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TAX EXPENDITURES

Compendium of Background Material on Individual Provisions

COMMITTEE ON THE BUDGET
UNITED STATES SENATE



DECEMBER 2022

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CONGRESSIONAL RESEARCH SERVICE

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LETTER OF TRANSMITTAL

December 5, 2022

UNITED STATES SENATE
COMMITTEE ON THE BUDGET
WASHINGTON, DC

To the Members of the Committee on the Budget:

The Congressional Budget and Impoundment Control Act of 1974 (as amended) requires the Budget Committees to examine tax expenditures as they develop the concurrent budget resolution. Section 3(3) of the Congressional Budget Act of 1974 defines tax expenditures as those revenue losses attributable to provisions of the federal tax laws that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Tax expenditures are often enacted as permanent legislation and can be compared to direct spending on entitlement programs. There are more than 200 separate tax expenditures in current law, costing the Treasury more than \$1 trillion each year. Despite their size and dramatic impact on society across a wide range of issues, these expenditures do not often get the attention and scrutiny that they deserve, which makes this analysis by the Congressional Research Service (CRS) absolutely essential. This print was prepared by CRS and was coordinated by Richard Phillips and Sion Bell of the Senate Budget Committee staff. All tax code changes through December 2, 2022, are included.

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

Bernard Sanders
Chairman

LETTER OF SUBMITTAL

CONGRESSIONAL RESEARCH SERVICE
THE LIBRARY OF CONGRESS
Washington, DC, December 2, 2022

Honorable Bernie Sanders
Chairman, Committee on the Budget
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

I am pleased to submit a revision of the December 2020 Committee Print on Tax Expenditures.

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

The revision was written under the general direction of Jane Gravelle, Senior Specialist in Economic Policy, Erika Lunder, Section Research Manager, and Donald Marples, Specialist in Public Finance. Contributors of individual entries include Andrew Austin, Anthony Cilluffo, Margot Crandall-Hollick, Grant Driessen, Jane Gravelle, Gary Guenther, Mark Keightley, Donald Marples, Brendan McDermott, Molly Sherlock, and Jennifer Teefy of the Government and Finance Division; and Bernadette Fernandez, Alexandra Hegji, Ryan Rosso, and Scott Szymendera of the Domestic Social Policy Division. Khalil Williams provided editorial review and prepared the document for publication.

Mary B. Mazanec
Director

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Introduction

This compendium gathers basic information concerning approximately 200 federal tax provisions currently treated as tax expenditures. They include those listed in Tax Expenditure Budgets prepared for fiscal years 2020-2024 by the Joint Committee on Taxation (JCT),¹ although certain separate items that are closely related and are within a major budget function may be combined. The JCT also lists 35 additional tax expenditures with de minimis revenue losses (i.e., less than \$50 million over 5 years) and 29 tax expenditures where quantification is not available, that are not included in this compendium. Other provisions that have expired, but may be extended, are included in this compendium although they are not in the JCT list. In addition, provisions enacted after September 20, 2020 are included in this compendium as appropriate. With respect to each tax expenditure, this compendium provides:

The estimated federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 2020-2024 as estimated by the Joint Committee on Taxation;

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

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

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

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

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

¹ U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024*, November 5, 2020 (JCX-23-20).

A selected bibliography.

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

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from tax provisions designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. The term tax expenditure is also generally used to describe the provision itself, and not just its associated revenue loss. These provisions may, in effect, be viewed as spending programs channeled through the tax system. They are, in fact, classified in the same functional categories as the U.S. budget.

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

... those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability;

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

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

Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs

under which benefits are paid to all eligible persons. Since tax expenditures are often enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals for which they were established.

Tax expenditure budgets that list the estimated annual revenue losses associated with each tax expenditure were first required to be published in 1975 as part of the Administration's budget for fiscal year 1976, and have since been required to be published every subsequent year by the Budget Committees. The tax expenditure concept is still being refined, and therefore the classification of certain provisions as tax expenditures continues to be discussed. One recent change regarding classification pertains to Medicare-related items that have historically been classified as tax expenditures, but were not included in recent lists produced by JCT. These and other items are described in Appendix B. Nevertheless, there has been widespread agreement that most of the provisions included in this compendium are tax expenditures.²

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

Administration Fiscal Year 2023 Expenditure Budget

There are several differences between the tax expenditures shown in this publication and the tax expenditure budget found in the Administration's

² For a discussion of the conceptual problems involved in defining tax expenditures and some of the differences between the Administration's and Joint Committee on Taxation's approaches, see *The Budget of the United States Government, Fiscal Year 2021, Analytical Perspectives*, "Tax Expenditures," pp. 147-198. See also Linda Sugin, "What Is Happening to the Tax Expenditure Budget?" *Tax Notes*, August 16, 2004, pp. 763-766; and Thomas L. Hungerford, "Tax Expenditures: Good, Bad, or Ugly?" *Tax Notes*, October 23, 2006, pp. 325-334.

