures eligible for expensing do not include those for the purchase of land and depreciable property or acquisition of circulation through the purchase of any part of the business of another publisher or its list of subscribers.

The tax expenditure is the difference between the current deduction of costs and the present value of the depreciation deductions that would be allowed if these costs were capitalized.

Impact

Publishers are permitted a current deduction for circulation costs, - including some that otherwise are considered capital in nature. This treatment speeds up the deduction of costs, possibly increasing cash flow or reducing the cost of capital for publishers. Investment in maintaining and expanding circulation is a critical expenditure for publishers of newspapers and magazines simply because the number of readers is an important source of revenue and the advertising rates they can charge typically are based on sales and readership levels.

Like many other business tax expenditures, the benefit tends to accrue to high-income individuals (see Introduction for a discussion).

Rationale

The rule allowing the expensing of circulation costs was added to the federal tax code through the Revenue Act of 1950. In taking this step, Congress was seeking to eliminate some of the difficulties associated with distinguishing between expenditures to maintain circulation, which had been treated as currently deductible, and those to establish or develop new circulation, which had to be capitalized. Numerous legal disputes between publishers and the Internal Revenue Service over the interpretation of such a distinction had arisen as far back as the late 1920s.

Section 173 remained unchanged until the passage of the Tax Equity and Fiscal Responsibility Act of 1982. Among other things, the act made the expensing of circulation expenditures a preference item under the alternative

minimum tax (AMT) for individuals and required affected individuals to amortize any such expenditures they claim on their tax returns over 10 years. Congress lowered the recovery period to three years in the Deficit Reduction Act of 1984, where it now stands. The Tax Reform Act of 1986 further clarified the treatment of circulation expenditures under the individual AMT; specifically, it allowed taxpayers who suffered a loss on the disposition of property related to such expenditures (e.g., a newspaper) to claim as a deduction against the AMT all remaining circulation expenditures that have yet to be deducted for minimum tax purposes.

Assessment

Although this provision provides a tax benefit for investments in expanding circulation that yield returns in future tax years, it simplifies tax compliance for publishers and tax administration for the IRS. Without such treatment, it would be necessary to promulgate detailed regulations clarifying the distinction between expenditures for establishing or expanding circulation and those for maintaining circulation.

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SPECIAL RULES FOR MAGAZINE, PAPERBACK BOOK, AND RECORD RETURNS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([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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Commerce and Housing:
Other Business and Commerce

COMPLETED CONTRACT RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	0.3	0.3
2006	([1])	0.3	0.3
2007	([1])	0.3	0.3
2008	([1])	0.3	0.3
2009	([1])	0.3	0.3

([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.

The most recent legislative change was a provision of the American Jobs Creation Act of 2004 permitting naval shipbuilders to use the completed contract method.

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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Commerce and Housing:
Other Business and Commerce

CASH ACCOUNTING, OTHER THAN AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.7	([1])	0.7
2006	0.8	([1])	0.8
2007	0.8	([1])	0.8
2008	0.8	([1])	0.8
2009	0.8	([1])	0.8

([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 $10 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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Commerce and Housing:
Other Business and Commerce

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
2005	0.3	0.1	0.4
2006	0.3	0.1	0.4
2007	0.4	0.1	0.5
2008	0.4	0.1	0.5
2009	0.4	0.1	0.5

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 $20 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. The American Jobs Creation Act of 2004 (P.L. 108-357) increased the related expenditures limit to $20 million for all qualified projects.

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 $80 per capita or $233.795 million in 2004. The cap has been adjusted for inflation since 2003.

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. With a greater supply of public bonds, the interest rate on bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds also increases the assets available to individuals and corporations to shelter their income from taxation.

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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
2005	-	0.6	0.6
2006	-	0.6	0.6
2007	-	0.6	0.6
2008	-	0.6	0.6
2009	-	0.6	0.6

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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TAX CREDIT FOR EMPLOYER-PAID FICA TAXES ON TIPS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.3	0.2	0.5
2006	0.3	0.2	0.5
2007	0.4	0.2	0.6
2008	0.4	0.2	0.6
2009	0.4	0.2	0.6

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.

The U.S. Supreme Court held on June 17, 2002, that the Internal Revenue Service (IRS) may use the aggregate estimation method to calculate a restaurant's FICA tax liability for unreported tip income. The Supreme Courts' decision rested on whether the law authorized the IRS to base the FICA assessment upon its aggregate estimate of all tips paid to its employees, or whether the law required IRS to determine total tip income by determining each individual employee's tip income separately, then adding those determinations together. The Supreme Court found that IRS could use an estimate as long as the method used was reasonable.

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 non-refundable 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 on the restaurant industry for 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 restaurant.

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Commerce and Housing:
Other Business and Commerce

PRODUCTION ACTIVITY DEDUCTION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.6	1.8	2.4
2006	0.9	2.7	3.6
2007	1.3	3.9	5.2
2008	1.8	5.5	7.3
2009	2.0	5.9	7.9

Authorization

Section 199.

Description

Qualified production activities income is allowed a deduction from taxable income of 3% in 2005-2006, 6% in 2007-2009, and 9% thereafter. The deduction cannot exceed total taxable income of the firm and is limited to 50% of wages.

Production property is property manufactured, produced, grown or extracted within the United States. Eligible property also includes domestic film, energy, and construction, and engineering and architectural services.

For the latter the services must be produced in the United for construction projects located in the United States. The law specifically excludes the sale of food and beverages prepared at a retail establishment, transmission and distribution of electricity, gas, and water, and receipts from property leased, licensed, or rented to a related party.

There are rules that allow the allocation of the deduction to pass through entities and cooperatives. The provision also allows the revocation without penalty of a prior election to treat timber cutting as the sale of a capital asset. The deduction is also allowed under the alternative minimum tax. The tax expenditure is the tax savings due to the deduction.

Impact

This provision lowers the effective tax rate on the favored property, in most cases when fully phased in from the top corporate tax rate of 35% to 31.85%. The deduction is available to both corporations and unincorporated businesses, but primarily benefits corporations, For the many proprietorships that have few or no employees, the benefit will be limited or absent because of the wage requirement unless the firm incorporates.

In a letter dated September 22, 2004 to Mark Prator and Patrick Heck, responding to a query about the similar (although slightly different) Senate version of the provision, the Joint Tax Committee indicated that three quarters of the benefit would have gone to corporations, 12% would have gone to Subchapter S firms (smaller incorporated firms that elect to be treated as partnerships) and cooperatives, 9% would have gone to partnerships, and 4% to sole proprietorships. Based on the revenue estimates ($3 billion for 2006) and projected corporate tax receipts of $249 billion for that year, the implication is that around a third of corporate activity qualifies.

The beneficial treatment given to income from these activities will encourage more investment in manufacturing and other production activities and less in sales and services. It will also encourage more equity investment in the affected sectors.

Rationale

This provision was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357), a bill that repealed the Extraterritorial Income provision that was found to be an unacceptable export subsidy by the World Trade Organization. The stated purpose was to enhance the ability of firms to compete internationally and to create and preserve manufacturing jobs.

Assessment

The provision should somewhat expand the sector qualifying for the benefit and contract other sectors. It will introduce some inefficiency into the economy by diverting investment into this area, although it will also primarily lower the burden on corporate equity investment which is more heavily taxed than other forms of investment and among qualifying firms reduce the incentive for debt finance. This latter effect would product an efficiency gain.

Economists in general do not expect that there is a need to use tax incentives to create jobs in the long run because job creation occurs naturally in the economy. Nor can tax provisions permanently affect the balance of trade, since exchange rates would adjust.

There has been some concern expressed about the complexity and difficulty in administering a tax provision that provides special benefits for a particular economic activity. Firms will have an incentive to characterize their activities as eligible and to allocate as much profit as possible into the eligible categories.

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Commerce and Housing:
Other Business and Commerce

DEDUCTION OF CERTAIN FILM AND TELEVISION PRODUCTION COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	0.1	0.1
2006	([1])	0.1	0.1
2007	([1])	0.1	0.1
2008	([1])	0.1	0.1
2009	([1])	([1])	([1])

([1]) Less than $50 million.

Authorization

Section 181.

Description

The cost of producing films and television programs must be depreciated over a period of time using the income forecast method (which allows deductions based on the pattern of expected earnings). This provision allows production costs for qualified film and television shows to be deducted when incurred. Eligible productions are restricted to those with a

cost of $15 million or less ($20 million if produced in certain designated low income areas) and in which at least 75 percent of the compensation is for services performed in the United States. The provision expires after 2008. Only the first 44 episodes of a television series qualify, and sexually explicit productions are not eligible.

Impact

Expensing provides a benefit because deductions can be taken earlier. For example, at a seven percent interest rate, the value of taking a deduction currently is 40 percent greater than taking a deduction five years from now $(1+.07)^5$. The benefit is greatest per dollar of investment for those productions whose expected income is spread out over a long period of time and whose production period is lengthy. This provision encourages film and television producers to locate in the United States and counters the growth in so-called "runaway" production.

The dollar ceiling targets the benefit to smaller productions. The average cost of producing a movie for theatrical release in 2003 (by members of the Motion Picture Association of America) was $63.8 million, so that many of these movie productions would not qualify. One study found that made-for-television movies and mini-series, in particular, have experienced relocation abroad, and that most of this business has gone to Canada. Many countries, including Canada, provide subsidies for production.

Rationale

This provision was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357). The purpose was to discourage the "runaway" production of film and television production to other countries, where tax and other incentives are often offered.

Assessment

This provision will provide an incentive to remain in the United States, at least for firms that are profitable enough to have tax liability. The magnitude of the benefit depends on the average lag time from production to earning income. If that lag is five years and the discount rate is seven percent, for example, the value of the deduction is increased by 40 percent, and with a 35 percent tax rate, the reduction in cost would be about 14

percent. If the average lag is only a year, the reduction is slightly over two percent.

In general, special subsidies to industries and activities tend to lead to inefficient allocation of resources, and in the long run, providing subsidies to counter those provided by other countries will not necessarily improve circumstances, unless they induce both parties to reduce or eliminate their subsidies. At the same time, individuals who have specialized in film and television production are harmed when production shifts to other countries, and the disruption can be significant when caused through provision of large subsidies or tax incentives.

Because tax subsidies cannot benefit firms that do not have tax liability, the scope of this provision may be narrower than would be the case with a direct subsidy.

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TAX CREDIT FOR CERTAIN RAILROAD TRACK MAINTENANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	0.1	0.1
2006	-	0.1	0.1
2007	-	0.1	0.1
2008	-	0.1	0.1
2009	-	0.1	0.1

Authorization

Section 451.

Description

Qualified railroad track maintenance expenditures paid or incurred in a taxable year by eligible taxpayers are eligible for a 50-percent business tax credit. The credit is limited to $3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer. Railroad track maintenance expenditures are amounts, which may be either repairs or capitalized costs, spent to maintain railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad. Eligible taxpayers are smaller (Class II or Class III)

railroads and any person who transports property using these rail facilities or furnishes property or services to such a person.

The taxpayer's basis in railroad track is reduced by the amount of the credit allowed (so that any deduction of cost or depreciation is only on the cost net of the credit). The credit cannot be carried back to years before 2005. The credit covers expenditures from 2005-2007.

Impact

This provision substantially lowers the cost of track maintenance for the qualifying short line (regional) railroads, with tax credits covering half the costs for those firms and individuals with sufficient tax liability. According to the Federal Railroad Administration, as of the last survey in 1993, these railroads accounted for 25% of the nation's rail miles. These regional railroads are particularly important in providing transportation of agricultural products.

Rationale

This provision was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357). While no official rationale was provided in the bill, sponsors of earlier free-standing legislation and industry advocates indicated that the purpose was to encourage the rehabilitation, rather than the abandonment, of short line railroads, which were spun off in the deregulation of railroads in the early 1980s. Advocates also indicated that this service is threatened by heavier 286,000 pound cars that must travel on these lines because of inter-connectivity. They also suggested that preserving these local lines will reduce local truck traffic. These is also some indication that a tax credit was thought to be more likely to be achieved than grants.

Assessment

The arguments stated by the industry advocates and sponsors of the legislation are also echoed in assessments by the Federal Railroad Administration (FRA), which indicated the need for rehabilitation and improvement, especially to deal with heavier cars. The FRA also suggested that these firms have particular difficulty with access to bank loans.

In general, special subsidies to industries and activities tend to lead to inefficient investment allocation since in a competitive economy businesses should earn enough to maintain their capital. Nevertheless it may be judged or considered desirable to subsidize rail transportation in order to reduce the congestion and pollution of highway traffic. At the same time, a tax credit may be less suited to remedy the problem than a direct grant since firms without sufficient tax liability cannot use the credit.

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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
2005	-	0.1	0.1
2006	-	0.1	0.1
2007	-	0.1	0.1
2008	-	0.1	0.1
2009	-	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 owner), 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 may be in doubt today, since U.S. firms control many vessels registered under a foreign flag and many U.S. allies control a substantial shipping fleet and have substantial ship-building capability that might be available to the U.S.

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
2005	4.0	-	4.0
2006	4.2	-	4.2
2007	4.3	-	4.3
2008	4.4	-	4.4
2009	4.5	-	4.5

Authorization

Section 132(f).

Description

Transit passes provided directly by the employer are excludable from income in amounts up to $100 per month, as adjusted for inflation with a 2001 base year. A similar exclusion applies to van pools. 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 $175 per month, as adjusted for inflation with a 1998 base year. In 2004 the actual limit after adjusting for inflation was $195.

The employers may choose to provide the benefits in cash, subject to a compensation reduction arrangement.

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. The value of the benefit also depends on the location of the employer: the provision is targeted towards the taxpayers working in the urbanized areas or other places where transit is available or parking space is limited.

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, 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.

In 1998 the Transportation Equity Act for the 21st Century increased the benefits' limits to their current levels and modified their phase-in periods and inflation adjustment rules. It also allowed employees to elect cash in lieu of transit benefits.

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 locations, 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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QUALIFIED GREEN BUILDING AND SUSTAINABLE DESIGN PROJECT BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1]) Less than $50 million.

Authorization

Section 103, 142(l), and 146(g).

Description

Interest income on State and local bonds used to finance the construction of "green building and sustainable design projects," as designated by the U.S. Environmental Protection Agency (EPA), is tax exempt. Green buildings are evaluated based on these criteria: (1) site sustainability; (2) water efficiency; (3) energy use and atmosphere; (4) material and resource use; (5) indoor environmental quality; and (6) innovative design. The

program is designed as a "demonstration" program, and requires that at least one designated project shall be located in or within a 10-mile radius of an empowerment zone and at least one shall be located in a rural state. These 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 green building and sustainable design projects are not, however, subject to the state volume cap on private activity bonds. This exclusion arguably reflects a belief that the 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 an aggregate face amount of $2 billion and must be issued before October 1, 2009.

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 green building projects at reduced interest rates.

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of both the factors that determine the shares of benefits going to bondholders and users of the green buildings and associated projects, 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

Proponents of green bonds argue that the federal subsidy is necessary because private investors are unwilling to accept the risk and relatively low return associated with green building projects. Proponents argue that the market has failed to produce green buildings because the benefits of these projects extend well beyond the actual building to the surrounding community and to the environment more generally. The owner of the green building is not compensated for these external benefits, and it is unlikely,

proponents argue, that a private investor would agree to provide them without some type of government subsidy.

Assessment

The legislation (P.L. 108-357) that created these bonds was enacted on October 22, 2004, and the potential success of the program is still uncertain. Before the legislation was enacted, some developers were voluntarily adhering to green building standards to attract tenants. If so, the market failure described earlier to justify the use of federal subsidy may be less compelling. In addition, as one of many categories of tax-exempt private-activity bonds, green bonds will likely increase the financing costs of bonds issued for other public capital stock and increase the supply of assets available to individuals and corporations to shelter their income from taxation.

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Community and Regional Development

NEW YORK CITY LIBERTY ZONE TAX INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.3	0.3	0.6
2006	0.4	0.4	0.8
2007	0.3	0.1	0.4
2008	0.2	-	0.2
2009	0.2	-	0.2

Authorization

Section 1400L.

Description

The "Liberty Zone" (the Zone) is generally defined as the area in lower Manhattan in New York City that was directly affected by the September 11, 2001 terrorist attacks. Specifically, the zone "...is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York." The tax incentives include expansion of the Work Opportunity Tax Credit (WOTC) for small employers in the Zone, accelerated depreciation for Zone businesses, increased private-purpose tax-exempt bond capacity for New York City (Liberty bonds and special one-time advance refunding); and more favorable tax treatment of gains realized from the replacement of

property in the Zone. In 2004, P.L. 108-311 extended the Liberty bond program through January 1, 2010 and extended the additional advance refunding allowance for bonds financing property in the Zone through January 1, 2006.

Impact

The tax benefits will likely reduce the tax burden on businesses in the Zone, and some of these benefits will be passed from the business owners in the Zone to their customers and investors. The impact on the Zone itself will be positive as business investment shifts to liberty zone businesses, their workers, and customers. The impact across metropolitan New York region will probably be less noticeable as most investment in the Zone is likely to be shifted from planned investment in neighboring areas. Some investment in the Zone, however, may represent new investment.

Rationale

The "New York City Liberty Zone Tax Incentives" were created by the "Job Creation and Worker Assistance Act of 2002" (P.L. 107-147). After the September 11, 2001 terrorist attacks, the livelihood of businesses and workers in lower Manhattan was severely tested. The Federal Reserve Bank of New York (FRBNY) estimated the total cost of the September 11th attack to be between $33 billion and $36 billion through June 2002. The same FRBNY study estimated that, as a result of the September 11 attacks, the number of people working in New York City's private sector fell by 51,000 in October 2001 and fell another 41,000 in the period between November 2001 and March 2002. The Liberty Zone tax incentives are designed to address the relatively severe economic shock that affected the lower Manhattan region. Congressional leaders hope that these benefits will help lure investors into lower Manhattan as well as retain businesses and workers that may otherwise emigrate away from lower Manhattan.

Assessment

The benefit of expanding the WOTC eases the tax burden on employers in the Zone who hire qualified new workers. The effectiveness of WOTC, however, may be limited by the relative cost and complexity of

administrative compliance. For more on the WOTC, see the entry in this volume titled: "Work Opportunity Tax Credit." The accelerated depreciation provision for Zone businesses will lower the cost of capital but only through deferral of the tax that would have been due under the normal depreciation schedule. Businesses that use the bonus depreciation will pay less taxes today, but the tax burden in the future will be slightly higher as depreciation expenses are smaller than they would have otherwise been. The tax benefit, therefore, is the present value of the tax deferred. The accelerated depreciation may induce some firms in the Zone to invest in new capital, however, the magnitude of the impact of the incentive is uncertain. For more on accelerated depreciation for business property, see the entry in this volume titled: "Expensing of Depreciable Business Property."

Increased tax-exempt bond capacity for projects in New York City will lower the cost of capital for qualified projects. The additional public infrastructure spending induced by the increased capacity will likely benefit businesses and workers in the Zone. Many economists, however, would argue that the new public investment would replace new private investment. Nevertheless, the subsidy responds to the relatively unique characteristics of the disruption caused by the September 11 attacks. For more on the subsidy for tax-exempt bonds, see the entry in this volume titled: "Exclusion of Interest on State and Local Small-Issue Industrial Development Bonds." The favorable tax treatment of gains realized from the replacement of property in the Zone will benefit property owners that replace property damaged in the liberty zone. Generally, only property owners can benefit from this provision because renters are not eligible. For more on this provision, see the entry in this volume titled: "Deferral of Gain on Involuntary Conversions Resulting from Presidentially-Declared Disaster."

Generally, these geographic benefits induce investors to shift investment spending rather than generate new investment spending. Thus, the localized tax incentives redistribute tax revenue and investment from all federal taxpayers to taxpayers in the Zone. From a national perspective, the economic benefit of geographically based incentives is not clear. However, taxpayers in the Zone are likely better off with the incentives.

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EMPOWERMENT ZONE TAX INCENTIVES, DISTRICT OF COLUMBIA TAX INCENTIVES, AND INDIAN RESERVATION TAX INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.6	0.5	1.1
2006	0.5	0.5	1.0
2007	0.5	0.3	0.8
2008	0.4	0.3	0.7
2009	0.4	0.4	0.8

Authorization

Sections 38(b), 39(d),45A, 168(j), 280C(a), 1391-1397D, 1400-1400B.

Description

Empowerment Zone (EZ) and Enterprise Community (EC) tax incentives were originally created by the OBRA of 1993 and expanded by the TRA of 1997. The EZ/EC program was expanded again by the Community Renewal Act (CRA) of 2000. The CRA of 2000 also harmonized the eligibility rules for EZs/ECs and created a new geography-based tax incentive program for so-called Renewal Communities (RC). There are currently authorized 40 EZs (30 urban and 10 rural), 95 ECs (65 urban and 30 rural), and 40 RCs (28

urban and 12 rural). The District of Columbia EZ was also authorized in the TRA of 1997 and is afforded the same tax incentives as the other EZs. The DC Enterprise Zone incentives were extended through December 31, 2005 by P.L. 108-311.

Designated areas must satisfy eligibility criteria including poverty rates and population and geographic size limits; they will be eligible for benefits through December 31, 2009.

For empowerment zones, the tax incentives include a 20% employer wage credit for the first $15,000 of wages for zone residents who work in the zone, $35,000 in expensing of equipment in investment (in addition to the amount allowed generally) in qualified zone businesses, and expanded tax exempt financing for certain zone facilities, primarily qualified zone businesses.

In addition, qualified public schools in enterprise communities and empowerment zones are allowed access to qualified zone academy bonds (QZABs). QZABs are bonds designated for school modernization and renovation where the federal government offers annual tax credits to the bondholders in lieu of interest payments from the issuer. The federal government is effectively paying the interest on the bonds for the state or local governments. For more on QZABs, see the tax expenditure entry "Tax Credit for Holders of Qualified Zone Academy Bonds" under the Education, Training, Employment, and Social Services heading.

Businesses in RC are allowed a 15% wage credit on the first $10,000 of wages for qualified workers and an additional $35,000 in capital equipment expensing. These qualified businesses are also allowed partial deductibility of qualified buildings placed in service. Renewal community the tax benefits are available through December 31, 2009.

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% 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 eligible qualified wages and health insurance cost payments made in

1993. These benefits are available for wages paid, and for property placed in service before December 31, 2005.

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% or more. There is also a zero capital gains rate for business sales in areas with 10% poverty rates. Those provisions are available through December 31, 2005. (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 benefitting 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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Community and Regional Development

NEW MARKETS TAX CREDIT AND RENEWAL COMMUNITY TAX INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.5	0.4	0.9
2006	0.7	0.4	1.1
2007	0.8	0.5	1.3
2008	1.0	0.7	1.7
2009	0.9	0.6	1.5

Authorization

Sections 45D, 1400F, 1400H, 1400I, and 1400J.

Description

The New Markets Tax Credit (NMTC) is available for investors who invest in community development entities (CDEs). The NMTC is a tax incentive for investors equal to 5% of their initial investment in the calendar year they made the investment and for the next two anniversary dates. The investor is allowed a 6% credit at each of the subsequent four anniversary dates. The maximum amount of annual investment eligible for the credit is $1.5 billion in 2002 and 2003; $2.0 billion in 2004 and 2005; and $3.5 billion in 2006 and 2007.

In contrast to the NMTC, renewal community (RC) tax incentives target businesses directly. The four RC tax incentives for businesses are (1) that gains from the sale of assets designated as RC business are taxed at 0%, (2) that a qualified RC business is eligible for a federal tax credit worth 15% of the first $10,000 of wages for each qualified employee hired by the RC business, (3) that each state can allocate up to $12 million for "commercial revitalization expenditures" for businesses in a RC, and that RC businesses can claim up to $35,000 in section 179 expensing for qualified RC property.

Impact

The NMTC is an investment credit. Thus investors, who are likely in higher income brackets, are the direct beneficiaries. Business owners are the direct beneficiaries of the RC tax incentives. Business owners, like investors, are also likely to fall in higher income brackets. Nevertheless, the tax incentives would likely encourage investment spending in economically distressed communities. The additional investment would indirectly benefit the workers and residents of these communities. A more direct means of providing assistance to individuals in distressed communities might entail direct aid to individuals.

Rationale

The "Community Renewal Tax Relief Act of 2000" (P.L. 106-544) created the renewal community provisions and the NMTC. The tax incentives in the RC legislation are designed to lower the cost of capital and labor for RC businesses relative to non-RC businesses. Policymakers hope the incentives will encourage investment in RC businesses and help lower the cost of doing business in renewal communities. The NMTC is designed to provide tax relief to investors in economically distressed communities through providing a more certain rate of return with fixed credit rates.

Assessment

The NMTC program is still in its initial stages of implementation, so an evaluation of the program's effectiveness difficult. The relative size of the credit program, however, may limit its influence on economic growth and development in distressed communities. According to a 2002 General

Accounting Office (GAO) report, the $15 billion of potential new investment over seven years must be assessed against the fact that the potential target area includes approximately 35% of the U.S. population and 40% of the land area. In addition, the fixed credit rate, 5% for the first three years and 6% for the four final years, may not be enough to compensate investors for the underlying risk of the principal investment.

The capital gain exclusion for RC businesses may shift investment into the RC. Investors could invest more money in a RC business because the after-tax return is higher that for than similar investments in non-RC businesses. The higher after-tax return will, in theory, encourage more investment in RC businesses, perhaps at the expense of businesses just outside the RC. The employee tax credit for RC businesses may encourage hiring the workers that qualify under the program. The federal tax credit should lower the per unit labor costs of the RC business and may lead to either more workers being hired or more hours worked. The relatively small size of the credit may limit the impact on overall employment in the renewal community.

RC businesses that realize a tax savings for rehabilitation expenses immediately, rather than over time, potentially encouraging more renovation. The RC businesses could decide to renovate because the immediate tax savings increases the after-tax rate of return on those expenditures. In short, a tax savings today is worth more than an equal tax savings earned in the future. The accelerated depreciation incentive is similar to the rehabilitation tax benefit. The RC business realizes a tax saving because it can deduct the entire cost of the capital equipment (and receive the tax savings) immediately rather than in increments spread into the future. The accelerated depreciation should lower the cost of capital and encourage more capital investment by RC businesses.

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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
2005	0.1	0.1	0.2
2006	([1])	([1])	([1])
2007	([2])	([2])	([1])
2008	([2])	([2])	([1])
2009	([2])	([2])	([1])

([1]) Less than $50 million per year.

([2]) Less than $500,000 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. Eligible expenses must be incurred before January 1, 2006. The deduction applies to both the regular and the alternative minimum tax.

A qualified contaminated site, or "brownfield," is generally defined as any property that 1) is held for use in a trade or business, and 2) on which there has been an actual or threatened release or disposal of certain hazardous substances as certified by the appropriate state environmental agency. Superfund sites — sites that are on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 — do not qualify as brownfields.

Impact

Immediate expensing provides a tax subsidy for capital invested by businesses, in this case for capital to be used for environmental cleanup and community development. Frequently, the costs of cleaning up contaminated land and water in abandoned industrial or commercial sites are 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 cleanup and redevelopment of "brownfields"— abandoned old industrial sites and dumps, including properties owned by the federal and subnational government, 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.

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. The provision was originally to expire at the end of 2000, but was extended to the end of 2001 in 1999. The provision expired on January 1, 2003, but was retroactively extended through December 31, 2005, by the Working Families Tax Relief Act of 2004 (P.L. 108-311).

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 has been questioned as many view the main disincentive to development of brownfield sites 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
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 47.

Description

Qualified expenditures made to substantially rehabilitate a 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. The basis must be reduced by the full amount of the rehabilitation credit.

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 firms to renovate rather than relocate. They reduce the cost of rehabilitation and thereby can turn unprofitable rehabilitation projects into profitable rehabilitation projects, and can make rehabilitation of a building more profitable than new construction.

Rationale

The Revenue Act of 1978 (P.L. 95-600) provided an investment tax credit for rehabilitation expenditures made for nonresidential buildings in use for at least 20 years, 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(P.L. 97-34); 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 (P.L. 99-514), 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, also changed by the 1986 act.

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 or the promotion of using the existing building stock rather than the promotion of destruction and rebuilding at a greater cost) that the firm would not take into account. Proponents of the credit note that if buildings at least 50 years old are worth saving, then a rolling qualification period should be provided rather than the fixed 1936 date, which was set in 1976 for buildings of that age. More recently, the Joint Committee on Taxation recommended the elimination of the 10 percent credit based on simplification arguments.

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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
2005	0.6	0.3	0.9
2006	0.7	0.3	1.0
2007	0.7	0.3	1.0
2008	0.7	0.3	1.0
2009	0.8	0.3	1.1

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, they must compete for cap allocations with bond proposals for all other private activities subject to the volume cap. The cap is equal to the greater of $80 per capita or $233.795 million in 2004. The cap has been adjusted for inflation since 2003.

Bonds issued for airports, docks, and wharves are not, however, subject to the annual federally imposed State volume cap on private-activity bonds. The cap is forgone 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

Before 1968, State and local governments were allowed to issue tax-exempt bonds to finance privately owned airports, docks, and wharves without restriction. The Revenue and Expenditure Control Act of 1968 (RECA 1968) imposed tests that restricted the issuance of these bonds. However, the Act also provided a specific exception which allowed unrestricted issuance for airports, docks, and wharves, and mass commuting facilities.

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 expired 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 federal taxpayer subsidy. Economic 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 a federal subsidy due to underinvestment at the State and local level, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, those issued for airports, docks, and wharves increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the 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 INCOME ATTRIBUTABLE TO THE DISCHARGE OF CERTAIN STUDENT LOAN DEBT AND NHSC EDUCATIONAL LOAN REPAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	-	([1])
2006	([1])	-	([1])
2007	([1])	-	([1])
2008	([1])	-	([1])
2009	([1])	-	([1])

([1]) Less than $50 million.

Authorization

Section 108(F).

