

5. TAX EXPENDITURES

Tax expenditures are revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. They are alternatives to other policy instruments, such as spending or regulatory programs, as means of achieving Federal policy goals. Tax expenditures are created for a variety of reasons: to encourage certain activities, to improve fairness, to ease compliance with and administration of the tax system, and to reduce certain tax-induced distortions. The Congressional Budget Act of 1974 (Public Law 93-344) requires that a list of tax expenditures be included in the budget.

The largest tax expenditures tend to be associated with the individual income tax. For example, sizeable tax preferences are provided for pension contributions and earnings, employer contributions for medical insurance, mortgage interest payments on owner-occupied homes, capital gains, and payments of State and local individual income and property taxes. Tax expenditures under the corporate income tax tend to be related to the rate of cost recovery for various investments; as is discussed below, the extent to which these provisions are classified as tax expenditures varies according to the conceptual baseline used. Charitable contributions and credits for State taxes on bequests are the largest tax expenditures under the unified transfer (i.e., estate and gift) tax.

Because of potential interactions among provisions, this chapter does not present a grand total for the

revenue loss estimated from tax expenditures. Moreover, past tax changes entailing broad elimination of tax expenditures were generally accompanied by changes in tax rates or other basic provisions, so that the net effects on Federal revenues were considerably (if not totally) offset. Nevertheless, in aggregate, tax expenditures have revenue impacts of hundreds of billions of dollars, and are some of the most important ways in which the Federal Government affects economic decisions and social welfare.

Tax expenditures relating to the individual and corporate income taxes are considered first in this chapter. They are estimated for fiscal years 1999-2005 using three methods of accounting: revenue loss, outlay equivalent, and present value. The present value approach provides estimates of the revenue losses for tax expenditures that involve deferrals of tax payments into the future or have similar long-term effects. Tax expenditures relating to the unified transfer tax are considered in a section at the end of the chapter.

The section of the chapter on performance measures and economic effects presents information related to assessment of the effect of tax expenditures on the achievement of program performance goals. This section is a complement to the government-wide performance plan required by the Government Performance and Results Act of 1993. Tax expenditures are also discussed in Section V of the Budget, which considers the Federal Government's spending, regulatory, and tax policies across functional areas.

TAX EXPENDITURES IN THE INCOME TAX

Tax Expenditure Estimates

The Treasury Department prepared all tax expenditure estimates presented here based upon tax law enacted as of December 31, 1999. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 1999. Due to the time required to estimate the large number of tax expenditures, the estimates are based on mid-session economic assumptions; exceptions are the earned income tax credit and child credit provisions, which involve outlay components and hence are updated to reflect the economic assumptions used elsewhere in the budget.

The total revenue loss estimates for tax expenditures for fiscal years 1999-2005 are displayed according to the budget's functional categories in Table 5-1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and discussion of general features of the tax expenditure concept.

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

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

holders, employees, customers, or others, depending on economic forces.

Table 5-3 ranks the major tax expenditures by fiscal year 2001 revenue loss. This table merges several individual entries provided in Table 5-1; for example, Table 5-3 contains one merged entry for charitable contributions instead of the three separate entries found in Table 5-1.

Interpreting Tax Expenditure Estimates

The revenue loss estimates shown for individual tax expenditures in Tables 5-1, 5-2, and 5-3 do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these special provisions, for the following reasons:

Eliminating a tax expenditure may have incentive effects that alter economic behavior. These incentives can affect the resulting magnitudes of the formerly subsidized activity or of other tax preferences or Government programs. For example, if deductibility of mortgage interest were limited, some taxpayers would hold smaller mortgages, with a concomitantly smaller effect on the budget than if no such limits were in force.

Tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the revenue losses associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue losses from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue loss from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, because each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 5-1 are the totals of individual and corporate income tax revenue losses reported in Table 5-2 and do not reflect any possible interactions between the individual and corporate income tax receipts. For this reason, the estimates in Table 5-1 (as well as those in Table 5-5, which are also based on summing individual and corporate estimates) should be regarded as approximations.

Revenues raised by changes to tax expenditures are sensitive to timing effects and effective dates. Changes in some provisions could yield their full potential revenue gains relatively quickly, whereas changes to other provisions would only gradually yield their full revenue

potential, especially if certain deductions or exemptions were grandfathered.

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 5-4. Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. Although such estimates are useful as a measure of cash flows into the Government, they do not accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals do have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real cost to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful supplement to the cash-basis estimates for provisions involving deferrals, are discussed below.

Repeal on major tax provisions may have some impact on overall levels of income and rates of economic growth and, thus, on the budget economic assumptions. In practice, however, most changes in particular provisions are unlikely to have significant macroeconomic effects.

Present-Value Estimates

Discounted present-value estimates of revenue losses are presented in Table 5-4 for provisions that involve tax deferrals or other long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue losses, net of future tax payments, that follow from activities undertaken during calendar year 1999 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 1999 would cause a deferral of tax payments on wages in 1999 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 1999 pension contribution and accrued earnings would be paid out and taxes would be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows.

Table 5-1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX
(In millions of dollars)

		Total revenue loss from corporate and individual income taxes							
		1999	2000	2001	2002	2003	2004	2005	2001-2005
	National Defense								
1	Exclusion of benefits and allowances to armed forces personnel	2,120	2,140	2,160	2,180	2,200	2,220	2,240	11,000
	International affairs:								
2	Exclusion of income earned abroad by U.S. citizens	2,330	2,550	2,790	3,040	3,285	3,545	3,825	16,485
3	Exclusion of certain allowances for Federal employees abroad	635	665	695	725	760	795	830	3,805
4	Exclusion of income of foreign sales corporations	3,640	3,890	4,160	4,460	4,770	5,100	5,460	23,950
5	Inventory property sales source rules exception	1,050	1,100	1,150	1,250	1,350	1,450	1,550	6,750
6	Deferral of income from controlled foreign corporations (normal tax method)	5,800	6,200	6,600	7,000	7,450	7,900	8,400	37,350
7	Deferred taxes for financial firms on certain income earned overseas	960	1,190	1,290	540	0	0	0	1,830
	General science, space, and technology:								
8	Expensing of research and experimentation expenditures (normal tax method)	1,890	1,865	1,885	1,965	2,090	2,245	2,410	10,595
9	Credit for increasing research activities	1,705	1,010	3,360	3,710	2,970	2,605	1,505	14,150
	Energy:								
10	Expensing of exploration and development costs, fuels	-80	-15	-30	-10	15	15	15	5
11	Excess of percentage over cost depletion, fuels	265	275	280	280	285	290	290	1,425
12	Alternative fuel production credit	1,025	960	905	845	125	125	125	2,125
13	Exception from passive loss limitation for working interests in oil and gas properties	30	25	25	25	25	25	25	125
14	Capital gains treatment of royalties on coal	65	65	70	70	75	80	85	380
15	Exclusion of interest on energy facility bonds	115	115	115	120	120	120	120	595
16	Enhanced oil recovery credit	225	260	295	340	390	450	515	1,990
17	New technology credit	50	60	80	90	90	90	85	435
18	Alcohol fuel credits ¹	15	15	15	15	15	15	15	75
19	Tax credit and deduction for clean-fuel burning vehicles	85	90	105	100	80	55	20	360
20	Exclusion from income of conservation subsidies provided by public utilities	85	80	80	80	85	85	85	415
	Natural resources and environment:								
21	Expensing of exploration and development costs, nonfuel minerals	15	15	20	20	20	20	20	100
22	Excess of percentage over cost depletion, nonfuel minerals	225	230	245	250	265	275	285	1,320
23	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	460	460	470	475	480	480	490	2,395
24	Capital gains treatment of certain timber income	65	65	70	70	75	80	85	380
25	Expensing of multiperiod timber growing costs	495	500	530	565	590	605	630	2,920
26	Investment credit and seven-year amortization for reforestation expenditures	10	10	10	15	15	15	15	70
27	Tax incentives for preservation of historic structures	210	220	240	250	265	280	295	1,330
	Agriculture:								
28	Expensing of certain capital outlays	70	70	75	75	80	85	90	405
29	Expensing of certain multiperiod production costs	85	85	90	95	105	110	110	510
30	Treatment of loans forgiven for solvent farmers	10	10	10	10	10	10	10	50
31	Capital gains treatment of certain income	635	665	695	725	760	795	830	3,805
32	Income averaging for farmers	75	75	80	80	80	85	85	410
33	Deferral of gain on sale of farm refiners	10	10	10	10	15	15	15	65
	Commerce and housing:								
	Financial institutions and insurance:								
34	Exemption of credit union income	1,470	1,550	1,650	1,765	1,890	2,020	2,155	9,480
35	Excess bad debt reserves of financial institutions	60	65	55	45	35	20	5	160
36	Exclusion of interest on life insurance savings	13,920	14,985	16,130	17,365	18,870	20,130	21,680	94,175
37	Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
38	Tax exemption of certain insurance companies owned by tax-exempt organizations	220	225	235	240	250	255	265	1,245
39	Small life insurance company deduction	100	100	100	100	100	105	105	510
	Housing:								
40	Exclusion of interest on owner-occupied mortgage subsidy bonds	905	915	920	930	940	950	955	4,695
41	Exclusion of interest on rental housing bonds	155	155	160	160	160	160	160	800
42	Deductibility of mortgage interest on owner-occupied homes	56,920	58,815	60,925	63,240	65,955	68,965	72,160	331,245
43	Deductibility of State and local property tax on owner-occupied homes	21,215	22,185	23,075	24,000	24,980	25,915	26,840	124,810
44	Deferral of income from post-1987 installment sales	995	1,015	1,035	1,055	1,075	1,095	1,115	5,375
45	Capital gains exclusion on home sales	18,000	18,540	19,095	19,670	20,260	20,870	21,495	101,390
46	Exception from passive loss rules for \$25,000 of rental loss	5,315	5,035	4,790	4,555	4,330	4,100	3,885	21,660
47	Credit for low-income housing investments	2,820	3,055	3,195	3,300	3,405	3,485	3,540	16,925
48	Accelerated depreciation on rental housing (normal tax method)	3,710	3,985	4,225	4,500	4,765	4,975	5,145	23,610
	Commerce:								
49	Cancellation of indebtedness	40	25	15	15	20	20	25	95
50	Exceptions from imputed interest rules	160	160	160	165	165	165	165	820
51	Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	39,405	40,575	41,780	43,025	44,300	45,615	46,965	221,685
52	Capital gains exclusion of small corporation stock	5	5	5	5	5	5	5	25
53	Step-up basis of capital gains at death	25,800	27,090	28,240	29,370	30,545	31,765	33,035	152,955
54	Carryover basis of capital gains on gifts	175	185	195	205	210	220	230	1,060
55	Ordinary income treatment of loss from small business corporation stock sale	35	35	40	40	40	40	40	200

Table 5-1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued
(In millions of dollars)