FY2023 budget document.³ In some cases, tax expenditures are combined in one list, but listed separately in the other. In other cases, changes in economic conditions (such as forecast growth in GDP) result in differences in the magnitude of the tax expenditure estimates.

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms:

1. exclusions, exemptions, and deductions, which reduce taxable income;
2. preferential tax rates, which apply lower rates to part or all of a taxpayer's income;
3. credits, which are subtracted from taxes as ordinarily computed; and
4. deferrals of tax, which result from delayed recognition of income or from allowing deductions in the current year that are properly attributable to a future year.

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

Largest Tax Expenditures

While JCT lists and estimates about 190 items in their tax expenditure publication, relatively few account for most of the aggregate cost. The following two tables list the top individual and corporate tax expenditures. The first table lists the 10 largest tax expenditures (in terms of revenue loss in FY2020) directed to individuals. For certain refundable tax credits, the tax expenditure estimate includes the outlay from the refundable portion of the credit (the amount that exceeds income tax liability). Overall, these 10 items

³ *The Budget of the United States Government, Fiscal Year 2023*, Analytical Perspectives, "Tax Expenditures," pp. 153-201.

account for more than 73 percent of the total dollars of tax expenditures directed to individuals.

10 Largest Tax Expenditures, FY2020: Individuals

[In billions of dollars]

Tax Expenditure	Amount
Recovery rebate	269.0
Exclusion of employer contributions for health care	169.6
Exclusion of contributions to defined contribution retirement plans	153.6
Reduced rates of tax on dividends and long-term capital gains	148.5
Child tax credit	117.6
Exclusion of contributions to defined benefit retirement plans	102.3
Earned income tax credit (including outlay effects)	68.3
Subsidies for insurance purchased through health benefit exchanges	52.5
20-percent deduction for qualified business income	45.7
Exclusion of capital gains at death	41.6

The next table reports the 10 largest tax expenditures (in terms of revenue loss in FY2020) directed to corporations. Overall, these 10 tax expenditure items account for almost 87 percent of the total dollars of tax expenditures directed to corporations, excluding bonus depreciation.

10 Largest Tax Expenditures, FY2020: Corporations
 [In billions of dollars]

Tax Expenditure	Amount
Reduced tax rate on active income of controlled foreign corporations	45.4
Depreciation of equipment in excess of the alternative depreciation system	43.2
Credit for increasing research activities (Code section 41)	13.0
Deduction for foreign derived intangible income derived from trade or business within the United States	12.6
Credit for low-income housing	9.9
Energy credit (section 48)	6.1
Exclusion of interest on public purpose state and local government bonds	5.5
Credit for electricity produced from renewable resources (section 45)	4.4
Deferral of gain on non-dealer installment sales	4.0
Work opportunity tax credit	2.9

Order of Presentation

The tax expenditures are presented in an order which generally parallels the budget functional categories used in the congressional budget (i.e., tax expenditures related to “national defense” are listed first, and those related to “international affairs” are listed next). In a few instances, two or three closely related tax expenditures derived from the same Internal Revenue Code

provision have been combined in a single summary to avoid repetitive references even though the tax expenditures are related to different functional categories. This parallel format is consistent with the requirement of section 301(d)(6) of the Budget Act, which requires that the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports present the estimated levels of tax expenditures “by major functional categories.”

Impact (Including Distribution)

The impact section includes information on the direct effect of the provisions and, where available, the distributional effect across individuals. Unless otherwise specified, distributional tables showing the share of the tax expenditure received by income class are calculated from data in the Joint Committee on Taxation’s committee print on tax expenditures for FY2020-FY2024. This distribution uses an expanded income concept that is composed of adjusted gross income (AGI), plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA taxes, (4) workers’ compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preferences, (8) excluded income of U.S. citizens abroad, and (9) individuals’ share of business taxes.

These estimates were made for 11 tax expenditures. For other tax expenditures, a distributional estimate or information on distributional impact is provided, when such information could be obtained.

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

***Distribution by Income Class of All
Returns, 2020***

Income Class (thousands of \$)	Percentage Distribution
Below \$10	9.7
\$10 to \$20	9.4
\$20 to \$30	11.3
\$30 to \$40	9.8
\$40 to \$50	8.9
\$50 to \$75	16.1
\$75 to \$100	10.3
\$100 to \$200	17.5
\$200 and over	7.1

Source: JCT 2020.

Note: The income concept used to place tax returns into classes is an expanded measure of income.

The Congressional Budget Office has examined how the selected major tax expenditures were distributed among households with different amounts of income in 2019.⁴ The table shows the share of the benefits of different types of tax expenditures accruing to households in different income groups. Overall, tax expenditures tend to benefit higher-income taxpayers—they have an “upside down” distributional pattern. The distribution pattern, however, differs by the type of tax expenditure. Exclusions, preferential tax rates on capital gains and dividends, and itemized deductions tend to benefit higher-income taxpayers, while tax credits tend to benefit lower-income taxpayers.