Description

Income for tax purposes generally includes forgiveness of debt. However, the tax code excludes from income forgiveness of loans made by the federal government, state and local governments, public benefit corporations, and qualified educational institutions that are forgiven

conditional on performing services in a specified occupation in a specified area for a certain period of time. The code also excludes repayment of loans for graduates made under the National Health Service Corps (NHSC) repayment program for 2004 and after.

Student loan forgiveness and service payback programs provide financial incentives in exchange for a specific work commitment. Loan forgiveness programs repay a percentage of an employee's student loan after service commences; service payback programs cover a portion of a student's school costs in return for an agreement to work in a specific job for a specified period of time in the future. These programs have one or more of the following four goals: to provide financial assistance to students to help them with the costs of college, to attract individuals to a particular occupation or field of specialization, to encourage individuals to work for a period of time in a certain job or under-served region, or to cause individuals to remain in a high need occupation, region or under-served facility.

The first major federal loan forgiveness program, the National Defense Student Loan Program, was authorized by the National Defense Education Act in 1958. It was a loan forgiveness program for public school teachers. Loan forgiveness provisions currently applicable to Federal Family Education Loans and Direct Loans were adopted in the 1998 reauthorization of the Higher Education Act of 1965, as amended (HEA). These provisions are for a teacher loan forgiveness program as well as a demonstration loan forgiveness program for childcare providers. Loan forgiveness is also available for Perkins Loans (low-interest loans made by institutions of higher education to students with financial need) for borrowers who work in specific public service jobs. In addition to the U.S. Department of Education administered provisions, there are federal loan forgiveness and service payback programs specific to particular occupations or categories of borrowers, for example, the military and health professions. States also offer many loan forgiveness and service payback programs. A survey of 100 state programs in 2000-2001 indicated that 43 states had one or more of these programs.

The National Health Service Corps (NHSC) provides a competitive educational loan repayment program to certain health care providers. Applicants selected for the program must commit to providing full-time primary care services in an approved practice site, located in a federally designated health professional shortage area. There is a 2 year minimum service commitment, for which the NHSC will pay up to $50,000 of the outstanding balance of a participant's qualifying educational loans, plus tax assistance equal to 39% of the total amount of loan repayment received during a tax year. The tax assistance amounts are paid directly to the IRS on the participant's behalf; the loan repayment amounts must be used by the

participant to repay qualified educational loans. For participants with qualifying loans of less than $50,000, the NHSC will pay one half of the qualifying loans annually. Participants may have the opportunity to participate in the program beyond 2 years.

The NHSC loan repayment program accepts applicants who are fully trained in the following areas: allopathic or osteopathic primary care physicians, primary care certified nurse practitioners, primary care physician assistants, certified nurse-midwives, general practice dentists, registered clinical dental hygienists, psychiatrists, clinical or counseling psychologists, clinical social workers, licensed professional counselors, marriage and family therapists, and psychiatric nurse specialists.

In addition to the direct NHSC loan repayment program, the NHSC also grants matching funds to states for their own loan repayment programs. The eligibility requirements and benefits for these programs are determined by individual states.

Impact

These provisions make loan forgiveness and payments to recipients of the NHSC loan repayment program and state loan repayment program (and for the HEA programs described above) exempt from gross income and employment taxes. These provisions will benefit taxpayers according to their marginal tax rate.

Rationale

Income for tax purposes generally includes forgiveness of debt. The tax code, however, excludes scholarships and fellowships, although scholarships and fellowships that reflect past, present, or future compensation or further the interests of the grantor are taxable. In 1973, the Internal Revenue Service ruled that forgiveness of a medical loan that required the recipient to practice in a rural area of the state was to be included in income. The 1976 tax act provided that loans forgiven prior to 1979 based on requirements to work for a certain period of time in a certain profession in a certain area or for a broad class of employers would not be included in income. The exclusion applied only to loans made by federal, state or local governments. The primary purpose was to attract doctors, nurses and teachers to service in rural and low-income areas. The 1978 revenue act extended this treatment to loans forgiven prior to 1983 and the

1984 act made the exclusion permanent. The 1997 and 1998 acts extended the number of entities that can make such loans that are eligible for the exclusion, and the 2004 tax cut added a provision that payments under the National Health Services Corps loan repayment program would not be included in income.

Assessment

Tax relief increases the value of the benefits of loan repayment programs, and that benefit depends on the marginal tax rate of the individual when the loan repayment is realized. The benefit varies across the professions, with the greater benefits accruing to more highly compensated individuals. These provisions should increase the incentives to locate in under-served areas, rather than taking higher paying jobs elsewhere.

The evidence on the effectiveness of these programs is not clear, although a Government Accountability Office (GAO) study examining the relative costs and benefits of NHSC loan forgiveness versus service payback programs, found the latter to be more costly.

The NHSC loan repayment and state loan repayment programs are intended to attract primary care clinicians to provide needed services in health professional shortage areas. Many private sector jobs available to these clinicians may provide higher wages and be located in areas more attractive to clinicians. The new tax exemption included in P.L. 108-357 should increase the attractiveness of serving in health professional shortage areas for needed clinicians by making this service more competitive with private sector jobs.

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Education, Training, Employment, and Social Services:
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DEDUCTION FOR CLASSROOM EXPENSES OF ELEMENTARY AND SECONDARY SCHOOL EDUCATORS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.2	-	0.2
2006	0.1	-	0.1
2007	-	-	-
2008	-	-	-
2009	-	-	-

Authorization

Section 62.

Description

An eligible employee of a public (including charter) and private elementary or secondary school may claim an above-the-line deduction for certain unreimbursed expenses. An eligible educator is defined to be an individual who, with respect to any tax year, is an elementary or secondary school teacher, instructor, counselor, principal, or aide in a school for a minimum of 900 hours in a school year. The expenses must be associated with the purchase of the following items for use by the educator in the classroom: books; supplies (other than nonathletic supplies for health or physical education courses); computer equipment, software, and services;

other equipment; and supplementary materials. The taxpayer may deduct up to $250 spent on these items.

The amount of deductible classroom expenses is not limited by the taxpayer's income. Educators must reduce the total amount they expend on eligible items by any interest from an Education Savings Bond or distribution from a Qualified Tuition (Section 529) Program or Coverdell Education Savings Account that was excluded from income. In other words, if educators or members of their tax filing units utilize earnings from these savings vehicles to pay tuition and other qualified educational expenses, only those classroom expenses that exceed the value of these income exclusions are deductible.

Impact

Educators, as an occupation, are actively involved in improving the human capital of the nation. The availability of the classroom expense deduction may encourage educators who already are doing so to continue to use their own money to make purchases to enhance their student's educational experience, and potentially encourages other educators to start doing the same. Alternatively, the deduction may be a windfall to educators.

Rationale

Section 62 was added to the law as part of the Job Creation and Worker Assistance Act of 2002, effective in 2002 and 2003. The provision expired on January 1, 2004. It was extended from its expiration date through December 31, 2005 by the Working Families Tax Relief Act of 2004.

Prior to the classroom deduction's enactment, the only tax benefit available to educators for trade/business expenses was the permanent deduction at Section 162 of the Code. That deduction remains available to educators but in order to take it, the total of their miscellaneous itemized deductions must exceed 2% of adjusted gross income. An above-the-line deduction targeted at educators was considered socially desirable because teachers voluntarily augment school funds by purchasing items thought to enhance the quality of children's education.

Assessment

Taxpayers with teachers in their filing units who make trade/business purchases in excess of $250 or who have other miscellaneous itemized deductions may now have to compute tax liability twice – under Code Sections 62 and 162 – to determine which provides the greater savings. Taxpayers also must now consider how the educator expense deduction interacts with other tax provisions. The temporary above-the-line deduction means, for example, that higher income families with eligible educators may not have to subject classroom expenditures of up to $250 to the 3% limit on itemized deductions. (Higher income taxpayers must reduce total allowable itemized deductions by 3% of their income in excess of an inflation-adjusted threshold.) By lowering adjusted gross income, the classroom expense deduction also allows taxpayers to claim more of those deductions subject to an income floor (e.g., medical expenses).

In addition to increasing complexity, the classroom expense deduction treats educators differently than others whose business-related expenses are subject to the 2% floor on miscellaneous itemized deductions and the 3% limit on total itemized deductions. Further, the above-the-line deduction is allowed against the alternate minimum tax while the Section 162 deduction is not.

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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
2005	5.2	-	5.2
2006	5.3	-	5.3
2007	5.3	-	5.3
2008	5.4	-	5.4
2009	5.4	-	5.4

Authorization

Section 25A.

Description

A Hope Scholarship Credit can be claimed for each eligible student in a family (including the taxpayer, the spouse, or their dependents) for two taxable years for qualified expenses incurred while attending an eligible postsecondary education program, provided the student has not completed the first two years of undergraduate education. An eligible student is one enrolled on at least a half-time basis for at least one academic period during the tax year in a program leading to a degree, certificate, or credential at an institution eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary

postsecondary institutions. The per student credit is equal to 100% of the first $1,000 of qualified tuition and fees and 50% of the next $1,000. The maximum credit is indexed for inflation. Tuition and fees financed with scholarships, Pell Grants, veterans' education assistance, and other income not included in gross income for tax purposes (with the exception of gifts and inheritances) are not qualified expenses.

The Lifetime Learning Credit provides a 20% credit per return for the first $10,000 of qualified tuition and fees that taxpayers pay for themselves, their spouses, or their dependents. The credit is available for any number of years for any level of postsecondary education at an eligible institution to acquire or improve an individual's job skills.

Both credits are phased out for single taxpayers with modified adjusted gross income between $41,000 and $51,000 ($83,000 and $103,000 for joint return taxpayers). The income thresholds are indexed to inflation. Neither credit is refundable. Both cannot be claimed for the same student in the same tax year. Taxpayers claiming a credit cannot concurrently take the temporary deduction for qualified higher education expenses.

Impact

The cost of investing in postsecondary education is reduced for those recipients whose marginal (i.e., last) 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. However, some of the federal revenue loss will be received by individuals whose investment decisions are not altered by the credits.

The ceilings limit the benefit to higher income individuals, and the lack of refundability limits the benefit to very low income individuals.

Distribution by Income Class of Education Tax Credits at 2001 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	14.0
$20 to $30	17.4
$30 to $40	15.0
$40 to $50	11.5
$50 to $75	27.9
$75 to $100	13.5
$100 to $200	0.0
$200 and over	0.0

Source: IRS *Statistics of Income.* This is not a distribution of the tax expenditures, but of the credits; it is classified by adjusted gross income, not expanded adjusted gross income, and reflects taxable returns.

Rationale

These credits were enacted in the Taxpayer Relief Act of 1997, along with a number of other higher education tax benefits. Their intent is to make postsecondary education more affordable for middle-income families and students who might not qualify for much need-based federal student aid.

Assessment

A 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 would require commercial lenders to charge high interest rates on education loans in light of the high risk of default. As a result, students often find themselves unable to afford loans from the financial sector. This financial constraint bears more heavily

on lower income groups than on higher income groups and accordingly, leads to inequality of opportunity to acquire a postsecondary education. It also is an inefficient allocation of resources because these students, on average, might earn a higher rate of return on loans for education than the financial sector could earn on alternative loans.

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 modern society rejects this practice, the federal government has strived to correct the market failure by providing 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.) The 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 inequality of opportunity has been diminished.

Some benefits from postsecondary education may accrue not to the individual being educated, but rather to the members of society at large. As these external benefits are not valued by individuals considering educational purchases, they invest less than is optimal for society (even assuming no capital market imperfections). External benefits are variously described as taking the form of increased productivity and better citizenship (for example, greater likelihood of participating in elections).

Potential students induced to enroll in higher education by the Hope Scholarship and Lifetime Learning credits cause investment in education to increase. The overall effectiveness of the tax credits depends upon whether the cost of the marginal investment dollar of those already investing in higher education is reduced, however. 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 credit-eligible students, and as a result, they will not experience a price effect (e.g., the Hope credit will not reduce by 50% the last dollar these students invest in postsecondary education). Although their investment decision is unaffected by the credits, these students can claim them (i.e., reap a "windfall gain") but federal taxpayers get no offsetting social benefits in the form of an increased quantity of investment.

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Education, Training, Employment, and Social Services:
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DEDUCTION FOR INTEREST ON STUDENT LOANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.8	-	0.8
2006	0.9	-	0.9
2007	0.9	-	0.9
2008	0.9	-	0.9
2009	1.0	-	1.0

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. Taxpayers are not eligible for the deduction if they can be claimed as a dependent by another taxpayer. The deduction is limited to $2,500. Beginning in 2002 and through 2010, the deduction is not restricted to interest paid within the first 60 months during which interest payments are required and the phase-out income thresholds are indexed for inflation. In 2003, for example, allowable deductions were phased out for taxpayers with modified adjusted gross income between $50,000 and $65,000 on individual returns and between $100,000 and $130,000 on joint returns. A sunset provision in the Economic Growth and Tax Relief

Reconciliation Act of 2001 will cause the deduction to revert to its pre-2002 structure after December 31, 2010, absent further congressional action.

Qualified education loans are indebtedness incurred solely to pay qualified higher education expenses of taxpayers, their spouse, or their dependents who were at the time the debt was incurred students enrolled on at least a half-time basis in a program leading to a degree, certificate, or credential at an institution eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions. Other eligible institutions are hospitals and health care facilities that conduct internship or residency programs leading to a certificate or degree. Qualified higher education expenses generally equal the cost of attendance (e.g., tuition, fees, books, equipment, room and board, and transportation) minus scholarships and other education payments excluded from income taxes. Refinancings are considered to be qualified loans, but loans from related parties are not.

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 that can be deducted limits the tax benefit's impact for those who have large debt.

Distribution by Income Class of Student Loan Deduction at 2002 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	14.4
$10 to $20	18.5
$20 to $30	13.7
$30 to $40	11.1
$40 to $50	8.1
$50 to $75	14.6
$75 to $100	8.5
$100 to $200	8.9
$200 and over	2.3

Source: Data obtained from IRS *Statistics of Income.* This is not a distribution of the tax expenditures, but of the deductions; it is classified by adjusted gross income, not expanded adjusted gross income.

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 need-based 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 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 unlikely to reduce loan defaults, which generally are related to low income and unemployment.

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Education, Training, Employment, and Social Services:
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EXCLUSION OF EARNINGS OF COVERDELL EDUCATIONAL SAVINGS ACCOUNTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	-	0.1
2006	0.1	-	0.1
2007	0.1	-	0.1
2008	0.1	-	0.1
2009	0.1	-	0.1

Authorization

Section 530.

Description

Coverdell Education Savings Accounts (ESAs), formerly known as "Education IRAs," are trusts or custodial accounts created solely for the purpose of paying qualified elementary, secondary, and postsecondary education expenses of designated beneficiaries. The contribution limit was raised from $500 annually to $2,000 annually effective from 2002 through 2010. It is phased-out for single taxpayers with modified adjusted gross income between $95,000 and $110,000 ($190,000 and $220,000 for joint return taxpayers) annually during the 9-year period. The income limits are

not adjusted for inflation and will revert to $95,000 and $150,000, respectively, after December 31, 2010. Corporations, tax-exempt organizations, or lower income individuals can contribute the maximum annual amount to accounts of children in families whose income falls in the phase-out range.

A contributor may fund multiple accounts for the same beneficiary, and a student may be the designated beneficiary of multiple accounts. A 6% tax is imposed if total contributions exceed the annual per-beneficiary limit. Funds withdrawn from one Coverdell ESA in a 12-month period and rolled over to another ESA on behalf of the same beneficiary or certain of their family members are excluded from the annual contribution limit and are not taxable.

Contributions may be made until beneficiaries reach age 18, although they may continue beyond that age for special needs beneficiaries. Similarly, with the exception of special needs beneficiaries, account balances typically must be totally distributed when beneficiaries attain age 30. Contributions are not deductible, but account earnings grow on a tax-deferred basis. Beginning in 2002, a contribution may be made to an ESA in the same year that a contribution is made to a Qualified Tuition Program for the same beneficiary.

Distributions are excluded from gross income of the beneficiary if used for tuition, fees, books, supplies, and equipment required for enrollment or attendance; contributions to Qualified Tuition Programs; special needs services; and room and board expenses for students enrolled on at least a half-time basis at eligible institutions of higher education. Distributions also are not taxed if they are used, from 2002 through 2010, toward the following expenses of beneficiaries pursuing elementary and secondary (K-12) education: tuition, fees, books, supplies, and other equipment incurred in connection with enrollment or attendance; academic tutoring; special needs services; room and board, uniforms, transportation, and supplementary items or services required or provided by the school; and computer software, hardware, or services if used by the beneficiary and the beneficiary's family during any years the beneficiary is in school.

Eligible postsecondary institutions are those eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions. From 2002 through 2010, eligible institutions have been expanded to public and private K-12 schools, either secular or religiously affiliated; they include homeschools in some states.

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. Distributions included in gross income are subject to a 10% penalty tax, with some exceptions. After 2001, beneficiaries can exclude from gross income distributions made in the same year that either the Hope Credit or the Lifetime Learning Credit is claimed (though not for the same expenses). This and other previously mentioned changes to the Coverdell ESA that went into effect in 2002 are set to expire after December 31, 2010 absent further congressional action.

Impact

The exclusion from gross income of account earnings withdrawn to pay for qualified expenses benefits beneficiaries according to their marginal tax rate (see Appendix A). As they are students, most beneficiaries likely have low tax rates. The deferral of taxes on accumulating earnings also confers benefits associated with the account owner's marginal tax rate. These benefits are most likely to accrue to middle-income families that have the means to save on a regular basis.

Tax benefits from Coverdell ESAs might be offset by reductions in student aid, most of which is awarded to students based on their financial need. Generally, students have need when their cost of attendance exceeds their expected family contribution (EFC). For purposes of need-based federal student aid programs (other than Pell Grants), the Department of Education has provided ambiguous guidance about the account's treatment as an asset in determining a student's EFC. Thus, a family might consider it a parental asset, which means a maximum of 5.64% of a Coverdell ESA's total value would be counted toward the EFC; alternatively, it might consider a Coverdell ESA a student asset, which means a fixed 35% of its total value would be counted toward the EFC of dependent students. Similarly, it is unclear whether untaxed income derived from a Coverdell ESA should be included in the EFC calculation.

Rationale

Tax-favored saving for higher education expenses 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 need-based federal student aid. The Economic Growth and Tax Relief Reconciliation Act of 2001 expanded eligible expenses to those incurred in connection with enrollment in public and private K-12 schools. It was intended, in part, to encourage families to exercise school choice (i.e., attend alternatives to the traditional public school).

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. Families that have the wherewithal to save are more likely to benefit. Whether families will save additional sums might be doubted. Tax benefits for Coverdell ESAs are not related to the student's cost of attendance or other family resources, as is most federal student aid for higher education.

Higher income families also are more likely than lower income families to establish accounts for their children's K-12 education expenses. The amount of the tax benefit is probably too small to affect a family's decision about whether to send their children to public or private school. The influence of Coverdell ESAs on a family's choice of school will be even less significant if the account is drawn upon for elementary school expenses and if less than the maximum is contributed each year.

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Education, Training, Employment, and Social Services:
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EXCLUSION OF INTEREST ON EDUCATION SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	-	([1])
2006	([1])	-	([1])
2007	([1])	-	([1])
2008	([1])	-	([1])
2009	([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 or Series I Savings Bonds when the bonds are used to pay qualified higher education expenses of the taxpayer or the taxpayer's spouse or dependents. Series EE Bonds are accrued bonds which earn a variable interest rate equal to 90% of the average yield on 5-year Treasury securities for the preceding six months. Series I Bonds are accrued

bonds which earn a fixed rate of return plus a variable semi-annual inflation rate. The bonds must have been issued after 1989 and be both purchased and owned by persons who are age 24 or over. 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.

Qualified higher education expenses generally are restricted to tuition and fees required for enrollment or attendance at eligible institutions. Tuition and fees are not taken into account if they are paid with tax-exempt scholarships, veterans' education assistance, employer education assistance, and distributions from Qualified Tuition Programs or from Coverdell ESAs, or if a tax credit or deduction is claimed for them. Expenditures for courses in sports, games, or hobbies are not considered unless they are part of a degree program. Contributions to Qualified Tuition Programs or to Coverdell ESAs are considered qualified expenses if made with redeemed proceeds. Eligible institutions are those eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions.

The interest exclusion is phased out for middle- and upper-income taxpayers. The phase-out ranges are based on the taxpayer's modified adjusted gross income in the year in which the bond is applied toward qualified expenses. The ranges are adjusted annually for inflation. For 2003, the phase-out range for a married couple filing jointly and for widow(er)s was $87,750 to $117,750. (Married couples must file a joint return to take the exclusion.) For all others, it was $58,500 to $73,500.

Impact

Education Saving Bonds provide lower- and middle-income families with a tax-favored way to save for higher education that is convenient and often familiar. The benefits are greater for families who live in states and localities with high income taxes because the interest income from Series EE and Series I Bonds is exempt from state and local income taxes.

Rationale

The interest exclusion for Education Savings Bonds was created by the Technical and Miscellaneous Revenue Act of 1988, making it among the earliest congressional efforts to assist family financing of postsecondary education. It reflects a long-held congressional concern that families have difficulty paying for college, particularly with the cost of higher education often rising faster than prices in general. If families would save more prior to their children's enrollment in college, they might find it easier to meet the cost without relying on student aid or borrowing. Although the tax provision has been subject to a number of technical and coordinating amendments since its inception (e.g., to take into account more recently enacted education tax benefits), the basic requirements have remained the same.

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 and Series I Savings Bonds is exempt from state and local income taxes.

The tax savings from the exclusion are greater for taxpayers in higher tax brackets. These savings would be partially offset by the below-market yield of these savings bonds. However, both Series EE and Series I Bonds are a safe way to save, and many taxpayers may find it easier to purchase and redeem them than other Treasury securities.

Since the interest exclusion for Education Savings Bonds can be limited when the bonds are redeemed, families intending to use them for college expenses must predict their income eligibility far in advance. They must also anticipate the future costs of tuition and fees and whether their children might receive scholarships. Further, unless students are tax dependents of their grandparents for example, the relatives cannot take the exclusion on bond interest used to pay the students' qualified expenses. In these respects, the bonds may not be as attractive an investment as some other education savings vehicles.

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Education, Training, Employment, and Social Services:
Education and Training

DEDUCTION FOR HIGHER EDUCATION EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	2.8	-	2.8
2006	0.7	-	0.7
2007	-	-	-
2008	-	-	-
2009	-	-	-

Authorization

Section 222.

Description

Taxpayers have been able to deduct qualified tuition and related expenses under Section 222 since 2002. The deduction will terminate after 2005, absent congressional action. The deduction is "above-the-line," that is, it is not restricted to itemizers. Taxpayers are eligible for the deduction if they pay qualified expenses for themselves, their spouses, or their dependents. Individuals who may be claimed as dependents on another taxpayer's return, married persons filing separately, and nonresident aliens who do not elect to be treated as resident aliens cannot take the deduction.

The maximum deduction per return in 2002 and 2003 was $3,000 (2004 and 2005, $4,000) for taxpayers with modified adjusted gross income that does not exceed $65,000 ($130,000 on joint returns). Taxpayers with incomes above $65,000 ($130,000 for joint returns) but not above $80,000 ($160,000 for joint returns) in 2004 and 2005 may deduct up to $2,000 in qualified expenses. These income limits are not adjusted for inflation and there is no phase-out of the deduction based upon income.

The deduction may be taken for qualified tuition and related expenses in lieu of claiming the Hope Scholarship Credit or Lifetime Learning Credit for the same student. Taxpayers cannot deduct qualified expenses under Section 222 if they deduct these expenses under any other provision in the Code (e.g., the itemized deduction for education that maintains or improves skills required in a taxpayer's current profession).

Before the deduction can be taken, qualified expenses must be reduced if financed with scholarships, Pell Grants, employer-provided educational assistance, veterans' educational assistance, and any other nontaxable income (other than gifts and inheritances). Qualified expenses also must be reduced if paid with tax-free interest from Education Savings Bonds, tax-free distributions from Coverdell Education Savings Accounts, and tax-free earnings withdrawn from Qualified Tuition Plans.

Qualified tuition and related expenses are tuition and fees required for enrollment or attendance in an institution eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions. The deduction may be taken for any year of undergraduate or graduate enrollment. It is available to part-time and full-time students, and the program need not lead to a degree, credential, or certificate.

Impact

The deduction benefits taxpayers according to their marginal tax rate (see Appendix A). Students usually have relatively low tax rates, but they may be part of families in higher tax brackets. The maximum amount of deductible expenses limits the tax benefit's impact on individuals attending schools with comparatively high tuition and fees. Because the income limits are not adjusted for inflation, the deduction might be available to fewer taxpayers over time.

Most of the deductions are taken by higher income families, except for the very highest income categories (see table which shows the distribution of deductions).

Distribution by Income Class of Education Deduction at 2002 Income Levels

Income Class (in thousands of $)	Percentage Distribution
Below $10	11.4
$10 to $20	9.4
$20 to $30	7.4
$30 to $40	6.8
$40 to $50	6.7
$50 to $75	15.6
$75 to $100	21.9
$100 to $200	20.8
$200 and over	0.0

Source: Data obtained from IRS *Statistics of Income.* This is not a distribution of the tax expenditures, but of the deductions; it is classified by adjusted gross income, not expanded adjusted gross income.

Rationale

The deduction, which was authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001, builds upon postsecondary tax benefits that were initiated by the Taxpayer Relief Act of 1997. It is one additional means that Congress has chosen to help families pay for escalating college expenses, particularly middle-income families that do not qualify for much need-based federal student aid.

Assessment

The deduction has been criticized for adding to the complexity faced by families trying to determine which higher education tax benefits they are

eligible for and what combination is their optimal mix for financing postsecondary education. Between 2002 and 2005, for example, some taxpayers (i.e., those whose incomes fall below the credit's lower income cutoff) could claim either a higher education tax credit or the deduction. In addition, the deduction must be coordinated with tax-advantaged college savings vehicles (e.g., the Coverdell Education Savings Accounts and Qualified Tuition Plans).

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Education, Training, Employment and Social Services:
Education and Training

EXCLUSION OF TAX ON EARNINGS OF QUALIFIED TUITION PROGRAMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.5	-	0.5
2006	0.6	-	0.6
2007	0.7	-	0.7
2008	0.8	-	0.8
2009	0.9	-	0.9

Authorization

Section 529.

Description

There are two types of Qualified Tuition Programs (QTPs) that allow persons to pay in advance or save for college expenses for designated beneficiaries: prepaid tuition plans and college savings plans. The former enable account owners to make payments on behalf of beneficiaries for a specified number of academic periods or course units at current prices, thus providing a hedge against tuition inflation. The latter enable payments to be made on behalf of beneficiaries into a variety of investment vehicles offered

by plan sponsors (e.g., age-based portfolios whose mix of stocks and bonds changes the closer the beneficiary's matriculation date or an option with a guaranteed rate of return); the balances in college savings accounts can be applied toward a panoply of qualified higher education expenses (e.g., tuition and fees, books, supplies, and room and board).

Initially, only states could sponsor QTPs. Effective from 2002 through 2010, one or more eligible institutions of higher education may establish prepaid tuition plans. Eligible institutions are those eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions. States remain the sole sponsors of tax-advantaged college savings plans.

To be qualified, a QTP must receive cash contributions, maintain separate accounting for each beneficiary, and not allow investments to be directed by contributors and beneficiaries. (The last restriction has been loosened somewhat as, after 2001, account owners can make tax-free transfers from one QTP to another for the same beneficiary once in any 12-month period). A contributor may fund multiple accounts for the same beneficiary in different states, and a student may be the designated beneficiary of multiple accounts.

The specifics of plans vary greatly from one state to another. Plan sponsors may establish restrictions that are not mandated either by the Code or federal regulation. There are no income caps on contributors, unlike the limits that generally apply to taxpayers who want to claim the other higher education benefits. Similarly, there is no annual limit on contributions, unlike the case with the Coverdell ESA.

There is no federal income tax deduction for contributions to QTPs. Payments to QTPs are considered completed gifts of present interest from the contributor to the beneficiary meaning that an individual could contribute up to $11,000 in 2003 (subject to indexation) as a tax-free gift per QTP beneficiary. A special gifting provision allowed a QTP contributor to make an excludable gift of up to $55,000 in 2003 by treating the payment as if it were made over 5 years. By making QTP contributions completed gifts, their value generally is removed from the contributor's taxable estate.

Earnings on contributions accumulate on a tax-deferred basis. Starting in 2002 for state-sponsored plans and in 2004 for programs of higher education institutions, earnings withdrawn to pay qualified expenses are free from federal income tax. This change, like the other QTP amendments that

generally began after 2001, is due to expire after December 31, 2010, absent congressional action.

Except in the case of the beneficiary's death, disability, or receipt of a scholarship, veterans educational assistance allowance or other nontaxable payment for educational purposes (excluding a gift or inheritance), a 10% tax penalty is assessed (effective in 2002) on the earnings portion of distributions that exceed or are not used toward qualified higher education expenses. Nonqualified earnings withdrawals are taxable to the distributee as well. An account owner can avoid paying income tax and a penalty on nonqualified distributions by transferring the account to a new beneficiary who is a family member of the old beneficiary.

Contributions can be made to a QTP and to a Coverdell ESA in the same year for the same beneficiary effective after 2001. Also starting in 2002, the higher education tax credits can be claimed for tuition and fees in the same year that tax-free distributions are made from a QTP or a Coverdell ESA on behalf of the same beneficiary, provided that the distributions are not used toward the same expenses for which the credits/deduction are claimed. The higher education deduction can be taken for qualified expenses paid with contributions, but not earnings, withdrawn from QTPs.

Impact

A deferral is beneficial to taxpayers because it delays the payment of tax (see discussion in Appendix A). The tax deferral and recently enacted income exclusion are more likely to accrue to higher income families because they have higher tax rates and the means to save for college.