		Total revenue loss from corporate and individual income taxes							
		1999	2000	2001	2002	2003	2004	2005	2001–2005
56	Accelerated depreciation of buildings other than rental housing (normal tax method)	1,660	710	–435	–755	–1,115	–1,695	–2,145	–6,145
57	Accelerated depreciation of machinery and equipment (normal tax method)	26,445	27,740	32,830	33,345	34,265	36,390	37,330	174,160
58	Expensing of certain small investments (normal tax method)	1,465	1,590	1,925	1,965	1,920	1,895	1,905	9,610
59	Amortization of start-up costs (normal tax method)	200	205	205	215	215	220	225	1,080
60	Graduated corporation income tax rate (normal tax method)	6,360	6,300	6,275	6,460	6,490	6,710	6,815	32,750
61	Exclusion of interest on small issue bonds	310	315	315	320	320	325	330	1,610
Transportation:									
62	Deferral of tax on shipping companies	15	15	15	15	15	15	15	75
63	Exclusion of reimbursed employee parking expenses	1,725	1,805	1,895	1,995	2,100	2,210	2,330	10,530
64	Exclusion for employer-provided transit passes	130	150	170	190	215	235	260	1,070
Community and regional development:									
65	Investment credit for rehabilitation of structures (other than historic)	25	25	30	30	30	30	30	150
66	Exclusion of interest for airport, dock, and similar bonds	730	735	740	750	755	765	770	3,780
67	Exemption of certain mutuals' and cooperatives' income	60	60	60	65	65	65	70	325
68	Empowerment zones and enterprise communities	330	445	500	465	330	300	260	1,855
69	Expensing of environmental remediation costs	115	150	175	60	–30	–35	–30	140
Education, training, employment, and social services:									
Education:									
70	Exclusion of scholarship and fellowship income (normal tax method)	1,085	1,110	1,120	1,130	1,140	1,150	1,165	5,705
71	HOPE tax credit	4,595	4,925	5,125	5,145	4,745	4,615	5,335	24,965
72	Lifetime Learning tax credit	2,170	2,375	2,420	2,465	4,405	4,430	4,630	18,350
73	Education Individual Retirement Accounts	0	10	25	40	60	80	105	310
74	Deductibility of student-loan interest	240	265	310	350	375	395	430	1,860
75	Deferral for State prepaid tuition plans	120	175	225	275	320	350	385	1,555
76	Exclusion of interest on student-loan bonds	245	250	255	255	255	260	260	1,285
77	Exclusion of interest on bonds for private nonprofit educational facilities	590	595	600	600	610	615	620	3,045
78	Credit for holders of zone academy bonds	5	10	20	35	50	65	70	240
79	Exclusion of interest on savings bonds redeemed to finance educational expenses	10	15	15	15	15	20	20	85
80	Parental personal exemption for students age 19 or over	915	965	1,015	1,055	1,105	1,155	1,185	5,515
81	Child credit ²	19,435	19,575	19,480	18,970	18,155	17,535	16,855	90,995
82	Deductibility of charitable contributions (education)	2,525	2,650	2,765	2,910	3,035	3,140	3,300	15,150
83	Exclusion of employer-provided educational assistance	220	235	250	175	0	0	0	425
Training, employment, and social services:									
84	Work opportunity tax credit	270	455	465	350	215	95	35	1,160
85	Welfare-to-work tax credit	35	60	80	80	60	25	10	255
86	Exclusion of employer-provided child care	645	670	700	725	765	805	850	3,845
87	Adoption assistance	125	140	140	125	40	15	10	330
88	Exclusion of employee meals and lodging (other than military)	650	680	710	740	775	810	845	3,880
89	Credit for child and dependent care expenses	2,420	2,390	2,360	2,330	2,305	2,275	2,250	11,520
90	Credit for disabled access expenditures	50	50	55	55	55	60	60	285
91	Expensing of costs of removing certain architectural barriers to the handicapped	0	0	5	5	5	5	5	25
92	Deductibility of charitable contributions, other than education and health	19,220	20,015	20,860	21,780	22,750	23,765	24,895	114,050
93	Exclusion of certain foster care payments	35	40	40	45	45	50	50	230
94	Exclusion of parsonage allowances	320	340	365	390	415	445	475	2,090
Health:									
95	Exclusion of employer contributions for medical insurance premiums and medical care	69,610	75,095	80,570	86,175	90,655	95,960	102,725	456,085
96	Self-employed medical insurance premiums	935	1,250	1,380	1,545	2,070	2,905	3,210	11,110
97	Workers' compensation insurance premiums	4,420	4,585	4,555	4,935	5,120	5,315	5,515	25,440
98	Medical Savings Accounts	20	30	30	30	30	30	25	145
99	Deductibility of medical expenses	3,695	3,910	4,160	4,440	4,720	5,005	5,305	23,630
100	Exclusion of interest on hospital construction bonds	1,210	1,225	1,235	1,250	1,265	1,275	1,290	6,315
101	Deductibility of charitable contributions (health)	2,675	2,800	2,930	3,080	3,210	3,315	3,490	16,025
102	Tax credit for orphan drug research	70	80	90	100	115	130	140	575
103	Special Blue Cross/Blue Shield deduction	245	315	200	135	180	245	315	1,075
Income security:									
104	Exclusion of railroad retirement system benefits	395	405	410	415	420	430	430	2,105
105	Exclusion of workers' compensation benefits	5,185	5,330	5,785	6,040	6,310	6,575	6,865	31,575
106	Exclusion of public assistance benefits (normal tax method)	345	360	375	390	405	420	435	2,025
107	Exclusion of special benefits for disabled coal miners	75	75	70	70	65	60	55	320
108	Exclusion of military disability pensions	130	130	135	140	140	145	150	710
Net exclusion of pension contributions and earnings:									
109	Employer plans	83,780	88,830	92,390	97,085	102,575	108,020	113,705	513,775
110	Individual Retirement Accounts	13,350	15,050	15,975	17,030	17,630	18,250	18,750	87,635
111	Keogh plans	5,230	5,550	5,895	6,255	6,635	7,040	7,465	33,290
Exclusion of other employee benefits:									

Table 5-1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued
(In millions of dollars)

		Total revenue loss from corporate and individual income taxes							
		1999	2000	2001	2002	2003	2004	2005	2001–2005
112	Premiums on group term life insurance	1,700	1,740	1,780	1,820	1,860	1,915	1,970	9,345
113	Premiums on accident and disability insurance	185	195	205	215	225	235	245	1,125
114	Income of trusts to finance supplementary unemployment benefits	0	0	0	5	5	5	5	20
115	Special ESOP rules	1,130	1,175	1,205	1,250	1,300	1,360	1,425	6,540
116	Additional deduction for the blind	30	30	30	30	35	35	35	165
117	Additional deduction for the elderly	1,785	1,830	1,890	1,955	1,985	2,030	2,110	9,970
118	Tax credit for the elderly and disabled	35	35	35	35	35	35	35	175
119	Deductibility of casualty losses	255	265	275	285	295	310	325	1,490
120	Earned income tax credit ³	4,825	4,700	4,790	4,985	5,205	5,440	5,740	26,160
Social Security:									
Exclusion of social security benefits:									
121	Social Security benefits for retired workers	17,135	18,010	18,885	19,995	21,230	22,505	16,515	99,130
122	Social Security benefits for disabled	2,390	2,595	2,830	3,090	3,375	3,700	3,150	16,145
123	Social Security benefits for dependents and survivors	3,775	3,900	4,050	4,210	4,385	4,555	3,625	20,825
Veterans benefits and services:									
124	Exclusion of veterans death benefits and disability compensation	2,940	3,070	3,200	3,335	3,490	3,655	3,830	17,510
125	Exclusion of veterans pensions	65	70	75	80	85	85	90	415
126	Exclusion of GI bill benefits	75	85	90	90	95	100	105	480
127	Exclusion of interest on veterans housing bonds	40	40	40	40	40	40	40	200
General purpose fiscal assistance:									
128	Exclusion of interest on public purpose bonds	22,750	22,975	23,205	23,440	23,670	23,905	24,145	118,365
129	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	37,740	40,240	42,390	44,735	47,610	50,530	53,480	238,745
130	Tax credit for corporations receiving income from doing business in U.S. possessions	2,515	2,590	2,670	2,600	2,550	2,600	2,650	13,070
Interest:									
131	Deferral of interest on U.S. savings bonds	1,015	1,065	1,115	1,175	1,235	1,295	1,355	6,175
Addendum: Aid to State and local governments:									
Deductibility of:									
Property taxes on owner-occupied homes		21,215	22,185	23,075	24,000	24,980	25,915	26,840	124,810
Nonbusiness State and local taxes other than on owner-occupied homes		37,740	40,240	42,390	44,735	47,610	50,530	53,480	238,745
Exclusion of interest on State and local bonds for:									
Public purposes		22,750	22,975	23,205	23,440	23,670	23,905	24,145	118,365
Energy facilities		115	115	115	120	120	120	120	595
Water, sewage, and hazardous waste disposal facilities		460	460	470	475	480	480	490	2,395
Small-issues		310	315	315	320	320	325	330	1,610
Owner-occupied mortgage subsidies		905	915	920	930	940	950	955	4,695
Rental housing		155	155	160	160	160	160	160	800
Airports, docks, and similar facilities		730	735	740	750	755	765	770	3,780
Student loans		245	250	255	255	255	260	260	1,285
Private nonprofit educational facilities		590	595	600	600	610	615	620	3,045
Hospital construction		1,210	1,225	1,235	1,250	1,265	1,275	1,290	6,315
Veterans' housing		40	40	40	40	40	40	40	200
Credit for holders of zone academy bonds		5	10	20	35	50	65	70	240

¹In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1999 \$760; 2000 \$800; 2001 \$805; 2002 \$810; 2003 \$815; 2004 \$825; and 2005 \$830.

²The figures in the table indicate the effect of the child tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$445; 2000 \$550; 2001 \$520; 2002 \$505; 2003 \$460; 2004 \$450; and 2005 \$420.

³The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$25,632; 2000 \$25,676; 2001 \$25,799; 2002 \$26,876; 2003 \$27,638; 2004 \$28,701; and 2005 \$29,722.

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest \$5 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Table 5-2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES

(In millions of dollars)

		Revenue Loss															
		Corporations								Individuals							
		1999	2000	2001	2002	2003	2004	2005	2001–2005	1999	2000	2001	2002	2003	2004	2005	2001–2005
1	National Defense Exclusion of benefits and allowances to armed forces personnel									2,120	2,140	2,160	2,180	2,200	2,220	2,240	11,000
2	International affairs: Exclusion of income earned abroad by U.S. citizens									2,330	2,550	2,790	3,040	3,285	3,545	3,825	16,485
3	Exclusion of certain allowances for Federal employees abroad									635	665	695	725	760	795	830	3,805
4	Exclusion of income of foreign sales corporations	3,640	3,890	4,160	4,460	4,770	5,100	5,460	23,950								
5	Inventory property sales source rules exception	1,050	1,100	1,150	1,250	1,350	1,450	1,550	6,750								
6	Deferral of income from controlled foreign corporations (normal tax method)	5,800	6,200	6,600	7,000	7,450	7,900	8,400	37,350								
7	Deferred taxes for financial firms on certain income earned overseas	960	1,190	1,290	540	0	0	0	1,830								
8	General science, space, and technology: Expensing of research and experimentation expenditures (normal tax method)	1,855	1,830	1,850	1,925	2,050	2,200	2,365	10,390	35	35	35	40	40	45	45	205
9	Credit for increasing research activities ..	1,675	995	3,300	3,650	2,925	2,565	1,490	13,930	30	15	60	60	45	40	15	220
10	Energy: Expensing of exploration and development costs, fuels	–70	–15	–30	–10	15	15	15	5	–10	0	0	0	0	0	0	0
11	Excess of percentage over cost depletion, fuels	220	225	230	230	235	240	240	1,175	45	50	50	50	50	50	50	250
12	Alternative fuel production credit	975	915	860	805	125	125	125	2,040	50	45	45	40	0	0	0	85
13	Exception from passive loss limitation for working interests in oil and gas properties									30	25	25	25	25	25	25	125
14	Capital gains treatment of royalties on coal									65	65	70	70	75	80	85	380
15	Exclusion of interest on energy facility bonds	30	30	30	30	30	30	30	150	85	85	85	90	90	90	90	445
16	Enhanced oil recovery credit	205	235	270	310	355	410	470	1,815	20	25	25	30	35	40	45	175
17	New technology credit	45	50	60	70	70	70	65	335	5	10	20	20	20	20	20	100
18	Alcohol fuel credits ¹	10	10	10	10	10	10	10	50	5	5	5	5	5	5	5	25
19	Tax credit and deduction for clean-fuel burning vehicles	70	75	85	80	65	45	15	290	15	15	20	20	15	10	5	70
20	Exclusion from income of conservation subsidies provided by public utilities ...	–5	–5	–5	–5	0	0	0	–10	90	85	85	85	85	85	85	425
21	Natural resources and environment: Expensing of exploration and development costs, nonfuel minerals	10	10	15	15	15	15	15	75	5	5	5	5	5	5	5	25
22	Excess of percentage over cost depletion, nonfuel minerals	180	185	195	200	210	220	230	1,055	45	45	50	50	55	55	55	265
23	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	115	115	120	120	120	120	125	605	345	345	350	355	360	360	365	1,790
24	Capital gains treatment of certain timber income									65	65	70	70	75	80	85	380
25	Expensing of multiperiod timber growing costs	305	310	330	350	365	375	390	1,810	190	190	200	215	225	230	240	1,110
26	Investment credit and seven-year amortization for reforestation expenditures ...									10	10	10	15	15	15	15	70
27	Tax incentives for preservation of historic structures	170	180	195	205	215	230	240	1,085	40	40	45	45	50	50	55	245
28	Agriculture: Expensing of certain capital outlays	10	10	10	10	10	10	10	50	60	60	65	65	70	75	80	355
29	Expensing of certain multiperiod production costs	10	10	10	10	15	15	15	65	75	75	80	85	90	95	95	445
30	Treatment of loans forgiven for solvent farmers									10	10	10	10	10	10	10	50
31	Capital gains treatment of certain income									635	665	695	725	760	795	830	3,805
32	Income averaging for farmers									75	75	80	80	80	85	85	410
33	Deferral of gain on sale of farm refiners ..	10	10	10	10	15	15	15	65								
	Commerce and housing: Financial institutions and insurance:																
34	Exemption of credit union income	1,470	1,550	1,650	1,765	1,890	2,020	2,155	9,480								
35	Excess bad debt reserves of financial institutions	60	65	55	45	35	20	5	160								