⁴ Congressional Budget Office, *The Distribution of Major Tax Expenditures in 2019*, October 27, 2021.

Distribution of Selected Major Tax Expenditures by Income Group, 2019

Type	Lowest Quintile	Middle Quintile	Highest Quintile	Top 1 Percent
Exclusions	2	15	50	5
Deductions	0	3	87	43
Capital gains, dividends	0	1	95	75
Credits	32	19	9	0
All	9	12	51	19

Source: CBO 2021.

Many tax expenditures are corporate and thus do not directly affect the taxes of individuals. Most analyses of capital income taxation suggest that the majority of such taxes are likely to be borne by capital given reasonable behavioral assumptions.⁵ Capital income is heavily concentrated in the upper-income levels. For example, the Congressional Budget Office⁶ reported for 2018 that the top 1 percent of taxpayers accounted for 44.8 percent of corporate income tax liability, the top 5 percent accounted for 60.2 percent, the top 10 percent accounted for 68.3 percent, and the top 20 percent accounted for 77.9 percent. The distribution of corporate income tax liabilities across the first four quintiles was 1.4 percent, 3.1 percent, 5.8 percent, and 10.4 percent. Corporate tax expenditures would, therefore, tend to benefit higher-income individuals.

Rationale

Each tax expenditure item contains a brief statement of the rationale for the adoption of the expenditure, where it is known. They are the principal rationales publicly given at the time the provisions were enacted. The rationale includes a legislative history of the tax expenditure, which chronicles major changes in the provisions over time and the reasons for the changes.

⁵ See Jane G. Gravelle, *Corporate Tax Reform: Issues for Congress*, Library of Congress, Congressional Research Service Report RL34229, December 3, 2021.

⁶ U.S. Congress, Congressional Budget Office, *The Distribution of Household Income, 2018*, October 2021, Supplemental Table 12.

Assessment

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

Estimating Tax Expenditures

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

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

First, in some cases, if two or more items were simultaneously eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items. Thus, the arithmetical sum of all tax expenditures (reported below) may be different from the actual revenue consequences of eliminating all tax expenditures.⁷

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

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until sometime after enactment.

⁷ A 2008 study estimates that the sum of revenues lost under the separate tax expenditures is about 8 percent less than the revenue loss when the tax expenditures are taken as a group. See Leonard E. Burman, Christopher Geissler, and Eric J. Toder, "How Big Are Individual Income Tax Expenditures and Who Benefits from Them?" *American Economic Review, Papers and Proceedings*, vol. 98, no. 2, May 2008, pp. 79-83.

Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

These tax expenditure estimating considerations are, in many ways, similar to estimating considerations involving entitlement programs. First, like tax expenditures, annual budget estimates for each transfer and income-security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Second, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be fully reflected until several years later because the termination of benefits is usually only for new recipients, with persons already receiving benefits continued under "grandfather" provisions.

The table below shows tax expenditure estimates by year for individuals and corporations. All revenue loss estimates are based upon the tax law enacted through September 30, 2020. For a provision that has or was assumed to expire, its extension would typically add to its projected cost in the table listed below.

***Sum of Tax Expenditure Estimates by Type of
Taxpayer, Fiscal Years 2020-2024***

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1,592.0	169.7	1,761.7
2021	1,368.8	166.1	1,534.9
2022	1,406.5	179.3	1,585.8
2023	1,483.0	180.0	1,663.0
2024	1,567.7	169.8	1,737.5

Note: These totals are the mathematical sum of the estimated fiscal year effect of each of the tax expenditure items included in this publication as appearing in the Joint Committee on Taxation's November 2020 list.

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	0.2	—	0.2
2023	0.2	—	0.2
2024	0.2	—	0.2

Authorization

Sections 162(p) and 62(a)(2)(E).

Description

An adjustment to gross income is available for the unreimbursed travel, meal, and lodging expenses of National Guard and Reserve members. To qualify for this above-the-line deduction, a member must travel more than 100 miles from home and stay overnight while on official duty. The deduction applies to all qualified expenses paid or incurred after December 31, 2002. It may not exceed the federal government’s per-diem allowance for food, lodging and incidental expenses in a specific locale and the standard federal mileage rate for use of a car. Commuting expenses to and from drill meetings do not qualify for the deduction. This deduction is available to taxpayers who claim the standard deduction or who itemize their deductions on their income tax return.

The unreimbursed travel expenses of reservists who travel less than 100 miles from home and stay overnight while on duty cannot be deducted under current law. Those expenses are considered a miscellaneous itemized deduction for tax purposes. The tax revision enacted in 2017 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) suspended the miscellaneous itemized deduction from 2018 to 2025.