Tax benefits from QTPs might be offset by reductions in student aid, much of which is awarded to students based on their financial need. Generally, students have need when their cost of attendance exceeds their expected family contribution (EFC). For purposes of need-based federal student aid programs (other than Pell Grants), prepaid tuition plans are treated much differently from college savings accounts: the former generally reduce a student's financial need on a dollar-for-dollar basis; in contrast, the latter are treated as a parental asset with a maximum of 5.64% of a college savings account's value counted toward the EFC. Further, if someone other than a parent is the college savings plan's account owner, then the asset would not enter into the EFC calculation.

Rationale

QTPs have been established 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 benefits are generally limited to higher income individuals, however.

For some time, families had been favoring college savings plans over prepaid tuition plans because the former potentially offered higher returns and received better treatment under some federal student aid programs. The steep decline in stock prices in recent years has diminished the value of investments in college savings plans, which prompted renewed interest among families in prepaid tuition plans. However, QTPs have been criticized for creating unfunded state liabilities. Because of the comparatively poor performance of the stock market, in which states typically invest the funds in their prepaid plans, and of college costs continuing to rise faster than inflation, some states have stopped accepting contributions to or have changed the terms of their prepaid tuition plans.

Once having decided whether to save for their children's postsecondary education through one of the numerous prepaid tuition or college savings plans, families then are faced with choosing from the multiple investment options offered by a college savings plan. The latter decision is made more difficult by the limited and varying disclosure of information on plan specifics by states (e.g., administrative and other fees) and by financial advisors (e.g., the amount of investment fees and whether a tax benefit is available to residents who invest in their own state's plan). The availability of QTPs also has complicated families ' decision-making process because of their interaction with other education tax benefits. In addition, the exclusion from income of QTP earnings is set to expire after 2010 unless extended by the Congress.

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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
2005	1.4	-	1.4
2006	1.5	-	1.5
2007	1.6	-	1.6
2008	1.6	-	1.6
2009	1.6	-	1.6

Authorization

Section 117.

Description

Scholarships and fellowships include awards based upon financial need (e.g., Pell Grants) as well as those based upon scholastic achievement or promise (e.g., National Merit Scholarships). In recent years, interest has arisen in utilizing scholarships to promote school choice at the elementary and secondary levels in lieu of relying upon publicly funded vouchers.

Scholarships and fellowships can be excluded from the gross income of students or their families, provided (1) the students are pursuing degrees and

(2) the amounts are used for tuition and fees required for enrollment or for books, supplies, fees, and equipment required for courses at educational institutions that maintain a regular teaching staff and curriculum and that have a regularly enrolled student body attending classes where the school carries out its educational activities. Amounts used for room, board, and incidental expenses are not excludable.

Generally, 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. An exception to the rule went into effect for awards received after 2001 under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship.

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. The potential benefit is greatest for students at private schools, 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 more substantial tax benefit for married postsecondary students who file joint returns with their employed spouses.

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 (e.g., government support of public colleges, which has the effect of lowering tuition, is not considered income to the students), and it might be inequitable to tax them without taxing the others.

The exclusion provides greater benefits to taxpayers with higher marginal tax rates. While students themselves generally have low (or even zero) marginal rates, 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.

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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
2005	0.8	-	0.8
2006	0.8	-	0.8
2007	0.9	-	0.9
2008	0.9	-	0.9
2009	0.9	-	0.9

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 written qualified educational assistance program. The annual limit is $5,250. Any excess is includable in the employee's gross income and is subject to both employment and income taxes. However, amounts that exceed the limit may be excludable if they meet the working condition fringe benefits provision of Code Section 132. While courses covered by the plan need not be job-related, those involving sports, games, or hobbies are covered only if they involve the employer's business. With passage of the

Economic Growth and Tax Relief Reconciliation Act of 2001 the exclusion was extended to include graduate education after December 31, 2001.

The employer may make qualified assistance payments directly, by reimbursement to the employee, or may directly provide the education. The plan may not discriminate in favor of highly compensated employees. One requirement is that no more than 5% of the total amount paid out during the year may be paid to or for employees who are shareholders or owners of at least 5% of the business. The employer must maintain records and file a plan return.

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. Availability of the benefit varies across firms. The Employee Benefit Research Institute reports that "in 1995, 65 percent of full-time employees and 36 percent of part-time employees of medium and large private establishments were eligible for job-related educational assistance benefits. Eligibility among state and local government employees in 1994 was very similar to the numbers above: 64 percent of full-time employees and 35 percent of part-time employees were eligible for job-related benefits. Eligibility was lower among small private establishment employees, with 37 percent of full-time workers and 15 percent of part-time workers eligible."

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. The Taxpayer Relief Act of 1997 extended the exclusion for employer-provided educational assistance only for undergraduate education (and with respect to courses beginning before June 1, 2000). The exclusion does not apply to graduate level courses after June 30, 1996. The most recent extension was in the Ticket to Work and Work Incentives Improvement Act of 1999. Under provisions of that act, the exclusion applies to employer education assistance through December 31, 2001.

Passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 provide an extension of the existing rules for employer provided education assistance benefits. It also extended the provision to graduate level students, which had not been covered since 1996. Congressional committee reports indicate that this extension is designed to lessen the complexity of the tax law and hope it will lead to fewer disputes between taxpayers and the Internal Revenue Service.

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. 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 medium and 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
2005	1.1	-	1.1
2006	0.5	-	0.5
2007	0.3	-	0.3
2008	0.2	-	0.2
2009	0.2	-	0.2

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 ($3,100 in 2004) and could not normally be claimed. Other standard dependency tests must be met, including the taxpayer's 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 2004, with some exceptions, the standard deduction for students is equal to the greater of $800 (in any combination of earned or

unearned income) or their earned income plus up to $250 of unearned income providing it does not exceed the standard deduction amount of $4,850 for single taxpayers. If the student's income is greater than these amounts in 2004, he or she must file a tax 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 the inflation adjusted threshold for phasing out personal exemptions. In 2004 the threshold amounts are: $214,050 for joint returns, $142,700 for single returns, or $178,350 for heads of household.

Rationale

With the codification in 1954, the Internal Revenue Code first allowed parents to claim dependency exemptions for their children regardless of the student's 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 (the amount of the personal exemption at the time). 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 working 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. It did allow a partial standard deduction for students equal to the greater of $500 (earned and/or unearned income), or earned income up to the generally applicable standard deduction amount. As a result, students with no earned income were able to shelter up to $500 in unearned income from taxation. The $500 is indexed for inflation as is the amount of the standard deduction.

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.

The Taxpayer Relief Act of 1997 raised students' standard deduction to the greater of $700 ($500 adjusted for inflation) or the total of earned income plus $250 in unearned income provided the total did not exceed the full standard deduction. This change, effective beginning in 1998, enables students with earned income greater than $700 but less than the standard deduction amount and with little unearned income to shelter their unearned income from taxation and to no longer file a separate tax return (unless they must do so to claim a refund of withheld tax). The limit on unearned income is adjusted annually for inflation.

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 working 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
2005	0.3	0.1	0.4
2006	0.3	0.1	0.4
2007	0.3	0.1	0.4
2008	0.3	0.1	0.4
2009	0.3	0.1	0.4

Authorization

Sections 103, 141, 144, and 146 of the Internal Revenue Code of 1986.

Description

Since interest on student loan bonds is tax exempt, purchasers are willing to accept lower pre-tax rates of interest than on taxable securities. The relatively low interest rate may increase the availability of student loans because States may be more willing to lend to more students. The interest rate paid by the students is not any lower since the rate is set by Federal law. Student loan bonds also create a secondary market for student loans that compares favorably with the private sector counterpart in the secondary

market for such loans, the Student Loan Marketing Association (SLMA, however, is still considered a government sponsored enterprise).

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 related to direct subsidy assistance provided by the Federal Family Education Loan Program that consists 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 student loan bonds is tax exempt, purchasers are willing to accept lower pre-tax rates of interest than on taxable securities. The relatively low interest rate may increase the availability of students loans because States may be more willing to lend to more students. However, the interest rate paid by the students is not any lower since the rate is set by Federal law. Student loan bonds also create a secondary market for student loans that compares favorably with the private sector counterpart in the secondary market for students loans, the Student Loan Marketing Association.

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 potential costs. 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 INTERESTON STATE AND LOCAL GOVERNMENT BONDSFOR PRIVATE NONPROFIT AND QUALIFIED PUBLIC EDUCATIONAL FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.8	0.3	1.1
2006	0.9	0.3	1.2
2007	0.9	0.3	1.2
2008	0.9	0.4	1.3
2009	1.0	0.4	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 provided 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 direct federal expenditure.

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 ZONE ACADEMY BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	0.1	0.1
2006	-	0.1	0.1
2007	-	0.1	0.1
2008	-	0.1	0.1
2009	-	0.1	0.1

Authorization

Section 1397E of the Internal Revenue Code

Description

Holders of qualified zone academy bonds (QZABs) 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. The discount rate for the calculation is 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. The limit for new QZAB debt is $400 million in each year of 1998 through 2005.

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. QZABs are structured to have the entire interest cost of the State or local government paid by the federal government in the form of a tax credit to the bond holders. In that sense, QZABs are not tax-exempt bonds.

The cost has been capped at the value of federal tax credits generated by the $3.2 billion QZAB volume. If the school districts in any state do not use their state's annual allotment of $400 million, the unused capacity can be carried forward no more than two years.

Rationale

The Taxpayer Relief Act of 1997 introduced QZABs. 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 forgone 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
2005	4.9	0.8	5.7
2006	5.4	0.9	6.3
2007	5.9	0.9	6.8
2008	6.3	0.9	7.2
2009	6.9	1.0	7.9

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 contribution amounts of up to 50 percent of their adjusted gross income (AGI) and up to 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.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts have been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. However, an accrual-basis corporation is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

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.

As a result of the enactment of the American Jobs Creation Act of 2004, P.L. 108-357, donors of noncash charitable contributions face increased reporting requirements. For charitable donations of property valued at $5,000 or more, donors must obtain a qualified appraisal of the donated property. For donated property valued in excess of $500,000, the appraisal must be attached to the donor's tax return. Deductions for donations of patents and other intellectual property are limited to the lesser of the taxpayer's basis in the donated property or the property's fair market value. Taxpayers can claim additional deductions in years following the donation based on the income the donated property provides to the donee. The 2004 act also mandates additional reporting requirements for charitable organizations receiving vehicle donations from individuals claiming a tax deduction for the contribution, if it is valued in excess of $500.

Taxpayers are required to obtain written substantiation from a donee organization for contributions that 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 2004, otherwise allowable deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $142,700 (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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.1
$20 to $30	0.4
$30 to $40	1.2
$40 to $50	2.3
$50 to $75	8.5
$75 to $100	10.7
$100 to $200	27.5
$200 and over	49.4

Before the 2004 enactment, donors could deduct the fair market value of donations of intellectual property. The new restrictions may result in fewer such donations to universities and other qualified institutions. The need to account for any increased income attributable to the donation might involve more work for recipient institutions.

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.

The provisions enacted in 2004 resulted from Internal Revenue Service and congressional concerns that taxpayers were claiming inflated charitable deductions, causing significant federal revenue loss. In the case of patent and other intellectual property donations, the IRS expressed concern not only about overvaluation of property, but also whether consideration was received in return for the donation and whether only a partial interest, rather than full interest, of property was being transferred.

Assessment

Most economists agree that education produces substantial "spillover" effects benefitting 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 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. More highly valued contributions, like intellectual property and patents, tend to be made by corporations to educational institutions.

It has been estimated by the American Association of Fund-Raising Counsel 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 $31.59 billion in calendar year 2003.

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 any corresponding increase in charitable gifts. It is generally argued that the charitable contributions deduction is difficult to administer and adds complexity to the tax code.

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Education, Training, Employment, and Social Services:
Employment

EXCLUSION OF EMPLOYEE MEALS AND LODGING (OTHER THAN MILITARY)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.9	-	0.9
2006	0.9	-	0.9
2007	0.9	-	0.9
2008	0.9	-	0.9
2009	1.0	-	1.0

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 (based on the difficulty in determining their fair market value), and the benefits to employers and employees are side effects. Some observers challenge the argument that administrative problems are an adequate rationale for excluding employer-provided meals and lodging. 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
2005	23.6	-	23.6
2006	24.9	-	24.9
2007	26.6	-	26.6
2008	28.6	-	28.6
2009	30.7	-	30.7

Authorization

Section 125.

Description

Cafeteria plans allow employees to choose among cash and certain nontaxable benefits (such as health care benefits) without paying taxes if they select the latter. A general rule of tax accounting is that when taxpayers have the option of receiving both cash and nontaxable benefits they are taxed even if they select the benefits since they are deemed to be in constructive receipt of the cash (that is, since it is within their control to receive it). Section 125 of the Internal Revenue Code provides an express

exception to this rule when certain nontaxable benefits are chosen under a cafeteria plan. The tax expenditure measures the loss of revenue from not including the nontaxable benefits in taxable income when employees have this choice. Cafeteria plan benefits are also not subject to employment taxes of either the employer or employee.

"Cash" includes not only cash payments but also employment benefits that are normally taxable, such as vacation pay. Nontaxable benefits include any employment benefits that are excluded from gross income under a specific section of the Code, other than long-term care insurance, scholarships or fellowships, employer educational assistance, miscellaneous fringe benefits, and most forms of deferred compensation. Nontaxable benefits typically included in cafeteria plans are accident and health insurance, dependent care assistance, group-term life insurance, and adoption assistance. Employer contributions to health savings accounts are also an allowable nontaxable benefit.

Most flexible spending accounts (FSAs) are governed by cafeteria plan provisions, as are premium conversion arrangements under which employees pay their share of health insurance premiums on a pretax basis. In both cases, employees are choosing between cash wages (through voluntary salary-reduction agreements) and nontaxable benefits.

Cafeteria plans must be in writing. The written plan must describe the available benefits, eligibility rules, procedures governing benefit elections (usually occurring during an annual open season), employer contributions, and other matters. Under IRS regulations, midyear election changes generally are allowed only for employee status changes (e.g., the birth of a child) or benefit cost changes (e.g., child care fees increase), though midyear changes on the basis of cost are not allowed for health benefits.

A highly compensated participant 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 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. There are some exceptions to these rules, including cafeteria plans maintained under collective bargaining agreements.

Impact

Cafeteria plans allow employees to choose among a number of nontaxable employment benefits without incurring a tax liability simply because they could have received cash. The principal effect is to encourage employers to give employees some choice in the benefits they receive.

As with other tax exclusions, the tax benefits are greater for taxpayers with higher incomes. Higher income taxpayers may be more likely to choose nontaxable benefits (particularly health care benefits) instead of cash, which would be taxable. Lower income taxpayers may be more likely to choose cash, which they may value more highly and for which the tax rates would be comparatively low.

More employers reportedly are offering cafeteria plans, but employee access to them depends largely on firm size. Consider health care flexible spending accounts (FSAs), one of the most common plan options, which the 2002 Medical Expenditure Panel Survey (MEPS) found were offered by 11 percent of private-sector firms and were available to 39 percent of private-sector employees. According to this survey, 47 percent of larger firms (50 or more workers) offered health care FSAs but only 3 percent of smaller firms did. Similarly, 57 percent of workers in larger firms had access to health care FSAs, but only 7 percent did in smaller firms.

Actual usage is considerably less. According to a 2003 Mercer survey, only 36% of eligible employees participate in health care FSAs. Reasons for low FSA participation include employee perceptions of complexity, concerns about end-of-year forfeitures, and limited employer encouragement. For lower income employees, particularly those who do not use much health care, the tax savings may not be sufficient incentive to participate.

FSAs were made available to federal government employees starting on July 1, 2003. Following the open season for calendar year 2004 enrollment, 133,000 federal employees had a health care FSA.

Rationale

Under 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 the employee *actually* elected taxable benefits. For plans not in existence on June 27, 1974, the employer contribution was included in gross income to the extent the employee *could* have elected taxable benefits.

The Tax Reform Act of 1976 extended these rules to employer contributions made before January 1, 1978. The Foreign Earned Income Act of 1978 made a further extension until the effective date of the Revenue Act of 1978 (*i.e.*, through 1978 for calendar-year taxpayers).

In the Revenue Act of 1978, the current provision as outlined above was added to the Code to ensure that the tax exclusion was permanent, but no specific rationale was provided.

The Deficit Reduction Act of 1984 limited permissible benefits and established additional reporting requirements. The Tax Reform Act of 1986 imposed stricter nondiscrimination rules (regarding favoritism towards highly compensated employees) on cafeteria and other employee benefit plans. In 1989, the latter rules were repealed by legislation to increase the public debt limit (P.L. 101-140).

By administrative rulings, federal government employees were allowed to start paying their health insurance premiums on a pretax basis in 2000 and to establish flexible spending accounts in 2003.

Assessment

Cafeteria plans often are more attractive to employees than fixed benefit packages since they can choose the benefits best suited to their individual circumstances. Usually, choice extends to both the type of benefit (health care, child care, etc.) as well as the amount, at least within certain limits. Ability to fine-tune benefits increases the efficient use of resources and may help some employees better balance competing demands of family and work.

As with other employment benefits, however, the favored tax treatment of cafeteria plans leads to different tax burdens for individuals with the same economic income. One justification for this outcome might be that it is in the public interest for employers to provide social benefits to workers if otherwise they would enroll in public programs or go without coverage. However, providing social benefits through employment puts burdens on

employers, particularly those with a small number of workers, and may impede workers' willingness and ability to move among jobs.

Health care flexible spending accounts (FSAs) funded through salary reduction agreements allow employees to receive tax benefits for the first dollars of their unreimbursed medical expenditures; in contrast, other taxpayers get tax benefits only if they itemize deductions and their unreimbursed expenditures exceed 7 ½ percent of adjusted gross income. It is possible that FSAs encourage additional consumption of health care, though many workers are reluctant to put large sums in their accounts since unused amounts cannot be carried over to later years.

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Education, Training, Employment, and Social Services:
Employment

EXCLUSION OF HOUSING ALLOWANCES FOR MINISTERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.5	-	0.5
2006	0.5	-	0.5
2007	0.5	-	0.5
2008	0.5	-	0.5
2009	0.6	-	0.6

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.

Further, some ministers 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, Congress may have wished to provide equal tax treatment to both groups. Another suggested rationale is that originally 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) providing that, to the extent of the tax-free housing allowance, deductions for interest and property taxes may not be itemized as a tax deduction. 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), Congress reversed the IRS ruling because the tax treatment had been long-standing, and some Members were concerned that the IRS might treat tax-free housing allowances provided to U.S. military personnel similarly.

The Internal Revenue Service's position (Revenue Ruling 71-280) is that the exclusion may not exceed the fair rental value of the home plus the cost of utilities. The Tax Court held that amounts used to provide a home are excludable even if the amount received exceeds the fair market rental value of the home (Richard D. Warren, et ux. v. Commissioner; 114 T.C. No. 23 (May 16, 2000)). In that case, 100 percent of compensation was designated as a housing allowance ($77,663 in 1993, $76,309 in 1994, and $84,278 in 1995). The court dismissed the IRS's argument that its position prevents unequal treatment between ministers for whom housing is provided and excluded and those ministers receiving a rental allowance. That decision was appealed to the Ninth Circuit Court of Appeals, which directed parties to submit briefs on whether the court should address the constitutionality of the parsonage exclusion.

In order to forestall action by the Ninth Circuit by making the underlying issue in the Warren case moot, Congress clarified the parsonage housing tax allowance with passage of the Clergy Housing Allowance Clarification Act of 2002 (P.L. 107-181). In large part Congress adopted the more conservative IRS position such that the "allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities." The Act says that it is intended to "minimize government intrusion into internal church operations and the relationship between a church and its clergy" and "recognize that clergy frequently are required to use their homes for purposes that would otherwise qualify for favorable tax treatment, but which may require more intrusive inquiries by the government into the relationship between clergy and their respective churches with respect to activities that are inherently religious."

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 economic principles of horizontal and vertical equity. 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 tax subsidy than lower-income ministers because of their higher marginal tax rates. Vertical equity is a concept which requires that tax burdens be distributed fairly among people with different abilities to pay. The disproportionate benefit of the tax exclusion to individuals with higher incomes reduces the progressivity of the tax system, which is viewed as a reduction in equity.

Ministers who have church-provided homes do not receive the same tax 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. As such, this result is inconsistent with the general tax policy principle of preventing double tax benefits.

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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
2005	6.4	-	6.4
2006	6.6	-	6.6
2007	6.8	-	6.8
2008	7.0	-	7.0
2009	7.3	-	7.3

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
2005	0.2	-	0.2
2006	0.2	-	0.2
2007	0.2	-	0.2
2008	0.2	-	0.2
2009	0.2	-	0.2

Authorization

Sections 74(c), 274(j).

Description

Generally, prizes and awards to employees that do not qualify as a de minimis fringe benefit under Section 132(e) are taxable to the employee. Section 74(c), however, provides an exclusion for certain awards of tangible personal property given to employees for length of service or for safety achievement.

The amount of the exclusion (under subsection 74(c)) for the employee is the value of the property awarded, and is generally limited by the

employer's deduction for the award (under Section 274(j)) — $400, or up to $1,600 for awards granted as part of qualified employee achievement award plans. Qualified employee achievement plans are established or written employer programs which do not discriminate in favor of highly compensated employees. In addition, the average cost per recipient of all awards granted under all established plans for an employer cannot exceed $400.

For employees of non-profit employers, the amount of the exclusion is the amount that would have been allowed if the employer were taxable (non-profit organizations are generally not subject to federal income taxes) - $400, and up to $1,600 if the non-profit employer has a qualified employee achievement award plan.

Generally, the limitation on the exclusion for the employee is the cost to (and deduction for) the employer related to the award. If however both the cost to the employer for the award and the fair market value of the award exceed the limitation, the employee must include the excess (fair market value minus the limitation) in gross income.

Length of service awards which qualify for the exclusion (and the employer deduction of cost), cannot be awarded to an employee in the first five years of service, or to an employee who has received a length of service award (other than an award excluded as a de minimis fringe benefit under Section 132(e)) in that year or any of the prior four years of service. Awards for safety achievement (other than an award excluded as a de minimis fringe benefit under Section 132(e)) which qualify for the exclusion (and the employer deduction of cost) cannot be awarded to a manager, administrator, clerical employee, or other professional employee. In addition, awards for safety achievement cannot have been awarded, in that year, to more than 10% of employees.

The amount of an eligible employee award which is excluded from gross income is also excluded under the Federal Insurance Contributions Act (FICA) for Social Security and Medicare taxes (Old Age, Survivors and Disability tax and Hospital tax).

Impact

Sections 74(c) and 274(j) exclude from gross income certain employee awards of tangible personal property for length of service and safety achievement that would otherwise be taxable.

Rationale

The exclusion for certain employee awards was adopted in the Tax Reform Act of 1986. Prior to that Act, with exceptions that were complex and difficult to interpret, awards received by employees generally were taxable.

Assessment

The exclusion recognizes a traditional business practice which may have social benefits. The combination of the limitation on the exclusion as to eligibility for qualifying awards, and the dollar amount of the exclusion not being increased since 1986, keep the exclusion from becoming a vehicle for significant tax avoidance. However, the lack of an increase in the exclusion effectively reduces the tax-free portion of some awards.

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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
2005	3.1	-	3.1
2006	3.3	-	3.3
2007	3.4	-	3.4
2008	3.5	-	3.5
2009	3.7	-	3.7

Authorization

Sections 419, 419A, 501(a), 501(c)(9), 4976

Description

Voluntary Employees' Beneficiary Associations (VEBAs) provide life insurance, medical, disability, accident, and other welfare benefits to employee members and their dependents and beneficiaries. Most VEBAs are organized as trusts to be legally separate from employers. Provided certain requirements are met, the income earned by a VEBA is exempt from federal income taxes under Sections 501(a) and 501(c)(9). If the requirements are not met however, the income is subject to the unrelated

business income tax (UBIT). With some exceptions, income earned by a VEBA used for prefunding retiree health benefits is subject to this tax.

Employer contributions to VEBAs are deductible within limits described below, while employee contributions are made with after-tax dollars. When distributed, VEBA benefits are taxable income to recipients unless there is a statutory exclusion explicitly pertaining to those kinds of benefits. Thus, accident and health benefits are excludable under Sections 104 and 105, but severance and vacation pay benefits are taxable.

VEBAs must meet a number of general requirements, including: (1) the organization must be an association of employees who share a common employment-related bond; (2) membership in the association must be voluntary (or, if mandatory, under conditions described below); (3) the association must be controlled by its members, by an independent trustee (such as a bank), or by trustees or fiduciaries at least some of whom are designated by or on behalf of the members; (4) substantially all of the organization's operations must further the provision of life, sickness, accident, and other welfare benefits to employees and their dependents and beneficiaries; (5) none of the net earnings of the organization may accrue, other than by payment of benefits, directly or indirectly to any shareholder or private individual; (6) benefit plans (other than collectively-bargained plans) must not discriminate in favor of highly compensated individuals; and (7) the organization must apply to the IRS for a determination of tax exempt status.

These general requirements have been refined and limited by both IRS and court decisions. For example, employee members may have a common employer or affiliated employers, common coverage under a collective bargaining agreement, or membership in a labor union or a specified job classification. In addition, members may be employees of several employers engaged in the same line of business in the same geographic area. Not all members need be employees, but at least 90 percent of the membership one day each calendar quarter must be employees. Membership may be required if contributions are not mandatory or if it is pursuant to a collective bargaining agreement or union membership. Permissible benefits generally include those that safeguard or improve members' health or that protect against contingencies that interrupt or impair their earning power including vacation benefits, recreational activities, and child care. Prohibited benefits include pension and annuities payable at retirement and deferred compensation unless it is payable due to an unanticipated event such as unemployment.

VEBA benefits may not discriminate in favor of the highly paid. In addition, VEBAs used for prefunding of retiree medical or life insurance

benefits are required to establish separate accounts for members who are key employees.

In general, employer deductions for VEBA contributions are limited to the sum of qualified direct costs and additions to qualified asset accounts, minus VEBA after-tax net income. These account limits are specified in Internal Revenue Code Sections 419 and 419A. *Qualified direct costs* are the amounts employers could have deducted for employee benefits had they used cash basis accounting (essentially, benefits and account expenses actually paid during the year). *Qualified asset accounts* include: (1) reserves set aside for claims incurred but unpaid at the end of the year for disability, medical, supplemental unemployment and severance pay, and life insurance benefits; (2) administrative costs for paying those claims; and (3) additional reserves for post-retirement medical and life insurance benefits. The reserve for post-retirement benefits must be funded over the working lives of covered individuals on a level basis, using actuarial assumptions incorporating current, not projected, medical costs. For post-retirement life insurance, amounts in excess of $50,000 per employee may not be taken into account in determining the reserve. *After-tax net income* consists of net interest and investment earnings plus employee contributions, minus any unrelated income tax liability. Employer contributions are deductible only if they would otherwise be deductible as a trade or business expense or as an expense related to the production of income. In addition, employer contributions are deductible only in the year actually paid.

The prefunding limits just described do not apply to collectively bargained or employee pay-all plans (sometimes called 419A(f)(5) plans) or to multiple employer welfare plans (MEWAs) of ten or more employers in which no employer makes more than 10 percent of the contributions (sometimes called 419A(f)(6) plans). The latter plans (MEWAs) cannot have experienced rated contributions for single employers.

VEBAs are subject to the UBIT to the extent they are overfunded because contributions exceed account limits. However, the UBIT does not apply on the following sources of income: (1) income that is either directly or indirectly attributable to assets held by a VEBA as of July 18, 1984 (the date of enactment of the Deficit Reduction Act of 1984); (2) income on collectively bargained or employee pay-all VEBAs; and (3) income on VEBAs for which substantially all contributions came from tax-exempt employers. Tax rates applicable to trusts are used to calculate the UBIT for VEBAs organized as trusts.

Under Section 4976, any reversion of VEBA assets to the employer is subject to a 100% excise tax.

Impact

VEBAs have been used by employers for a variety of reasons including to segregate assets, earn tax free investment returns, reduce future contribution requirements by prefunding, create an offsetting asset for an employer liability and meet requirements of rate making bodies and regulatory agencies. Funding a welfare benefit through a VEBA often offers tax advantages to the employer. The magnitude of the tax advantage depends on the amount of benefits payable and the duration of the liability. Thus, the tax advantage is greater for a VEBA that funds the disabled claim reserve for a Long Term Disability plan than for a VEBA that funds the Incurred but Not Paid claim reserve for a medical plan. The greatest tax advantage accrues to an employer that uses a VEBA for prefunding of a retiree health care plan, especially if the prefunding is for a collectively bargained group of employees.

Unlike qualified defined benefit pension plans, employers are not legally required to prefund retiree health plans. However, certain employers have found it advantageous to prefund retiree health benefits. Utilities such as electric, gas, water, and telephone companies (prior to deregulation) were required by regulators to prefund retiree benefits in order to include the cost of the benefits in rates they charged to customers. Similarly, companies that did business with the U.S. Department of Defense were required to prefund retiree benefits in order to include the cost of benefits as part of the contract charges.

Use of VEBAs for prefunding retiree health benefits gathered momentum after the Financial Accounting Standards Board (FASB) required accrual accounting for post-retirement benefits other than pensions under Statement of Financial Accounting Standard 106 (FAS 106). This accounting standard, which was effective for employers' fiscal years beginning after December 15, 1992, required employers to calculate the net periodic postretirement health care cost on an accrual basis and recognize it as an expense in the employer's income statement. If the employer had segregated assets dedicated to the payment of retiree health care benefits, the return on these assets reduced the net periodic postretirement health care cost. With the release of FAS 106, employers were in search of the ideal funding vehicle that met all of the following conditions: (1) the employer could make tax deductible contributions; (2) the rate of return on the funding vehicle compared favorably to alternate uses of employer funds; (3) adequate contributions could be made for funding the plan obligations; and (4) assets were inaccessible to the employer for any purpose other than specified in the plan. A collectively bargained VEBA was the one funding vehicle that met all of these criteria. Although non-collectively bargained VEBAs had shortcomings, some employers used them nonetheless. Investment strategies used to improve the after-tax rate of return for such

VEBAs included buying life insurance within the VEBA trust so that the VEBA could benefit from the tax-free inside buildup of the insurance policy.