Table 5-2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

		Revenue Loss															
		Corporations								Individuals							
		1999	2000	2001	2002	2003	2004	2005	2001–2005	1999	2000	2001	2002	2003	2004	2005	2001–2005
36	Exclusion of interest on life insurance savings	420	450	485	520	565	605	650	2,825	13,500	14,535	15,645	16,845	18,305	19,525	21,030	91,350
37	Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25	.....	.....	.....	.....	.....	.....	.....	.....
38	Tax exemption of certain insurance companies owned by tax-exempt organizations	220	225	235	240	250	255	265	1,245	.....	.....	.....	.....	.....	.....	.....	.....
39	Small life insurance company deduction	100	100	100	100	100	105	105	510	.....	.....	.....	.....	.....	.....	.....	.....
	Housing:																
40	Exclusion of interest on owner-occupied mortgage subsidy bonds	230	230	230	235	235	240	240	1,180	675	685	690	695	705	710	715	3,515
41	Exclusion of interest on rental housing bonds	40	40	40	40	40	40	40	200	115	115	120	120	120	120	120	600
42	Deductibility of mortgage interest on owner-occupied homes .....	.....	.....	.....	.....	.....	.....	.....	.....	56,920	58,815	60,925	63,240	65,955	68,965	72,160	331,245
43	Deductibility of State and local property tax on owner-occupied homes .....	.....	.....	.....	.....	.....	.....	.....	.....	21,215	22,185	23,075	24,000	24,980	25,915	26,840	124,810
44	Deferral of income from post-1987 installment sales	260	265	270	275	280	285	290	1,400	735	750	765	780	795	810	825	3,975
45	Capital gains exclusion on home sales .....	.....	.....	.....	.....	.....	.....	.....	.....	18,000	18,540	19,095	19,670	20,260	20,870	21,495	101,390
46	Exception from passive loss rules for \$25,000 of rental loss .....	.....	.....	.....	.....	.....	.....	.....	.....	5,315	5,035	4,790	4,555	4,330	4,100	3,885	21,660
47	Credit for low-income housing investments	2,115	2,290	2,395	2,475	2,555	2,615	2,655	12,695	705	765	800	825	850	870	885	4,230
48	Accelerated depreciation on rental housing (normal tax method)	110	120	135	160	180	200	230	905	3,600	3,865	4,090	4,340	4,585	4,775	4,915	22,705
	Commerce:																
49	Cancellation of indebtedness .....	.....	.....	.....	.....	.....	.....	.....	.....	40	25	15	15	20	20	25	95
50	Exceptions from imputed interest rules .....	.....	.....	.....	.....	.....	.....	.....	.....	160	160	160	165	165	165	165	820
51	Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method) .....	.....	.....	.....	.....	.....	.....	.....	.....	39,405	40,575	41,780	43,025	44,300	45,615	46,965	221,685
52	Capital gains exclusion of small corporation stock .....	.....	.....	.....	.....	.....	.....	.....	.....	5	5	5	5	5	5	5	25
53	Step-up basis of capital gains at death .....	.....	.....	.....	.....	.....	.....	.....	.....	25,800	27,090	28,240	29,370	30,545	31,765	33,035	152,955
54	Carryover basis of capital gains on gifts .....	.....	.....	.....	.....	.....	.....	.....	.....	175	185	195	205	210	220	230	1,060
55	Ordinary income treatment of loss from small business corporation stock sale .....	.....	.....	.....	.....	.....	.....	.....	.....	35	35	40	40	40	40	40	200
56	Accelerated depreciation of buildings other than rental housing (normal tax method)	1,195	655	230	15	–260	–625	–905	–1,545	465	55	–665	–770	–855	–1,070	–1,240	–4,600
57	Accelerated depreciation of machinery and equipment (normal tax method)	21,100	22,085	26,970	27,265	27,965	29,825	30,465	142,490	5,345	5,655	5,860	6,080	6,300	6,565	6,865	31,670
58	Expensing of certain small investments (normal tax method)	395	490	630	665	630	625	645	3,195	1,070	1,100	1,295	1,300	1,290	1,270	1,260	6,415
59	Amortization of start-up costs (normal tax method)	120	125	125	130	130	135	135	655	80	80	80	85	85	85	90	425
60	Graduated corporation income tax rate (normal tax method)	6,360	6,300	6,275	6,460	6,490	6,710	6,815	32,750	.....	.....	.....	.....	.....	.....	.....	.....
61	Exclusion of interest on small issue bonds	80	80	80	80	80	80	85	405	230	235	235	240	240	245	245	1,205
	Transportation:																
62	Deferral of tax on shipping companies	15	15	15	15	15	15	15	75	.....	.....	.....	.....	.....	.....	.....	.....
63	Exclusion of reimbursed employee parking expenses .....	.....	.....	.....	.....	.....	.....	.....	.....	1,725	1,805	1,895	1,995	2,100	2,210	2,330	10,530
64	Exclusion for employer-provided transit passes .....	.....	.....	.....	.....	.....	.....	.....	.....	130	150	170	190	215	235	260	1,070
	Community and regional development:																
65	Investment credit for rehabilitation of structures (other than historic)	15	15	15	15	15	15	15	75	10	10	15	15	15	15	15	75
66	Exclusion of interest for airport, dock, and similar bonds	185	185	185	190	190	195	195	955	545	550	555	560	565	570	575	2,825
67	Exemption of certain mutuals' and co-operatives' income	60	60	60	65	65	65	70	325	.....	.....	.....	.....	.....	.....	.....	.....
68	Empowerment zones and enterprise communities	150	205	220	185	130	110	90	735	180	240	280	280	200	190	170	1,120
69	Expensing of environmental remediation costs	95	125	145	50	–25	–30	–25	115	20	25	30	10	–5	–5	–5	25

Table 5-2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

		Revenue Loss															
		Corporations								Individuals							
		1999	2000	2001	2002	2003	2004	2005	2001–2005	1999	2000	2001	2002	2003	2004	2005	2001–2005
	Education, training, employment, and social services:																
	Education:																
70	Exclusion of scholarship and fellow- ship income (normal tax method) ...									1,085	1,110	1,120	1,130	1,140	1,150	1,165	5,705
71	HOPE tax credit									4,595	4,925	5,125	5,145	4,745	4,615	5,335	24,965
72	Lifetime Learning tax credit									2,170	2,375	2,420	2,465	4,405	4,430	4,630	18,350
73	Education Individual Retirement Ac- counts									0	10	25	40	60	80	105	310
74	Deductibility of student-loan interest ...									240	265	310	350	375	395	430	1,860
75	Deferral for State prepaid tuition plans									120	175	225	275	320	350	385	1,555
76	Exclusion of interest on student-loan bonds	60	65	65	65	65	65	65	325	185	185	190	190	190	195	195	960
77	Exclusion of interest on bonds for pri- vate nonprofit educational facilities	150	150	150	150	155	155	155	765	440	445	450	450	455	460	465	2,280
78	Credit for holders of zone academy bonds	5	10	20	35	50	65	70	240								
79	Exclusion of interest on savings bonds redeemed to finance educational expenses									10	15	15	15	15	20	20	85
80	Parental personal exemption for stu- dents age 19 or over									915	965	1,015	1,055	1,105	1,155	1,185	5,515
81	Child credit ²									19,435	19,575	19,480	18,970	18,155	17,535	16,855	90,995
82	Deductibility of charitable contributions (education)	485	515	545	595	615	610	650	3,015	2,040	2,135	2,220	2,315	2,420	2,530	2,650	12,135
83	Exclusion of employer-provided edu- cational assistance									220	235	250	175	0	0	0	425
	Training, employment, and social serv- ices:																
84	Work opportunity tax credit	230	385	395	300	185	80	30	990	40	70	70	50	30	15	5	170
85	Welfare-to-work tax credit	30	50	65	70	50	20	10	215	5	10	15	10	10	5	0	40
86	Exclusion of employer-provided child care									645	670	700	725	765	805	850	3,845
87	Adoption assistance									125	140	140	125	40	15	10	330
88	Exclusion of employee meals and lodging (other than military)									650	680	710	740	775	810	845	3,880
89	Credit for child and dependent care expenses									2,420	2,390	2,360	2,330	2,305	2,275	2,250	11,520
90	Credit for disabled access expendi- tures	15	15	15	15	15	15	15	75	35	35	40	40	40	45	45	210
91	Expensing of costs of removing cer- tain architectural barriers to the handicapped	0	0	5	5	5	5	5	25								
92	Deductibility of charitable contribu- tions, other than education and health	600	635	680	740	760	755	805	3,740	18,620	19,380	20,180	21,040	21,990	23,010	24,090	110,310
93	Exclusion of certain foster care pay- ments									35	40	40	45	45	50	50	230
94	Exclusion of parsonage allowances ...									320	340	365	390	415	445	475	2,090
	Health:																
95	Exclusion of employer contributions for medical insurance premiums and medical care									69,610	75,095	80,570	86,175	90,655	95,960	102,725	456,085
96	Self-employed medical insurance pre- miums									935	1,250	1,380	1,545	2,070	2,905	3,210	11,110
97	Workers' compensation insurance pre- miums									4,420	4,585	4,555	4,935	5,120	5,315	5,515	25,440
98	Medical Savings Accounts									20	30	30	30	30	30	25	145
99	Deductibility of medical expenses									3,695	3,910	4,160	4,440	4,720	5,005	5,305	23,630
00	Exclusion of interest on hospital con- struction bonds	305	310	310	315	320	320	325	1,590	905	915	925	935	945	955	965	4,725
101	Deductibility of charitable contributions (health)	585	620	660	720	740	735	780	3,635	2,090	2,180	2,270	2,360	2,470	2,580	2,710	12,390
102	Tax credit for orphan drug research	70	80	90	100	115	130	140	575								
103	Special Blue Cross/Blue Shield deduction	245	315	200	135	180	245	315	1,075								
	Income security:																
104	Exclusion of railroad retirement system benefits									395	405	410	415	420	430	430	2,105
105	Exclusion of workers' compensation ben- efits									5,185	5,330	5,785	6,040	6,310	6,575	6,865	31,575
106	Exclusion of public assistance benefits (normal tax method)									345	360	375	390	405	420	435	2,025

Table 5-2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

		Revenue Loss															
		Corporations								Individuals							
		1999	2000	2001	2002	2003	2004	2005	2001–2005	1999	2000	2001	2002	2003	2004	2005	2001–2005
	Credit for holders of zone academy bonds	5	10	20	35	50	65	70	240	.....	.....	.....	.....	.....	.....	.....	.....

¹In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1999 \$760; 2000 \$800; 2001 \$805; 2002 \$810; 2003 \$815; 2004 \$825; and 2005 \$830.

²The figures in the table indicate the effect of the child tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$445; 2000 \$550; 2001 \$520; 2002 \$505; 2003 \$460; 2004 \$450; and 2005 \$420.

³The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$25,632; 2000 \$25,676; 2001 \$25,799; 2002 \$26,876; 2003 \$27,638; 2004 \$28,701; and 2005 \$29,722.

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest \$5 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Table 5-3. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 2001 REVENUE LOSS

(In millions of dollars)

Provision	2001	2001-2005
Net exclusion of pension contributions and earnings: Employer plans	92,390	513,775
Exclusion of employer contributions for medical insurance premiums and medical care	80,570	456,085
Deductibility of mortgage interest on owner-occupied homes	60,925	331,245
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	42,390	238,745
Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	41,780	221,685
Accelerated depreciation of machinery and equipment (normal tax method)	32,830	174,160
Step-up basis of capital gains at death	28,240	152,955
Deductibility of charitable contributions, total	26,555	145,225
Exclusion of interest on public purpose bonds	23,205	118,365
Deductibility of State and local property tax on owner-occupied homes	23,075	124,810
Child credit ²	19,480	90,995
Capital gains exclusion on home sales	19,095	101,390
Exclusion of Social Security benefits for retired workers	18,885	99,130
Exclusion of interest on life insurance savings	16,130	94,175
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	15,975	87,635
Deferral of income from controlled foreign corporations (normal tax method)	6,600	37,350
Graduated corporation income tax rate (normal tax method)	6,275	32,750
Net exclusion of pension contributions and earnings: Keogh plans	5,895	33,290
Exclusion of workers' compensation benefits	5,785	31,575
HOPE tax credit	5,125	24,965
Exclusion of interest on non-public purpose State and local debt	4,850	24,720
Earned income tax credit ³	4,790	26,160
Exception from passive loss rules for \$25,000 of rental loss	4,790	21,660
Workers' compensation insurance premiums	4,555	25,440
Accelerated depreciation on rental housing (normal tax method)	4,225	23,610
Exclusion of income of foreign sales corporations	4,160	23,950
Deductibility of medical expenses	4,160	23,630
Exclusion of Social Security benefits for dependents and survivors	4,050	20,825
Credit for increasing research activities	3,360	14,150
Exclusion of veterans death benefits and disability compensation	3,200	17,510
Credit for low-income housing investments	3,195	16,925
Exclusion of Social Security benefits for disabled	2,830	16,145
Exclusion of income earned abroad by U.S. citizens	2,790	16,485
Tax credit for corporations receiving income from doing business in U.S. possessions	2,670	13,070
Lifetime Learning tax credit	2,420	18,350
Credit for child and dependent care expenses	2,360	11,520
Exclusion of benefits and allowances to armed forces personnel	2,160	11,000
Expensing of certain small investments (normal tax method)	1,925	9,610
Exclusion of reimbursed employee parking expenses	1,895	10,530
Additional deduction for the elderly	1,890	9,970
Expensing of research and experimentation expenditures (normal tax method)	1,885	10,595
Exclusion of other employee benefits: Premiums on group term life insurance	1,780	9,345
Exemption of credit union income	1,650	9,480
Self-employed medical insurance premiums	1,380	11,110
Deferred taxes for financial firms on certain income earned overseas	1,290	1,830
Special ESOP rules	1,205	6,540
Inventory property sales source rules exception	1,150	6,750
Exclusion of scholarship and fellowship income (normal tax method)	1,120	5,705
Deferral of interest on U.S. savings bonds	1,115	6,175
Deferral of income from post-1987 installment sales	1,035	5,375
Parental personal exemption for students age 19 or over	1,015	5,515
Alternative fuel production credit	905	2,125
Exclusion of employee meals and lodging (other than military)	710	3,880
Exclusion of employer-provided child care	700	3,845
Capital gains treatment of certain income from agriculture	695	3,805
Exclusion of certain allowances for Federal employees abroad	695	3,805
Expensing of multiperiod timber growing costs	530	2,920
Excess of percentage over cost depletion, fuels and nonfuel minerals	525	2,745
Empowerment zones and enterprise communities	500	1,855
Work opportunity tax credit	465	1,160
Exclusion of railroad retirement system benefits	410	2,105
Exclusion of public assistance benefits (normal tax method)	375	2,025
Exclusion of parsonage allowances	365	2,090
Deductibility of student-loan interest	310	1,860
Enhanced oil recovery credit	295	1,990
Deductibility of casualty losses	275	1,490
Exclusion of employer-provided educational assistance	250	425
Tax incentives for preservation of historic structures	240	1,330
Tax exemption of certain insurance companies owned by tax-exempt organizations	235	1,245