Impact

Like any deduction, the tax benefit from the above-the-line deduction for the overnight travel expenses of National Guard and Reserve members depends on a taxpayer's marginal tax rate. As this rate increases, the tax savings from the deduction also rise, all else being equal. Consequently, higher-income reservists and National Guard members benefit more from the deduction than their lower-income counterparts.

Furthermore, an above-the-line deduction lowers a taxpayer's adjusted gross income (AGI). Decreases in someone's AGI could lead to increases in other deductions and credits. For example, the maximum child tax credit that may be claimed under section 24 was \$3,000 or \$3,600 per qualifying child in 2021; this amount phased out when a single filer's income exceeded \$112,500 or a joint filer's income exceeded \$150,000. In this case, a large above-the-line deduction may allow a high-income taxpayer to claim the credit. Above-the-line deductions can provide a greater tax benefit than below-the-line deductions of the same amount, which have no effect on AGI.

Rationale

The deduction was added to the federal tax code by the Military Family Tax Relief Act of 2003 (MFTRA, P.L. 108-121). Under previous law, the overnight travel expenses that National Guard and Reserve members incurred while on duty were only deductible as an itemized deduction to the extent that they and other miscellaneous deductions exceeded 2 percent of a taxpayer's AGI. As a result, reservists who did not itemize were unable to deduct these expenses, and reservists who did itemize could deduct the expenses only in certain cases. In enacting the deduction, Congress recognized the increasing role that Reserve and National Guard members were playing in national defense.

Assessment

Some military benefits are similar to the "for the convenience of the employer" benefits provided in the private sector. These include allowances for housing, meals, moving and storage, overseas cost-of-living, and uniforms. Other military benefits are equivalent in their tax treatment to employer-provided fringe benefits, such as medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits.

The tax deduction for the overnight travel expenses of National Guard members and reservists had a counterpart among civilian employees in the section 162(a) deduction for the unreimbursed travel expenses of employees who are required to travel as part of their job. The Tax Cuts and Jobs Act suspended the latter deduction. Both deductions lower the after-tax cost of required travel.

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National Defense

**EXCLUSION OF BENEFITS AND ALLOWANCES FOR
ARMED FORCES PERSONNEL**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.3	—	5.3
2021	5.5	—	5.5
2022	5.9	—	5.9
2023	6.2	—	6.2
2024	6.5	—	6.5

Authorization

Sections 104, 112 and 134 and a federal court decision: *Jones v. United States*, 60 Ct. Cl. 552 (1925).

Description

Members of the armed forces and their dependents receive a variety of in-kind and cash benefits that are excluded from gross income for tax purposes. The armed forces, in this case, consist of the Army, Navy, Air Force, Marine Corps, Coast Guard, Commissioned Corps of the National Oceanic and Atmospheric Administration, Commissioned Corps of the Public Health Service, and Space Force. The exclusions stem from a mix of statutes, regulations, court decisions, and administrative practices.

Under current law, the following benefits received by members of the armed services and/or their dependents are exempt from the federal income tax:

- Combat zone pay;
- Other pay, including disability payments, group life insurance payments, uniform allowances, state bonus pay for serving in a

combat zone, survivor and retirement protection plan premiums, defense counsel services, ROTC education and subsistence allowances, and professional education expenses;

- Death allowances, including burial costs, death gratuity payments to eligible survivors, and travel of dependents to burial sites;
- Family allowances, including certain education expenses for dependents, emergency assistance, evacuation allowances, and family counseling and separation allowances;
- Living allowances, including basic allowances for domestic housing and subsistence, as well as housing and cost-of-living allowances for living abroad;
- Moving allowances, including dislocation benefits, military base closure and realignment benefits, moving and storage allowances, and temporary lodging expenses;
- Travel allowances, including annual round-trip expenses for dependent students, leave between consecutive overseas tours, reassignment in a dependent-restricted status, and per-diem costs; and
- In-kind military benefits, including medical and dental care, dependent-care assistance, legal assistance, commissary and exchange discounts, and travel on government aircraft.

A member of the armed forces who dies as a result of wounds, disease, or injury incurred while serving in a combat zone is excused from all federal tax liability. This means that any unpaid income tax owed at the date of the member's death (including interest, additions to the tax, and additional amounts) is forgiven. In addition, families of the deceased receive a \$100,000 death gratuity payment, all of which is tax-exempt.

Personal use of a military vehicle, however, is not considered an excludable military benefit.

Impact

Many military benefits qualify for the section 112 and 134 exclusions from gross income. As with deductions, the tax savings depend in part on a recipient's marginal tax rate. For example, the tax savings from \$100 in excludable benefits is \$10 for an individual in the 10-percent tax bracket and

\$35 for an individual in the 35-percent tax bracket. In this case, the higher-income recipient realizes a greater tax benefit from the exclusion than the lower-income recipient does.