Because of the more advantageous tax treatment for collectively bargained VEBAs, employers used VEBAs for prefunding retiree health benefits more frequently for unionized employees than for non-union employees. Investment income on the funds accumulated tax free and there were no limits on contributions. Some employers also established employee-pay-all VEBAs for prefunding employee out-of-pocket health care costs in retirement. In this type of VEBA, employees make all of the contributions, with no contributions made by employers, and the investment income on the VEBA accumulates tax free. Employees can withdraw funds after retirement from the VEBA to pay health care costs without paying taxes on the withdrawals.

Recently, there has been interest in the use of employee-pay-all VEBAs in order to provide medical benefits to retirees of bankrupt companies. Retirees in bankrupt companies often lose some or all of their health care coverage. By pooling the risk in a VEBA, retirees may find that the premiums are more attractive than otherwise available in the individual health insurance market.

The Survey of Employer Health Benefits conducted by the Kaiser Family Foundation and the Health Research and Educational Trust indicates that in 2004, 36 percent of large firms (200 or more employees) offered retiree health benefits compared with 5 percent of small firms (3 to199 employees). Among large firms, firms with union employees were much more likely to offer retiree health benefits (60 percent) than firms without union employees (22 percent).

Not all firms that offer retiree health benefits use a VEBA for prefunding them. According to the 2003 Mercer National Survey of Employer-Sponsored Health Plans, 9 percent of employers with 500 or more employees are currently using a VEBA for prefunding of retiree medical benefits and another 7 percent are considering using a VEBA for this purpose. The likelihood of funding retiree health benefits with a VEBA increases with the size of the employer. While 30 percent of employers with 20,000 or more employees are currently using a VEBA for prefunding of retiree health benefits, only 4 percent of employers with 500 to 999 employees use a VEBA for this purpose. Mercer also reports that the use of a VEBA for prefunding retiree health benefits is most common for employers in the communication, transportation and utility industries.

Unlike pensions, VEBA health benefits accrue uniformly across all income groups. Retiree health benefits unlike pension benefits are not salary

related. In fact, the benefits of VEBAs are more likely to accrue in favor of the lower paid employees for two reasons. First, VEBAs are used more often for unionized employees who are typically paid less than management employees. And secondly, when VEBAs are used for non-union employees, employers typically exclude key employees from the VEBA in order to avoid cumbersome administrative requirements to maintain separate accounts within the VEBA.

Rationale

VEBAs were originally granted tax-exempt status by the Revenue Act of 1928, which allowed associations to provide payment of life, sickness, accident, or other benefits to their members and dependents provided: (1) no part of their net earnings accrued (other than through such payments) to the benefit of any private shareholder or individual; and (2) 85 percent or more of their income consisted of collections from members for the sole purpose of making benefit payments and paying expenses. The House report noted that these associations were common and, without further explanation, that a specific exemption was desirable. Presumably, VEBAs were seen as providing welfare benefits that served a public interest and normally were exempt from taxation.

The Revenue Act of 1942 allowed employers to contribute to the association without violating the 85-percent-of-income requirement. In the Tax Reform Act of 1969, Congress completely eliminated the 85-percent requirement, allowing a tax exclusion for VEBAs that had more than 15 percent of their income from investments. However, the legislation imposed the UBIT on VEBA income (as well as the income of similar organizations) to the extent it was not used for exempt functions.

While VEBAs cannot be used for deferred compensation, sometimes it has been difficult to distinguish such benefits. Particularly after 1969, VEBAs presented opportunities for businesses to claim tax deductions for contributions that would not be paid out in benefits until many years afterwards, with investment earnings building tax-free. In many cases, the benefits were disproportionately available to corporate officers and higher-income employees. After passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), there was increased marketing of plans providing readily available deferred benefits (for severance pay, for example) to owners of small businesses that appeared to circumvent restrictions the Act had placed on qualified pensions.

In response, the Deficit Reduction Act of 1984 (DEFRA) placed tight restrictions on employer contributions (Section 419 of the Code) and

limitations on accounts (Section 419A). In addition, tighter nondiscrimination rules were adopted with respect to highly compensated individuals. These changes applied to welfare benefit funds generally, not just VEBAs. The nondiscrimination rules were further modified by the Tax Reform Act of 1986. The Tax Reform Act of 1986 also exempted collectively bargained welfare benefit funds and employee pay-all plans from account limits, thereby exempting the investment income on such VEBA trusts from the UBIT.

DEFRA did not apply these restrictions to collectively bargained plans or the multiple employer welfare plans (MEWAs) described above. In practice, both exemptions allowed arrangements that the IRS and others criticized as tax shelters. In 2003, the IRS stated its intention to issue regulations disallowing employer deductions for arrangements set up through sham labor negotiations. It also issued final regulations defining experienced-rating arrangements that preclude employer deductions for MEWAs.

Assessment

Although there appears to be some abuse of VEBAs by small employers for estate planning purposes, VEBAs have usually been used in ways that further social goals. When VEBAs are used for prefunding of retiree health benefits, they increase the likelihood of employees receiving such benefits. Particularly in case of bankruptcy, the presence of a VEBA with accumulated assets for payment of retiree health benefits offers retirees a measure of protection. Under current law, VEBAs offer an attractive way to prefund retiree health benefits for union employees, but not for non-union employees.

When an employer provides retiree health benefits, retirees typically have significant out-of-pocket payments for premiums, deductibles, and copayments. An employee-pay-all VEBA could be used to allow employees to accumulate funds during their working years for payment of out-of-pocket health care costs during retirement. However, current law poses some problems in the use of an employee-pay-all VEBA for this purpose. Amounts contributed by an active employee cannot be refunded to the employee or his family upon job termination or premature death. In addition, although investment income on funds in an employee-pay-all VEBA is not subject to the UBIT, if employee and employer contributions are commingled in the same VEBA, all investment income is subject to that tax. As concerns mount about the future of retiree health benefits, Congress might reconsider some of these restrictions.

With the addition of prescription drug coverage to Medicare, it is possible that some employers that are currently providing retiree health benefits will eliminate or reduce prescription drug coverage. To the extent that these employers have been prefunding retiree health benefits through VEBAs, the new provision would reduce their deductions for such prefunding.

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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
2005	0.3	0.8	1.1
2006	0.3	0.9	1.2
2007	0.3	0.9	1.2
2008	0.3	0.9	1.2
2009	0.3	0.9	1.2

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, if the dividends are used to repay a loan that was used to buy the stock, or for dividends paid on stock in a retirement plan. 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. The Economic Growth and Recovery Tax Act of 2001 allowed firms to deduct dividends on stock held in retirement plans.

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. The cost of such a lack of diversification was demonstrated with the failure of Enron and other firms whose employees' retirement plans were heavily invested in company stock. 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
2005	0.1	0.2	0.3
2006	([1])	0.2	0.2
2007	([1])	0.1	0.1
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

*The tax credit is effective through December 31, 2005.

([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 Temporary Assistance for Needy Families (TANF) program 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 in an empowerment zone, renewal community, 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 in an empowerment zone, renewal community, 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 by state vocational rehabilitation agencies or employment networks 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 under Title XVI of the Social Security Act 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 1 year or carried forward 20 years for workers hired on or after January 1, 1998.

Impact

An employer completes a "pre-screening" notice by the date a job offer is made to an applicant thought to belong to the WOTC-eligible population. The IRS form must be mailed to the state's Employment Service (ES) agency within 21 days after the new hire starts working. The ES then certifies whether the new hire belongs to one of the WOTC's eligible groups.

According to the ES, 377,310 certifications were issued to employers for FY2002. About 42% were for members of the TANF group. Another 25% were for members of the 18-24 year old Food Stamp group, and 11%, for the high-risk youth 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 temporary credit was authorized by the Small Business Job Protection Act of 1996, effective from October 1, 1996 through September 30, 1997. It subsequently was extended and amended in several pieces of legislation. Most recently, it was extended (retroactive to its expiration date after having lapsed on January 1, 2004) through December 31, 2005 by the Working Families Tax Relief Act of 2004.

WOTC is intended to help individuals who have difficulty obtaining employment in both good and bad economic times get jobs in the private sector. The credit is designed to reduce the relative cost of hiring these low-skilled individuals by subsidizing their wages, and hence to increase employers' willingness to give them jobs 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. The TJTC was subject to criticism, but Congress, after making some revisions, retained this approach to increasing employment of disadvantaged workers.

Assessment

Since its inception in 1996, no funds have been explicitly included in legislation to conduct an assessment of the WOTC's effectiveness. Based upon a survey of employers in two states conducted by the General Accounting Office (GAO) in 2001, the agency speculated that employers were not displacing employees in order to replace them with individuals for whom they could claim the credit. According to the GAO, the cost of recruiting, hiring, and training WOTC-eligible workers appears to be higher than the amount of the credit that employers could claim. As employees certified for the credit were not terminated any more frequently than others when their earnings reached about $6,000 (the credit-maximizing level), the GAO surmised that employers were not churning their workforces to maximize credit receipt.

Another limited analysis yielded a fairly unfavorable assessment of the credit's performance. Based on interviews with 16 firms in 5 states that claimed the credit, researchers found that the WOTC had little or no influence on the employers' hiring decisions.

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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
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

*The tax credit is effective through December 31, 2005.

([1])Less than $50 million.

Authorization

Sections 51 and 52.

Description

The Welfare to Work (WtW) Credit 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 credit-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 1 years or carried forward 20 years. Employers cannot claim both the WOTC and WtW credit for the same individuals.

Impact

An employer completes a "pre-screening notice" by the date a job offer is made to an applicant thought to belong to the credit-eligible population. The IRS form must be mailed to the state's Employment Service (ES) agency within 21 days after the new hire starts working. The ES then certifies whether the new hire is part of the eligible group. The employer uses the certification of eligibility to claim the WtW credit.

According to the ES, 46,652 certifications were issued to employers for FY2002. 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 WtW credit 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 this and other criticisms, Congress opted to retain this approach to job creation for long-term family assistance recipients.

Assessment

The temporary credit most recently was extended (retroactive to its expiration date after having lapsed on January 1, 2004) through December 31, 2005 by the Working Families Tax Relief Act of 2004. With a target group very similar to one of the Work Opportunity Tax Credit's eligible groups, its availability has increased the complexity of the Code.

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Education, Training, Employment, and Social Services:
Employment

DEFERRAL OF TAXATION ON SPREAD ON ACQUISITION OF STOCK UNDER INCENTIVE STOCK OPTION PLANS AND EMPLOYEE STOCK PURCHASE PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.4	-	0.4
2006	0.4	-	0.4
2007	0.4	-	0.4
2008	0.4	-	0.4
2009	0.4	-	0.4

Authorization

Sections 422-423.

Description

Qualified (or "statutory") options include "incentive stock options," which are limited to $100,000 a year for any one employee, and "employee stock purchase plans," which are limited to $25,000 a year for any employee. Employee stock purchase plans must be offered to all full-time employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees. Qualified options are not taxed to the employee when granted or

exercised (under the regular tax); tax is imposed only when the stock is sold. If the stock is held one year from purchase and two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction. The value of incentive stock options is included in minimum taxable income in the year of exercise.

Impact

Both types of qualified stock options receive some tax benefit under current law. The employee recognizes no income (for regular tax purposes) when the options are granted or when they are exercised. Taxes (under the regular tax) are not imposed until the stock purchased by the employee is sold. If the stock is sold after it has been held for at least two years from the date the option was granted *and* one year from the date it was exercised, the difference between the market price of the stock when the option was exercised and the price for which it was sold is taxed at long-term capital gains rates. If the option price was less than 100% of the fair market value of the stock when it was granted, the difference between the exercise price and the market price (the discount) is taxed as ordinary income (when the stock is sold). Taxpayers with above average or high incomes are the primary beneficiaries of these tax advantages.

Rationale

The Revenue Act of 1964 (P.L. 88-272) enacted special rules for qualified stock options, which excluded these options from income when they were granted or exercised and instead included the gains as income at the time of sale of the stock. The Tax Reform Act of 1976 (P.L. 94-455) repealed these special provisions and thus subjected qualified stock options to the same rules as applied to nonqualified options. Therefore, if an employee receives an option, which has a readily ascertainable fair market value at the time it is granted, this value (less the option price paid for the option, if any) constituted ordinary income to the employee at that time. But, if the option did not have a readily ascertainable fair market value at the time it was granted, the value of the option did not constitute ordinary income to the employee at that time. However, when the option was exercised, the spread between the option price and the value of the stock constituted ordinary income to the employee. The Economic Recovery Tax Act of 1981 (P.L. 97-34) reinstituted special rules for qualified stock options

with the justification that encouraging the management of a business to have a proprietary interest in its successful operation would provide an important incentive to expand and improve the profit position of the companies involved.

Assessment

Tax advantages for qualified stock options encourage companies to provide them to employees rather than other forms of compensation that are not tax favored. Paying for the services of employees, officers, and directors by the use of stock options has several advantages for the companies. Start-up companies often use the method because it does not involve the immediate cash outlays that paying salaries involves; in effect, a stock option is a promise of a future payment, contingent on increases in the value of the company's stock. It also makes the employees' pay dependent on the performance of the company's stock, giving them extra incentive to try to improve the company's (or at least the stock's) performance. Ownership of company stock is thought by many to assure that the company's employees, officers, and directors share the interests of the company's stockholders. Lastly, receiving pay in the form of stock options serves as a form of forced savings, since the money cannot be spent until the restrictions expire.

Critics of the stock options, however, argue that there is no real evidence that the use of stock options instead of cash compensation improves corporate performance. (Many of the leading users of stock options were among the companies suffering substantial recent stock losses.) Furthermore, stock options are a risky form of pay, since the market value of the company's stock may decline rather than increase. Some employees may not want to make the outlays required to buy the stock, especially if the stock is subject to restrictions and cannot be sold immediately. And some simply may not want to invest their pay in their employer's stock.

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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
2005	46.6	-	46.6
2006	46.5	-	46.5
2007	46.4	-	46.4
2008	46.4	-	46.4
2009	45.8	-	45.8

*Does not include the refundable portion.

Authorization

Section 24.

Description

Families with qualifying children are allowed a credit against their federal individual income tax of $1,000 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 calendar year in which the taxable year of the taxpayer begins.

The child tax credit is phased out for taxpayers whose adjusted gross incomes (AGIs) exceed certain thresholds. For married taxpayers filing joint returns, the phaseout begins at AGI levels in excess of $110,000, for married couples filing separately the phaseout begins at AGI levels in excess of $55,000, and for single individuals filing as either heads of households or as singles the phaseout 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 nor the phaseout thresholds are indexed for inflation.

The child tax credit is refundable. For families with less than three qualifying children, the maximum refundable credit cannot exceed 15% of a taxpayer's earned income in excess of a given income threshold. For 2004, the income threshold is $10,750. The threshold is indexed annually for inflation. For families with three or more children, the maximum refundable credit is limited to the extent that the taxpayer's Social Security taxes and income taxes exceed the taxpayer's earned income tax credit or to the extent of 15% of their earned income in excess of income threshold. In these cases, the taxpayer can use whichever method results in the largest refundable credit.

The child tax credit can be applied against both a taxpayer's regular income tax and his or her alternative minimum tax.

Impact

The child tax credit will benefit all families with qualifying children whose incomes fall below the AGI phaseout ranges.

Distribution by Income Class of the Tax Credit for Children Under Age 17, 2004

Income Class (in thousands of $)	Percentage of Amount
Below $10	0.3
$10 to $20	4.0
$20 to $30	11.0
$30 to $40	13.9
$40 to $50	11.9
$50 to $75	24.9
$75 to $100	18.4
$100 to $200	15.5
$200 and over	0.0

Rationale

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997. Initially, for tax year 1998, families with qualifying children were allowed a credit against their federal income tax of $400 for each qualifying child. For tax years after 1998, the credit increased to $500 for each qualifying child. For families with three or more children, the credit was refundable.

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 a family's tax liabilities, would better recognize the financial responsibilities of child rearing, and promote family values.

The amount and coverage of the child tax credit was substantially increased by the Economic Growth and Tax Relief Reconciliation Act of 2001. Proponents of this increase argued that a $500 child tax credit was inadequate. It was argued that the credit needed to be increased in order to better reflect the reduced ability to pay taxes of families with children. Furthermore, it was felt that the credit should be refundable for all families with children.

The 2001 Act increased the child tax credit to $1,000 with the increase scheduled to be phased in between 2001and 2010. It also made the credit refundable for families with less than three children. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the child tax credit to $1,000 for tax years 2003 and 2004. The Working Families Tax Relief Act of 2004 effectively extended the $1,000 child tax credit through 2010. The 2004 act also included combat pay, which is not subject to income taxes, in earned income for purposes of calculating the refundable portion of the credit.

Under current law, the changes made by the 2001 act will sunset at the end of 2010. For tax years beyond 2010, the child tax credit will revert to its pre-2001 law levels and refundability rules.

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, and expanded upon on the 2001, 2003, and 2004 tax Acts, 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
2005	3.0	-	3.0
2006	2.2	-	2.2
2007	1.9	-	1.9
2008	1.8	-	1.8
2009	1.7	-	1.7

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 35 percent of expenses up to $3,000, if there is one qualifying individual, and up to $6,000 for two or more qualifying individuals. The credit rate is reduced by one percentage point for each $2,000 of adjusted gross income (AGI), or fraction thereof, above $15,000, until the credit rate of 20 percent is reached for taxpayers with AGI incomes above $43,000. 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.

Distribution by Income Class of the Tax Expenditure for Child and Dependent Care Services, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.9
$20 to $30	5.8
$30 to $40	12.4
$40 to $50	11.2
$50 to $75	21.9
$75 to $100	19.2
$100 to $200	24.3
$200 and over	4.1

Source: Data obtained from IRS *Statistics of Income*, http://www.irs.ustreas.gov/pub/irs-soi/01in33ar.xls, visited Oct. 25, 2004. Amounts may not add up due to rounding.

The credit rate phases down from 35 to 20 percent as incomes rises from $15,000 to $43,000, providing the largest monetary benefit to parents with incomes of $43,000 or less. In the past, the absence of an inflation adjustment has affected the ability of moderate-income taxpayers to receive the maximum benefits under the credit.

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. Single parents and widow(er)s did not have an income limitation for the deduction. The provision was intended to recognize the similarity of child care expenses to employee business expenses and provide 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.

The deduction was replaced by a nonrefundable credit with enactment of the Tax Reform Act of 1976. Congress believed that such expenses were 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 provided 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 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 became available for care of children under 13 rather than 15. Second, a dollar-for-dollar offset was 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 provided that the taxpayer must report on his or her tax return the name, address, and taxpayer identification number of the dependent care provider.

With passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, the sliding-scale credit was increased 5 percent while the maximum expenditure amounts for care were raised from $2,400 to $3,000 for one qualifying individual and from $4,800 to $6,000 in the case of two or more qualified individuals. It seems likely that these changes were made because these provisions are not subject to an automatic inflation provision.

The provision was further amended by the Job Creation and Worker Assistance Act of 2002 which determined that the amount of "deemed earned income" in the case of a nonworking spouse incapable of self-care or a student is increased to $250 if there is one qualifying child or dependent, or $500 if there are two or more children.

In 2004, the Working Families Tax Relief Act was passed which made two changes for dependent care expenses. The bill imposed a requirement that a disabled dependent (or spouse), who is not a qualifying child under age 13, live with the taxpayer for more than half the tax year. It also eliminated the requirement that the taxpayer maintain a household in which the qualifying dependent resides.

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 adjusted gross incomes were under $20,000 claimed 0.7 percent of the total value of credits claimed in 2001, while taxpayers in the $50-$75,000 income class claimed approximately twelve percent. However, the determination of the dependent care tax credit progressivity cannot be made simply by comparing federal revenue loss from use of credit by low- versus high-income taxpayers. A more appropriate measure is the credit amount relative to the taxpayer's income.

Prior economic studies have found 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 still lacks an automatic adjustment for inflation, while other code provisions are adjusted yearly. In the past, this absence of an automatic yearly adjustment has affected the ability of low-income taxpayers to use the credit.

Prior to the legislated increase for 2003, the qualifying expenditure amount had not been increased since 1982. The new amounts of $3,000 for a single qualifying individual and $6,000 for two or more qualifying individuals break down to $58 per week for one and $115 for two or more qualifying individuals. This amount is equivalent to $1.45 per hour per individual (using a standard 40 hour work-week) and falls far below the federal minimum wage level. 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 is generally acknowledged to provide adequately 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 select care providers from peers, the reporting of income could reduce the careprovider's welfare benefits.

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EXCLUSION OF EMPLOYER-PROVIDED CHILD CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	1.0	-	1.0
2006	1.1	-	1.1
2007	1.1	-	1.1
2008	1.2	-	1.2
2009	1.3	-	1.3

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, employer expenditures for dependent care assistance 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, the 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 and employment taxes, 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 Trust Fund 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 services for their employees.

Assessment

The debate over the tax treatment of dependent 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 the economic principle of horizontal equity, in that all taxpayers with similar incomes are not treated equally. Employer dependent-care plans are typically offered by large employers, so that those most 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 higher 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 provision of these 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

TAX CREDIT FOR EMPLOYER-PROVIDED CHILD CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	0.1	0.1
2006	([1])	0.1	0.1
2007	([1])	0.2	0.2
2008	([1])	0.2	0.2
2009	([1])	0.2	0.2

([1])Less than $50 million.

Authorization

Section 45F.

Description

Employers are allowed a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. Qualified child care expenses

include the cost of acquiring, constructing, rehabilitating or expanding property used for a child care facility, costs for the operation of the facility (including training costs and certain compensation for employees, and scholarship programs), and for contracting with a facility to provide child care. The facility must have child care as its principal purpose and must be open to all employees. Additionally, use of the facility cannot discriminate in favor of highly paid employees; use of child care resources and referral services also cannot discriminate in favor of highly paid employees. The maximum total credit that may be claimed by a taxpayer cannot exceed $150,000 per taxable year. These credits are reduced by the amounts of any tax deduction claimed for the same expenditure. Credits for acquiring, constructing, rehabilitating, or expanding property are recaptured if the facility is transferred to a different use within the first 10 years.

Impact

A 25 percent credit is a very large tax subsidy which should significantly decrease the cost of on-site facilities for employers and encourage some firms to develop on-site facilities. Firms have to be large enough to make the facility viable, i.e. have enough employees with children in need of child care. Thus, large firms will be those that provide on-site child care.

This nonrefundable tax credit has the potential to violate the principle of horizontal equity, which requires that similarly situated taxpayers should bear similar tax burdens. Mid- and small-sized firms may not have sufficient tax liability to be able to take advantage of the credit. Even for those firms that are able to claim the credit, they may not be able to claim the full amount because of limited tax liability.

Although the credit is contingent on non-discrimination in favor of more highly compensated employees, this provision, unlike child care tax benefits in general, may provide greater benefits to middle and upper income individuals because its relative cost effect is dependent on the size of the firm and not the income of the employees. Indeed, lower income employees may not be able to afford the higher quality child care facilities offered by some firms (although some employers subsidize costs for lower income workers).

Rationale

This provision was adopted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) and was designed to encourage on-site employer child care facilities.

Assessment

Specific subsidies for on-site employer-provided child care would be economically justified if there were a market failure that prevented firms from providing this service. Few firms offer such facilities, although small firms may not have enough potential clients to allow the center to be economically viable. The limit on the subsidy amount is intended to target smaller firms, but it is not clear why such activities are under-supplied by the market. Some research has suggested that on-site care produces benefits that firms may not take into account, such as reduced absenteeism and increased productivity, but not all evidence is consistent with that view. In addition, employers may be reluctant to commit to on-site child care because of uncertainties regarding costs and return. There is also some concern that employer-provided child care centers may create resentment among employees who are either childless or on a waiting list for admittance of their children to the center.

Some firms have also begun offering emergency or back-up care, which is a more limited proposition that may be more likely to reduce absenteeism. The credits may encourage more firms of larger size to provide these benefits, which may increase productivity because parents are not forced to stay home with a sick child or a child whose care giver is temporarily not available.

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Education, Training, Employment, and Social Services:
Social Services

EXCLUSION OF CERTAIN FOSTER CARE PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.6	-	0.6
2006	0.6	-	0.6
2007	0.6	-	0.6
2008	0.7	-	0.7
2009	0.7	-	0.7

Authorization

Section 131.

Description

A "qualified foster care payment" is paid to the provider for caring for a "qualified foster individual" in the foster care provider's home. Such payments (made by a State or local governmental agency or any "qualified foster care placement agency" that is licensed or certified by a state or local government, or an entity designated by a state or local government to make payments to providers of foster care) are excluded from the foster care

provider's income. A "qualified foster individual" is defined as an individual placed by a qualified foster care placement agency, regardless of the individual's age at the time of placement.

"Difficulty of care" payments are compensation approved by the State for additional care necessitated by an individual's physical, mental, or emotional handicap. These payments also qualify for exclusion from the foster care provider's income.

The Internal Revenue Service has ruled that foster care payments that are excluded from income are not "earned income" for purposes of the Earned Income Tax Credit (EITC), while those included in gross income may be earned income for purposes of the EITC, depending on the specific facts of the case.

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 higher 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, to the foster provider.

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. 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.

Under a provision included in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), the definition of "qualified foster care payments" was expanded to include for-profit agencies contracting with State and local governments to provide foster home placements. The change was made in recognition that States often contract services out to for-profit firms and that the tax code had not recognized the role of private agencies in helping the States provide foster care services for placement and delivery of payments. The provisions are thought to reduce complexity with the hope that simpler rules may encourage more families to provide foster care services.

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
2005	0.2	-	0.2
2006	0.2	-	0.2
2007	0.2	-	0.2
2008	0.2	-	0.2
2009	0.2	-	0.2

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 $10,390 per child in calendar year 2004 and are inflation adjusted in future years. Adoption expenses may be incurred over several years. This nonrefundable tax credit may be carried forward five years. Employer-provided adoption assistance

benefits 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 modified adjusted gross income over $152,390, the amounts are reduced such that the amounts are fully phased out for taxpayers whose modified adjusted gross income exceeds $192,390. The phase-out range is adjusted for inflation. The adoption credit is allowed against the alternative minimum tax.

The two incentives are available through tax year 2010. After 2010, taxpayers will be able to claim the adoption credit only if they incur expenses for an adoption of a child with special needs. The exclusion of employer-provided adoption assistance is not available after 2010.

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. In the case of special needs adoptions, state required expenses such as construction, renovations, alterations, or other purchases may qualify as adoption expenditures. In the case of a special needs adoption, the $10,390 credit is allowed regardless of whether the taxpayer has qualified adoption expenses.

The provisions are unavailable for surrogate parenting arrangements and for 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 provisions are also unavailable for expenditures contrary to state or federal law.

The code 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 of the Treasury 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. Special rules apply when the adopted child is not a citizen or resident of the United States. 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 Congress to devise an administrative solution to minimize processing burdens with potential compliance difficulties.

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 $192,390. The $10,390 tax credit 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. The upward shift in the adjusted gross income phase-out makes the benefits available to a larger group of adoptive taxpayers. While the provisions are only used by a small proportion of taxpayers, the dollar amounts of the tax benefits are relatively large. Like other tax benefits, the adoption provisions will reduce federal tax revenues. The revenue losses stem not only from the larger tax benefit level of the credit and exclusion 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 foster care exclusion is essentially a one-time per child revenue loss, foster care payments may go on for many years.

Distribution by Income Class of the Adoption Credit at 2001 Income Levels

Adjusted Gross Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.2
$20 to $30	0.0
$30 to $40	3.1
$40 to $50	4.4
$50 to $75	4.4
$75 to $100	29.9
$100 to $200	47.6
$200 and over	10.4

Source: Data obtained from IRS *Statistics of Income*, http://www.irs.gov/pub/irs-soi/01in33ar.xls, visited Oct. 25, 2004.

Rationale

An adoption expense itemized deduction was provided by the Economic Recovery Tax Act of 1981 (P.L. 97-34) and was designed to encourage, through the reduction of financial burdens, 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.

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 credit was enacted because of the committee's belief that the financial costs associated with the adoption process should not be a barrier to adoptions.

The Hope for Children Act was made a part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). The act extended the adoption credit for children other than special needs children and increased the maximum credit to $10,000 per eligible child, including special needs children. The act also extended the exclusion from income for employer provided adoption assistance and increased the beginning point of the income phase-out range to $150,000. Congressional reports noted that both the credit and exclusion had been successful in reducing the after-tax cost of adoption to affected taxpayers. It was felt that increasing the size of both the credit and exclusion and expanding the number of taxpayers who qualify for the tax benefit would encourage more adoptions and allow more families to afford adoption. The legislation intended to make portions of the law permanent which were previously only temporary (those provisions will sunset after December 31, 2010).

Changes made by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) were designed to clarify the provisions contained in the Economic Growth and Tax Relief Reconciliation Act of 2001.

Assessment

While federal tax assistance has been provided in the past for the placement of special needs children, both the tax credit and exclusion are more broadly based. The provisions apply to the vast majority of adoptions—and are not targeted only to the adoptions of special needs children.

It appears that the credit and exclusion are designed to provide tax relief to moderate income families for the costs associated with adoptions and to encourage families to seek adoptable children. Taxpayers with adjusted gross incomes of less than $152,390 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 exceed $152,390. It would appear that the rationale for the cap is that taxpayers whose incomes exceed $152,390 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 loss associated with these provisions.

The tax credit and exclusion are in addition to a direct expenditure program which was first undertaken in 1986 to replace the tax deduction of that time. However, especially with regard 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, for example, the timing of expenditures or the amount to spend, 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 added 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
2005	26.0	1.8	27.8
2006	29.4	1.9	31.3
2007	31.9	2.0	33.9
2008	34.2	2.1	36.3
2009	37.7	2.1	39.8

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.