Table 5-3. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 2001 REVENUE LOSS—
Continued
(In millions of dollars)

Provision	2001	2001-2005
Deferral for State prepaid tuition plans	225	1,555
Amortization of start-up costs (normal tax method)	205	1,080
Exclusion of other employee benefits: Premiums on accident and disability insurance	205	1,125
Special Blue Cross/Blue Shield deduction	200	1,075
Carryover basis of capital gains on gifts	195	1,060
Expensing of environmental remediation costs	175	140
Exclusion for employer-provided transit passes	170	1,070
Exceptions from imputed interest rules	160	820
Adoption assistance	140	330
Exclusion of military disability pensions	135	710
Tax credit and deduction for clean-fuel burning vehicles	105	360
Small life insurance company deduction	100	510
Expensing of certain multiperiod production costs	90	510
Exclusion of GI bill benefits	90	480
Tax credit for orphan drug research	90	575
Welfare-to-work tax credit	80	255
Income averaging for farmers	80	410
New technology credit	80	435
Exclusion from income of conservation subsidies provided by public utilities	80	415
Exclusion of veterans pensions	75	415
Expensing of certain capital outlays	75	405
Capital gains treatment of royalties on coal	70	380
Exclusion of special benefits for disabled coal miners	70	320
Capital gains treatment of certain timber income	70	380
Exemption of certain mutuals' and cooperatives' income	60	325
Credit for disabled access expenditures	55	285
Excess bad debt reserves of financial institutions	55	160
Ordinary income treatment of loss from small business corporation stock sale	40	200
Exclusion of certain foster care payments	40	230
Tax credit for the elderly and disabled	35	175
Medical Savings Accounts	30	145
Additional deduction for the blind	30	165
Investment credit for rehabilitation of structures (other than historic)	30	150
Education Individual Retirement Accounts	25	310
Exception from passive loss limitation for working interests in oil and gas properties	25	125
Credit for holders of zone academy bonds	20	240
Expensing of exploration and development costs, nonfuel minerals	20	100
Cancellation of indebtedness	15	95
Alcohol fuel credits ¹	15	75
Exclusion of interest on savings bonds redeemed to finance educational expenses	15	85
Deferral of tax on shipping companies	15	75
Deferral of gain on sale of farm refiners	10	65
Investment credit and seven-year amortization for reforestation expenditures	10	70
Treatment of loans forgiven for solvent farmers	10	50
Capital gains exclusion of small corporation stock	5	25
Special alternative tax on small property and casualty insurance companies	5	25
Expensing of costs of removing certain architectural barriers to the handicapped	5	25
Income of trusts to finance supplementary unemployment benefits	0	20
Expensing of exploration and development costs, fuels	-30	5
Accelerated depreciation of buildings other than rental housing (normal tax method)	-435	-6,145

¹ In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1999 \$760; 2000 \$800; 2001 \$805; 2002 \$810; 2003 \$815; 2004 \$825; and 2005 \$830.

² The figures in the table indicate the effect of the child tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$445; 2000 \$550; 2001 \$520; 2002 \$505; 2003 \$460; 2004 \$450; and 2005 \$420.

³ The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$25,630; 2000 \$25,675; 2001 \$25,800; 2002 \$26,875; 2003 \$27,640; 2004 \$28,700; and 2005 \$29,720.

Note: Provisions with estimates denoted "normal tax method" have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest \$5 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Note: Three categories in the table are aggregated: Deductibility of charitable contributions, exclusion of interest for non-public purpose State and local debt, and excess of percentage over cost depletion for fuels and nonfuel minerals.

Table 5-4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 1999

(In millions of dollars)

	Provision	Present Value of Revenue Loss
1	Deferral of income from controlled foreign corporations (normal tax method)	5,960
2	Deferred taxes for financial firms on income earned overseas	965
3	Expensing of research and experimentation expenditures (normal tax method)	2,570
4	Expensing of exploration and development costs—fuels	110
5	Expensing of exploration and development costs—nonfuels	10
6	Expensing of multiperiod timber growing costs	240
7	Expensing of certain multiperiod production costs—agriculture	90
8	Expensing of certain capital outlays—agriculture	75
9	Deferral of income on life insurance and annuity contracts	22,100
10	Accelerated depreciation of rental housing (normal tax method)	2,845
11	Accelerated depreciation of buildings other than rental housing (normal tax method)	335
12	Accelerated depreciation of machinery and equipment (normal tax method)	32,780
13	Expensing of certain small investments (normal tax method)	1,030
14	Amortization of start-up costs (normal tax method)	170
15	Deferral of tax on shipping companies	15
16	Deferral for state prepaid tuition plans	170
17	Credit for holders of zone academy bonds	220
18	Credit for low-income housing investments	2,730
19	Exclusion of pension contributions—employer plans	95,620
20	Exclusion of IRA contributions and earnings	6,005
21	Exclusion of contributions and earnings for Keogh plans	3,510
22	Exclusion of interest on public-purpose bonds	26,995
23	Exclusion of interest on non-public purpose bonds	3,950
24	Deferral of interest on U.S. savings bonds	405

Outlay Equivalents

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

The outlay-equivalent measure is larger than the revenue-loss estimate when the tax expenditure is judged to function as a Government payment for service. This

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

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

Table 5-5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX
(In millions of dollars)

		Outlay Equivalents							
		1999	2000	2001	2002	2003	2004	2005	2001-2005
1	National Defense								
	Exclusion of benefits and allowances to armed forces personnel	2,470	2,495	2,520	2,545	2,570	2,600	2,630	12,865
2	International affairs:								
	Exclusion of income earned abroad by U.S. citizens	3,940	4,270	4,625	5,000	5,370	5,760	6,185	26,940
3	Exclusion of income of foreign sales corporations	5,600	5,980	6,400	6,860	7,340	7,850	8,400	36,850
4	Inventory property sales source rules exception	1,620	1,690	1,770	1,920	2,080	2,230	2,380	10,380
5	Deferral of income from controlled foreign corporations (normal tax method)	5,800	6,200	6,600	7,000	7,450	7,900	8,400	37,350
6	Deferred taxes for financial firms on income earned overseas	960	1,190	1,290	540	0	0	0	1,830
7	General science, space, and technology:								
	Expensing of research and experimentation expenditures (normal tax method)	1,890	1,865	1,875	1,960	2,090	2,245	2,415	10,585
8	Credit for increasing research activities	2,625	1,550	5,175	5,710	4,570	4,010	2,320	21,785
9	Energy:								
	Expensing of exploration and development costs, fuels	-80	-20	-30	-10	15	15	15	5
10	Excess of percentage over cost depletion, fuels	325	330	335	340	345	350	355	1,725
11	Alternative fuel production credit	1,495	1,400	1,315	1,235	775	180	180	3,685
12	Exception from passive loss limitation for working interests in oil and gas properties	30	25	25	25	25	25	25	125
13	Capital gains treatment of royalties on coal	85	85	95	95	100	105	115	510
14	Exclusion of interest on energy facility bonds	165	165	165	170	170	170	170	845
15	Enhanced oil recovery credit	315	360	415	480	550	635	730	2,810
16	New technology credit	70	85	120	130	125	125	125	625
17	Alcohol fuel credits ¹	15	15	15	15	15	15	15	75
18	Tax credit and deduction for clean-fuel burning vehicles	110	125	135	125	105	70	25	460
19	Exclusion from income of conservation subsidies provided by public utilities	115	110	105	110	115	115	115	560
20	Natural resources and environment:								
	Expensing of exploration and development costs, nonfuel minerals	15	15	15	15	15	20	20	85
21	Excess of percentage over cost depletion, nonfuel minerals	275	285	295	310	320	335	350	1,610
22	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	660	660	670	680	685	685	705	3,425
23	Capital gains treatment of certain timber income	85	85	95	95	100	105	115	510
24	Expensing of multiperiod timber growing costs	495	500	530	565	585	610	630	2,920
25	Investment credit and seven-year amortization for reforestation expenditures	15	15	15	15	15	15	15	75
26	Tax incentives for preservation of historic structures	205	225	240	255	265	280	295	1,335
27	Agriculture:								
	Expensing of certain capital outlays	65	70	75	75	80	85	85	400
28	Expensing of certain multiperiod production costs	85	85	90	95	100	105	110	500
29	Treatment of loans forgiven for solvent farmers	10	10	10	10	10	10	10	50
30	Capital gains treatment of certain income	845	885	925	965	1,015	1,060	1,105	5,070
31	Income averaging for farmers	75	75	80	80	80	85	85	410
32	Deferral of gain on sale of farm refiners	10	10	10	10	15	15	15	65
33	Commerce and housing:								
	Financial institutions and insurance:								
	Exemption of credit union income	1,910	2,015	2,160	2,320	2,490	2,675	2,865	12,510
34	Excess bad debt reserves of financial institutions	75	85	70	55	40	25	5	195
35	Exclusion of interest on life insurance savings	13,920	14,985	16,130	17,365	18,870	20,130	21,680	94,175
36	Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
37	Tax exemption of certain insurance companies owned by tax-exempt organizations	295	300	315	320	335	340	355	1,665
38	Small life insurance company deduction	135	135	135	135	135	140	140	685
39	Housing:								
	Exclusion of interest on owner-occupied mortgage subsidy bonds	1,300	1,310	1,320	1,330	1,345	1,365	1,370	6,730
40	Exclusion of interest on rental housing bonds	220	220	230	230	230	230	230	1,150
41	Deductibility of mortgage interest on owner-occupied homes	56,920	58,815	60,925	63,240	65,955	68,965	72,160	331,245
42	Deductibility of State and local property tax on owner-occupied homes	21,215	22,185	23,075	24,000	24,980	25,915	26,840	124,810
43	Deferral of income from post-1987 installment sales	995	1,015	1,035	1,055	1,075	1,095	1,115	5,375
44	Capital gains exclusion on home sales	22,500	23,175	23,870	24,590	25,325	26,090	26,870	126,745
45	Exception from passive loss rules for \$25,000 of rental loss	5,315	5,035	4,790	4,555	4,330	4,100	3,885	21,660
46	Credit for low-income housing investments	0	0	0	5	5	5	5	20
47	Accelerated depreciation on rental housing (normal tax method)	3,710	3,985	4,225	4,495	4,760	4,975	5,145	23,600
48	Commerce:								
	Cancellation of indebtedness	40	25	15	15	20	20	25	95
49	Exceptions from imputed interest rules	160	160	160	165	165	165	165	820
50	Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	52,540	54,100	55,705	57,365	59,065	60,820	62,620	295,575
51	Capital gains exclusion of small corporation stock	5	5	5	5	5	5	5	25
52	Step-up basis of capital gains at death	34,400	36,120	37,655	39,160	40,725	42,355	44,045	203,940
53	Carryover basis of capital gains on gifts	175	185	195	205	210	220	230	1,060
54	Ordinary income treatment of loss from small business corporation stock sale	45	45	55	55	55	55	55	275
55	Accelerated depreciation of buildings other than rental housing (normal tax method)	1,655	705	-435	-755	-1,110	-1,695	-2,140	-6,135

Table 5-5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued
(In millions of dollars)