Rationale

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

The exemption for armed forces benefits and allowances evolved from the precedent set by *Jones v. United States* through a series of subsequent statutes, regulations, and administrative practices. For some compensation, the rationale for an exclusion was a desire to reduce the tax burden of military personnel during wartime (e.g., the exclusion for combat pay). For other compensation, the exclusion was based on the belief that the benefits were intrinsic to the military way of life.

The Tax Reform Act of 1986 (P.L. 99-514) consolidated these rules in a new section of the federal tax code (section 134). Congress took this step so that members of the armed services and the Internal Revenue Service (IRS) could clearly understand and administer tax law in a manner consistent with the changes in the tax treatment of fringe benefits enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369).

The Military Family Tax Relief Act of 2003 (P.L. 108-121) added dependent-care assistance programs to the list of qualified military benefits.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) revised the definition of earned income by excluding non-taxable employee compensation (including combat zone pay). As a result, the earned income reported for tax purposes by many armed forces members decreased, leading to a net loss in tax benefits (e.g., child tax credit) for some.

To address this result, the Working Families Tax Relief Act of 2004 (P.L. 108-311) allowed members of the armed services to continue to exclude combat pay from gross income, and elect to treat it as earned income in calculating the earned income tax credit and the child tax credit in 2004 and 2005. This provision was extended through 2006 by the Gulf Opportunity

Zone Act of 2005 (P.L. 109-135), extended through 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432), and made permanent by the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245).

The tax revision passed by Congress at the end of 2017 (P.L. 115-97) repealed the tax deduction under prior law for out-of-pocket job-related moving expenses and the tax exclusion for employer reimbursements for such expenses between 2018 through 2025. This change did not affect any of the exclusions for military benefits,

Assessment

The exclusion for some military benefits and allowances has parallels with the exclusion for many employer-provided benefits. Some military benefits are akin to the “for the convenience of the employer” standard for benefits available to private firms. They include allowances for housing, meals, moving and storage expenses, overseas cost-of-living, and uniforms. Other military benefits are equivalent to employer-provided fringe benefits such as medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits.

Some argue that the exclusion for military allowances and benefits functions as an inequitable substitute for additional taxable compensation, since high-income military personnel derive greater benefits from this treatment than do low-income members.

One barrier to such a substitution is the complications that would arise in taxing some military benefits and allowances. For example, placing a value on meals and lodging when the option to receive cash instead is not available could impose another administrative burden on the IRS. Another barrier is the possible impact on the size of the armed forces. The elimination of exclusions could lead some service members to think their benefits were being cut, or provide an opportunity for Congress or the President to cut benefits, making it more difficult to recruit new military personnel and to retain existing personnel.

Then again, eliminating exclusions and adjusting military pay scales accordingly could simplify the determination of military pay levels and make “actual” salaries more transparent to military personnel. The upward adjustment of military pay scales that would result from the elimination of the exclusion for some military benefits and allowances might also increase the retirement income of military personnel.

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National Defense

EXCLUSION OF MILITARY DISABILITY BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.3	—	0.3
2021	0.3	—	0.3
2022	0.3	—	0.3
2023	0.3	—	0.3
2024	0.3	—	0.3

Authorization

Section 104(a)(4) and (5) and 104(b).

Description

Most government pensions and retirement allowances are considered taxable income, but an exception is made for certain military pensions. Section 104(a)(4) allows individuals to exclude from gross income any amounts they receive as pensions, annuities, or other allowances for personal sickness or injuries they incurred while serving in the armed forces. The exclusion applies to individuals who were members of the armed forces or reserves on or before September 24, 1975, and suffered a combat-related injury or sickness. It also applies to persons eligible to receive disability payments from the Department of Veterans Affairs (VA); these payments are intended to compensate these individuals for the income they have lost because of their disabilities. Section 104(a)(5) allows individuals to exclude from gross income disability payments they receive for injuries from a terrorist attack that occurred while they were performing official duties as a U.S. government employee outside the United States before 2001.

Military disability pay is computed in two ways: the percentage-of-disability method or the years-of-service method. Under the former, the annual benefit is someone's percentage of disability on the date of retirement multiplied by the applicable basic pay. Under the latter, the applicable basic

pay is multiplied by 2.5 percent for each year of service. Only amounts paid under the percentage-of-disability method are excludable.

Impact

The exclusion for disability pension payments increases beneficiaries' after-tax income, relative to what it would be if the payments were taxed. The boost in after-tax income depends on a beneficiary's marginal tax rate. Consequently, higher-income veterans receive a larger tax benefit than their lower-income counterparts.