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.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts have been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. However, an accrual-basis corporation is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

As a result of the enactment of the American Jobs Creation Act of 2004, P.L. 108-357, donors of noncash charitable contributions face increased reporting requirements. For charitable donations of property valued at $5,000 or more, donors must obtain a qualified appraisal of the donated property. For donated property valued in excess of $500,000, the appraisal must be attached to the donor's tax return. Deductions for donations of patents and other intellectual property are limited to the lesser of the taxpayer's basis in the donated property or the property's fair market value. Taxpayers can claim additional deductions in years following the donation based on the income the donated property provides to the donee. The 2004

act also mandates additional reporting requirements for charitable organizations receiving vehicle donations from individuals claiming a tax deduction for the contribution, if it is valued in excess of $500.

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 2004, otherwise allowable deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $142,700 (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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.1
$20 to $30	0.4
$30 to $40	1.2
$40 to $50	2.3
$50 to $75	8.5
$75 to $100	10.7
$100 to $200	27.5
$200 and over	49.4

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.

The provisions enacted in 2004 resulted from Internal Revenue Service and congressional concerns that taxpayers were claiming inflated charitable deductions, causing the loss of federal revenue. In the case of vehicle donations, concern was expressed about the inflation of deductions. GAO reports published in 2003 indicated that the value of benefit to charitable organizations from donated vehicles was significantly less than the value claimed as deductions by taxpayers.

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 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. For example, the American Association of Fund-Raising Counsel Trust for Philanthropy, Inc. estimated that giving to religious institutions amounted to 35.9% of all contributions ($86.4 billion) in calendar year 2003. This was in comparison to the next largest component of charitable giving recipients, educational institutions, at 13.1% ($31.6 billion).

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 adds complexity to the tax code.

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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
2005	0.1	([1])	0.1
2006	0.1	([1])	0.1
2007	0.1	([1])	0.1
2008	0.1	([1])	0.1
2009	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 expenditures must be incurred to make a business accessible to disabled individuals.

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.

In 2002, the Internal Revenue Service (IRS) issued an alert (Internal Revenue News Release 2002-17) to taxpayers concerning a fraudulent disabled access credit scheme. That scheme involves the sale of coin-operated pay telephones to individual investors. Investors were advised incorrectly that they were entitled to claim the disabled access credit of up to $5,000 on their individual income tax returns because the telephone is equipped with a volume control. The IRS disallows this credit if claimed by a taxpayer who is not operating as a business or who does not qualify as an eligible small business and if the purchase does not make a business accessible to disabled individuals.

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 allows taxpayers to reduce tax liability by the cost of qualified expenditures.

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 by the credit than through immediate expensing of access expenditures. Second, the value to small businesses is increased by the amount to 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 (ADA; 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.

While the provision encourages compliance with ADA, subsequent access improvements are not covered by the provision. A 2004 IRS ruling (Internal Revenue Service Memorandum 200411042) clarified that eligible small businesses already in compliance with the ADA may not claim the disabled access credit for expenditures paid or incurred for the purchase of upgrading or improving disabled access.

Assessment

A firm's ability to benefit from the credit is dependent on its income tax liability. Some firms may not have sufficient tax liability to be able to take advantage of the credit, and for those firms that are able to claim the credit, some may not be able to claim the full amount.

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.

Alternatively, 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 proponents assert that the subsidy is justified in this instance.

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EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR HEALTH CARE, HEALTH INSURANCE PREMIUMS, AND LONG-TERM CARE INSURANCE PREMIUMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	88.7	-	88.7
2006	97.5	-	97.5
2007	104.8	-	104.8
2008	111.4	-	111.4
2009	118.8	-	118.8

Authorization

Sections 105, 106, and 125.

Description

Employees pay no income or payroll taxes on employer contributions for coverage under accident or health plans. This exclusion also applies to certain health benefits received by employees who participate in so-called cafeteria plans established by their employers. In general, employees

covered by these plans may exclude from taxable income their shares of employer-provided health insurance premiums. In addition, many employers offer health benefits to employees through flexible spending accounts (FSAs). Under the typical FSA, an employee chooses a benefit amount at the start of a calendar year and draws on the account to pay for medical expenses not covered by an employer's health plans. FSAs are funded either through wage and salary reductions or employer contributions, both of which are exempt from income and payroll taxes.

The exclusion for employer contributions to health and accident plans is available regardless of whether an employer self-insures or enters into contracts with third-party insurers to provide group and individual health plans. And unlike some other fringe benefits, there are no limits on the amount of employer contributions that may be excluded, with one notable exception. The exception is so-called "excess reimbursements" paid to highly compensated employees under self-insured medical plans that fail to satisfy certain non-discrimination requirements; these reimbursements must be included in an affected employee's taxable income.

Impact

The tax exclusion for employer contributions to employee health plans benefits taxpayers who participate in employer-subsidized plans. Beneficiaries comprise both present employees and their spouses and dependents, as well as retirees. In 2003, nearly 62 percent of the U.S. population received health insurance coverage through employers, down from 64 percent in 2001, according to data collected by the U.S. Census Bureau.

Although the tax exclusion benefits a majority of working Americans, it provides greater benefits to higher-income taxpayers than to lower-income ones. There are two reasons for this difference. First, high-wage employees typically receive larger amounts of employer-paid health insurance. And second, they end up in higher tax brackets. The value of an exclusion depends in part on a taxpayer's effective income tax rate.

As noted, non-discrimination rules apply to health and accident plans offered by self-insured employers. Under these rules, benefits paid to highly compensated employees must be included in their taxable incomes if a self-insured medical reimbursement plan discriminates in favor of these employees. However, the same rules do not apply to plans purchased from third-party insurers that offer more generous benefits to highly compensated employees. In this case, these employees may exclude the benefits from taxable income.

While the tax code encourages the provision of health insurance through the workplace, not all workers receive health insurance coverage from their employers. Those at greatest risk of being uninsured include workers under age 25, workers in firms with fewer than 25 employees, part-time workers, workers earning relatively low wages, and workers in the construction, business and personal service, entertainment, and wholesale and retail trade industries.

The following table presents data for 2003 on health insurance coverage by income group for the entire non-institutionalized, non-elderly population of the United States. Income is expressed as a percentage of the Federal poverty income level for that year.

The data show that the likelihood of being insured through an employer increases substantially with household income. The percentage of those covered by employment-based health insurance (column 3) in 2003 climbed from 18.8 percent for people whose income is less than the poverty-income level to 79.5 percent for people whose family income is two or more times that level.

At the same time, the likelihood of receiving public health insurance rose as household income dropped. The percentage of those covered by public insurance (column 4) descended in 2003 from 46.3 percent in the lowest income group to 5.4 percent in the highest income group. A similar pattern prevailed among the uninsured: the percentage of uninsured declined from 33.9 percent for those whose income was below the poverty level to 10.7 percent for those whose income was two or more times above the poverty level.

Health Insurance Coverage From Specified Sources, by Family Income Relative to the Federal Poverty Level, 2003

(Percent of U.S. Civilian, Non-institutionalized Population Under Age 65)

		Type of Insurance			
Income Relative to the Poverty Level[a]	Population (in millions)	Employment-based[b]	Public[c]	Other[d]	Uninsured
Less than 100%	32.3	18.8	46.3	6.3	33.8
100% to 149%	21.7	34.3	32.5	7.7	32.7
150% to 199%	21.9	50.7	20.2	9.4	27.9
200% and	177.1	79.5	5.4	10.2	11.5
Total	253.6	65.3%	14.3%	9.4%	17.6.%

People may have more than one source of health insurance; thus row percentages may total to more than 100.

[a] The weighted average poverty threshold for a family with two adults and two children in 2003 was $18,660. Excluded from the poverty analysis of the data on health insurance coverage are roughly 581,000 children who live with families to which they are unrelated. Most of them are foster children. As a result, the total size of the under-65 population is 0.6 million larger than the size of the total population covered by the poverty analysis.

[b] Group health insurance through employer or union.

[c] Medicare, Medicaid, the State Children's Health Insurance Program, or other state programs for low-income individuals.

[d] Private nongroup health insurance, veterans coverage, or military health care.

Note: Based on Congressional Research Service analysis of data from the March 2004 Current Population Survey (CPS). Source: Peterson, Chris L. *Health Insurance Coverage: Characteristics of the Insured and Uninsured Populations in 2003.* Library of Congress, Congressional Research Service, Report No. 96-891 EPW. Washington, DC: updated August 27, 2004. Table 2, p. 3.

Rationale

The exclusion of compensation received by individuals through employer-provided accident or health plans originated with the Revenue Act of 1918. But it was not until 1943 that the Internal Revenue Service (IRS) ruled that employer contributions to group health insurance policies were not considered part of taxable income. This ruling, however, did not cover employer contributions to individual health insurance policies. The tax status of those contributions remained uncertain until the IRS declared in 1953 that they were subject to taxation. This ruling had a brief existence, as the enactment of IRC section 106 in 1954 reversed it. As a result, employer contributions to all accident and health plans generally are excluded from taxable income. The legislative history of section 106 indicates that its principal purpose was to eliminate differences in the tax treatment of employer contributions to group and individual health insurance plans.

The Revenue Act of 1978 added the non-discrimination provisions of section 105(h). These provisions specified that the benefits paid to highly compensated employees under self-insured medical reimbursement plans were taxable if the plan discriminated in favor of these employees. The Tax Reform Act of 1986 repealed section 105(h) and replaced it with a new section 89 of the Internal Revenue Code, which extended non-discrimination 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 the Health Insurance Portability and Accountability Act of 1996 (P.L. 104-191), employer contributions to the cost of qualified long-term care insurance may be excluded from employees' taxable income. But this exclusion does not apply to long-term care benefits received under a cafeteria plan or flexible spending account (FSA).

Assessment

The exclusion for employer-provided health insurance is thought to play an important role in the health insurance coverage rates for a large fraction of current workers and their dependents. Because of the subsidy, employees have an incentive to prefer added compensation in the form of health benefits rather than taxable wages; on average, $1 in added benefits is worth only $0.70 in added wages. Such a preference, however, carries an economic cost in that it may lead employees to purchase too much health insurance coverage relative to their actual health needs. Many economists believe that the unlimited availability of employment-based health insurance

coverage has led to excessive use of health care services, which in turn has helped to drive up health care costs.

This is not to suggest, however, that there are no social benefits from the exclusion. Partly because of the widespread risk pooling that naturally arises under employment-based group health insurance, the exclusion makes it possible for many employees to purchase adequate health insurance coverage at a lower cost than they would be able to in the individual market. In addition, group policies are likely to have fewer benefit exclusions than individual policies.

Measured as a percentage of total 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 8.1 percent in 1993. The percentage dropped to 7.5 percent in 1995, to 7.3 percent in 1996, and to 7.0 percent in 1997, where it remained in 1998 and 1999. The percentage had fallen to 6.6 percent by 2001.

Workers and their dependents who are covered by employer-provided health insurance receive a much more generous subsidy from the tax exclusion than individuals who purchase health insurance in the individual market or who forego health insurance, pay out of pocket for their medical expenses, and claim the medical-expense itemized income tax deduction. Employer-paid health care is completely excluded from taxable income for all recipients. By contrast, relatively few taxpayers qualify to take advantage of the medical expense deduction. To do so, they must itemize on their tax returns, and their total medical expenses paid out of pocket (including health insurance premiums) must exceed 7.5 percent of their adjusted gross income. In addition to the income tax benefits, employer-paid health insurance is excluded from payroll taxation.

From time to time, legislative proposals are made to limit the amount of health benefits that an employee may exclude from taxable income. Generally, their aim is to retain the primary advantage of the exclusion – expanded access to health insurance – while curbing its primary disadvantage – an incentive to purchase excessive insurance coverage. This goal could be achieved by capping the tax exclusion at or below the typical cost of health insurance premiums in major regions. But some analysts argue that there are some serious drawbacks with such a reform. First, it might prove difficult to determine in an equitable manner when health insurance coverage becomes excessive. Second, designing a ceiling on non-taxable health benefits would need to consider the fact that health insurance premiums vary according to a host of factors, including the geographic location, size, and the risk profile of a firm's employees.

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Health

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
2005	1.6	-	1.6
2006	1.6	-	1.6
2007	1.7	-	1.7
2008	1.7	-	1.7
2009	1.7	-	1.7

Authorization

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

Description

Active-duty military personnel are provided with a variety of in-kind benefits (or cash payments in lieu of such benefits) that are not subject to taxation. Among such benefits are medical and dental care. Dependents of active-duty personnel, retired military personnel and their dependents, survivors of deceased members, and reservists who have served on active duty since September 11, 2001 and who commit to continued service in the Selected Reserve are also eligible for these benefits.

Military dependents and retirees receive some of their medical care in military facilities and from military doctors, provided capacity is available. They also have the option of being treated by civilian providers working under contract with the Department of Defense (DOD). DOD currently relies on a program known as Tricare to coordinate the medical care provided by military and civilian providers. Tricare gives most beneficiaries three choices for receiving medical care: Tricare Prime, a DOD-managed health maintenance organization (HMO); Tricare Extra, a preferred-provider organization (PPO); or Tricare Standard, formerly known as CHAMPUS, a fee-for-service option. In addition, Tricare For Life is available for beneficiaries who have reached age 65 or over and thus are eligible for Medicare. Tricare Extra and Tricare Standard/CHAMPUS reimburse beneficiaries for part of their spending for health care received from civilian providers.

Under certain provisions in the FY2001 Defense Authorization Act, retirees and their dependents who are eligible for Medicare A and participate in Medicare Part B are allowed to retain their Tricare coverage as a secondary payer to Medicare. Tricare coverage includes outpatient prescription drug benefits.

Impact

As with the exclusion for employer-provided health insurance, the benefits of the tax exclusion for health care received by military personnel dependents, retirees, and other eligible individuals depend on an individual's tax bracket. The higher one's tax bracket, the greater the tax savings. For example, an individual in the 10-percent tax bracket (the lowest Federal income tax bracket) avoids $10 in tax liability for every $100 of health benefits he or she may exclude; the tax savings rises to $35 for someone in the 35-percent tax bracket. Hence, the exclusion can be worth different amounts to different military personnel, depending on their taxable income.

The larger tax saving for higher-income military personnel may be partly offset by higher deductibles under the Tricare Extra plan and higher co-payments for outpatient visits under the Tricare Prime plan required of dependents of higher-ranked personnel (E-5 and above). Retirees under age 65 and their dependents pay an enrollment fee for Tricare Prime and pay higher deductibles and co-payments generally than the dependents of active-duty personnel. The FY2001 Defense Authorization Act eliminated these co-payments and deductibles for retirees and their dependents over age 64 who pay the Medicare Part B monthly premium.

Rationale

The tax exclusion for health care received by the dependents of active-duty military personnel, retirees and their dependents, and other eligible individuals has evolved over a number of decades from legal precedent, legislative action by Congress, a series of regulatory rulings by the Treasury Department, and long-standing administrative practices.

In 1925, the United States Court of Claims, in its ruling in *Jones v. United States,* 60 Ct. Cl. 552 (1925), drew a sharp distinction between the pay and the allowances received by military personnel. The court decided that housing and housing allowances for these individuals were reimbursements similar to other tax-exempt benefits received by employees in the executive and legislative branches.

Before this decision, the Treasury Department maintained that the rental value of living quarters, the value of subsistence allowances, and monetary commutations should be included in the taxable income of military personnel. This view rested on an earlier federal statute, the Act of August 27, 1894 (which later was ruled unconstitutional by the courts), which imposed 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 Tax Reform Act of 1986 consolidated these rules so that they were transparent and consistent with the tax treatment of fringe benefits that was enacted as part of the Deficit Reduction Act of 1984.

Even if there were no specific statutory exclusion for the health benefits received by eligible military personnel, these benefits arguably could be excluded through sections 105 and 106 of the Internal Revenue Code, which allow the exclusion from taxable income of medical payments received under employer-paid health and accident plans.

Under the Dependent Medical Care Act of 1956, the dependents of active-duty military personnel and retired military personnel and their dependents were allowed to receive medical care at military medical facilities on a "space-available" basis. Military personnel and their dependents gained access to civilian health care providers through the Military Medical Benefits Amendments Act of 1966, which created the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS).

Assessment

Some military benefits resemble the benefits provided by private employers, such as allowances for housing, subsistence, moving and storage expenses, higher living costs abroad, and uniforms. Others 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 it can be argued that health benefits for active-duty personnel are essential to the military's mission and thus should not be taxable, health care for dependents of active-duty personnel and retirees and their dependents has more in common with a fringe benefit.

Many of the economic issues raised by the tax treatment of military health benefits are similar to those associated with the tax treatment of civilian and employer-provided health benefits discussed elsewhere in this volume. A central concern is that a tax exclusion for health benefits directly encourages individuals to purchase inefficient amounts of medical insurance and indirectly leads them to consume medical care whose marginal costs may exceed its marginal benefits.

Nonetheless, there are some singular aspects to military health benefits. Direct care provided in military facilities may at times be difficult to value for tax purposes. At the same time, such care may be the only feasible option for dependents living with service members who have been assigned to isolated areas where adequate civilian medical facilities are lacking.

A change in the tax treatment of health care received by military dependents to make it less generous would probably need to be coupled with an increase in military pay to make remaining in the military an appealing occupational choice for military personnel with dependents and incomes high enough to incur tax liabilities.

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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
2005	3.2	-	3.2
2006	3.8	-	3.8
2007	4.2	-	4.2
2008	4.5	-	4.5
2009	5.0	-	5.0

Authorization

Section 162(l).

Description

Generally, a self-employed individual may deduct the entire amount he or she pays for health insurance (with some restrictions which are discussed below) or long-term care insurance for himself or herself and his or her spouse and dependents. The deductible percentage for both rose steadily from 25 percent in 1987 to 100 percent in 2003 and thereafter. For the purpose of this deduction, self-employed individuals are defined as sole proprietors, working partners in a partnership, and employees of an S corporation who own more than 2 percent of the corporation's stock. The

deduction is taken above-the-line, which means that it may be claimed regardless of whether or not a self-employed individual itemizes on his or her tax return.

Use of the deduction for health insurance expenditures is subject to several limitations. First, the deduction cannot exceed a taxpayer's net earned income from the trade or business in which the health insurance plan was established, minus the deductions for 50 percent of the self-employment tax and any contributions to certain pension plans. Second, the deduction is not available for any month in which a self-employed individual is eligible to participate in a health plan maintained by his or her employer or his or by her spouse's employer. Third, if a self-employed individual claims an itemized deduction for medical expenses under IRC section 213, any deduction for health insurance premiums claimed under section 162 must be subtracted from the medical expenses eligible for the itemized deduction. Whatever health insurance premiums cannot be deducted under section 162(1) may be included with these medical expenses, subject to the statutory threshold of 7.5 percent of adjusted gross income (AGI). And fourth, the self-employed must include their health insurance expenditures in computing their self-employment taxes.

Impact

In 2002, the health insurance deduction for the self-employed was claimed on 3.571 million individual tax returns (up from 3.011 million in 1995), and the total amount claimed came to $10.5 billion (up from $2.6 billion in 1995). It is not known how many self-employed claimed a deduction for long-term care insurance spending or the total value of those claims.

The deduction reduces the out-of-pocket cost of health insurance or long-term care insurance for self-employed individuals in a manner that varies with marginal income tax rates. As a result, it benefits higher-income individuals more than lower-income individuals. The deduction is also likely to persuade a greater proportion of the former than the latter to purchase generous (and perhaps unneeded) health insurance coverage.

This link between the size of the subsidy and income is illustrated in the following table. The table shows the percentage distribution by AGI of the total deduction for health insurance expenditures by the self-employed claimed for 2001, and the average amount claimed per tax return in each income class. On the whole, individuals with AGIs of under $50,000 accounted for 41 percent of the total amount claimed for the deduction. More telling was the distribution of the average amount claimed per tax

return filed in each AGI class: the average claim rose as one ascended the income ladder, and for individuals in the $200,000 and above class it was more than double the average claim for individuals in the below $15,000 class. If the deductions were weighted by the marginal tax rates applicable to each income class, the corresponding tax expenditure values would be even more heavily distributed among the higher-income groups.

Distribution of the Deduction for Medical Insurance Premiums by the Self-employed by Adjusted Gross Income Class in 2001

Adjusted Gross Income Class (in thousands of $)	Percentage Distribution of Deductions (%)	Average Amount of the Deduction Claimed per Tax Return ($)
Below $15	15	1,615
$15 to under $30	18	1,789
$30 to under $50	19	1,995
$50 to under $100	23	2,283
$100 to under $200	14	2,929
$200 and over	11	3,767
Total	100.0	2,297

Note: This is *not* a distribution of tax expenditure values. Derived from data in the following publication: Internal Revenue Service. *SOI Bulletin, Fall 2003,* table 1, p. 33. Covers taxable and non-taxable returns.

Rationale

The health insurance deduction for the self-employed first entered the tax code as a temporary provision of the Tax Reform Act of 1986; it was set to expire on December 31, 1989. The Technical and Miscellaneous Revenue Act of 1988 made certain technical corrections to the provision.

A series of laws extended the deduction for brief periods during the early 1990s. The Omnibus Budget Reconciliation Act of 1989 extended the deduction for 9 months (through September 30, 1990) and made it 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. And the Omnibus Budget Reconciliation Act of 1993 extended it through December 31, 1993.

The deduction expired and the end of 1993 and was suspended during 1994, when Congress devoted considerable time to considering a variety of major health insurance reform initiatives but ended up passing no legislation extending it. Under P.L. 104-5, which was enacted in April 1995, the deduction was reinstated retroactive to January 1, 1994 and made permanent; it remained at 25 percent for 1994 but was supposed to increase to 30 percent in 1995 and thereafter.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA, P.L. 104-191) increased the portion of health insurance expenditures that self-employed persons could deduct. From 30 percent of spending in 1995 and 1996, the deduction was supposed to rise to 40 percent in 1997 and gradually to 80 percent in 2006 and thereafter. HIPAA also allowed self-employed persons to include in the expenditures eligible for the deduction their payments for qualified long-term care insurance as of January 1, 1997. The act established indexed annual dollar limits on the amount of long-term care premiums that may be deducted, and the limits depended upon the age of the insured person. In 2003, these limits ranged from $250 for individuals age 40 and under to $3,250 for individuals over age 70.

The Omnibus Consolidated and Emergency Supplemental Appropriations Act for FY1999 (P.L. 105-277) increased the deduction for health insurance premiums paid by the self-employed to their present levels: 70 percent in 2002, and 100 in 2003 and thereafter.

Assessment

In enacting the deduction for spending on health insurance and long-term care insurance by the self-employed, Congress was motivated largely by two policy objectives. One was to provide them with a tax benefit similar to what is available to employees who receive health benefits through their employers. The second objective was to increase access to health care by the self-employed. The direct effect of the deduction is to lower the after-tax cost of health insurance for the self-employed by a factor equal to an individual's marginal income tax rate. Individuals who purchase health insurance coverage in the private market but are not self-employed receive no such tax subsidy. There is some evidence that the original 25-percent

deduction encouraged a significant increase in the number of self-employed, their spouses, and dependents covered by health insurance. Not surprisingly, the gains were concentrated in higher-income households headed by self-employed individuals.

One argument made in favor of allowing the self-employed to deduct 100 percent of spending on health insurance is that doing so would equalize the tax subsidies for health insurance available to the employed and the self-employed. While such a deduction improves one strand of the equity effects of the federal tax code, there is some concern about its efficiency effects. Critics of the current tax treatment of health insurance contend that a 100-percent deduction encourages self-employed individuals to purchase excessive health insurance coverage with relatively low co-payments and deductibles, which in turn leads to wasteful or inefficient use of health care. To remedy this problem, some propose capping the amount of insurance that the self-employed may deduct at a level based on a standardized health benefits package.

Nonetheless, under current federal tax law, strict equality in the tax subsidies for health insurance available to the employed and the self-employed does not prevail. Recipients of employer-provided health insurance (including shareholder-employees of S corporations who own more than 2 percent of their stock) are permitted to exclude employer contributions toward their health and accident plans from the wage bases used to determine their Social Security and Medicare tax contributions. By contrast, the self-employed must include their health insurance expenditures in the wage base used to calculate their Self-Employment Contributions Act (SECA) taxes. Thus, despite the deduction for the self-employed, it can be argued that the federal tax code offers a stronger incentive to work for an employer who provides insurance than to work for oneself.

There is reason to believe that health insurance coverage may not be as critical to the utilization of health care by the self-employed as many policymakers have assumed. A 2001 study by Harvey Rosen and Craig William Perry found that in 1996, the self-employed were able to finance the purchase of health care from sources other than insurance. Moreover, in the same year, there were no significant differences in utilization rates between employees and the self-employed in hospital admissions, hospital stays, dental checkups, and optometrist visits; and the self-employed had higher utilization rates for alternative care and chiropractor visits. Yet, the self-employed covered in the study had a lower health insurance coverage rate than the employees. These findings call into question one of the central arguments made in favor of expanding health insurance coverage through the use of generous tax subsidies: namely, that access to adequate health care hinges on having health insurance.

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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
2005	7.7	-	7.7
2006	8.2	-	8.2
2007	8.9	-	8.9
2008	9.5	-	9.5
2009	9.9	-	9.9

Authorization

Section 213.

Description

Certain medical expenses paid by an individual but not reimbursed by an employer or insurance company may be deducted from taxable income to the extent they exceed 7.5 percent of his or her adjusted gross income (AGI). In order to claim this deduction, individuals must itemize on their tax returns. If an individual receives reimbursements for medical expenses deducted in a previous tax year, the reimbursements must be included in taxable income for the year when they are received. But any reimbursement received for medical expenses incurred in a previous year for which no deduction was claimed may be excluded from an individual's taxable income.

A complex set of rules governs expenses eligible for the deduction. These include amounts paid by the taxpayer on behalf of himself or herself, his or her spouse, and eligible dependents for the following purposes:

(1) health insurance premiums, including a variable portion of premiums for long-term care insurance, employee payments for employer-sponsored health plans, Medicare Part B premiums, and other self-paid premiums;

(2) diagnosis, treatment, mitigation, 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 (but not over-the-counter medicines);

(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 for each individual.

Generally, expenses paid for programs entered by an individual on his or her own initiative to improve general health or alleviate physical or mental discomfort unrelated to a specific disease or illness may not be deducted. But similar programs prescribed by a physician to treat a particular disease are deductible. The same distinction applies to procedures mainly intended to improve an individual's appearance. For instance, the cost of whitening teeth discolored by aging are not deductible medical expenses, but the cost of breast reconstruction after a mastectomy and vision correction through laser surgery are deductible expenses.

Impact

For individual taxpayers who itemize, the deduction can ease the financial burden of costly medical expenses. For the most part, the federal tax code regards these expenses as involuntary expenses that reduce a taxpayer's ability to pay taxes by absorbing a substantial part of income.

But the deduction is not limited to strictly involuntary expenses. It also covers some costs of preventive care, rest cures, and other discretionary expenses. A significant share of qualified medical expenses now deducted

pertain to procedures and care not covered by many insurance policies (such as orthodontia).

Like all deductions, the medical expense deduction yields the largest tax savings per dollar of expense for taxpayers in the highest income tax brackets. Nonetheless, relative to other itemized deductions, a larger percentage of the tax benefits from the medical expense deduction goes to taxpayers in the lower-to-middle income brackets.

Distribution by Income Class of the Tax Expenditure for Medical Expenses, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.7
$20 to $30	2.5
$30 to $40	6.2
$40 to $50	9.3
$50 to $75	29.8
$75 to $100	19.8
$100 to $200	23.7
$200 and over	8.1

Rationale

Since 1942, numerous changes have been made to the rules for deducting medical expenses. For the most part, these changes have addressed the following issues: (1) the percentage of AGI where the threshold is set; (2) limits on the maximum amount that may be deducted; (3) whether or not to increase the maximum deductible amount for taxpayers who are 65 and over and disabled; (4) whether or not to subject spending on medicines and drugs to a separate threshold; (5) whether or not to subject health insurance expenditures to a separate threshold; and (6) what expenses should be eligible for the deduction.

Taxpayers were first allowed to deduct health care expenses above a specific income threshold in 1942. The deduction was a provision of the Revenue Act of 1942. In adopting such a rule, Congress was trying to

encourage high standards of public health and to ease the burden of high tax rates during World War II. The original deduction covered medical expenses (including spending on health insurance) in excess of 5 percent of adjusted gross income and was capped at $2,500 for a married couple filing jointly and $1,250 for a single individual.

Under the Revenue Act of 1948, the 5-percent floor remained intact, but the maximum deduction was changed so that it equaled the product of the personal exemption of $1,250 and the number of exemptions. The deduction could not exceed $5,000 for joint returns and $2,500 for all other returns.

The Revenue Act of 1951 lifted the 5-percent floor for taxpayers and spouses who were age 65 and over. No changes were made in the maximum deduction available to other taxpayers.

In 1954, Congress passed legislation substantially revising the Internal Revenue Code which included a reduction in the AGI threshold to 3 percent and the establishment of a one-percent floor on spending on drugs and medicines. In addition, the maximum deduction was increased to $2,500 per exemption, with a ceiling of $5,000 for each individual return and $10,000 for each joint and head of household return.

In 1959, the maximum deduction was increased to $15,000 for taxpayers who were 65 and over and disabled, and to $30,000 if their spouses also met both conditions. And in 1960, the threshold was removed on deductions for dependents age 65 and 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 filed by taxpayers and their spouses who both were 65 or over and disabled.

In 1964, Congress eliminated the one-percent floor on medicine and drug expenses 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 limitations on maximum deductions were removed, and a separate deduction of up to $150 was permitted for one-half of medical insurance premium costs, irrespective of the three-percent floor.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) raised the floor from three percent to five percent of adjusted gross income. It

eliminated the separate deduction for health insurance payments and made it possible to combine them with other medical expenses. TEFRA also eliminated the separate one-percent floor for drug costs, made non-prescription or over-the-counter drugs ineligible for the deduction, and combined the deduction for prescription drugs and insulin together with that for other medical expenses.