		Outlay Equivalents							
		1999	2000	2001	2002	2003	2004	2005	2001–2005
56	Accelerated depreciation of machinery and equipment (normal tax method)	26,440	27,735	32,825	33,340	34,260	36,380	37,325	174,130
57	Expensing of certain small investments (normal tax method)	1,465	1,590	1,920	1,965	1,915	1,890	1,900	9,590
58	Amortization of start-up costs (normal tax method)	200	205	205	215	215	220	225	1,080
59	Graduated corporation income tax rate (normal tax method)	9,790	9,690	9,655	9,940	9,985	10,325	10,485	50,390
60	Exclusion of interest on small issue bonds	445	450	450	460	460	465	475	2,310
Transportation:									
61	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
62	Exclusion of reimbursed employee parking expenses	2,225	2,330	2,450	2,575	2,710	2,855	3,005	13,595
63	Exclusion for employer-provided transit passes	180	205	235	265	295	330	360	1,485
Community and regional development:									
64	Investment credit for rehabilitation of structures (other than historic)	25	25	25	25	25	25	30	130
65	Exclusion of interest for airport, dock, and similar bonds	1,045	1,050	1,060	1,075	1,085	1,095	1,105	5,420
66	Exemption of certain mutuals' and cooperatives' income	60	60	60	65	65	65	70	325
67	Empowerment zones and enterprise communities	325	445	500	470	325	300	265	1,860
68	Expensing of environmental remediation costs	150	200	235	80	–40	–50	–40	185
Education, training, employment, and social services:									
Education:									
69	Exclusion of scholarship and fellowship income (normal tax method)	1,190	1,220	1,235	1,240	1,255	1,265	1,280	6,275
70	HOPE tax credit	5,890	6,310	6,570	6,595	6,080	5,915	6,845	32,005
71	Lifetime Learning tax credit	2,780	3,045	3,100	3,160	5,645	5,675	5,935	23,515
72	Education Individual Retirement Accounts	0	10	25	40	60	80	105	310
73	Deductibility of student-loan interest	300	335	390	440	470	495	535	2,330
74	Deferral for State prepaid tuition plans	120	175	225	275	320	355	385	1,560
75	Exclusion of interest on student-loan bonds	355	360	365	365	365	370	370	1,835
76	Exclusion of interest on bonds for private nonprofit educational facilities	845	855	860	860	875	880	890	4,365
77	Credit for holders of zone academy bonds	5	15	30	50	75	90	100	345
78	Exclusion of interest on savings bonds redeemed to finance educational expenses	15	20	20	20	20	30	30	120
79	Parental personal exemption for students age 19 or over	1,010	1,070	1,125	1,165	1,225	1,280	1,310	6,105
80	Child credit ²	25,915	26,100	25,975	25,290	24,205	23,385	22,475	121,330
81	Deductibility of charitable contributions (education)	3,435	3,685	3,850	4,040	4,250	4,395	4,610	21,145
82	Exclusion of employer-provided educational assistance	275	290	310	215	0	0	0	525
Training, employment, and social services:									
83	Work opportunity tax credit	270	455	465	350	215	95	35	1,160
84	Welfare-to-work tax credit	35	60	80	80	60	25	10	255
85	Exclusion of employer provided child care	860	890	930	970	1,020	1,075	1,135	5,130
86	Adoption assistance	160	175	180	160	55	20	10	425
87	Exclusion of employee meals and lodging (other than military)	795	830	865	905	945	990	1,030	4,735
88	Credit for child and dependent care expenses	3,225	3,185	3,145	3,110	3,075	3,035	3,000	15,365
89	Credit for disabled access expenditures	65	65	75	75	75	80	80	385
90	Expensing of costs of removing certain architectural barriers to the handicapped	0	0	5	5	5	5	5	25
91	Deductibility of charitable contributions, other than education and health	25,750	26,955	28,115	29,380	30,790	32,200	33,755	154,240
92	Exclusion of certain foster care payments	45	50	50	55	55	60	60	280
93	Exclusion of parsonage allowances	395	420	450	480	515	550	585	2,580
Health:									
94	Exclusion of employer contributions for medical insurance premiums and medical care	88,730	95,950	103,085	110,390	115,840	122,545	131,495	583,355
95	Self-employed medical insurance premiums	1,145	1,535	1,700	1,900	2,550	3,580	3,955	13,685
96	Workers' compensation insurance premiums	5,520	5,730	5,945	6,170	6,400	6,645	3,895	29,055
97	Medical Savings Accounts	30	40	45	45	45	40	35	210
98	Deductibility of medical expenses	3,695	3,910	4,160	4,440	4,720	5,005	5,305	23,630
99	Exclusion of interest on hospital construction bonds	1,735	1,755	1,770	1,790	1,815	1,830	1,850	9,055
100	Deductibility of charitable contributions (health)	3,640	3,910	4,095	4,300	4,525	4,665	4,900	22,485
101	Tax credit for orphan drug research	70	80	90	100	115	130	140	575
102	Special Blue Cross/Blue Shield deduction	325	420	270	180	240	325	420	1,435
Income security:									
103	Exclusion of railroad retirement system benefits	395	405	410	415	420	430	430	2,105
104	Exclusion of workers' compensation benefits	5,185	5,330	5,785	6,040	6,310	6,575	6,865	31,575
105	Exclusion of public assistance benefits (normal tax method)	345	360	375	390	405	420	435	2,025
106	Exclusion of special benefits for disabled coal miners	75	75	70	70	65	60	55	320
107	Exclusion of military disability pensions	130	130	135	140	140	145	150	710
Net exclusion of pension contributions and earnings:									
108	Employer plans	97,960	104,060	108,190	113,770	120,275	126,700	133,400	602,335
109	Individual Retirement Accounts	18,290	20,025	21,360	22,770	23,695	24,645	25,445	117,915
110	Keogh plans	6,630	7,040	7,475	7,930	8,415	8,925	9,465	42,210
Exclusion of other employee benefits:									
111	Premiums on group term life insurance	2,240	2,290	2,340	2,395	2,445	2,520	2,590	12,290

Table 5-5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued
(In millions of dollars)

		Outlay Equivalents							
		1999	2000	2001	2002	2003	2004	2005	2001–2005
112	Premiums on accident and disability insurance	235	250	260	275	290	305	315	1,445
113	Income of trusts to finance supplementary unemployment benefits	0	0	0	5	5	5	5	20
114	Special ESOP rules	1,565	1,630	1,670	1,730	1,800	1,885	1,975	9,060
115	Additional deduction for the blind	35	35	40	40	40	45	45	210
116	Additional deduction for the elderly	2,155	2,215	2,285	2,360	2,400	2,455	2,555	12,055
117	Tax credit for the elderly and disabled	45	45	45	45	45	45	45	225
118	Deductibility of casualty losses	280	290	300	315	325	340	355	1,635
119	Earned income tax credit ³	5,360	5,220	5,320	5,540	5,785	6,045	6,380	29,070
	Social Security:								
	Exclusion of social security benefits:								
120	Social Security benefits for retired workers	17,135	18,010	18,885	19,995	21,230	22,505	16,515	99,130
121	Social Security benefits for disabled	2,390	2,595	2,830	3,090	3,375	3,700	3,150	16,145
122	Social Security benefits for dependents and survivors	3,775	3,900	4,050	4,210	4,385	4,555	3,625	20,825
	Veterans benefits and services:								
123	Exclusion of veterans death benefits and disability compensation	2,940	3,070	3,200	3,335	3,490	3,655	3,830	17,510
124	Exclusion of veterans pensions	65	70	75	80	85	85	90	415
125	Exclusion of GI bill benefits	75	85	90	90	95	100	105	480
126	Exclusion of interest on veterans housing bonds	60	60	60	60	60	60	60	300
	General purpose fiscal assistance:								
127	Exclusion of interest on public purpose bonds	32,600	32,925	33,250	33,590	33,920	34,255	34,600	169,615
128	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	37,740	40,240	42,390	44,735	47,610	50,530	53,480	238,745
129	Tax credit for corporations receiving income from doing business in U.S. possessions	3,590	3,700	3,815	3,715	3,640	3,715	3,785	18,670
	Interest:								
130	Deferral of interest on U.S. savings bonds	1,015	1,065	1,115	1,175	1,235	1,295	1,355	6,175
	Addendum: Aid to State and local governments:								
	Deductibility of:								
	Property taxes on owner-occupied homes	21,215	22,185	23,075	24,000	24,980	25,915	26,840	124,810
	Nonbusiness State and local taxes other than on owner-occupied homes	37,740	40,240	42,390	44,735	47,610	50,530	53,480	238,745
	Exclusion of interest on State and local bonds for:								
	Public purposes	32,600	32,925	33,250	33,590	33,920	34,255	34,600	169,615
	Energy facilities	165	165	165	170	170	170	170	845
	Water, sewage, and hazardous waste disposal facilities	660	660	670	680	685	685	705	3,425
	Small-issues	445	450	450	460	460	465	475	2,310
	Owner-occupied mortgage subsidies	1,300	1,310	1,320	1,330	1,345	1,365	1,370	6,730
	Rental housing	220	220	230	230	230	230	230	1,150
	Airports, docks, and similar facilities	1,045	1,050	1,060	1,075	1,085	1,095	1,105	5,420
	Student loans	355	360	365	365	365	370	370	1,835
	Private nonprofit educational facilities	845	855	860	860	875	880	890	4,365
	Hospital construction	1,735	1,755	1,770	1,790	1,815	1,830	1,850	9,055
	Veterans' housing	60	60	60	60	60	60	60	300
	Credit for holders of zone academy bonds	5	15	30	50	75	90	100	345

¹In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1999 \$760; 2000 \$800; 2001 \$805; 2002 \$810; 2003 \$815; 2004 \$825; and 2005 \$830.

²The figures in the table indicate the effect of the child tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$445; 2000 \$550; 2001 \$520; 2002 \$505; 2003 \$460; 2004 \$450; and 2005 \$420.

³The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1999 \$25,632; 2000 \$25,676; 2001 \$25,799; 2002 \$26,876; 2003 \$27,638; 2004 \$28,701; and 2005 \$29,722.

Note: Provisions with estimates denoted normal tax method have no revenue loss under the reference tax law method. All estimates have been rounded to the nearest \$5 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Tax Expenditure Baselines

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

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

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

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

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

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

- *Tax rates.* The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first \$10 million of corporate income are thus regarded as a tax expenditure. Similarly, under the reference law baseline, preferential tax rates for capital gains generally do not yield a tax expenditure; only capital gains treatment of otherwise "ordinary income," such as that from coal and iron ore royalties and the sale of timber and certain agricultural products, is considered a tax expenditure. The alternative minimum tax is treated as part of the baseline rate structure under both the reference and normal tax methods.
- *Income subject to the tax.* Income subject to tax is defined as gross income less the costs of earning that income. The Federal income tax defines gross income to include: (1) consideration received in the exchange of goods and services, including labor services or property; and (2) the taxpayer's share of gross or net income earned and/or reported by another entity (such as a partnership). Under the reference tax rules, therefore, gross income does not include gifts—defined as receipts of money or property that are not consideration in an exchange—or most transfer payments, which can be thought of as gifts from the Government.² The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.³
- *Capital recovery.* Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for machinery and equipment is determined using straight-line depreciation over tax lives equal to mid-values of the asset depreciation range (a depreciation system in effect from 1971 through 1980). The normal tax baseline for real property is computed using 40-year straight-line depreciation.
- *Treatment of foreign income.* Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S.

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

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

income taxes that would otherwise be due), which prevents double taxation of income earned abroad. Under the normal tax method, however, controlled foreign corporations (CFCs) are not regarded as entities separate from their controlling U.S. shareholders. Thus, the deferral of tax on income received by CFCs is regarded as a tax expenditure under this method. In contrast, except for tax haven activities, the reference law baseline follows current law in treating CFCs as separate taxable entities whose income is not subject to U.S. tax until distributed to U.S. taxpayers. Under this baseline, deferral of tax on CFC income is not a tax expenditure because U.S. taxpayers generally are not taxed on accrued, but unrealized, income.

Beyond these examples, there are still more areas of difference where the Joint Committee on Taxation considers a somewhat broader set of tax expenditures under its normal tax baseline than under the reference baseline considered here.

Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives will be achieved through direct expenditure programs. However, tax expenditures may also contribute to achieving these goals. The report of the Senate Governmental Affairs Committee on GPRA⁴ calls on the Executive branch to undertake a series of analyses to assess the effect of specific tax expenditures on the achievement of agencies' performance objectives.

One finding of pilot studies on selected tax expenditures undertaken by Treasury's Office of Tax Analysis is that much of the data needed for thorough analysis are not currently available. Hence, assessment of data needs and availability from Federal statistical agencies, program-agency studies, or private-sector sources, should prove valuable to broader efforts to assess the effects of tax expenditures and to compare their effectiveness with other policy means of achieving important public objectives. This effort will complement information published by the Joint Committee on Taxation and the Senate Budget Committee on tax expenditures.⁵

Over the next few years, the Executive Branch's focus will be on the availability of the data needed to assess the effects of the tax expenditures designed to increase savings. As one part of this effort, Treasury's Office of Tax Analysis and its Statistics of Income Division (IRS) are developing the specifications for a new data sample which will follow the same individual income tax filers over an extended period of time. Such a sam-

ple is called a "panel" sample. Current economic analyses of the effect of Federal tax laws are generally based on data from "cross-section" samples, which capture the demographic and economic circumstances of individuals and the provisions of Federal tax law only at a single point in time. However, over time, the demographic and economic status of individuals changes in ways that can significantly change how they are affected by current (or proposed) Federal tax laws. In addition, some provisions of the tax law have effects over multiple years, and the effects of some tax provisions change over time due to phase-ins, phase-outs, and other factors. The new panel sample will capture the changing demographic and economic circumstances of individuals and the effects of changes in tax law over an extended period of time. Data from the panel sample will therefore permit more extensive, and better, analyses of many tax provisions than can be performed using only cross-section data. In particular, data from the panel sample will enhance our ability to analyze the effect of tax expenditures designed to increase savings. Other efforts to improve data available for the analysis of savings tax expenditures will be undertaken over the next several years by OMB, Treasury and other agencies.