Rationale

Historically, the laws that established disability pensions for veterans also excluded them from gross income. In 1942, the exclusion was broadened to include disability pensions furnished by other countries. Many Americans had joined the Canadian armed forces during the Second World War. Proponents of extending the exclusion to other countries argued that disability payments, whether provided by the U.S. or Canadian governments, were made for the same reasons. They also pointed out that the veteran's disability benefits were similar to compensation for injuries and sickness, which was excluded from U.S. taxation in the early 1940s.

The Tax Reform Act of 1976 (P.L. 94-455) repealed the exclusion for military disability benefits under section 104, except in certain circumstances. Congress sought to eliminate abuses by members of the armed forces who were classified as disabled shortly before becoming eligible for retirement to obtain tax-free pension benefits. After retiring from military service, some individuals earned income from other jobs while receiving tax-free military disability benefits. Congress limited the exclusion of disability payments to persons joining the armed services on or before September 24, 1975. Persons joining the armed forces after that date were allowed to exclude their military disability benefits from gross income only if the benefits were related to combat injuries or sickness.

The Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) extended the section 104 exclusion to disability income received by civilian employees of the U.S. government injured in a terrorist attack or military action, regardless of where in the world the attack occurred.

Assessment

As noted earlier, the tax benefit from an exclusion from gross income is directly proportional to someone's income. But its impact on the distribution of net income among beneficiaries may not be what Congress intended in creating the exclusion. If that intent included a desire to lessen any financial hardships associated with living with a combat-related disability, a tax benefit that rewards higher-income veterans more than their lower-income counterparts may be inconsistent with that intent.

In addition, the exclusion serves as a form of spending through the tax code. As a result, the true cost of compensation for military personnel is understated in the federal budget.

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National Defense

EXCLUSION OF COMBAT PAY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.6	—	0.6
2021	0.6	—	0.6
2022	0.7	—	0.7
2023	0.7	—	0.7
2024	0.7	—	0.7

Authorization

Section 112.

Description

Much of the compensation (including basic, bonus, and incentive pay) received by active members of the armed forces is taxed. Under section 112, however, commissioned warrant officers, warrant officers, and enlisted members may exclude from gross income the qualified compensation they receive for any month they serve in a combat zone. These types of compensation qualify for the exclusion:

- Active-duty pay,
- Imminent danger/hostile fire pay,
- Pay for accrued leave earned while serving in a combat zone,
- Any re-enlistment or retention bonus received while stationed in a combat zone,
- Pay received for duties in clubs, messes, post and station theaters, and other non-appropriated fund activities performed while serving in a combat zone,

- Awards for suggestions, inventions, or scientific achievements submitted when serving in combat, and
- Student loan repayments made during such a period.

Retirement pay and pensions do not qualify for the combat-zone exclusion. For a commissioned officer, the exclusion cannot exceed the highest rate of basic pay at the highest pay grade for enlisted personnel plus any imminent danger/hostile fire pay the officer receives.

The exclusion also applies to any month a service member is hospitalized because of wounds, injuries, or disease incurred while serving in a combat zone; it can apply up to two years after the cessation of combat.

Impact

The provision excludes from gross income compensation received by service members while serving in a combat zone. As with a deduction, the tax benefit from the exclusion depends in part on a taxpayer's marginal tax rate. The benefit is greater for higher-income taxpayers than for lower-income taxpayers, all else being equal. For example, in 2022, if someone subject to the 24-percent tax bracket and another person subject to the 12-percent bracket were each to exclude \$1,000 of active-duty pay as a result of serving in a combat zone, the tax savings for the former would be double (\$240) the tax savings of the latter (\$120).

Rationale

The exclusion for combat pay began during World War I, when compensation for eligible military personnel of up to \$3,500 was exempt from the federal income tax. During World War II, the compensation of all active-duty military personnel and certain federal civilian employees was exempt from income taxes. Section 112 was added to the federal tax code by the Revenue Act of 1945 (P.L. 79-214). During the Korean War, the exclusion applied without limit to eligible compensation received by active military personnel serving in combat, but no more than \$200 of such compensation could be excluded for commissioned officers. Under the revision of the Internal Revenue Code in 1954 (P.L. 83-591), the exclusion was made permanent. P.L. 89-739 raised the excludable amount for commissioned officers to \$500. In 1996, P.L. 104-117 changed the limit to the highest rate of basic pay at the highest pay grade for enlisted personnel plus the amount of imminent danger/hostile fire pay an officer receives.

Generally, the compensation paid to military personnel serving in a combat zone is increased to reflect the hazards inherent in such a duty. Excluding combat pay from taxation may reflect a general public recognition that service members should be rewarded for putting their lives at risk.

Assessment

The exclusion of combat pay can significantly reduce (or eliminate) the tax burden for active-duty military personnel while serving in a combat zone. There has been some interest in expanding the section 112 exclusion to cover income received by federal civilian employees while working in combat zones, but none of these proposals have been enacted.