The Tax Reform Act of 1986 (TRA86) raised the threshold for the combined medical expenses deduction from 5 percent to its present level of 7.5 percent of AGI.

The Omnibus Budget Reconciliation Act of 1990 disallowed deductions for the cost of cosmetic surgery, with certain exceptions. It also exempted the medical expense deduction from the overall limit on itemized deductions for high-income taxpayers.

Under the Health Insurance Portability and Accountability Act of 1996 (HIPAA, P.L. 104-191), expenditures for qualified long-term care and long-term care insurance were granted the same tax treatment as health insurance expenditures and unreimbursed medical expenses. This meant that as of January 1, 1997, taxpayers were allowed to include unreimbursed expenditures for long-term care (including premium costs) in the medical expenses eligible for the deduction. The act also imposed annual dollar limits, indexed for inflation, on the amount of long-term care insurance premiums that a taxpayer may deduct, subject to the 7.5 percent of AGI threshold. The limits depend on the age of the insured person: in 2003, they ranged from $250 for individuals age 40 and under to $3,250 for individuals over age 70.

HIPAA also specified that periodic reimbursements received under a qualified long-term care insurance plan were considered payments for personal injuries and sickness and could be excluded from gross income, subject to a cap which was indexed for inflation. In 2002, the cap was $210 per person per day (minus expenses covered by reimbursements and other payments). These payments could not be claimed as part of the medical expense deduction because they were considered reimbursement for health care received under a long-term care contract. Insurance payments above the cap that did not offset the actual costs incurred for long-term care services had to be included 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, or 67 percent of itemized returns and 21 percent of all returns, claimed the deduction. But in 1983, the first full tax year reflecting the changes made by TEFRA, 9.7 million returns, representing 28 percent of itemized returns and 10 percent of all returns, claimed the deduction. The modifications made by TRA86 led to a further decline in the number of individuals claiming the deduction. In 1990, for instance, 5.1 million returns, or 16 percent of itemized returns and 4 percent of all returns, claimed the deduction. Since then, however, the number of individuals claiming the deduction has been steadily rising. By 2002, the number of returns claiming the deduction reached 8.5 million, or 19 percent of all itemized returns and 6.5 percent of all returns.

The deduction is intended to assist taxpayers with high unreimbursed medical expenses relative to their taxable income during a given year. Of course taxpayers are more likely to use the deduction if they can squeeze a number of large medical expenditures into a single tax year. Unlike the itemized deduction for casualty losses, a taxpayer may not carry over medical deductions that cannot be used in the current tax year to previous or future tax years.

Some maintain that a chief justification for the deduction is that it expands health insurance coverage. Yet there appears to be no more than a weak link between the deduction and domestic health insurance coverage rates. While health insurance premiums paid by individuals are eligible for the deduction, so few taxpayers are able to claim it that the deduction is unlikely to have much impact on the decision to purchase health insurance, especially among individuals forced to seek insurance coverage in individual markets where premiums tend to be much higher than in group markets. Relatively few taxpayers itemize on their tax returns, particularly those in lower-income households. And among those who itemize, few with health insurance coverage are likely to qualify for the deduction because substantial shares of their medical expenses are covered by insurance.

Under current tax law, taxpayers with employer-provided health insurance receive a larger tax subsidy than taxpayers who purchase health insurance on their own or self-insure. Employer-paid health care is fully excluded from taxable income, and the exclusion is unlimited. Eliminating the current AGI threshold for claiming the deduction would make the tax treatment of health insurance expenditures between the two groups more equitable.

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EXCLUSION OF WORKERS' COMPENSATION BENEFITS (MEDICAL BENEFITS)

Estimated Revenue Loss*

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	5.2	-	5.2
2006	5.5	-	5.5
2007	5.7	-	5.7
2008	6.0	-	6.0
2009	6.3	-	6.3

Authorization

Section 104(a)(1).

Description

Payments for medical treatment of work-related injury or disease are provided as directed by various State and Federal laws governing workers' compensation. Employers finance workers' compensation benefits through commercial insurance or self-insurance arrangements (with no employee contribution) and their costs are deductible as a business expense. Employees are not taxed on the value of insurance contributions for workers' compensation medical benefits made on their behalf by employers, or on the medical benefits or reimbursements they actually receive. This is similar to the tax treatment of other employer-paid health insurance.

Impact

The exclusion from taxation of employer contributions for workers' compensation medical benefits provides a tax benefit to any worker covered by the workers' compensation program, not just those actually receiving medical benefits in a particular year.

Figures are not available on employer contributions specifically for workers' compensation medical benefits. As an approximation, however, in 2002, medical payments under workers' compensation programs totaled $24.3 billion. This represented 46 percent of total workers' compensation benefits. The rest consisted mainly of earnings-replacement cash benefits. (See entry on Exclusion of Workers' Compensation Benefits: Disability and Survivors Payments.)

Rationale

This exclusion was first codified in the Revenue Act of 1918. 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.

Assessment

Not taxing employer contributions to workers' compensation medical benefits subsidizes these benefits relative to taxable wages and other taxable benefits, for both the employee and employer. The exclusion allows employers to provide their employees with workers' compensation coverage at a lower cost than if they had to pay the employees additional wages sufficient to cover a tax liability on these medical benefits. In addition to the income tax benefits, workers' compensation insurance benefits are excluded from payroll taxation.

The tax subsidy reduces the employer's cost of compensating employees for accidents on the job and can be viewed as blunting financial incentives to maintain safe workplaces. Employers can reduce their workers'

compensation costs if the extent of accidents is reduced. If the insurance premiums were taxable to employees, a reduction in employer premiums would also lower employees' income tax liabilities. Employees might then be willing to accept lower before-tax wages, thereby providing additional savings to the employer from a safer workplace.

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HEALTH SAVINGS ACCOUNTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.4	-	0.4
2006	0.5	-	0.5
2007	0.5	-	0.5
2008	0.6	-	0.6
2009	0.7	-	0.7

Authorization

Section 223.

Description

Health Savings Accounts (HSAs) are a new tax-advantaged way that people can pay for unreimbursed medical expenses such as deductibles, copayments, and services not covered by insurance. Eligible individuals can establish and fund these accounts when they have qualifying high deductible health insurance (insurance with a deductible of at least $1,000 for single coverage and $2,000 for family coverage plus other criteria described below) and no other health care coverage, with some exceptions. Individuals may deduct their HSA contributions from gross income in determining their taxable income. Employer contributions are excluded from income and employment taxes of the employee and from employment taxes of the employer.

Withdrawals from HSAs are not taxed if used for medical expenses, and account earnings are tax-exempt. Unused balances may accumulate without limit.

Individuals do not lose their HSA or the right to access it by obtaining insurance with a low deductible; they simply cannot make further contributions until they become eligible once again. Individual members of a family may have their own HSA, provided they each meet the eligibility rules. They can also be covered through the HSA of someone else in the family; for example, a husband may use his HSA to pay expenses of his spouse even though she has her own HSA.

Qualifying health plans cannot have limits on out-of-pocket expenditures that exceed $5,000 for single coverage and $10,000 for family coverage. The minimum deductible levels do not apply to preventive care, which the IRS has defined by regulation. After January 1, 2006, payments for prescription drugs will also be subject to the minimum deductible levels.

The annual contribution limit for single coverage is $2,600 or 100% of the insurance deductible, whichever is lower. The annual contribution limit for family coverage is $5,150, 100% of the overall deductible, or the embedded deductible (the deductible applying to one individual) multiplied by the number of covered family members, whichever of the three is lowest. (These dollar amounts are for 2004; they will be adjusted for inflation in subsequent years.) Individuals who are at least 55 years of age but not yet enrolled in Medicare may make an additional contribution of $500 in 2004. The additional contribution amount will increase by $100 each year through 2009, when it will be $1,000.

Withdrawals from HSAs are exempt from federal income taxes if used for qualified medical expenses, with the exception of health insurance premiums. However, payments for four types of insurance are considered to be qualified expenses: (1) long-term care insurance, (2) health insurance premiums during periods of continuation coverage required by federal law (e.g., COBRA), (3) health insurance premiums during periods the individual is receiving unemployment compensation, and (4) for individuals age 65 years and older, any health insurance premiums (including Medicare Part B premiums) other than a Medicare supplemental policy.

Withdrawals from HSAs not used for qualified medical expenses are included in the gross income of the account owner in determining

federal income taxes; they also are subject to a 10% penalty tax. The penalty is waived in cases of disability or death and for individuals age 65 and older.

Impact

HSAs encourage individuals to purchase high deductible health insurance and build a reserve for routine and other unreimbursed health care expenses. They may be more attractive to individuals with higher marginal tax rates since the tax benefits would be greater, though some younger, lower income taxpayers might try to build up account balances in anticipation of when their income will be higher. Some higher income individuals may be reluctant to start or continue funding HSAs if they have health problems for which low deductible insurance would be more appropriate. Two important questions affecting participation are whether some employers will only offer high deductible insurance plans, giving employees no other options, and whether they will make contributions to workers' accounts.

There is widespread interest in HSAs in both the employer and individual health insurance market. The first products combining HSAs and high deductible insurance were marketed by insurers that previously had offered high deductible coverage. Throughout 2004 other insurance companies also announced HSA options. Many of the first employers to express interest were already offering health reimbursement accounts (HRAs), which usually were coupled with higher deductible coverage. (First authorized by the IRS in 2002, HRAs are accounts that employees can use for unreimbursed medical expenses; they can be established and funded only by employers and normally terminate when employees leave.) More employers became interested after the IRS issued guidance clarifying how statutory provisions would be interpreted. The federal government is offering HSA plans to its employees beginning in 2005.

Nonetheless, it remains uncertain how popular HSAs will be. While most individuals who choose them can reasonably expect to have gradually increasing account balances, it is unclear whether this will be enough of an incentive to compensate them for the increased risks associated with high deductible insurance. Many people are very risk averse with respect to health insurance, even when they recognize that is to their long-term financial detriment.

Rationale

HSAs were authorized by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173). Congress adopted them as a replacement for Archer medical savings accounts (MSAs), which proponents considered unduly constrained by limitations on eligibility and contributions. (Archer MSAs, which are still available, are restricted to self-employed individuals and employees covered by a high deductible plan established by their small employer (50 or fewer workers). MSA contributions are limited to 65 percent of the insurance deductible (75% for family policies) or earned income, whichever is less. Individuals cannot make contributions if their employer does. Only about 100,000 MSAs have ever been established.) Like MSAs, HSAs were advanced as a way to slow the growth of health care costs by reducing reliance on insurance, to preserve freedom of choice in obtaining health care services, and to help individuals and families finance future health care costs. Taxpayers can carry their HSAs with them when they change jobs, which may help maintain continuity of health care if their new employer offers different or perhaps no health insurance coverage.

HSAs are seen as the cornerstone of consumer driven health care, which some employers hope will limit their exposure to rising health care costs. Some health care providers favor consumer driven health care in order to avoid managed care restrictions on how they practice medicine. HSAs are predicated upon market-based rather than regulatory solutions to health care problems, as the 108th Congress appeared to favor.

Assessment

HSAs 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. Properly designed, they may encourage more prudent health care use and the accumulation of funds for medical emergencies. For these outcomes to occur, however, individuals will have to put money into their account regularly (especially if their employer doesn't) and refrain from spending it for things other than health care. In addition, they must be able to find out what health care providers charge and be willing to switch to lower-cost providers.

One issue surrounding HSAs is whether they drive up insurance costs for everyone else. If HSAs primarily attract young, healthy individuals, premiums for plans without high deductibles 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 premiums in higher cost plans even more. If this process continued unchecked, eventually people who need insurance the most would be unable to afford it.

HSAs 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, HSAs 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 about 80% of the cost of a plan that has a low deductible ($400 a year, for example) and a 20% copayment requirement. If the plan instead had a high-deductible ($2,000, for example) and the same copayment requirement, employees normally would have to pay for expenses associated with the increase in the deductible ($1,600 minus the $320 copayment they would otherwise have made) with after-tax dollars. They would lose a tax benefit for assuming more financial risk. HSAs restore this benefit as long as an account is used for health care expenses. In this respect, HSAs 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
2005	1.3	0.5	1.8
2006	1.3	0.5	1.8
2007	1.4	0.5	1.9
2008	1.4	0.6	2.0
2009	1.5	0.6	2.1

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.

Before 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 were 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 December 31, 1986 as the 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, including for-profit hospitals and nursing homes.

The private-activity status of these bonds subjects them to severe restrictions that would not apply if they were classified as governmental bonds.

Assessment

Recently, some efforts have been made to reclassify nonprofit bonds, including nonprofit hospital bonds, as governmental bonds. The proponents of such a change suggest that the public nature of services provided by nonprofit organizations merit such a reclassification. Opponents argue that the expanded access to subsidized loans coupled with the absence of sufficient government oversight may lead to greater misuse than if the facilities received direct federal spending. Questions have also been raised about whether nonprofit hospitals fulfill their charitable purpose and if they deserve continued access to tax-exempt bond finance.

Even if a case can be made for this federal subsidy for nonprofit organizations, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, bonds for nonprofit organizations increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the 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
2005	3.3	0.9	4.2
2006	3.7	1.0	4.7
2007	4.1	1.0	5.1
2008	4.3	1.0	5.3
2009	4.8	1.1	5.9

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 contribution amounts of up to 50 percent of their adjusted gross income (AGI) and up to 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.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts have been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. However, an accrual-basis corporation is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

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.

As a result of the enactment of the American Jobs Creation Act of 2004, P.L. 108-357, donors of noncash charitable contributions face increased reporting requirements. For charitable donations of property valued at $5,000 or more, donors must obtain a qualified appraisal of the donated property. For donated property valued in excess of $500,000, the appraisal must be attached to the donor's tax return. Deductions for donations of patents and other intellectual property are limited to the lesser of the taxpayer's basis in the donated property or the property's fair market value. Taxpayers can claim additional deductions in years following the donation based on the income the donated property provides to the donee. The 2004 act also mandates additional reporting requirements for charitable organizations receiving vehicle donations from individuals claiming a tax deduction for the contribution, if it is valued in excess of $500.

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 2004, otherwise allowable deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds $142,700 (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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.1
$20 to $30	0.4
$30 to $40	1.2
$40 to $50	2.3
$50 to $75	8.5
$75 to $100	10.7
$100 to $200	27.5
$200 and over	49.4

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.

The provisions enacted in 2004 resulted from Internal Revenue Service and congressional concerns that taxpayers were claiming inflated charitable

deductions, causing the loss of federal revenue. In the case of vehicle donations, concern was expressed about the inflation of deductions. GAO reports published in 2003 indicated that the value of benefit to charitable organizations from donated vehicles was significantly less than the value claimed as deductions by taxpayers.

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 some of the 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 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. In 2003, the American Association of Fund-Raising Counsel Trust for Philanthropy, Inc. (AAFRC) estimated that contributions to religious institutions amounted to 35.9% of all contributions ($86.4 billion), while contributions to health care providers and associations amounted to less than 12% ($20.89 billion).

AAFRC reported, using current dollars, that giving to health increased by 4.8% in 2000, declined in 2001 and 2002, and rose by 8.2% in 2003.

There has been a 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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TAX CREDIT FOR ORPHAN DRUG RESEARCH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	0.2	0.2
2006	-	0.2	0.2
2007	-	0.2	0.2
2008	-	0.3	0.3
2009	-	0.3	0.3

Authorization

Sections 41(b), 45C, and 280C.

Description

Business taxpayers may claim a tax credit for 50 percent of qualified clinical testing expenses they incur in the development of certain drugs to treat rare diseases or conditions. These drugs are often referred to as orphan drugs. Qualified testing expenses are defined as the costs incurred or paid to test an orphan drug after it has been approved for human testing by the Food and Drug Administration (FDA) but before the FDA has approved it for sale in the United States. A rare disease or condition is one affecting fewer than 200,000 persons in the United States, or one that may affect more than 200,000 persons, but for which there is no reasonable expectation of recovering research and development costs from U.S. sales alone. The credit is a component of the general business credit and subject to its

limitations and carryback and carryforward rules. As a result, orphan drug credits that cannot be used because they exceed the limitations in a tax year may be carried back for one year and forward for up to 20 years.

Not all expenses incurred in connection with clinical trials for orphan drugs qualify for the credit. Specifically, the cost of supplies and salaries does qualify, but the cost of depreciable property does not. Expenses that qualify for the orphan drug research credit may not also be used to qualify for the research tax credit under section 41. What is more, qualified testing expenses generally may be deducted in the year when they are incurred or paid as qualified research expenditures under section 174. If a taxpayer claims the orphan drug tax credit, then the total deduction for these expenditures must be reduced by the amount of the credit.

Impact

The orphan drug tax credit reduces the cost of capital for private investment in orphan drug development and increases the cash flow in the short run of firms making such investments. Most of these benefits are captured by pharmaceutical firms, which collectively account for about 80 percent of all claims for the orphan drug credit.

In the long run, the burden of the corporate income tax (and any benefits generated by reductions in the burden) probably spreads far beyond corporate stockholders to owners of capital in general.

To the extent that the credit has accelerated the rate of development for orphan drugs, it also benefits persons suffering from rare diseases. According to FDA's Office of Orphan Products Development, to date, more than 1,300 drugs and biologics have been designated as orphan drugs, and over 250 have received regulatory approval for marketing in the United States. An estimated 11 million Americans are presently being treated with these products.

Rationale

The orphan drug tax credit entered the federal tax code through the Orphan Drug Act of 1983. Its main purpose was to provide a robust incentive for firms to develop drugs for diseases that are so rare that there was little hope of recovering their development costs without federal financial support. The act provided two other forms of government support

for such drugs: federal grants for the testing of drugs, and a seven-year period of domestic market exclusivity for orphan drugs gaining regulatory approval. Under the Act, the only test for determining a drug's eligibility was that there was no reasonable expectation of recovering its cost of development from U.S. sales alone.

This test, however, soon proved unfeasible because it required business taxpayers to provide complex proof that a drug in development would end up being unprofitable. So in 1984, Congress passed Public Law 98-551, which added another eligibility test: namely, that the potential domestic market for a drug not exceed 200,000 persons.

The initial tax credit was scheduled to expire at the end of 1987, but it was extended in succession 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 expired but was reinstated for the period July 1, 1996, through December 31, 1997, by the Small Business Job Protection Act of 1996, which also allowed taxpayers with unused credits to carry them back up to three tax years or carry them forward up to 15 tax years. The credit became a permanent part of the Internal Revenue Code with the passage of the Taxpayer Relief Act of 1997.

To increase U.S. investment in the development of diagnostics and treatments for patients with rare diseases and disorders, Congress passed the Rare Diseases Act of 2002. Among other things, the act established an Office of Rare Diseases at the National Institutes of Health and authorized increases in annual funding from FY2003 through FY2006.

Assessment

Supporters of the Orphan Drug Act view the fact that over 250 orphan drugs have been approved for marketing and that over 11 million Americans have been treated with them as conclusive evidence that its incentives are accomplishing their goal of developing drugs that otherwise would not be produced.

However, critics of the Act have pointed out that a number of the drugs developed and marketed under the Orphan Drug Act have turned out to be highly profitable, making it likely that they would have been developed without the incentives provided by the Act. Supporters respond 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 calling into question the desirability of Government support. For example, some argue 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.

The orphan drug tax credit encourages domestic private investment in the development of drugs to treat rare diseases. While some find this effect laudable, others view it as troublesome. To the latter, the credit raises the important policy issue of whether it is appropriate for federal tax policy to divert economic resources from the development of new drugs that may benefit a multitude of persons to the development of those that benefit relatively few, albeit with dramatic results in some cases.

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TAX CREDIT FOR PURCHASE OF HEALTH INSURANCE BY CERTAIN DISPLACED PERSONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	-	0.1
2006	0.1	-	0.1
2007	0.1	-	0.1
2008	0.1	-	0.1
2009	0.1	-	0.1

Authorization

Section 35.

Description

Eligible taxpayers are allowed a refundable tax credit for 65 percent of the premiums they pay for qualified health insurance for themselves and family members. The credit is now known as the health coverage tax credit (HCTC). Eligibility is limited to three groups: (1) individuals who are receiving a Trade Readjustment Assistance (TRA) allowance, or who would be except their state unemployment benefits are not yet exhausted; (2) individuals who are receiving an Alternative Trade Adjustment Assistance allowance for people age 50 and over; and (3) individuals who are receiving a pension paid in part by the Pension Benefit Guaranty Corporation (PBGC), or who received a lump-sum PBGC payment, and are age 55 and over. For TRA recipients, eligibility for the HCTC generally does not extend beyond

two years, the maximum length of time most can receive TRA allowances or benefits, and could be less in some states.

The HCTC is not available to individuals who are covered under insurance for which an employer or former employer pays 50 percent or more of the cost, who are entitled to benefits under Medicare part A or an armed services health plan, or who are enrolled in Medicare part B, Medicaid, the State Children's Health Insurance Program (SCHIP), or the federal employees health plan. The Treasury Department makes advance payments of the credit to insurers for eligible taxpayers who choose this option.

The HCTC can be claimed only for ten types of insurance specified in the statute. Seven require state action to become effective, including coverage through a state high risk pool, coverage under a plan offered to state employees, and, in some limited circumstances, coverage under individual market insurance. As of August, 2004, 36 states and the District of Columbia made at least one of the seven types of coverage available; in the remaining 14 states, only three automatically qualified types not requiring state action were available, though not necessarily to all individuals eligible for the credit. For example, COBRA continuation coverage is available in all states, but it applies only if the taxpayer had employment-based insurance prior to losing his job and the employer continues to provide the insurance to the remaining employed workers.

Impact

The HCTC substantially reduces the after-tax cost of health insurance for eligible individuals and has enabled some to maintain or acquire coverage. However, given the cost of health insurance, which in 2004 approached $3,000 a year for single coverage and $10,000 a year for family coverage, a 65 percent credit has often not been sufficient to ensure coverage for workers who are unemployed for extended periods (in the case of TRA recipients) or who are early retirees (in the case of those receiving pensions paid by the PBGC). For these workers, paying the remaining 35 percent of the cost of the insurance can be difficult. Sometimes cash-constrained individuals reassess their need for insurance altogether, particularly if they are young and single. In addition to not being able to afford the remaining 35% of the cost, taxpayers have had difficulty learning about eligibility, finding qualifying insurance, and quickly arranging for advance payments.

IRS data indicate that the HCTC is not widely used. According to the Government Accountability Office, 12,594 taxpayers claimed the credit on their 2003 tax returns without receiving advance payments, and 6,816

received advance payments. (Some of the latter also claimed additional amounts on their tax return.) Together, these groups represented just over 8% of the estimated 235,000 taxpayers who were eligible for the credit. As of June, 2004, 13,222 taxpayers were receiving advance payments, so the enrollment percentage may be increasing.

Rationale

The HCTC was authorized by the Trade Act of 2002 (P.L. 107-210). One impetus for the legislation was to assist workers who had lost their jobs, and consequently their health insurance coverage, due to economic dislocations in the wake of the September 11, 2001 terrorist attacks. Difficulties in reaching consensus on who should be included in this group contributed to the decision to restrict eligibility for the credit primarily to workers adversely affected by international trade (e.g., imported goods contributed importantly to their unemployment, or their companies shifted production to other countries). Extension to taxpayers receiving pensions paid by the PBGC occurred late in the legislative process.

By adopting a tax credit, Congress signaled its intention to help individuals maintain or acquire private market health insurance rather than expand public insurance programs like Medicaid or SCHIP. Both proponents and opponents see the credit as a legislative precedent for a broader tax credit that may become the principal strategy for reducing the number of uninsured, who by one measure now exceed 45 million. Thus, the rationale for the credit may lie more in what it indicates for future policy than in what it presently accomplishes.

Assessment

Tax credits for health insurance can be assessed by their effectiveness in continuing and expanding coverage, particularly for those who would otherwise be uninsured, as well as from the standpoint of equity. The HCTC is helping some unemployed and retired workers keep their insurance, at least temporarily; the impact may be greatest in the case of individuals who most need insurance (those with chronic medical conditions, for example) and who have the ability to pay the 35% of the cost not covered by the credit. For many eligible taxpayers, the effectiveness of the credit may depend on the advance payment arrangements; these might work well where there is a concentration of eligible taxpayers (where a plant is closed, for example) and if the certification process is simple and not perceived as part of the welfare system.

Nonetheless, it is clear that in its first two years the HCTC has not reached many of the people it was intended to benefit. With less than10% of the eligible 235,000 taxpayers receiving the credit, one might question whether its cost exceeds its benefits. According to the Government Accountability Office, administrative costs so far include $69 million for establishing and implementing the HCTC credit program through April, 2004, and $40 million in yearly operating costs starting in July, 2004. As of August, 2004, states had received $45 million in grants to pay for administrative expenses and for premium subsidies before advance payments begin. Additional sums were provided states to help with expanded high risk pools. In contrast, total HCTC payments for tax year 2003 were about $37 million.

The 65% HCTC rate is available to all eligible taxpayers with qualified insurance, regardless of income. From the standpoint of inclusiveness, this seems equitable. Using ability to pay as a measure, however, the one rate appears inequitable since it provides the same dollar subsidy to taxpayers regardless of income. An unemployed taxpayer with an employed spouse, for example, can receive the same credit amount as a taxpayer in a household where no one works. At the same time, the credit is refundable, so it is not limited to the taxpayer's regular tax liability.

The 65% rate is roughly comparable to the proportion of insurance typically paid by employers (actually, that proportion usually is somewhat higher); from this perspective, the HCTC continues what employers would be paying if the workers had not lost their jobs. However, employers can claim a tax deduction for their insurance expense and likely shift most of their after-tax cost back to the workers in the form of reduced wages and other benefits. By an economic measure, employer subsidies for health insurance probably are far less than 65%. But if a 65% tax credit provides a more generous subsidy than employers, it apparently is still not high enough to help many cash-constrained families purchase insurance.

The HCTC is limited to taxpayers in one of the three eligibility groups described above, who likely consider it appropriate to receive tax benefits for health insurance since most other taxpayers receive some as well. However, unemployed workers who do not receive TRA allowances or benefits may question why they are denied the credit, as may early retirees whose pensions are not paid by the PBGC, or who receive no pension at all.

The present tax credit is available to families that have individual market insurance only in limited circumstances. (If they do not purchase such insurance through a state qualified plan, they must have had it during the entire 30-day period prior to the separation from employment that qualified the worker for the TAA or PBGC assistance.) Some observers criticize

these restrictions for limiting consumer choice; they argue that younger and healthier families could find less expensive individual coverage than what they must pay for group plans. Others see the restriction as helping to preserve larger insurance pools, which help keep rates down for older and less healthy individuals.

Some observers also criticize the requirements that state-operated health plans must meet in order to be considered qualified insurance for purpose of the credit, including guaranteed issue, no preexisting condition exclusions, nondiscriminatory premiums, and similar benefit packages. In their view, these requirements drive up the cost of insurance and lead some to forego coverage altogether. Other observers, however, maintain that these requirements are essential consumer protections.

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EXCLUSION OF UNTAXED MEDICARE BENEFITS: HOSPITAL INSURANCE (PART A)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	16.4	-	16.4
2006	18.1	-	18.1
2007	19.7	-	19.7
2008	21.4	-	21.4
2009	23.9	-	23.9

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31.

Description

The Medicare program currently is divided into several parts. Part A basically offers hospital insurance (HI). Specifically, it helps pay for most in-patient hospital care and up to 100 days a year of skilled nursing facility care, home health care, and hospice care for individuals who are age 65 or over or disabled. In FY2003, an estimated 40.3 million aged and disabled persons were enrolled in Part A, and expenditures for Part A benefits totaled an estimated $152.9 billion, an increase of 67 percent since FY1993.

Medicare Part A is financed primarily by a payroll tax levied on the earnings of current workers. The tax rate is 2.90 percent, and there is no ceiling on the earnings subject to the tax. Self-employed individuals pay the full rate, while employees and employers each pay 1.45 percent. The revenues are paid into a trust fund, from which payments are made to health care providers. Individuals contribute to the fund during their working years in exchange for receiving Part A benefits during their retirement years.

The employer's share of the payroll tax is excluded from an employee's taxable income. In addition, the expected lifetime value of Part A benefits under current law exceeds the amount of payroll tax contributions by current beneficiaries. These projected excess benefits are also excluded from the taxable income of Medicare Part A beneficiaries.

Impact

All Medicare Part A beneficiaries are assumed to receive the same dollar value of in-kind insurance benefits per year. There is, however, substantial variation among individuals in the portion of those benefits covered by their payroll tax contributions – or, conversely, the portion considered untaxed benefits.

This latter portion depends on an individuals's taxable earnings history and life expectancy over the period when benefits are received. The untaxed benefits are likely to be larger for persons who became eligible in the earliest years of the Medicare program, for persons who had low taxable wages in their working years or who qualified as a spouse with little or no payroll contributions of their own, and for persons who have a relatively long life expectancy. Beyond these considerations, the tax expenditure associated with any dollar of untaxed insurance benefits is affected by the beneficiary's marginal income tax rate during retirement.

Rationale

The exclusion of Medicare benefits from the federal income tax has never been expressly established or endorsed by statute. Although the Medicare program was enacted in 1965, it was not until 1970 when the IRS ruled (Rev. Rul. 70-341) that the benefits under Part A of Medicare may be excluded from gross income because they are in the nature of disbursements made to achieve the social welfare objectives of the Federal Government.

The ruling also specified that in determining an individual's gross income under section 61 of the Internal Revenue Code, Medicare Part A benefits had the same legal status as the monthly Social Security payments to an individual. An earlier IRS ruling (Rev. Rul. 70-217, 1970-1 C.B. 13) allowed these payments to be excluded from gross income.

Assessment

The tax subsidy for Part A benefits lowers the after-tax cost to the elderly for the hospital care they receive under Medicare. As a result, it is likely to divert more resources to hospital care than otherwise would be the case.