Comparison of tax expenditure, spending, and regulatory policies. Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available.⁶ Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in some cases. In addition, some tax expenditures actually simplify the tax system (for example, the exclusion for up to \$500,000 of capital gains on home sales). Tax expenditures also implicitly subsidize certain activities. Spending, regulatory or tax-disincentive policies, can also modify behavior, but may have different economic effects. Finally, a variety of tax expenditure tools can be used—e.g., deductions, credits, exemptions and deferrals; floors and ceilings; and phase-ins and phase-outs, dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, various holding periods and tax rates for capital gains can complicate filing and decisionmaking. The income tax system may have little or no contact with persons who have no or very low incomes, and does not inquire into certain characteristics of individ-

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

⁵ Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 1999-1993," JCS-7-98, December 14, 1998; and Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions," prepared by the Congressional Research Service (S. Prt. 104-69, December 1996).

⁶ Although this section focuses upon tax expenditures under the income tax, tax preferences also arise under the unified transfer, payroll, and excise tax systems. Such preferences can be useful when they relate to the bases of those taxes, such as an excise tax exemption for certain types of consumption that are deemed meritorious.

uals used in some spending programs, such as wealth. These features may reduce the effectiveness of tax expenditures for addressing certain income-transfer objectives. Tax expenditures also generally do not enable the same degree of agency discretion as outlay programs. For example, grant or direct Federal service delivery programs can prioritize which activities are addressed with what amount of resources in a way that is difficult to emulate with tax expenditures. Finally, tax expenditures may not receive the same frequency or level of scrutiny afforded to other programs.

Outlay programs, in contrast, have advantages where direct government service provision is particularly warranted—such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a return. Outlay programs may also receive more year-to-year oversight and fine tuning through the legislative and executive budget process. In addition, the availability of many different types of spending programs—including direct government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts—provides flexibility for policy design. On the other hand, certain outlay programs—such as direct government service provision—may rely less directly on economic incentives and private-market provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Spending programs also require resources to be raised via taxes, user charges, or government borrowing. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

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

for outlays and tax-expenditures. To some extent, the GPRA requirement for performance evaluation will address this lack of formal analysis.

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

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

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

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

An overview of evaluation issues by budget function. The discussion below considers the types of measures that might be useful for some major programmatic groups of tax expenditures. The discussion is intended to be illustrative and not all encompassing. However, it is premised on the assumption that the data needed to perform the analysis are available or can be devel-

oped. In practice, data availability is likely to be a major challenge, and data constraints may limit the assessment of the effectiveness of many provisions. In addition, such assessments can raise significant challenges in economic modeling.

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

International affairs.—Tax expenditures are also aimed at promoting U.S. exports. These include the exclusion for income earned abroad by nongovernmental employees and preferences for income from exports and U.S.-controlled foreign corporations. Measuring the effectiveness of these provisions raises challenging issues. In addition to determining their effectiveness in markets of the benefitting firms, analysis should consider the extent to which macroeconomic factors lead to offsetting effects, such as increased imports, which could moderate any net effects on employment, national output, and trade deficits. Similar issues arise in the case of export promotion programs supported by outlays.

General science, space and technology; energy; natural resources and the environment; agriculture; and commerce and housing.—A series of tax expenditures reduces the cost of investment, both in specific activities—such as research and experimentation, extractive industries, and certain financial activities—and more generally, through accelerated depreciation for plant and equipment. These provisions can be evaluated along a number of dimensions. For example, it could be useful to consider the strength of the incentives by measuring their effects on the cost of capital (the interest rate which investments must yield to cover their costs) and effective tax rates. The impact of these provisions on the amounts of corresponding forms of investment—such as research spending, exploration activity, or equipment—might also be estimated. In some cases, such as research, there is evidence that the investment can provide significant positive externalities—that is, economic benefits that are not reflected in the market transactions between private parties. It could be useful to quantify these externalities and compare them with the degree of tax subsidy provided. Measures could also indicate the provisions' effects on production from these investments—such as

numbers or values of patents, energy production and reserves, and industrial production. Issues to be considered include the extent to which the preferences increase production (as opposed to benefitting existing producers) and their cost-effectiveness relative to other policies. Analysis could also consider objectives that are more difficult to measure but still are ultimate goals, such as promoting the Nation's technological base, energy security, environmental quality, or economic growth. Such an assessment is likely to involve tax analysis as well as consideration of non-tax matters such as market structure, scientific, and other information (such as the effects of increased domestic fuel production on imports from various regions, or the effects of various energy sources on the environment).

Housing investment also benefits from tax expenditures, including the mortgage interest deduction and preferential treatment of capital gains on homes. Measures of the effectiveness of these provisions could include their effects on increasing the extent of home ownership and the quality of housing. In addition, the mortgage interest deduction offsets the taxable nature of investment income received by homeowners, so the relationship between the deduction and such earnings is also relevant to evaluation of this provision. Similarly, analysis of the extent of accumulated inflationary gains is likely to be relevant to evaluation of the capital gains preference for home sales. Deductibility of State and local property taxes assists with making housing more affordable as well as easing the cost of providing community services through these taxes. Provisions intended to promote investment in rental housing could be evaluated for their effects on making such housing more available and affordable. These provisions should then be compared with alternative programs that address housing supply and demand.

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

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

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

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

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

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

General purpose fiscal assistance and interest.—The tax-exemption for public purpose State and local bonds reduces the costs of borrowing for a variety of purposes (borrowing for non-public purposes is reflected under other budget functions). The deductibility of certain State and local taxes reflected under this function primarily relates to personal income taxes (property tax deductibility is reflected under the commerce and housing function). Tax preferences for Puerto Rico and other U.S. possessions are also included here. These provi-

sions can be compared with other tax and spending policies as means of benefitting fiscal and economic conditions in the States, localities, and possessions. Finally, the tax deferral for interest on U.S. savings bonds benefits savers who invest in these instruments. The extent of these benefits and any effects on Federal borrowing costs could be evaluated.

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

Descriptions of Income Tax Provisions

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

National Defense

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

International Affairs

2. **Income earned abroad.**—U.S. citizens who lived abroad, worked in the private sector, and satisfied a foreign residency requirement in 1999 may exclude up to \$74,000 in foreign earned income from U.S. taxes. The exclusion increases in 2000, 2001, and 2002 to \$76,000, \$78,000, and \$80,000, respectively. In addition, if these taxpayers receive a specific allowance for foreign housing from their employers, they may also exclude the value of that allowance. If they do not receive a specific allowance for housing expenses, they may deduct against their U.S. taxes that portion of such expenses that exceeds one-sixth the salary of a civil servant at grade GS-14, step 1 (\$63,567 in 1999). Beginning this year, the value of U.S. tax benefits provided to employees of the U.S. government who live and work overseas is not included under this heading. Those tax benefits now are included under their own heading, Exclusion of Certain Allowances for Federal Employees Abroad (#3).

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

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

5. **Sales source rule exceptions.**—The worldwide income of U.S. persons is taxable by the United States and a credit for foreign taxes paid is allowed. The amount of foreign taxes that can be credited is limited to the pre-credit U.S. tax on the foreign source income. The sales source rules for inventory property allow U.S. exporters to use more foreign tax credits by allowing the exporters to attribute a larger portion of their earnings abroad than would be the case if the allocation of earnings was based on actual economic activity.

6. **Income of U.S.-controlled foreign corporations.**—The income of foreign corporations controlled by U.S. shareholders is not subject to U.S. taxation. The income becomes taxable only when the controlling U.S. shareholders receive dividends or other distributions from their foreign stockholding. Under the normal tax method, the currently attributable foreign source pre-tax income from such a controlling interest is considered to be subject to U.S. taxation, whether or not distributed. Thus, the normal tax method considers the amount of controlled foreign corporation income not distributed to a U.S. shareholder as tax-deferred income.

7. **Exceptions under subpart F for active financing income.**—Financial firms can defer taxes on income earned overseas in an active business. Taxes on income earned through December 31, 2001 can be deferred. The Tax Relief Extension Act of 1999 extended the expiration date from December 31, 1999 to December 31, 2001.

General Science, Space, and Technology

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

9. **R&E credit.**—The research and experimentation (R&E) credit, which expired on June 30, 1999, was reinstated (retroactively) in the Tax Relief Extension Act of 1999 for five years (through June 30, 2004). The Act also increased the credit rates for the alternative credit by one percentage point and extended the research credit to include research conducted in Puerto Rico and the U.S. possessions. The tax credit is 20 percent of qualified research expenditures in excess of a base amount. The base amount is generally determined by multiplying a "fixed-base percentage" by the average amount of the company's gross receipts for the prior four years. The taxpayer's fixed base percentage

generally is the ratio of its research expenses to gross receipts for 1984 through 1988. Taxpayers may also elect an alternative credit regime. Under the alternative credit regime the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage that would otherwise apply, and the credit rate is reduced (the rates range from 2.65 percent to 3.75 percent). A 20-percent credit with a separate threshold is provided for a taxpayer's payments to universities for basic research.

Energy

10. **Exploration and development costs.**—For successful investments in domestic oil and gas wells, intangible drilling costs (e.g., wages, the costs of using machinery for grading and drilling, the cost of unsalvageable materials used in constructing wells) may be expensed rather than amortized over the productive life of the property. Integrated oil companies may deduct only 70 percent of such costs and must amortize the remaining 30 percent over five years. The same rule applies to the exploration and development costs of surface stripping and the construction of shafts and tunnels for other fuel minerals.

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

12. **Alternative fuel production credit.**—A non-taxable credit of \$3 per barrel (in 1979 dollars) of oil-equivalent production is provided for several forms of alternative fuels. The credit is generally available if the price of oil stays below \$29.50 (in 1979 dollars). The credit generally expires on December 31, 2002.

13. **Oil and gas exception to passive loss limitation.**—Owners of working interests in oil and gas properties are exempt from the "passive income" limitations. As a result, the working interest-holder, who manages on behalf of himself and all other owners the development of wells and incurs all the costs of their operation, may aggregate negative taxable income from such interests with his income from all other sources.

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

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

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

17. **New technology credits.**—A credit of 10 percent is available for investment in solar and geothermal energy facilities. In addition, a credit of 1.5 cents is provided per kilowatt hour of electricity produced from renewable resources such as wind and biomass. The renewable resources credit applies only to electricity produced by a facility placed in service on or before December 31, 2001. The Tax Relief Extension Act of 1999 extended the expiration date from June 30, 1999 to December 31, 2001 and expanded the credit to apply to electricity produced from poultry waste facilities (placed in service after December 31, 1999).

18. **Alcohol fuel credits.**—An income tax credit is provided for ethanol that is derived from renewable sources and used as fuel. The credit equals 54 cents per gallon in 1998, 1999, and 2000; 53 cents per gallon in 2001 and 2002; 52 cents per gallon in 2003 and 2004; and 51 cents per gallon in 2005, 2006, and 2007. To the extent that ethanol is mixed with taxable motor fuel to create gasohol, taxpayers may claim an exemption of the Federal excise tax rather than the income tax credit. In addition, small ethanol producers are eligible for a separate 10 cents per gallon credit.

19. **Credit and deduction for clean-fuel vehicles and property.**—A tax credit of 10 percent (not to exceed \$4,000) is provided for purchasers of electric vehicles. Purchasers of other clean-fuel burning vehicles and owners of clean-fuel refueling property may deduct part of their expenditures. The credit and deduction are phased out from 2002 through 2005.

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

Natural Resources and Environment

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

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

23. **Sewage, water, and hazardous waste bonds.**—Interest earned on State and local bonds used to finance the construction of sewage, water, or haz-

ardous waste facilities is tax-exempt. These bonds are generally subject to the State private-activity bond annual volume cap.

24. **Capital gains treatment of certain timber.**—Certain timber sold under a royalty contract can be treated as a capital gain rather than ordinary income.

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

26. **Credit and seven-year amortization for reforestation.**—A 10-percent investment tax credit is allowed for up to \$10,000 invested annually to clear land and plant trees for the production of timber. Up to \$10,000 in forestation investment may also be amortized over a seven-year period rather than capitalized and deducted when the trees are sold or harvested. The amount of forestation investment that may be amortized is not reduced by any of the allowable investment credit.

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

Agriculture

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

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

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

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

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

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

Commerce and Housing

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

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

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

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

37. **Small property and casualty insurance companies.**—Insurance companies that have annual net premium incomes of less than \$350,000 are exempt from tax; those with \$350,000 to \$2.1 million of net premium incomes may elect to pay tax only on the income earned by their investment portfolio.