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International Affairs

EXCLUSION OF FOREIGN EARNED INCOME: HOUSING AND SALARY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations	Total
	Housing	Salary		
2020	0.8	4.6	—	5.4
2021	0.9	5.1	—	6.0
2022	1.0	5.8	—	6.8
2023	1.0	6.3	—	7.3
2024	1.1	6.7	—	7.8

Authorization

Section 911.

Description

The United States generally taxes its citizens and residents on their worldwide income. Worldwide income includes foreign-source income as well as domestic-source income. Section 911 of the tax code, however, permits U.S. taxpayers who live and work abroad a capped exclusion of their wage and salary income. The maximum amount of wage and salary income that can be excluded has been indexed for U.S. inflation since tax year 2006; the exclusion is \$112,600 for 2022. Qualifying individuals can also exclude certain excess foreign housing costs. Section 911, however, does not apply to federal employees working abroad. (See the entry on “Exclusion of Certain Allowances for Federal Employees Abroad.”) Foreign tax credits (section 901) cannot be claimed for foreign taxes paid on excluded income.

To qualify for either the income or housing cost exclusion, a person must be a U.S. citizen or permanent resident, must have their tax home in a foreign

country, and must either be a bona fide resident of a foreign country or have lived abroad for at least 330 days of any 12 consecutive months. Qualified income must be “earned” income rather than investment income. If a person qualifies for only part of the tax year, only part of the annual exclusion can be claimed. The housing cost exclusion is designed to offset higher housing costs of living abroad. According to the tax code, the housing cost amount that may be excluded is equal to the excess of foreign housing expenses over 16 percent of the applicable year’s earned income exclusion amount, but may not exceed 30 percent of the taxpayer’s maximum foreign earned income exclusion (30 percent of \$112,000 in 2022). In practice, however, the Treasury Department has the authority to adjust the limitation based on geographic differences in housing costs relative to housing costs in the United States. The Treasury Department uses this authority annually to raise the maximum housing exclusion to reflect actual housing costs in particular foreign cities. While a taxpayer can claim both the housing and income exclusions, the combined exclusions cannot exceed total foreign-earned income, including housing allowances.

Impact

U.S. taxpayers who work overseas benefit from section 911 if they can use it to reduce their U.S. tax liability. The impact of the exclusions on Americans working abroad depends partly on whether their foreign taxes are higher or lower than their U.S. taxes (before taking the exclusion into account). For expatriates who pay high foreign taxes, the exclusion holds little importance, because they can use the foreign tax credit to offset their U.S. tax liability. For expatriates who pay little or no foreign taxes, however, the exclusion can reduce or eliminate their U.S. tax liability.

Many employers offer their overseas employees “tax equalization” packages whereby the employer guarantees that the employees will not pay more taxes working overseas than they would pay if they were working in the United States. The section 911 provisions relieve the employer from having to reimburse employees for U.S. tax on the amounts that are excluded under the income and housing exclusions. In this way, section 911 subsidizes employers sending employees overseas.

The effect of the exclusion on horizontal equity is complicated. The U.S. tax liability of Americans working abroad can differ from the tax on those with identical real income living in the United States, because of differences in the cost of living and corresponding differences in nominal income. A person

working in a high-cost country needs a higher nominal income to match the real income of a person in the United States. In contrast, an expatriate in a low-cost country needs a lower nominal income than a person in the United States. Because tax brackets, exemptions, and the standard deduction are expressed in nominal dollars, people living in low-cost countries, who have low nominal incomes, would consequently have a lower tax bill than people with identical real income living in the United States. And, if not for the foreign-earned income exclusion, U.S. citizens working in high-cost countries, with high nominal incomes, would likely pay higher taxes than their U.S. counterparts.

The maximum income exclusion for a particular year is a set dollar amount for all taxpayers and is not linked to the actual cost of living in a particular geographic location. For low-cost foreign locations, it may overcompensate. In that case, the exclusion may have the unintended effect of increasing horizontal inequity in the tax system. Some point out that the tax code does not take into account variations in living costs within the United States; they argue that the appropriate equity comparison would be between an expatriate and a person living in the highest cost area within the United States.

The Internal Revenue Code sets the limit on the housing cost exclusion based on the formula discussed previously. However, legislation enacted in 2005 granted the Treasury Department authority to adjust the statutory housing expense limitation, and the agency annually adjusts the limitation upward to reflect high costs in particular foreign real estate markets.

Rationale

The Revenue Act of 1926 (P.L. 69-20) provided an unlimited exclusion for foreign earned income for persons residing abroad for an entire tax year. Supporters of the exclusion argued that the provision would bolster U.S. trade performance, since it would provide tax relief to U.S. expatriates engaged in trade promotion.