Nevertheless, there are several reasons why it is difficult to reduce this subsidy in an equitable manner. First, Medicare benefits are untaxed, like most other health insurance benefits. Second, taxing the value of the health care benefits actually received is generally not considered a viable policy option. This is because health care spending by individuals who suffer serious illnesses can be very large, and few think it fair or right to tax people heavily under these trying circumstances.

In addition, under current tax law, insurance payments for reimbursable expenses are not considered taxable income. The tradeoff is that the premiums paid for insurance – except health insurance – cannot be deducted from an individual's taxable income. One difference in the tax treatment of Medicare benefits is that the employer's half of the Medicare payroll tax is exempt from individual income taxation – consistent with the convention for Social Security taxes.

For middle- and high-income beneficiaries, an additional portion of their Social Security payments is now subject to taxation, and the revenues are deposited in the HI trust fund. This treatment originated with the Omnibus Budget Reconciliation Act of 1993 (OBRA93, P.L. 101-508) and 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 gross income (see the entry on the exclusion of untaxed Social Security and railroad retirement benefits for more details). The same rules apply to railroad retirement tier 1 benefits. Because the base amounts are not indexed to rise with inflation, over time, a growing proportion of Medicare beneficiaries is likely to face income taxes on their Social Security benefits to help pay for Medicare HI.

For future retirees, the portion of HI benefits in excess of their payroll tax contributions is likely to decrease gradually, as the contribution period covers more of their work years. In addition, the absence of a cap on worker earnings subject to the Medicare HI payroll tax means that today's high-wage earners will contribute more during their working years and consequently receive a lower (and possibly negative) subsidy once they begin to receive Medicare Part A benefits.

Before 1991, the taxable earnings base for Medicare Part A was the same as the earnings base for Social Security. But the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) severed this tie by raising the cap on the amount of employee earnings subject to the Medicare HI tax to $125,000 in 1991 and indexing it for inflation in succeeding years. Consequently, the cap reached $130,200 for 1992 and $135,000 for 1993. OBRA93 repealed the cap on wages and self-employment income subject to the Medicare HI tax as of January 1, 1994.

The changes in the HI payroll tax enacted in 1990 and 1993 reflected a desire on the part of Congress to finance the HI trust fund in a more progressive way than the leading alternative of raising HI payroll tax rates on the Social Security earnings base.

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EXCLUSION OF MEDICARE BENEFITS: SUPPLEMENTARY MEDICAL INSURANCE (PART B)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	10.9	-	10.9
2006	11.8	-	11.8
2007	12.8	-	12.8
2008	13.9	-	13.9
2009	15.7	-	15.7

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31.

Description

The Medicare program currently consists of several parts. Part B of Medicare provides supplementary medical insurance (SMI). Among the services covered under Part B are certain physician services, outpatient hospital services, and durable medical equipment. In FY2003, an estimated 38.3 million Americans were enrolled in SMI, and expenditures for SMI totaled $120.0 billion, an increase of 121 percent since 1993.

Unlike Part A of Medicare, participation in SMI is voluntary. Enrollees must pay a monthly premium that varies over time and was set at $58.70 in

2003. The program generally pays 80 percent of Medicare's fee schedule or other approved amount once a beneficiary has met the annual $100 deductible. Currently, premiums cover about 25 percent of the program's costs, and the remaining 75 percent is funded out of general revenues. Transfers from the general fund of the U.S. Treasury to cover the cost of covered services are excluded from the taxable income of enrollees.

Impact

The tax expenditure associated with this exclusion hinges on the marginal tax rates of enrollees. Unlike many other tax expenditures (where the amount of the subsidy can vary widely among individual taxpayers), the value of the general-fund premium subsidy for SMI is the same for all enrollees. All enrollees are assumed to receive the same dollar value of in-kind benefits and are charged the same monthly premium. As a result, they receive the same subsidy, which is measured as the difference between the value of insurance benefits and the premium. Nonetheless, the tax savings from the exclusion are greater for enrollees in higher tax brackets, as one would expect. Taxpayers who claim the itemized deduction for medical expenses under section 213 may include the Part B premiums they paid or had deducted from their monthly Social Security benefits.

Rationale

The exclusion of Medicare benefits has never been expressly established or endorsed by statute. Rather, it is the product of a few related regulatory decisions.

In 1966, the Internal Revenue Service (IRS) ruled (Rev. Rul. 66-216) that benefits received under Part B of Medicare may be excluded from taxable income as the benefits were received through an accident and health insurance plan. While there was no doubt that this pronouncement applied to the premium-financed portion of the SMI program, it was uncertain whether it applied with equal force to the portion financed by the general fund of the Treasury.

The IRS addressed this ambiguity four years later and in the process set forth a new rationale for excluding certain insurance benefits from taxation. In 1970, the IRS ruled (Rev. Rul. 70-341) that the subsidized portion of Medicare Part B benefits should be excluded from taxable income on the

grounds that they were disbursements made to promote the social welfare objectives of the Federal Government. The ruling applied with equal force to the tax treatment of subsidized benefits received under Medicare part A.

Assessment

Medicare benefits are similar to most other health insurance benefits in that they escape taxation.

Initially, Part B premiums were set to cover 50 percent of projected SMI program costs. But between 1975 and 1983, that share gradually fell to less than 25 percent. From 1984 through 1997, 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 projected program costs.

The tax subsidy for Part B reduces the after-tax cost of supplementary medical insurance to retirees. One possible result is that individuals end up purchasing excessive amounts of health care. Moreover, as the subsidy is not means-tested, many high-income elderly individuals do benefit from it.

Some have proposed adding the value of the subsidy to taxable income. There appear to be no insurmountable administrative barriers to doing so. The value of the subsidy could be estimated, assigned to beneficiaries, and reported as income on their tax returns. One clear drawback to such an idea is that it would impose a burden on older individuals of moderate means who have little flexibility in their budgets to absorb an additional tax.

Legislation to lower or eliminate the subsidy for high-income individuals would have the same effect as taxing it. Several proposals introduced in recent Congresses would effectively raise the Part B premiums for high-income enrollees – in some cases, the increase would cover 100 percent of average benefits per enrollee – by recapturing the subsidy through the individual income tax. All revenues raised by taxing the subsidy would be added to the Medicare SMI Trust Fund. An individual would be permitted to deduct the recaptured amount to the same extent that is allowed with other health insurance premiums. Any employer reimbursement of the recaptured amount would be excluded from the recipient's taxable income.

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EXCLUSION OF MEDICARE BENEFITS: PRESCRIPTION DRUG INSURANCE AND EXCLUSION OF SUBSIDIES TO EMPLOYERS WHO MAINTAIN PRESCRIPTION DRUG PLANS FOR MEDICARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	-	-
2006	4.3	1.2	5.5
2007	7.2	1.7	8.9
2008	8.4	1.9	10.3
2009	9.8	2.1	11.9

Note: The individual tax expenditure reflects the exclusion of benefits to individuals, and the corporate expenditure reflects the exclusion of the subsidy to employers.

Authorization

Section 139A, Section 1860D-22 of the Social Security Act (42 U.S.C. 1395w-132)

Description

The Medicare program currently is divided into three parts: A , B, and C. Part A offers hospital insurance (HI). More specifically, it covers most in-patient hospital care and up to 100 days a year of skilled nursing facility

care, home health care, and hospice care for individuals who are age 65 or over or disabled. Part B provides voluntary insurance coverage for most other health care services the elderly may require, including hospital outpatient care, diagnostic tests, durable medical equipment, and physician care. Beneficiaries who are enrolled in both Parts A and B may elect to receive all of their Medicare benefits through managed care plans under Part C.

Beginning in 2006, Medicare will add a new private insurance option under a new Part D. It will provide coverage for outpatient prescription drugs, and participation will be voluntary. Every individual enrolled in Medicare Part A or Part B, or those who receive their Medicare benefits through a private heath plan under Part C, will be entitled to obtain this coverage through enrollment in a qualified prescription drug plan.

Under Part D, beneficiaries will be able to purchase from plan sponsors either standard drug coverage or other coverage with actuarially equivalent benefits. In 2006, standard coverage will consist of a $250 deductible; 25-percent coinsurance for qualified drug expenses above the deductible and up to the initial coverage limit of $2,250; no coverage for expenses above this limit and up to the annual out-of-pocket threshold of $3,600; then unlimited coverage for expenses above $3,600, with enrollees paying the greater of $2 for generic drugs and $5 for branded drugs or a 5-percent coinsurance fee. An enrollee's out-of-pocket spending on drugs counting toward the out-of-pocket threshold does not include amounts paid or reimbursed by most third parties, including retiree health plans. In future years, the deductible, initial coverage limit, and the out-of-pocket threshold will be indexed to annual growth in per-capita spending by Medicare beneficiaries on drugs covered under Part D. Coverage will be offered through newly formed private prescription drug plans or Medicare comprehensive plans that integrate Part A and B benefits under a revised Part C known as Medicare Advantage. Enrollees will pay premiums intended to cover roughly 26 percent of the overall cost of drug benefits under Part D; in 2006, the average premium is expected to be about $35 a month. Substantial subsidies will be available to encourage broad participation by low-income beneficiaries, and to discourage a large number of public and private employers and unions that currently offer prescription drug benefits to retirees from dropping or sharply curtailing such coverage.

Public and private employers and unions providing prescription drug benefits deemed actuarially equivalent to the standard coverage under Part D to qualified retirees will be eligible to receive subsidies from Medicare. A retiree will be considered qualified if he or she is eligible for coverage under part D but not enrolled in it and is covered under an employment-based group health plan. The Secretary of Health and Human Services (HHS) will audit the prescription drug benefits for retirees offered by

employers seeking or receiving the subsidies to determine whether they conform to this standard. In addition, to continue to receive a subsidy, an employer will be required to provide HHS with annual proof that the actuarial value of its prescription drug benefits for Medicare-eligible retirees is at least equal to that of the standard coverage under Part D.

The subsidies will be in the form of payments equal to 28 percent of allowable prescription drug costs per enrollee above the deductible and up to a specified limit; in 2006, those costs will range from $250 to $5,000. Allowable costs are defined as the combined amounts paid by a qualified retiree and his or her employer for prescription drugs covered under Part D, less rebates and discounts. In future years, the upper limit will be indexed to annual growth in per-capita spending by Medicare beneficiaries on prescription drugs covered under Part D.

Employers receiving subsidy payments will be allowed to exclude them from their taxable income under both the regular income tax and the alternative minimum tax. What is more, the allowable costs used to determine the amount of subsidies an employer is entitled to receive may be included in its total deductions for contributions to health and accident plans for current and retired workers.

The revenue loss for individuals reflects the exclusion of prescription drug benefits for individuals in excess of their costs, while the loss for corporations reflects the exclusion of subsidy payments from employer incomes.

Impact

The exclusion of the direct benefits to individuals of the prescription drug benefits under Medicare is the same as the treatment of the hospital and supplementary portions.

In the case of the employer subsidies the exclusion departs from the general rule. Generally, all sources of income are subject to taxation, except those specifically excluded by statute. Section 61 identifies sources of income that typically are taxed, including employee compensation, capital gains, interest, and dividends. Nonetheless, some sources of income are granted a statutory exemption from taxation, including certain death benefits, interest on state and local bonds, amounts received under employer accident and health plans, certain other fringe benefits, and disaster relief payments. Sections 101 to 140 identify these sources and explain their tax

treatment. The new Medicare subsidy payments for certain employers under Section 139A are one of these sources. Their exclusion from taxable income is considered a tax expenditure.

In combination, the subsidy and its preferential tax treatment have the potential to lower significantly the after-tax cost to employers paying taxes of providing prescription drug benefits to retirees. In essence, the exclusion means that the subsidy payments are equivalent to larger taxable payments that reflect an employer's marginal tax rate. For example, for employers taxed at a marginal rate of 35 percent, a subsidy payment of $1,000 would be equivalent to a taxable payment of $1,538: $1,000/(1-.35) = $1,538.

Rationale

In passing the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA, P.L. 108-173), Congress added coverage of outpatient prescription drugs to Medicare. The tax treatment of benefits received directly from Medicare Part D conforms with treatment of other Medicare benefits. As explained above, the Act also allows Medicare to make subsidy payments beginning in 2006 to employers offering certain prescription drug benefits to retirees eligible for Medicare. By adding a new Section 139A, MMA also enables employers receiving such payments to exclude them from taxable income and to disregard them in determining their deductions for contributions to health and accident plans for current employees and retirees.

This exclusion means that for employers subject to taxation, the effective subsidy rate over the range of qualified spending is 28 percent rather than some lower rate. The lower rate hinges on an employer's marginal tax rate. For example, if an employer is taxed at a rate of 35 percent and there were no exclusion for the subsidy payments, then its effective subsidy rate would be 18.2 percent: .28 x (1-.35) = .182.

The subsidy payments and their preferential tax treatment are intended to convince a large number of employers that currently provide prescription drug benefits to Medicare-eligible retirees not to drop or curtail sharply this coverage once the new Part D goes into effect.

Assessment

The issues surrounding the exclusion of the benefits of Medicare part D are the same as those surrounding the exclusion of the benefits for other types of health coverage.

The exclusion for the subsidy serves to enhance the value of the new Medicare subsidy for employers that pay taxes. Basically, it reduces the after-tax cost of providing certain prescription drug benefits to Medicare-eligible retirees by a factor dependent on an employer's marginal tax rate. Assume, for example, that an employer is taxed at a rate of 35 percent and receives part D subsidy payments totaling $1,000 in 2006. Because of the exclusion, its after-tax cost of prescription drug benefits for retirees falls by $1,000; but if the payments were subject to taxation, this cost would fall by only $650.

How much revenue is lost in a given year after 2006 because of the exclusion will depend on the number of employers paying taxes that receive the subsidy, their marginal tax rates, and the total amount of subsidy payments they receive.

At this point, it is uncertain how many employers subject to taxation are likely to receive the subsidy and in what amounts in 2006 and each year thereafter. Generating credible predictions about these outcomes is a difficult challenge because of the many complex factors that must be considered. Among the key ones are the net cost (including administrative burden) to employers that currently offer prescription drug coverage to retirees of the numerous new options for providing such coverage that will open up under the new Part D, the final HHS regulations that will govern the Medicare subsidy payments to employers and unions, existing legal obligations of employers to retirees, and the competitive environment facing these employers now and in the future.

Under the MMA, private employers offering prescription drug benefits to retirees appear to face three broad courses of action starting in 2006. First, they could instruct their retirees to enroll in a prescription drug plan or Medicare Advantage plan to obtain the standard drug coverage under Part D and then enter into a contract with that plan or another plan to provide supplemental drug benefits to those individuals. Second, they could continue to provide health benefits with prescription drug coverage that is actuarially equivalent to the standard benefit under Part D and receive the subsidy. And third, they could refuse to offer any prescription drug coverage to retirees, forcing those who are eligible to enroll in Part D if they want such a benefit. Given that employers would reduce their cost for

retiree health benefits with drug coverage the most under the third option, it might seem reasonable to suppose that all private employers would eliminate drug coverage for all their Medicare-eligible retirees once Part D goes into effect. But a recent analysis by the Congressional Budget Office (CBO) of the budgetary cost of the new Medicare prescription drug benefit suggests that such a supposition is unwarranted. CBO estimates that 2.7 million Medicare-eligible retirees who would be likely to receive relatively generous prescription drug coverage from former employers in 2006 in the absence of the this benefit would lose all their employer-sponsored coverage and end up enrolling in Part D; CBO also estimates that another 8.2 million Medicare-eligible retirees would retain their employer-sponsored drug benefits in 2006.

The subsidy and its preferential tax treatment address a key policy issue in the debate that culminated in the enactment of the MMA: the likely response of employers currently providing prescription drug coverage to retirees (especially paying taxes) to the new prescription drug benefit under Medicare, and the implications of that response for the net cost to federal government of the benefit and the welfare of retirees who are eligible for Medicare. Some are concerned that the new Part D will lead most such employers to either drop such coverage and not replace it with something of comparable worth, or sharply curtail it.

This concern springs from several sources. One is certain recent trends in retiree health benefits. Specifically, the share of private-sector employers with 200 or more employees offering health benefits to retirees and the generosity of those benefits have been steadily declining in the past 10 to 15 years. Among the forces driving this trend have been rising competitive pressures, the growing number of workers approaching retirement, and steep increases in the cost of retiree health plans offering drug benefits. Another source for the concern is the critical role played by former employers in providing coverage of prescription drugs for Medicare-eligible retirees. An estimated one in three current Medicare beneficiaries receives prescription drug benefits from former employers. In addition, the typical package of employer-sponsored drug benefits for retirees is more generous than the standard coverage under the new Part D; employer plans tend to have relatively low cost-sharing obligations and limits on out-of-pocket spending on covered drugs. Finally, the concern reflects the fact that the total cost to taxpayers of the new Medicare prescription drug benefit will be significantly affected by the number of retirees currently receiving prescription drug benefits from former employers who continue to do so in 2006 and beyond. The Congressional Budget Office has estimated that the net federal subsidy for drug benefits under part D will be $1,211 per enrollee in 2006 for beneficiaries with no access to employer health plans but $766 per enrollee for beneficiaries who receive qualified drug benefits from former employers that opt to receive subsidy payments.

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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
2005	3.9	-	3.9
2006	4.1	-	4.1
2007	4.3	-	4.3
2008	4.5	-	4.5
2009	4.7	-	4.7

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. Employers finance benefits through insurance or self-insurance arrangements (with no employee contribution), and their costs are deductible as a business expense.

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

Generally, any amounts received for personal injury or sickness through an employer-paid accident or health plan must be reported as income for tax purposes. This includes disability payments and disability pensions, as well as sick leave payments. In contrast, an exception is made for the monthly cash payments paid under State workers' compensation programs, which are excluded from income taxation.

Workers' compensation benefits in 2002 totaled $53.4 billion, about 54 percent of which consisted of cash payments to injured employees and survivors replacing lost earnings, and 46 percent of which was paid for medical and rehabilitative services. The costs to employers in 2002 came to $72.9 billion, equivalent to 1.58 percent of covered payrolls (up from 1.33 percent in 2000 but still down substantially from 2.17 percent as recently as 1993).

The Census Bureau's Current Population Survey gives the following profile of those who reported receiving workers' compensation in 2001:

Workers' compensation cash benefits were less than $5,000 for 58 percent of recipients, between $5,000 and $10,000 for 19 percent, between $10,000 and $15,000 for 12 percent, and more than $15,000 for 11 percent.

Recipients' income (including workers' compensation) was below $15,000 for 24 percent, between $15,000 and $30,000 for 33 percent, between $30,000 and $45,000 for 22 percent, and above $45,000 for 21 percent.

Total family income (including workers' compensation) was below $15,000 for about 9 percent of recipients, between $15,000 and $30,000 for 18 percent, between $30,000 and $45,000 for 21 percent, and above $45,000 for 51 percent. Seven percent had family income below the Federal poverty thresholds.

Rationale

This exclusion was first codified in the Revenue Act of 1918. 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.

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. It also would place the "true" cost of workers' compensation on employers if compensation benefits were increased in response to taxation. It is possible that "marginal" claims would be reduced if workers knew their benefits would be taxed like their regular earnings.

Furthermore, exclusion of workers' compensation payments from taxation is a relatively regressive subsidy because it replaces more income for (and is worth more to) those with higher earnings and other taxable income than for 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 were subjected to taxation, those who could continue to work or return to work (such as those with partial or short-term disabilities) or who have other sources of taxable income (such as a working spouse or investment earnings) are likely to be the most affected. These groups represent the majority of beneficiaries. Those who receive only workers' compensation payments (such as permanently and totally disabled beneficiaries) would be less affected, because their income is likely to be below the taxable threshold level.

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, with 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. If taxation of compensation were targeted on income replacement and not medical payments, some method of identifying lump-sum settlements (*e.g.*, a new kind of "1099") 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, 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 and jurisdictions that use after-tax income replacement would be called on to change.

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EXCLUSION OF DAMAGES ON ACCOUNT OF PERSONAL PHYSICAL INJURIES OR PHYSICAL SICKNESS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	1.4	-	1.4
2006	1.4	-	1.4
2007	1.5	-	1.5
2008	1.5	-	1.5
2009	1.5	-	1.5

Authorization

Section 104(a)

Description

Damages paid, either through a court award or a settlement, to compensate for physical injury and sickness are not included in income of the recipient. This exclusion applies to both lump sum payments and periodic payments. They do not include punitive damages (except in certain cases where States only permit the awarding of punitive damages).

Impact

Income received in the form of damages is not taxable to individuals even though it may substitute for wages that would have been taxable. The tax treatment constitutes a benefit compared to some forms of income. To the extent that payments substitute for medical payments that would have been received from insurance companies the tax treatment is consistent with the treatment that would otherwise have occurred for these payments. To the extent that the compensation compensates for forgone wages, the payments are beneficially treated by comparison with the wages (which would have been taxed). To the extent that awards are successful in reflecting the actual costs of injuries, the benefit of the provision, including the lack on tax on the interest earnings included in annuities or periodic payments, accrues to the recipients.

Rationale

A provision allowing an exclusion for damages had historically been part of the tax law (based on the notion that these payments were compensating for a loss) and were codified in 1918. The statute was amended by the Periodic Payment Settlement Act of 1982 to allow full exclusion of periodic payments as well as lump sum payments. Normally periodic payments would have been partially taxable to reflect the interest element. An argument for encouraging the full exclusion of periodic payments was to avoid circumstances where individuals used up lump sum payments and might then require public assistance. The latest revision of the exclusion provision was in 1996 by the Small Business Job Protection Act, when the provision was amended to make it clear that punitive damages (except for those cases where State law requires all damages to be paid as punitive damages) and damages arising from discrimination and emotional distress were not to be excluded. This change was intended to settle and clarify the law, following considerable variation in the interpretation by the courts.

Assessment

The tax benefit is largely a benefit to individuals receiving compensation for injuries and illness. It parallels the treatment of workers compensation which covers on-the-job injuries. However, since it is not paid for by excluded insurance and since the size of the payments is (at least in theory) tied specifically to the magnitude of the injury, the benefit accrues to the recipients. It therefore especially benefits higher income individuals whose

payments would be larger (because they reflect larger lifetime earnings) and subject to higher tax rates.

By restricting tax benefits to compensatory rather than punitive damages, the provision encourages plaintiffs to settle out of court so that the damages can be characterized as compensatory (an outcome that may usually be preferred by the defendant as well). There is also an incentive to characterize damages as physical in nature, for example, to demonstrate that emotional distress led to physical symptoms.

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EXCLUSION OF SPECIAL BENEFITS FOR DISABLED COAL MINERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	0.1	-	0.1
2006	0.1	-	0.1
2007	0.1	-	0.1
2008	([1])	-	([1])
2009	([1])	-	([1])

([1])Less than $50 million.

Authorization

30 U.S.C. 922(c), Section 104(a)(1), Revenue Ruling 72-400, 1972-2 C.B. 75.

Description

Cash and medical 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 paid under State workers' compensation laws also are not taxed.

Black lung eligibility 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, the statute's broad definition of total disability makes it possible for a beneficiary to be working outside the coal industry (although earnings tests apply in some cases).

Black lung benefits consist of monthly cash payments and payment of black-lung-related medical costs. There are two distinct black lung programs, known as part B and part C. They pay the same benefits, but differ in eligibility rules and funding sources.

The part B program provides cash benefits to those miners who filed eligibility claims prior to June 30, 1973 (or December 31, 1973, in the case of survivors). It is financed by annual Federal appropriations. The part C program pays medical benefits for all eligible beneficiaries (both parts B and C) and cash payments to those whose eligibility claims were filed after the part B deadlines. Part C benefits are paid either by the "responsible" coal mine operator or, in most cases, by the Black Lung Disability Trust Fund.

To pay their obligations under the part C program, coal mine operators may set up special "self-insurance trusts," contributions to which are tax deductible and investment earnings on which are tax-free. Otherwise, they may fund their liability through a third-party insurance arrangement and deduct the insurance premium costs. The Black Lung Disability Trust Fund is financed by an excise tax on coal mined in and sold for use in the United States and borrowing from the Federal Treasury.

Impact

Generally, any income-replacement amounts received for personal injury or sickness through an employer-paid accident or health plan must be reported as income for tax purposes. This includes disability payments and disability pensions, as well as sick leave. An exception is made for the monthly cash payments paid under the Federal black lung program, and comparable cash benefits paid under State workers' compensation programs, which are excluded from income taxation.

Black lung medical benefits, however, are treated like other employer-paid or government-paid health insurance. Recipients are not taxed on the employer or Federal contributions for their black lung health insurance, or on the value of medical benefits or reimbursements actually received.

Part B cash payments to 59,000 beneficiaries totaled $417 million in fiscal year 2003. However, virtually all recipients are over 65 years old, and this caseload is declining by almost 10,000 a year. More than 80 percent of the beneficiaries are single widows or other survivors. Part C cash payments to some 48,000 beneficiaries totaled approximately $317 million in fiscal year 2003. In addition, $72 million in payments for black-lung related medical treatment were made to, or on behalf of, part B and part C recipients. As with part B, the part C rolls are declining, but at a much slower rate because new claims continue to be approved. In calendar year 2004, monthly black lung cash payments per beneficiary (under both part B and part C) range from $549 to $1,098, depending on the number of dependents.

Rationale

Part B payments are excluded from taxation 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) of the Internal Revenue Code. Like workers' compensation and in contrast to other disability payments, eligibility for black lung benefits is directly linked to work-related injury or disease (see entry on Exclusion of Workers' Compensation Benefits: Disability and Survivors Payments).

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. 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 has been argued with workers' compensation. However, it would be difficult to argue for their taxation, especially now that practically all recipients are elderly survivors. 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 would take back with one hand what Federal appropriations give with the other, although almost no beneficiaries would likely pay tax, given their age, retirement status, and low income.

A stronger argument can be made for taxing part C benefits. If workers' compensation were to be made taxable, part C benefits 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. It would remove a subsidy to those with other taxable income. However, because those on the part C rolls are aging, the revenue effect of taxing their benefits should decline over time. On the other hand, black lung benefits are legislatively established (as a percentage of minimum Federal salaries). They are not directly reflective of a worker's pre-injury earnings as in workers' compensation. They 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
2005	2.5	-	2.5
2006	2.6	-	2.6
2007	2.7		2.7
2008	2.7	-	2.7
2009	2.8	-	2.8

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 or Safety Net.

(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 little 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, TANF payments per family (averaging 2.5 persons) averaged $355 monthly in FY2002; and the weighted average maximum benefit (for families with no other income) was $454 monthly, far below the federal income tax threshold. Further, relatively few TANF families have earnings (22% in FY2000), and these earnings usually qualify for the earned income tax credit. 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 $564 monthly per individual and $846 per couple in 2004) 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 counted). Public assistance benefits are based on monthly income, and thus families whose fortunes improve during the year generally keep welfare benefits received earlier.

During FY2002, TANF ongoing cash benefits were received by a monthly average of about 5.7 million persons in 2.2 million families. As of December, 2002, 6.8 million persons received federal SSI benefits (and

another 282,000 received federally administered SSI supplements paid with state funds). Most recipients of cash help also receive some non-cash aid.

An unpublished Census Bureau table (*Income Distribution Measures, by Definition of Income, 2002*) indicates that in 2002, $34.3 billion was received in means-tested cash transfers from TANF, SSI, GA, and veterans' pensions. Per recipient household, cash payments averaged $5,578. For this table, see <http://ferret.bls.census.gov/macro/032001/rdcall/1_000.htm> A total of 6,156 households (5.5% of all U.S. households) received aid from one of the means-tested cash programs, and 56% of these households were in the bottom quintile of the income distribution. (Note: Veterans' pensions were placed 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 found that other means-tested cash aid totaling $26.2 billion was received in the form of federal and state earned income tax credits. These credits went to 16.3 million households, 44% of whom were in the second lowest quintile of the income distribution. The average value of earned income tax credits in 2002 was reported to be $1,612 per recipient household.

In addition, the Census Bureau table shows the 2002 value of major *noncash* means-tested benefits at $74.8 billion. The Bureau estimated the fungible value of Medicaid (defined below) at $45.9 billion ($3,732 on average per recipient household, counting only households where Medicaid had a positive value) and the value of noncash aid from three other major programs (food stamps, rent subsidies, and free or reduced-price school lunches) at $28.9 billion. On average, recipient households received $2,018 from various combinations of the three latter programs. Of 12.299 million Medicaid recipient households, 22% were in the bottom quintile of the income distribution and 30% in the second lowest quintile.

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 free and reduced price school lunches at their full subsidy value. The income value of housing subsidies is calculated by a complex procedure that is based on the 1985 American Housing Survey.

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 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, some of those supporting the taxation of cash welfare payments argue that 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, benefitting primarily those with other income. Seventh, 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 have the effect of providing guarantees of minimum cash income; these 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 Federal income tax in California, which provides a state-funded supplement of more than $200 monthly. But in States with no supplement, or a relatively small one, recipients would remain free of the income tax.

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
2005	111.1	-	111.1
2006	117.0	-	117.0
2007	124.1	-	124.1
2008	130.4	-	130.4
2009	136.2	-	136.2

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 2001, only 26 percent of individuals earning less than $20,000 and 52 percent of individuals earning between $20,000 and $40,000 were covered by retirement plans; 73 percent of individuals earning over $60,000 are covered.

Although some of these differences reflect the correlation between low income and age the Congressional Budget Office (1987) found differences in coverage by income level 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.

More recent data from Purcell (2004) show a slight decline in participation across all income quartiles, but with participation rising from 28.4% in the lowest quartile, 51.7% in the second quartile, 63.6% in the third quartile, and 72.5% in the top quartile.

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-Hartley 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.

The 2001 tax cut raised the contribution and benefit limits for pension plans, allowed additional contributions for those over 50, increased the full-funding limit for defined benefit plans, allowed additional ability to roll over limits on 401(k) and similar plans, and provided a variety of other regulatory changes. Technically, these provisions sunset at the end of 2010.

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 individual's 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.