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

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

40. **Mortgage housing bonds.**—Interest earned on State and local bonds used to finance homes purchased by first-time, low-to-moderate-income buyers is tax-exempt. The amount of State and local tax-exempt bonds that can be issued to finance such private activity is limited. The combined volume cap for mortgage housing bonds, rental housing bonds, student loan bonds, and industrial development bonds is \$50 per capita (\$150 million minimum) per State. The volume cap increases to \$55 per capita (\$165 million minimum) in 2003 and ratably annually thereafter until the cap reaches \$75 per capita (\$225 million minimum) in 2007. States may issue mortgage credit certificates (MCCs) in lieu of mortgage revenue bonds. MCCs entitle home buyers to income tax credits for a specified percentage of interest on qualified mortgages. The total amount of MCCs issued by a State cannot exceed 25 percent of its annual ceiling for mortgage-revenue bonds.

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

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

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

44. **Installment sales.**—Dealers in real and personal property (i.e., sellers who regularly hold property for sale or resale) cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers (i.e., sellers of real property used in their business) are required to pay interest on deferred taxes attributable to their total installment obligations in excess of \$5 million. Only properties with sales prices exceeding \$150,000 are includable in the total. The pay-

ment of a market rate of interest eliminates the benefit of the tax deferral. The tax exemption for nondealers with total installment obligations of less than \$5 million is, therefore, a tax expenditure.

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

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

47. **Low-income housing credit.**—Taxpayers who invest in certain low-income housing are eligible for a tax credit. The credit rate is set so that the present value of the credit is equal to 70 percent for new construction and 30 percent for (1) housing receiving other Federal benefits (such as tax-exempt bond financing), or (2) substantially rehabilitated existing housing. The credit is allowed in equal amounts over 10 years. State agencies determine who receives the credit; States are limited in the amount of credit they may authorize annually to \$1.25 per resident.

48. **Accelerated depreciation of rental property.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under the reference method. Under the normal tax method, however, a 40-year tax life for depreciable real property is the norm. Thus, a statutory depreciation period for rental property of 27.5 years is a tax expenditure. In addition, tax expenditures arise from pre-1987 tax allowances for rental property.

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

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

51. **Capital gains (other than agriculture, timber, iron ore, and coal).**—Capital gains on assets held for more than 1 year are taxed at a lower rate than

ordinary income. The lower rate on capital gains is considered a tax expenditure under the normal tax method but not under the reference law method.

For assets held for more than 1 year, the top tax rate is 20 percent (10 percent for taxpayers who would otherwise pay capital gains tax at the 15-percent rate).

In addition, for assets acquired after December 31, 2000, the maximum capital gains tax rates for assets held more than 5 years are 8 percent and 18 percent (rather than 10 percent and 20 percent). On January 1, 2001, taxpayers may mark-to-market existing assets to start the 5-year holding period.

52. **Capital gains exclusion for small business stock.**—An exclusion of 50 percent is provided for capital gains from qualified small business stock held by individuals for more than 5 years. A qualified small business is a corporation whose gross assets do not exceed \$50 million as of the date of issuance of the stock.

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

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

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

56. **Accelerated depreciation of non-rental-housing buildings.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, a 40-year life for non-rental-housing buildings is the norm. Thus, the 39-year depreciation period for property placed in service after February 25, 1993, the 31.5-year depreciation period for property placed in service from 1987 to February 25, 1993, and the pre-1987 depreciation periods create a tax expenditure.

57. **Accelerated depreciation of machinery and equipment.**—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Statutory depreciation of machinery and equipment, however, is accelerated somewhat relative to the normal tax baseline, creating a tax expenditure.

58. **Expensing of certain small investments.**—In 1999, qualifying investments in tangible property up to \$19,000 can be expensed rather than depreciated

over time. (The expensing limit increases annually until 2003, when it reaches \$25,000). To the extent that qualifying investment during the year exceeds \$200,000, the amount eligible for expensing is decreased. In 1999, the amount expensed is completely phased out when qualifying investments exceed \$219,000.

59. **Business start-up costs.**—When taxpayers enter into a new business, certain start-up expenses, such as the cost of legal services, are normally incurred. Taxpayers may elect to amortize these outlays over 60 months even though they are similar to other payments made for nondepreciable intangible assets that are not recoverable until the business is sold. The normal tax method treats this amortization as a tax expenditure; the reference tax method does not.

60. **Graduated corporation income tax rate schedule.**—The corporate income tax schedule is graduated, with rates of 15 percent on the first \$50,000 of taxable income, 25 percent on the next \$25,000, and 34 percent on the next \$9.925 million. Compared with a flat 34-percent rate, the lower rates provide an \$11,750 reduction in tax liability for corporations with taxable income of \$10 million. This benefit is recaptured for corporations with taxable incomes exceeding \$100,000 by a 5-percent additional tax on corporate incomes in excess of \$100,000, but less than \$335,000.

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

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

Transportation

62. **Deferral of tax on U.S. shipping companies.**—Certain companies that operate U.S. flag vessels can defer income taxes on that portion of their income used for shipping purposes, primarily construction, modernization and major repairs to ships, and repayment of loans to finance these investments. Once indefinite,

the deferral has been limited to 25 years since January 1, 1987.

63. **Exclusion of employee parking expenses.**—Employee parking expenses that are paid for by the employer or that are received in lieu of wages are excludable from the income of the employee. In 1999, the maximum amount of the parking exclusion was \$175 (indexed, except in 1999) per month. The tax expenditure estimate does not include parking at facilities owned by the employer.

64. **Exclusion of employee transit pass expenses.**—Transit passes, tokens, fare cards, and van-pool expenses paid for by an employer or provided in lieu of wages to defray an employee's commuting costs are excludable from the employee's income. In 1999, the maximum amount of the exclusion was \$65 (indexed, except in 1999) per month.

Community and Regional Development

65. **Rehabilitation of structures.**—A 10-percent investment tax credit is available for the rehabilitation of buildings that are used for business or productive activities and that were erected before 1936 for other than residential purposes. The taxpayer's recoverable basis must be reduced by the amount of the credit.

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

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

68. **Empowerment zones and enterprise communities.**—Qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increased expensing of investment in equipment, special tax-exempt financing, and accelerated depreciation. A tax credit for contributions to certain community development corporations can also be available. In addition, certain first-time buyers of a principal residence in the District of Columbia can receive a tax credit on homes purchased on or before December 31, 2001, and investors in certain D.C. property can receive a capital gains break.

69. **Expensing of environmental remediation costs.**—Taxpayers who clean up hazardous substances at a qualified site may expense the clean-up costs, rather than capitalize the costs, even though the expenses will generally increase the value of the property significantly or appreciably prolong the life of the property. The expensing only applies to clean-up costs incurred on or before December 31, 2001. Tax Relief Extension Act of 1999 extended the expiration date from December 31, 2000 to December 31, 2001.

Education, Training, Employment, and Social Services

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

71. **HOPE tax credit.**—The non-refundable HOPE tax credit allows a credit for 100 percent of an eligible student's first \$1,000 of tuition and fees and 50 percent of the next \$1,000 of tuition and fees. The credit only covers tuition and fees paid during the first two years of a student's post-secondary education. The credit is phased out ratably for taxpayers with modified AGI between \$80,000 and \$100,000 (\$40,000 and \$50,000 for singles).

72. **Lifetime Learning tax credit.**—The non-refundable Lifetime Learning tax credit allows a credit for 20 percent of an eligible student's tuition and fees. For tuition and fees paid before January 1, 2003, the maximum credit per return is \$1,000. For tuition and fees paid after December 31, 2002, the maximum credit per return is \$2,000. The credit is phased out ratably for taxpayers with modified AGI between \$80,000 and \$100,000 (\$40,000 and \$50,000 for singles). The credit applies to both undergraduate and graduate students.

73. **Education Individual Retirement Accounts.**—Contributions to an education IRA are not tax-deductible. Investment income earned by education IRAs is not taxed when earned, and investment income from an education IRA is tax-exempt when withdrawn to pay for a student's tuition and fees. The maximum contribution to an education IRA is \$500 per year per beneficiary. The maximum contribution is phased down ratably for taxpayers with modified AGI between \$150,000 and \$160,000 (\$95,000 and \$110,000 for singles). Contributions may not be made to an education IRA in any year in which a contribution has been made to a State tuition plan for the same beneficiary.

74. **Student-loan interest.**—Taxpayers may claim an above-the-line deduction of up to \$2,500 (\$1,000 in 1998, \$1,500 in 1999, and \$2,000 in 2000) on interest paid on an education loan. Interest may only be deducted for the first five years in which interest payments are required. The maximum deduction is phased down ratably for taxpayers with modified AGI between \$60,000 and \$75,000 (\$40,000 and \$55,000 for singles).

75. **State prepaid tuition plans.**—Some States have adopted prepaid tuition plans and prepaid room and board plans, which allow persons to pay in advance for college expenses for designated beneficiaries. Taxes on the earnings from these plans are paid by the beneficiaries and are deferred until the tuition is actually paid.

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

77. **Bonds for private nonprofit educational institutions.**—Interest earned on State and local government bonds issued to finance the construction of facilities used by private nonprofit educational institutions is not taxed. The aggregate volume of all such private activity bonds that each State may issue during any calendar year is limited.

78. **Credit for holders of zone academy bonds.**—Financial institutions that own zone academy bonds receive a non-refundable tax credit (set by the Treasury Department) rather than interest. The credit is included in gross income. Proceeds from zone academy bonds may only be used to improve impoverished schools. The total amount of zone academy bonds that may be issued is limited to \$1.6 billion—\$400 million in each year between 1998 and 2001. The Tax Relief Extension Act of 1999 allowed bonds to be issued in 2000 and 2001.

79. **U.S. savings bonds for education.**—Interest earned on U.S. savings bonds issued after December 31, 1989 is tax-exempt if the bonds are transferred to an educational institution to pay for educational expenses. The tax exemption is phased out for taxpayers with AGI between \$79,650 and \$109,650 (\$53,100 and \$68,100 for singles) in 1999.

80. **Dependent students age 19 or older.**—Taxpayers may claim personal exemptions for dependent children age 19 or over who (1) receive parental support payments of \$1,000 or more per year, (2) are full-time students, and (3) do not claim a personal exemption on their own tax returns.

81. **Child credit.**—Taxpayers with children under age 17 can qualify for a \$500 child credit. The credit is phased out for taxpayers at the rate of \$50 per \$1,000 of modified AGI above \$110,000 (\$75,000 for singles). The child credit is refundable for taxpayers with three or more children.

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

83. **Employer-provided educational assistance.**—Employer-provided educational assistance is excluded

from an employee's gross income even though the employer's costs for this assistance are a deductible business expense. This exclusion applies only to non-graduate courses beginning on or before December 31, 2001. The Tax Relief Extension Act of 1999 extended the expiration date from May 31, 2000 to December 31, 2001.

84. **Work opportunity tax credit.**—Employers can claim a tax credit for qualified wages paid to individuals who begin work on or before December 31, 2000 and who are certified as members of various targeted groups. The Tax Relief Extension Act of 1999 extended the expiration date from June 30, 1999 to December 31, 2000. The amount of the credit that can be claimed is 25 percent for employment of less than 400 hours and 40 percent for employment of 400 hours or more. The maximum credit per employee is \$2,400 and can only be claimed on the first year of wages an individual earns from an employer. Employers must reduce their deduction for wages paid by the amount of the credit claimed.

85. **Welfare-to-work tax credit.**—An employer is eligible for a tax credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first \$10,000 of wages in the first year of employment and 50 percent of the first \$10,000 of wages in the second year of employment. The maximum credit is \$8,500 per employee. The credit applies to wages paid to employees who are hired on or before December 31, 2001. The Tax Relief Extension Act of 1999 extended the expiration date from June 30, 1999 to December 31, 2001.

86. **Employer-provided child care.**—Employer-provided child care is excluded from an employee's gross income even though the employer's costs for the child care are a deductible business expense.

87. **Adoption credit and exclusion.**—Taxpayers can receive a nonrefundable tax credit for qualified adoption expenses. The maximum credit is \$5,000 per child (\$6,000 for special needs adoptions, except foreign adoptions). The credit is phased-out ratably for taxpayers with modified AGI between \$75,000 and \$115,000. Unused credits may be carried forward. In lieu of the tax credit, taxpayers may exclude qualified adoption expenses from income, subject to the same maximum amounts and phase-out as the credit. The non-special needs adoption assistance and foreign special needs assistance expire on December 31, 2001.

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

89. **Child and dependent care expenses.**—Married couples with child and dependent care expenses may claim a tax credit when one spouse works full time and the other works at least part time or goes to school. The credit may also be claimed by divorced or separated parents who have custody of children, and by single parents. Expenditures up to a maximum \$2,400 for one

dependent and \$4,800 for two or more dependents are eligible for the credit. The credit is equal to 30 percent of qualified expenditures for taxpayers with incomes of \$10,000 or less. The credit is reduced to a minimum of 20 percent by one percentage point for each \$2,000 of income between \$10,000 and \$28,000.

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

91. **Expensing costs of removing architectural barriers.**—Taxpayers can expense (up to \$15,000 annually) the cost of removing architectural barriers to the handicapped rather than depreciate the cost over the useful life of the asset.

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

93. **Foster care payments.**—Foster parents provide a home and care for children who are wards of the State, under contract with the State. Compensation received for this service is excluded from the gross incomes of foster parents; the expenses they incur are nondeductible.