The Enron collapse focused attention on another important issue in pension plans: the displacement of defined benefit plans by defined contribution plans (particularly those with voluntary participation, such as the 401(k) plan) which are not insured) and the instances in which defined contribution plans were heavily invested in employer securities, increasing the risk to the employee who could lose retirement savings (as well as a job) when his firm failed. Research has suggested that individuals do not diversify their portfolios in the way that investment advisors would suggest, that they actually increase the share of their own contributions invested in employer stock when the employer stock is also used to make matching contributions, and that they are strongly affected by default choices in the level and allocation of investment.

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NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS: INDIVIDUAL RETIREMENT PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	11.6	-	11.6
2006	14.8	-	14.8
2007	16.3	-	16.3
2008	18.0	-	18.0
2009	19.5	-	19.5

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. 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 $3,000 or 100 percent of compensation . The ceiling will rise to $4,000 in 2005 and $5,000 in 2008. It will then be indexed for inflation in $500 increments. For individuals age 50 and older, the maximum will increase by an additional $500 in 2002 through 2005 and by $1,000 in each year thereafter. (Technically, these increases from the 2001 limit of $2,000, added by the 2001 tax cut, will sunset at the end of 2010). An individual is eligible for the deduction so long as the individual has compensation includable in gross income and has not attained age 70 ½ before the close of the taxable year.

There is a nonrefundable tax credit of up to $1,000 for contributions to a qualified retirement plan by individuals with adjusted gross income less than $25,000 and couples with adjusted gross income under $50,000; this credit expires at the end of 2006.

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 ½ (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 ½. 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 forgone 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 earnings less withdrawals 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 forgone 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.

A final source is contributions to non--deductible IRAs. This part of the tax expenditure would simply be forgone 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.

The 2001 tax cut raised the contribution and limits to $3,000, with an eventual increase to $5,000 and inflation indexing. Technically, these provisions sunset at the end of 2010. This act also added the temporary tax credit and catch up contributions.

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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TAX CREDIT FOR CERTAIN INDIVIDUALS FOR ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	1.7	-	1.7
2006	1.6	-	1.6
2007	0.5	-	0.5
2008	-	-	-
2009	-	-	-

Authorization

Section 25B.

Description

For the years 2002-2006 taxpayers who are 18 or over and not full time students or dependents can claim a tax credit for elective contributions to qualified retirement plans or IRAs. The maximum amount eligible for the credit is $2,000. Credit rates depend on filing status and adjusted gross income. For joint returns the credit is 50% for adjusted gross income under $30,000, 20% for incomes between $30,000 and $32,500, and 10% for incomes above $32,5000 and less than $50,000. Income categories are half

as large for singles ($15,000, $16,250, and $25,000) and between those for singles and joint returns for heads of household ($22,500, $24,375, and $37,500). The credit may be taken in addition to general deductions or exclusions.

Impact

Because of the phase-out, the credit's benefits are targeted to lower income individuals. However, the ability to use the credit is limited because so many lower income individuals have no tax liability. According to the Treasury Department, about 57 million taxpayers would be eligible for the credit, but about 26 million would receive no credit because they have no tax liability. This restriction in coverage may be especially severe for families with children because the credit is allowed after accounting for the child credit and it will particularly affect taxpayers who would have been eligible for the larger (50%) credit. Thus, of those actually able to benefit from the credit, the amount of benefit will probably be relatively small.

Historically, most lower income individuals do not tend to save or participate in voluntary plans such as individual retirement accounts, perhaps because of pressing current needs. Thus, the number of families and individuals claiming the credit may be relatively small.

Rationale

This provision was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. Its purpose was to provide savings incentives for lower income individuals who historically had not been covered by pension plans.

Assessment

The expectation is that the credit would have limited impact on increasing savings for its target group because so many lower income individuals will not have enough tax liability to benefit from the credit. Among those who are eligible, the higher incomes necessary for them to have tax liability mean that the credit rate will be lower. The credit could

be redesigned to cover more lower income individuals by stacking it first, before the refundable child credit.

As with other savings incentives, there is no clear evidence that these incentives are effective in increasing savings. Moreover, at this point, the savings credit is not permanent, which also means its long run effect on savings is likely to be small. The credit also has a cliff effect: because the credit is not phased down slowly, a small increase in income can trigger a shift in the percentage credit rate and raise taxes significantly.

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TAX CREDIT FOR NEW RETIREMENT PLAN EXPENSES OF SMALL BUSINESSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([1])

([1])Less than $50 million.

Authorization

Section 45E.

Description

Eligible small employers that began to offer qualified pension plans to their employees starting in 2002 and each year thereafter may claim a tax credit for qualified costs they incur in starting the plans and maintaining

them in their first few years. The credit is equal to 50 percent of up to $1,000 in these costs incurred in each of the first three years the plans are in effect, beginning with the tax year in which the plans become effective.

An eligible small employer is one that had no more than 100 employees receiving a minimum of $5,000 in total compensation in the preceding tax year. The credit applies to the following new pension plans: defined benefit plans, defined contribution plans (including 401(k) plans), savings incentive match plans for employees (SIMPLE), and simplified employee pension (SEP) plans. At least one employee who is not considered highly compensated must participate. Qualified costs are any ordinary and necessary expenses incurred to establish and administer an eligible plan or to educate employees about the plan and retirement planning. Qualified costs offset by any credit claimed may not also be deducted as ordinary and necessary business expenses.

The credit is part of the general business credit, and therefore is subject to its limitations and carryover rules. It is scheduled to expire at the end of 2010.

Impact

The provision is intended to encourage smaller employers to set up and maintain retirement savings plans for their employees. Survey data for 2002 collected by the Employee Benefit Research Institute indicated that the cost of establishing a pension plan was the most important reason for not having such a plan for 10 percent of firms and a major reason for a third of them. In addition, the survey results suggested that most small business owners were unaware of the credit in its first year of existence. Arguably, it is too soon to tell how effective the credit will be in spurring the creation of new pension plans among eligible small employers.

Rationale

This provision was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. Its principal purpose was to expand access to retirement savings plans in the private sector by removing an administrative obstacle to such plans among small businesses. According to data collected by the Employee Benefit Research Institute, in 1999, 64 percent of full-time employees at firms with more than 100 employees were

covered by an employment-based retirement plan, whereas only 34 percent of full-time employees at firms with 100 or fewer employees were covered by such a plan.

Assessment

The credit reduces the after-tax cost to qualified small employers of setting up qualified pension plans for their employees. In effect, the Federal Government assumes a small share of the cost of starting up and maintaining these plans.

A reduction in start-up costs may lead some small firms to set up pension plans that otherwise would not come into existence. Yet it is unclear how responsive eligible small firms will be to the cost reduction. Because of the small annual limit on the size of the credit ($500), it may prove more influential with very small firms than larger eligible firms. While the credit is of no benefit to firms with more than 100 employees, it could be viewed as an attempt to create a more level playing field in that the credit may offset some or all of the cost advantage they may enjoy in establishing employee retirement plans. Some argue that there are at least two reasons why it is reasonable to expect that the credit will have little effect on overall saving for retirement. First, it is unlikely that the credit will induce many eligible firms to set up pension plans. Second, there is little evidence that pension plans actually increase the savings of individuals.

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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
2005	2.5	-	2.5
2006	2.5	-	2.5
2007	2.6	-	2.6
2008	2.6	-	2.6
2009	2.7	-	2.7

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
2005	2.5	-	2.5
2006	2.6	-	2.6
2007	2.7	-	2.7
2008	2.8	-	2.8
2009	2.9	-	2.9

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
2005	1.8	-	1.8
2006	1.8	-	1.8
2007	1.7	-	1.7
2008	1.8	-	1.8
2009	1.9	-	1.9

Authorization

Section 63(f).

Description

An additional standard deduction is available for blind and elderly taxpayers. To qualify for the additional standard deduction amount, a taxpayer must be age 65 (or blind) before the close of the tax year. The added standard deduction amounts, $950 for a married individual or surviving spouse or $1,200 for an unmarried individual for tax year 2004, are added to the basic standard deduction amounts. A couple could receive

additional deductions totaling $3,800 if both were 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 marginal 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 2001 Income Levels

Adjusted Gross Income Class (in thousands of $)	Percentage Distribution
Below $10	18.7
$10 to $20	30.9
$20 to $30	16.4
$30 to $40	10.1
$40 and over	21.4

Source: Data obtained from IRS *Statistics of Income*, http://www.irs.ustreas.gov/pub/irs-soi/01in33ar.xls visited Oct. 25, 2004. Amounts may not add up due to rounding.

Note: This is not a distribution of the tax expenditures, but of the deductions. It is classified by adjusted gross income, not expanded adjusted gross income.

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 purpose of the deduction 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 forgo 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. Opponents of the provision argue that if the provision is retained the eligibility age should be raised. It is noted that life expectancy has been growing longer and that most 65 year olds are healthy and could continue to work. The age for receiving Social Security benefits has been increased for future years.

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 the economic principle of horizontal equity 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 from the additional standard deduction 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
2005	([1])	-	([1])
2006	([1])	-	([1])
2007	([1])	-	([1])
2008	([1])	-	([1])
2009	([1])	-	([1])

([1])Negative tax expenditure of 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. Additionally, tax credits are used to reduce income tax liability, as opposed to tax deductions which reduce income available to be taxed. Individuals with low tax liabilities may be ineligible to claim the credit, or the full value of the credit, since it is nonrefundable.

Preliminary Distribution by Income Class of the Tax Expenditure for Credit for the Elderly and Disabled at 2001 Income Levels

Adjusted Gross Income Class (in thousands of $)	Percentage Distribution
Below $10	0.1
$10 to $20	63.0
$20 to $30	36.8
$30 and over	0.0

Source: Data obtained from IRS *Statistics of Income*, http://www.irs.ustreas.gov/pub/irs-soi/01in33ar.xls visited Oct. 25, 2004. Amounts may not add up due to rounding.

Note: This table classifies by adjusted gross income, not expanded adjusted gross income.

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 inflation adjustments since 1983. Therefore, tax relief currently provided by the tax credit lags behind tax relief provided to 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
2005	0.2	-	0.2
2006	0.2	-	0.2
2007	0.2	-	0.2
2008	0.2	-	0.2
2009	0.2	-	0.2

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.

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 10 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 for losses in excess of 10 percent of the taxpayer's AGI. While Congress wished to maintain the deduction for losses having a significant effect on an individual's ability to pay taxes, it included a percentage-of-adjusted-gross-income floor because it found that the size of a loss that significantly reduces an individual's ability to pay tax varies with income.

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 2001, the latest available year, only 97,424 returns claimed such a deduction.

Use of the casualty and theft loss deduction can fluctuate 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
2005	39.0	-	39.0
2006	39.0	-	39.0
2007	38.8	-	38.8
2008	39.0	-	39.0
2009	39.3	-	39.3

Note: The figures in the table show the effect of the basic earned income credit on receipts and do not include the refundable portion.

Authorization

Section 32.

Description

Eligible married couples and single individuals meeting certain earned income and adjusted gross income (AGI) limits may be eligible for an earned income credit (EIC). For purposes of the credit, earned income includes wages, salaries, tips, and net income from self employment. In addition to earned income and AGI, the value of the credit will depend on

whether or not the taxpayer has a qualifying child, based on three criteria: (1) relationship - the child must be a son, daughter, stepson, stepdaughter, or descendent of such a relative; a brother, sister, stepbrother, stepsister, or descendent of such a relative cared for by the taxpayer as his/her own child; or a foster child; (2) residence - the child must live with the taxpayer for more than half the year; and (3) age - the child must be under age 19 (or under age 24, if a full-time student) or be permanently and totally disabled. If a taxpayer does not have a qualifying child, the taxpayer must be at least 25 years of age but not more than 64 years of age, be a resident of the United States for more than half of the year, and not be claimed as a dependent on another taxpayer's return. A taxpayer will be disqualified from receiving the credit if investment income exceeds a specified amount ($2,650 in 2004, the amount is indexed for inflation). Married couples generally must file a joint tax return.

The EIC increases with earnings up to a maximum, remains flat for a given range of income, and then declines to zero as income continues to increase. The credit is calculated as a percentage of the taxpayer's earned income up to a statutory maximum earned income amount. The credit remains at this maximum until earned income or AGI (whichever is larger) reaches a point at which it begins to phase out. Above this level, the EIC is reduced (phased out) by a percentage of the income above the phase out income amount. The maximum earned income and phase out income amounts are adjusted for inflation.

For tax year 2004, the maximum EIC is equal to 34.0 percent of the first $7,660 of earned income for one qualifying child (i.e. the maximum basic credit is $2,604) and 40.0 percent of earned income up to $10,750 for two or more qualifying children (i.e. the maximum basic credit is $4,300).

For individuals with children, in tax year 2004, the EIC begins to phase out at $14,040 of earned income or AGI, whichever is larger. For married couples with children the phase out begins at an income level that is $1,000 higher ($15,040). For families above the phase out income amount, the credit is phased out at a rate of 15.98 percent of income above the phase out income level for one qualifying child, and 21.06 percent for two or more qualifying children.

For married couples and individuals without children the EIC is 7.65 percent of the first $5,100 for a maximum credit of $390. The credit begins to phase out at $6,390 of earned income (or AGI whichever is larger) and at a 7.65 percent rate. For married couples with children the phase out begins at an income level that is $1,000 higher ($7,390). The maximum earned income and phase out income amounts are adjusted for inflation.

If the credit is greater than Federal income tax owed, the difference is refunded. The portion of the credit that offsets (reduces) income tax is a tax expenditure, while the portion refunded to the taxpayer is treated as an outlay. Working parents may arrange with their employers to receive the credit in advance (before filing an annual tax return) through reduced tax withholding during the year.

While gross income for tax purposes does not generally included certain combat pay earned by members of the armed forces, P.L. 108-311 allowed members of the armed forces to include this combat pay for purposes of computing the earned income credit for tax years that ended after October 4, 2004 and before January 1, 2006.

Impact

The earned income tax credit increases the after-tax income of lower- and moderate-income working couples and individuals, particularly those with children. Alternative measures of income by the U.S. Census Department, which are designed to show the impact of taxes and transfers on poverty, estimate that the earned income credit reduced the number of people in poverty in 2002 by 4.0 million. Because the number of people in poverty is 35 million before the EIC (using an alternative income definition, and not the official definition), the reduction due to the EIC is 11.6%.

The following table provides estimates of the distribution of the earned income credit by income level, and includes the refundable portion of the credit. Because the estimates use an expanded definition of income, the estimates contain a distribution for incomes above the statutory limits. For further information on the definition of income see pages 4-5 of the introduction to this document.

Distribution by Income Class of the Tax Expenditure for the Earned Income Credit, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	17.5
$10 to $20	40.8
$20 to $30	27.9
$30 to $40	12.1
$40 to $50	1.5
$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 temporarily 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 made the credit permanent, raised the maximum amount of the credit, and provided for advance payment of the credit. The 1978 Act also created a range of income for which the maximum credit is granted before the credit begins to phase out.

The maximum credit was raised by both the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986. The 1986 Act also indexed the maximum earned income and phase out income amounts to inflation. The Omnibus Budget Reconciliation Act (OBRA) of 1990 increased the percentage used to calculate the credit, created an adjustment for family size, and created supplemental credits for young children (under age 1) and health insurance.

OBRA 1993 increased the credit, expanded the family-size adjustment, extended the credit to individuals without children, and repealed the

supplemental credits for young children and health insurance. To increase compliance, the Taxpayer Relief Act of 1997 included a provision denying the credit to persons improperly claiming the credit in prior years.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 simplified calculation of the credit by excluding nontaxable employee compensation from earned income, eliminating the credit reduction due to the alternative minimum tax, and using adjusted gross income rather than modified adjusted gross income for calculation of the credit phase out. EGTRRA also expanded the phase out range for married couples filing a joint return to reduce the marriage penalty. The EGTRRA changes do not apply to tax years after 2010.

Assessment

The earned income credit raises the after-tax income of several million lower- and moderate-income families, especially those with children. The credit has been promoted as an alternative to raising the minimum wage, as a method for reducing the burden of social security tax increases, and as an incentive to work. The credit has, in dollar terms, become the largest cash welfare program.

Up to the maximum earned income amount (at which the credit reaches a maximum) the credit generally provides a work incentive: the more a person earns, the greater the amount of the credit. But within the income range over which the credit is phased out, the credit may act as a work disincentive: as the credit declines, the taxes owed increase. As income increases a credit recipient may switch from receiving a refund (because of the credit) to receiving no credit or paying taxes. The combination of higher taxes and a lower credit increases the marginal tax rate of the individual. The marginal tax rate may in many cases be higher than the rate for taxpayers with substantially higher incomes. This creates an incentive for the individual to reduce work hours (to avoid the increase in taxes and maintain the credit).

While the credit encourages single parents to enter the work force, the decline of the credit above the phase out amount can discourage the spouse of a working parent from entering the workforce. This "marriage penalty" may also discourage marriage when one or both parties receive the earned income credit. EGTRRA may have moderated this effect somewhat.

Some eligible individuals do not receive the credit because of incorrect or incomplete tax return information, or because they do not file. Conversely, payments to ineligible individuals, and overpayments to eligible recipients, have been a source of concern, resulting in IRS studies of EIC compliance and federally funded initiatives to improve administration of the credit. For tax year 2003, the IRS conducted a pre-certification study in which approximately 25,000 tax filers were asked to certify before filing their tax return that the child claimed for the credit had lived with the tax filer for more than half of the tax year (making the child a qualifying child for the taxpayer to claim the EIC). The IRS has not completed the final report assessing the impacts of the pre-certification study.

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. Very few credit recipients elect advance payments. There are a number of reasons why a recipient may not choose advance payments, including not wanting to inform an employer that he/she is a credit recipient. A recipient may also be making a choice between consumption (using advance payments for current needs) and savings (using an annual payment for future needs or wants).

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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
2005	22.3	-	22.3
2006	22.3	-	22.3
2007	22.8	-	22.8
2008	23.5	-	23.5
2009	24.4	-	24.4

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 (married couple filing a joint return).

If provisional income is between the $25,000 threshold ($32,000 for a married couple) and a second-level threshold of $34,000 ($44,000 for a married couple), the amount of benefits subject to tax is the lesser of: (1) 50 percent of benefits; or (2) 50 percent of provisional income in excess of the first threshold.

If provisional 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 ($6,000 for a married couple) or,

(b) 50 percent of benefits.

For a married person filing separately who has lived with his or her spouse at any time during the tax year, taxable benefits are the lesser of 85 percent of benefits or 85 percent of provisional income.

The tax treatment of social security and tier one railroad retirement benefits differs from that of pension benefits. For pension benefits, all benefits that exceed (or are not attributable to) 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

The Congressional Budget Office estimates that about 61 percent of social security and railroad retirement tier one recipients pay no tax on their benefits. The distribution of the tax expenditure is shown below.

Distribution by Income Class of Tax Expenditure, Untaxed Social Security and Railroad Retirement Benefits, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	3.4
$20 to $30	15.0
$30 to $40	18.2
$40 to $50	16.1
$50 to $75	35.4
$75 to $100	7.9
$100 to $200	3.2
$200 and over	0.8

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 exclusion of benefits paid under the railroad retirement system was enacted in the Railroad Retirement Act of 1935.

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 now 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 1981 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. The inclusion of one-half of benefits represented the employer contribution to the benefits.

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 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. At that time is was estimated that the highest paid category of worker would, during the worker's lifetime, contribute fifteen percent of the value of the social security benefits received by the worker. That is, at least eighty-five percent of the social security benefits received by a retiree could not be attributed to contributions by the retiree. 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). This introduced the current two levels of taxation.

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 other pension benefits and IRA distributions on which taxes have never been paid is fully taxable, so too should the portion of social security and railroad benefits 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, and that the lowest proportion of retirement benefits that would be taxable for anyone in the work force 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 under other pension plans, a maximum of 85 percent of social security benefits is currently in taxable income.

To the extent that social security benefits reflect social welfare payments, it can be argued that benefits be taxed similar to other general untaxed social welfare payments and not like other retirement benefits. One exception to the concept of horizontal equity is social welfare payments — payments made for the greater good (social welfare). Not all social security payments have a pension or other retirement income component (for example, some are disability payments) and, unlike other pensions, more than one person may be entitled to benefits for a single worker. In addition, social security benefits are based on work earnings history and not contributions, with the formula providing additional benefits to recipients with lower work earnings histories.

Because the calculation of provisional income (to determine if benefits are taxable) includes a portion of social security benefits and certain otherwise untaxed income, the provisional income calculation can be compared to the income resources concept often used for means testing of various social benefits. Because the taxation increases as the provisional income increases, the after-tax social security benefits will decline as provisional income increases (but not below 15% of pre-tax benefits). This has resulted in the taxation of benefits being viewed as a "back-door" means test.

Under the current two level structure, all social security beneficiaries have some untaxed benefits. Taxes are imposed on at least half of the benefits for middle and upper income beneficiaries, while lower income beneficiaries have no benefits taxed.

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EXCLUSION OF VETERANS' BENEFITS AND SERVICES

(1) EXCLUSION OF VETERANS' DISABILITY COMPENSATION
(2) EXCLUSION OF VETERANS' PENSIONS
(3) EXCLUSION OF READJUSTMENT BENEFITS

Estimated Revenue Loss

[in billions of dollars]

	Individuals			
Fiscal Year	Veterans Disability Compensation	Veterans Pensions	Readjustment Benefits	Total
2005	3.4	0.1	0.2	3.7
2006	3.5	0.1	0.2	3.8
2007	3.5	0.1	0.2	3.8
2008	3.6	0.1	0.2	3.9
2009	3.6	0.1	0.3	4.0

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 the loss of earnings capacity in civilian occupations resulting from a service-related wound, injury, or disease. Typically, benefits increase with the severity of disability. Veterans whose service-connected disabilities are rated at 30 percent or more are entitled to additional allowances for dependents. Veterans with a 60- to 90-percent disability may receive compensation at the 100-percent level if they are 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, service persons, and eligible dependents. These programs have varying eligibility requirements and benefits.

With passage of the Veterans Millennium Health Care Act of 1999, veterans received expanded long-term care benefits and increased in home care. The act gave severely disabled veterans and those needing care for service-connected conditions higher priority access to long-term care benefits and services. The act also provided higher priority access to veterans awarded Purple Hearts and certain military retirees. It authorized the VA to increase co-payments for pharmacy benefits used for treatment of non-service-connected conditions, and authorized emergency care coverage for certain veterans without health insurance. Another provision included surviving spouses of certain totally disabled former prisoners of war as eligible for health care.

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. Many have concluded that the exclusion is in recognition of the extraordinary sacrifices made by armed forces personnel, especially during periods of war.

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. Some view veterans' compensation as a career indemnity payment owed to those disabled to any degree while serving in the nation's armed forces. If benefits were to become taxable, higher benefit levels would be required if lost income were replaced. Some disabled veterans would find it difficult to increase working hours to make up for the loss of expected compensation payments. Some commentors have noted that if veterans with new disability ratings below 30 percent were to be made ineligible for compensation it would concentrate spending on those veterans most impaired. Further, not only would direct expenditures be reduced, but the indirect tax expenditure of these payments would be excluded from the tax base.

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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
2005	([1])	([1])	([1])
2006	([1])	([1])	([1])
2007	([1])	([1])	([1])
2008	([1])	([1])	([1])
2009	([1])	([1])	([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 before 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 before 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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EXCLUSION OF INTEREST ON PUBLIC PURPOSE STATE AND LOCAL GOVERNMENT DEBT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	19.1	7.4	26.5
2006	19.3	7.5	26.8
2007	19.7	7.6	27.3
2008	20.1	7.8	27.9
2009	20.5	8.0	28.5

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, although State governments do have self-imposed debt limits. The revenue loss estimates in the above table for general fiscal assistance are based on the difference between excluded interest income on these governmental bonds and taxable 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 each State currently are subject to a federally imposed State volume cap on new issues of these tax-exempt private-activity bonds equal to the greater of $80 per resident or $233.795 million in 2004. The cap has been adjusted for inflation since 2003.

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 both to 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 8.5% when the taxable rate is 10%, there is a 1.5-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 15% marginal tax rate is equally well off purchasing either the 8.5% tax-exempt bond or the 10-percent taxable bond (both yield an 8.5% after-tax interest rate).

But a taxpayer facing a 35% marginal tax rate is better off buying a tax-exempt bond, because the after-tax return on the taxable bond is 6.5%, and on the tax-exempt bond, 8.5%. These "inframarginal" investors receive what have been characterized as 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% individual rate that prevailed prior to 1981 to the 35% individual rate that prevails in 2004 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).

Approximately 64% of individuals' tax-exempt interest income is earned by returns with adjusted gross income in excess of $100,000, although these returns represent only 8.3% of all returns.

Returns below $30,000 earn only 9.6% of tax-exempt interest income, although they represent more than 52% 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, 2002

Income Class (in thousands of $)	Percentage Distribution
Below $15	5.0
$15 to $30	4.6
$30 to $50	8.7
$50 to $100	18.1
$100 to $200	19.1
$200 and over	44.4

Rationale

This exemption has been in the income tax laws since 1913, and was based on the belief that state and local interest income had constitutional protection from Federal Government taxation. The argument in support of this constitutional protection was rejected 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 largely 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. Critics maintain there is no evidence that any underconsumption of State and local public services is isolated in capital facilities and argue that, to the extent a subsidy of State and local public service provision is needed to obtain the service levels desired by Federal taxpayers, the subsidy should not be restricted only 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 controversy.

This State and local share of the benefits (but not the amount) 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% to 31% and on corporations from 46% to 34%. (The highest current rate on individuals and corporations is now 35%.)

The open-ended structure of the subsidy affects Federal control of its budget and 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
2005	46.2	-	46.2
2006	36.8	-	36.8
2007	33.9	-	33.9
2008	33.7	-	33.7
2009	35.2	-	35.2

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. Over 83% of the tax benefits are taken by families with adjusted gross income in excess of $75,000 in 2003. As with any deduction, it is worth more as marginal tax rates increase. Personal property tax deductions (typically for cars and boats) are but a small fraction of state and local income tax deductions, 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, 2004

Income Class (in thousands of $)	Percentage Distribution
Below $10	0.0
$10 to $20	0.2
$20 to $30	0.9
$30 to $40	2.0
$40 to $50	3.6
$50 to $75	12.2
$75 to $100	14.5
$100 to $200	27.4
$200 and over	39.1

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 (OBRA) of 1990 curtailed the tax benefit from State and local income and real property tax deductions for higher income taxpayers (those whose AGI exceeds the applicable threshold amount--$142,700 for 2004). OBRA 1990 requires that itemized deductions be reduced by a percentage of the amount by which adjusted gross income exceeds the threshold amount. The phaseout is scheduled to gradually phase-out beginning in the 2006 tax year and be completely eliminated beginning with the 2010 tax year.

In 2004, sales tax deductibility was reinstated for the 2004 and 2005 tax years by the "American Jobs Creation Act of 2004," (P.L. 108-357). In contrast to pre-1986 law, State sales and use taxes can only be deducted *in lieu of* State income taxes not in addition to. Taxpayers who itemize and live in States without a personal income tax will benefit the most from the new law.

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.

In theory, there is an incentive for sub-federal governments to rely upon the taxes that are deductible from federal income, such as personal property taxes, because the tax "price" to the taxpayer is lower than the "price" on taxes that are not deductible.

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TAX CREDIT FOR PUERTO RICO AND POSSESSION INCOME AND PUERTO RICO ECONOMIC ACTIVITY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	-	1.2	1.2
2006	-	0.3	0.3
2007	-	-	-
2008	-	-	-
2009	-	-	-

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 and the Puerto Rican economic activity tax credit provided by section 30A permit 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 credits have the effect of exempting some or all of qualified income from tax 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 of 1996 (Public Law 104-188), the Federal credits are scheduled to end after 2005. In addition, only firms that were using the credit in 1995 ("existing claimants") may now claim the credit.

To qualify for either 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 possession-source income, subject to one of two alternative caps enacted in 1993. Under one cap–that applicable under section 30A's economic activity credit–the credit is limited to a specified portion of wages and depreciation. The alternative cap in effect provides a flat 40% tax exemption. The Small Business Job Protection Act of 1996 also provided for an additional limit that phases the credit out in the case of Puerto Rico and the U.S. Virgin Islands (but not the other possessions). Under this additional cap, the amount of income eligible for the credit is linked to a firm's average possessions earnings during a base period.

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 2001, for example, it accounted for 49 percent of all credits claimed under sections 936 and 30A. 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 and its caps linked to economic activity in the possessions--it is likely that part of the benefit of the tax credits 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 require repeal of the tax credits.

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.

The tax credits' 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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DEFERRAL OF INTEREST ON SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2005	1.1	-	1.1
2006	1.1	-	1.1
2007	1.1	-	1.1
2008	1.1	-	1.1
2009	1.1	-	1.1

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, before September 1, 2004, EE bonds could be exchanged for current income HH savings bonds with the accrued interest deferred until the HH bonds are redeemed. As of September 1, 2004, the U.S. Treasury ended the sale and exchange of HH savings bonds. 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 taxpayers.

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 currently applied at rates of 10, 15, 25, 28, 33, and 35 percent, with brackets varying across types of tax returns. These rates enacted in the 2001 and 2003 tax bills are technically temporary (expiring in 2010). At that time the 10% rate will return to the 15% rate and the four top rates will return to 28, 31, 36, and 39.6 percent, with brackets varying across types of tax returns. For joint returns, in 2005, rates on taxable income are 10 percent on the first $14,600, 15 percent for amounts from $14,600 to $59,400, 25 percent for amounts from $59,400 to $119,950, 28

percent for incomes from $119,950 to $182,800, 33 percent for taxable incomes of $182,800 to $326,450, and 35 percent for amounts over $326,450. 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. These phase are scheduled to be eliminated in 2005.

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 $35 in tax for every $100 of interest for the taxpayer in the 35-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 almost twice as much in tax saving to a taxpayer in the 28-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 and child credit are the only tax credits which are now refundable. That is, a qualifying individual will obtain in cash the entire amount of the refundable credit even if it exceeds tax liability. Child credits are not fully refundable, however, for certain very low income families.

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 took 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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