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

Health

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

96. **Self-employed medical insurance premiums.**—Self-employed taxpayers may deduct a percentage of their family health insurance premiums. Taxpayers without self-employment income are not eligible for the special percentage deduction. The deductible percentage is 60 percent in 1999 through 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter.

97. **Workers compensation insurance premiums.**—Workers compensation insurance premiums are paid by employers and deducted as a business expense, but the premiums are not included in employee gross income.

98. **Medical savings accounts.**—Some employees may deduct annual contributions to a medical savings

account (MSA); employer contributions to MSAs (except those made through cafeteria plans) for qualified employees are also excluded from income. An employee may contribute to an MSA in a given year only if the employer does not contribute to the MSA in that year. MSAs are only available to self-employed individuals or employees covered under an employer-sponsored high deductible health plan of a small employer. The maximum annual MSA contribution is 75 percent of the deductible under the high deductible plan for family coverage (65 percent for individual coverage). Earnings from MSAs are excluded from taxable income. Distributions from an MSA for medical expenses are not taxable. The number of taxpayers who may benefit annually from MSAs is generally limited to 750,000. No new MSAs may be established after December 31, 2000.

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

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

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

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

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

Income Security

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

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

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

107. **Special benefits for disabled coal miners.**—Disability payments to former coal miners out of the

Black Lung Trust Fund, although income to the recipient, are not subject to the income tax.

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

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

110. **401(k) plans and Individual Retirement Accounts.**—Individual taxpayers can take advantage of several different tax-preferenced retirement plans: deductible IRAs, non-deductible IRAs, Roth IRAs, and 401(k) plans (and 401(k)-type plans like 403(b) plans and the government's Thrift Savings Plan).

In 1999, an employee could exclude up to \$10,000 (indexed) of wages from AGI under a qualified arrangement with an employer's 401(k). Employees can annually contribute to a deductible IRA up to \$2,000 (or 100 percent of compensation, if less) or \$4,000 on a joint return with only one working spouse if: (a) neither the individual nor spouse is an active participant in an employer-provided retirement plan, or (b) their AGI is below \$40,000 (\$25,000 for singles). The IRA deduction is phased out for taxpayers with AGI between \$50,000 and \$60,000 (\$30,000 and \$40,000 for singles). The phase-out range increases annually until it reaches \$80,000 to \$100,000 in 2007 (\$50,000 to \$60,000 for singles). Taxpayers whose AGI is above the start of the IRA phase-out range or who are active participants in an employer-provided retirement plan can contribute to a non-deductible IRA. The tax on the investment income earned by 401(k) plans, non-deductible IRAs, and deductible IRAs is deferred until the money is withdrawn.

An employed taxpayer can make a non-deductible contribution of up to \$2,000 (a non-employed spouse can also contribute up to \$2,000 if a joint return is filed) to a Roth IRA. Investment income of a Roth IRA is not taxed when earned. Withdrawals from a Roth IRA are tax free if (1) the Roth IRA was opened at least 5 years before the withdrawal, and (2) the taxpayer either (a) is at least 59-1/2, (b) dies, (c) is disabled, or (d) purchases a first-time house. The maximum contribution to a Roth IRA is phased out for taxpayers with AGI between \$150,000 and \$160,000 (\$95,000 and \$110,000 for singles). Total annual contributions to a taxpayer's deductible, non-deductible, and Roth IRAs cannot exceed \$2,000 (\$4,000 for joints).

111. **Keogh plans.**—Self-employed individuals can make deductible contributions to their own retirement (Keogh) plans equal to 25 percent of their income, up to a maximum of \$30,000 per year. In addition, the tax on the investment income earned by Keogh plans is deferred until the money is withdrawn.

112. Employer-provided life insurance benefits.—Employer-provided life insurance benefits are excluded from an employee's gross income even though the employer's costs for the insurance are a deductible business expense.

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

114. Employer-provided supplementary unemployment benefits.—Employer-provided supplementary unemployment benefits are excluded from an employee's gross income even though the employer's costs for the benefits are a deductible business expense.

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

116. Additional deduction for the blind.—Taxpayers who are blind may take an additional \$1,000 standard deduction if single, or \$800 if married.

117. Additional deduction for the elderly.—Taxpayers who are 65 years or older may take an additional \$1,000 standard deduction if single, or \$800 if married.

118. Tax credit for the elderly and disabled.—Individuals who are 65 years of age or older, or who are permanently disabled, can take a tax credit equal to 15 percent of the sum of their earned and retirement income. Income is limited to no more than \$5,000 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older, and up to \$7,500 for joint returns where both spouses are 65 years of age or older. These limits are reduced by one-half of the taxpayer's adjusted gross income over \$7,500 for single individuals and \$10,000 for married couples filing a joint return.

119. Casualty losses.—Neither the purchase of property nor insurance premiums to protect its value are deductible as costs of earning income; therefore, reimbursement for insured loss of such property is not reportable as a part of gross income. Taxpayers, however, may deduct uninsured casualty and theft losses of more

than \$100 each, but only to the extent that total losses during the year exceed 10 percent of AGI.

120. Earned income tax credit (EITC).—The EITC may be claimed by low income workers. For a family with one qualifying child, the credit is 34 percent of the first \$6,800 of earned income in 1999. The credit is 40 percent of the first \$9,540 of income for a family with two or more qualifying children. When the taxpayer's income exceeds \$12,460, the credit is phased out at the rate of 15.98 percent (21.06 percent if two or more qualifying children are present). It is completely phased out at \$26,928 of modified adjusted gross income (\$30,580 if two or more qualifying children are present).

The credit may also be claimed by workers who do not have children living with them. Qualifying workers must be at least age 25 and may not be claimed as a dependent on another taxpayer's return. The credit is not available to workers age 65 or older. In 1999, the credit is 7.65 percent of the first \$4,530 of earned income. When the taxpayer's income exceeds \$5,670, the credit is phased out at the rate of 7.65 percent. It is completely phased out at \$10,200 of modified adjusted gross income.

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

Social Security

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

122. Social Security benefits for the disabled.—Benefit payments from the Social Security Trust Fund, for disability and for dependents and survivors, are excluded from the beneficiaries' gross incomes.

123. Social Security benefits for dependents and survivors.—Benefit payments from the Social Security

Trust Fund for dependents and survivors are excluded from the beneficiaries' gross income.

Veterans Benefits and Services

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

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

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

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

General Government

128. **Public purpose State and local bonds.**—Interest earned on State and local government bonds issued to finance public purpose construction (e.g., schools, roads, sewers) is tax-exempt.

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

130. **Business income earned in U.S. possessions.**—U.S. corporations receiving income from investments or businesses located in a U.S. possession (e.g., Puerto Rico) can claim a credit against U.S. tax, which effectively excludes some of this income from tax. The credit expires December 31, 2005.

Interest

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

TAX EXPENDITURES IN THE UNIFIED TRANSFER TAX

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

Unified Transfer Tax Reference Rules

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

- *Definition of the taxpaying unit.* The payment of the tax is the liability of the transferor whether the transfer of cash or property was made by gift or bequest.
- *Definition of the tax base.* The base for the tax is the transferor's cumulative, taxable lifetime gifts made plus the net estate at death. Gifts in the tax base are all annual transfers in excess of \$10,000 (indexed) to any donee except the donor's spouse. Excluded are, however, payments on behalf of family members' educational and medical expenses, as well as the cost of ceremonial gatherings and celebrations that are not in honor of the donor.
- *Property valuation.* In general, property is valued at its fair market value at the time it is transferred. This is not necessarily the case in the valuation of property for transfer tax purposes. Executors of estates are provided the option to value assets at the time of the testator's death or up to six months later.

- *Tax rate schedule.* A single graduated tax rate schedule applies to all taxable transfers. This is reflected in the name of the "unified transfer tax" that has replaced the former separate gift and estate taxes. The tax rates vary from 18 percent on the first \$10,000 of aggregate taxable transfers, to 55 percent on amounts exceeding \$3 million. A lifetime credit is provided against the tax in determining the final amount of transfer taxes that are due and payable. For decedents dying in 1999, this credit allows each taxpayer to make a \$650,000 tax-free transfer of assets that otherwise would be liable to the unified transfer tax. This figure is scheduled to increase in steps to \$1 million in 2005.⁷
- *Time when tax is due and payable.* Donors are required to pay the tax annually as gifts are made. The generation-skipping transfer tax is payable by the donees whenever they accede to the gift. The net estate tax liability is due and payable within nine months after the decedent's death. The Internal Revenue Service may grant an extension of up to 10 years for a reasonable cause. Interest is charged on the unpaid tax liability at a rate equal to the cost of Federal short-term borrowing, plus three percentage points.

Tax Expenditures by Function

The estimates of tax expenditures in the Federal unified transfer tax for fiscal years 1999–2005 are dis-

⁷An additional tax, at a flat rate of 55 percent, is imposed on lifetime, generation-skipping transfers in excess of \$1 million. It is considered a generation-skipping transfer whenever the transferee is at least two generations younger than the transferor, as it would be in the case of transfers to grandchildren or great-grandchildren. The liability of this tax is on the recipients of the transfer.

played by functional category in Table 5–6. Outlay equivalent estimates are similar to revenue loss estimates for transfer tax expenditures and, therefore, are not shown separately. A description of the provisions follows.

Natural Resources and Environment

1. **Donations of conservation easements.**—Bequests of property and easements (in perpetuity) for conservation purposes can be excluded from taxable estates. Use of the property and easements must be restricted to at least one of the following purposes: outdoor recreation or scenic enjoyment for the general public; protection of the natural habitats of fish, wildlife, plants, etc.; and preservation of historic land areas and structures. Conservation gifts are similarly excluded from the gift tax. Up to 40 percent of the value of land subject to certain conservation easements may be excluded from taxable estates; the maximum amount of the exclusion is \$200,000 in 1999 and increases by \$100,000 in each year through 2002.

Agriculture

2. **Special-use valuation of farms.**—Up to \$750,000 (indexed) in farmland owned and operated by a decedent and/or a member of the family may be valued for estate tax purposes on the basis of its “continued use” as farmland if: (1) the value of the farmland is at least 25 percent of the gross estate; (2) the entire value of all farm property is at least 50 percent of the gross estate; and (3) family heirs to the farm agree to continue to operate the property as a farm for at least 10 years.

3. **Tax deferral of closely held farms.**—The tax on a decedent’s farm can be deferred for up to 14 years if the value of the farm is at least 35 percent of the net estate. For the first 4 years of deferral, no tax need be paid. During the last 10 years of deferral, the tax liability must be paid in equal annual installments. Throughout the 14 year period, interest is charged at a special, favorable rate.

Commerce and Housing

4. **Special-use valuation of closely-held businesses.**—The special-use valuation rule available for family farms is also available for nonfarm family businesses. To be eligible for the special-use valuation, the same three conditions previously described must be met.

5. **Tax deferral of closely-held businesses.**—The tax-deferral rule available for family farms is also available for nonfarm family businesses. To be eligible for the tax deferral, the value of stock in closely-held corporations must exceed 35 percent of the decedent’s gross estate, less debt and funeral expenses.

6. **Exclusion for family-owned businesses.**—Certain family-owned businesses that are bequeathed to qualified heirs can be excluded from taxable estates. The exclusion generally cannot exceed \$1.3 million less the exemption value of the unified credit. The exclusion is recaptured if certain conditions are not maintained for 10 years.

Education, Training, Employment, and Social Services

7. **Charitable contributions to educational institutions.**—Bequests to educational institutions can be deducted from taxable estates.

8. **Charitable contributions, other than education and health.**—Bequests to charitable, religious, and certain other nonprofit organizations can be deducted from taxable estates.

Health

9. **Charitable contributions to health institutions.**—Bequests to health institutions can be deducted from taxable estates.

General Government

10. **State and local death taxes.**—A credit against the Federal estate tax is allowed for State taxes on bequests. The amount of this credit is determined by a rate schedule that reaches a maximum of 16 percent of the taxable estate in excess of \$60,000.

Table 5-6. REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE FEDERAL UNIFIED TRANSFER TAX

(In millions of dollars)

	Description	1999	2000	2001	2002	2003	2004	2005	2001-2005
	Natural Resources and Environment:								
1	Donations of conservation easements	10	25	40	55	75	95	105	370
	Agriculture:								
2	Special use valuation of farm real property	95	100	105	110	115	125	120	575
3	Tax deferral of closely held farms	5	15	20	20	20	25	30	115
	Commerce:								
4	Special use valuation of real property used in closely held businesses	10	10	10	10	15	15	15	65
5	Tax deferral of closely held business	35	100	110	110	120	130	180	650
6	Exclusion for family owned businesses	505	520	535	550	495	440	395	2,415
	Education, training, employment, and social services:								
7	Deduction for charitable contributions (education)	682	760	830	855	910	930	1,020	4,545
8	Deduction for charitable contributions (other than education and health) ...	2,015	2,240	2,450	2,525	2,680	2,750	3,015	13,420
	Health:								
9	Deduction for charitable contributions (health)	615	685	750	775	820	840	925	4,110
	General government:								
10	Credit for State death taxes	5,825	6,070	6,345	6,640	6,945	7,265	7,595	34,790