The subsequent history of the exclusion shows a continuing attempt by policymakers to find a balance between the provision's perceived beneficial effects on U.S. trade and economic performance and perceptions of tax equity. In 1962, the Kennedy Administration recommended eliminating the exclusion in some cases and scaling it back in others in order to "support the general principles of equity and neutrality in the taxation of U.S. citizens at home and abroad." The final version of the Revenue Act of 1962 (P.L. 87-834) simply

capped the exclusion in all cases at \$20,000. The Tax Reform Act of 1976 (P.L. 94-455) would have pared the exclusion further (to \$15,000), again for reasons of equity.

The Foreign Earned Income Act of 1978 (P.L. 95-615) revamped the exclusion, and the 1976 proposals never took effect. The 1978 Act sought to provide tax relief more closely tied to the actual costs of living abroad. It replaced the single exclusion with a set of separate deductions that were linked to various components of the cost of living abroad, such as the excess cost-of-living in general, excess housing expenses, schooling expenses, and home-leave expenses.

In 1981, the emphasis again shifted to the perceived beneficial effects of encouraging U.S. employment abroad. The Economic Recovery Tax Act of 1981 (ERTA, P.L. 97-34) provided a large flat income exclusion and a separate housing exclusion. ERTA's income exclusion was \$75,000 for 1982, but was scheduled to increase to \$95,000 by 1986. However, concern about the revenue consequences of the increased exclusion led Congress to temporarily freeze the exclusion at \$80,000 under the Deficit Reduction Act of 1984 (P.L. 98-369); annual \$5,000 increases were to resume in 1988. In 1986, as part of its general broadening of the tax base, the Tax Reform Act (P.L. 99-514) fixed the exclusion at \$70,000. The Taxpayer Relief Act of 1997 (P.L. 105-34) provided the gradual increase in the exclusion to \$80,000 by 2002, as well as indexing for U.S. inflation, beginning in 2008.

The Taxpayer Increase Prevention and Reconciliation Act of 2006 (TIPRA, P.L. 109-222) contained new restrictions on both the housing and earned income exclusions as a revenue-raising element designed to partly offset unrelated revenue-losing items in the act. The Act contained four principal changes. First, it moved up from 2008 to 2006 the scheduled indexation of the exclusion. (While the combined, net impact of TIPRA's changes was expected to reduce the benefit's revenue loss, the indexation provision, taken alone, likely increases it.) Second, TIPRA changed the way tax rates apply to a taxpayer's income that exceeds the exclusion. Under prior law, if a person had income in excess of the maximum exclusion, tax rates applied to the additional income beginning with the lowest marginal rate. Under TIPRA, marginal rates apply beginning with the rate that would apply if the taxpayer had not used the exclusion. Third, TIPRA changed the "base amount" related to the housing exclusion. Under prior law, the housing exclusion applied to housing expenses exceeding 16 percent of the salary level applicable to the GS-14 federal grade level; TIPRA set the base amount at 16

percent of the foreign earning income exclusion amount. In addition, TIPRA capped the housing exclusion at 30 percent of the maximum excludable income; there was no cap under prior law. TIPRA also gave the Treasury Department the authority to adjust the 30 percent housing cost cap based on geographic differences in housing costs relative to housing costs in the United States.

Assessment

The foreign-earned income and housing costs exclusions likely increase the number of Americans willing to work overseas in countries with high living costs (in particular, high housing costs) and in countries with low taxes. Without section 911 or a similar provision, U.S. taxes on Americans working abroad would generally be higher than taxes on domestic workers with equivalent real economic income. The higher taxes would discourage Americans from accepting employment overseas. While the uniformly applied income exclusion eases this distortion for some countries, it overcompensates in others, thereby introducing new distortions.

Historically, the foreign-earned income and housing cost exclusions have been defended on the grounds that they help increase U.S. exports, because Americans working abroad play an important role in promoting the sale of U.S. goods abroad. The impact of the provision is uncertain, however. U.S. citizens do not need to be employed by a U.S.-based corporation in order to qualify for the exclusions; they can be employed by foreign corporations. Self-employed Americans working abroad also qualify for the exclusions. Recently, scholars have argued that the exclusions may actually work against U.S. domestic economic interests by encouraging highly compensated U.S. citizens to work overseas, thereby both expatriating U.S. intellectual capital and reducing U.S. tax revenue.

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International Affairs

**EXCLUSION OF CERTAIN ALLOWANCES FOR
FEDERAL EMPLOYEES ABROAD**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.5	—	1.5
2021	1.6	—	1.6
2022	1.6	—	1.6
2023	1.7	—	1.7
2024	1.7	—	1.7

Authorization

Section 912.

Description

U.S. federal civilian employees who work abroad are allowed to exclude from income certain special allowances they receive that are generally linked to the cost-of-living. These federal employees are not eligible for the foreign earned income or housing exclusion provided to private-sector individuals under section 911. (See the entry on section 911, “Exclusion of Foreign Earned Income: Housing and Salary.”) Like other U.S. citizens, federal employees working abroad are subject to U.S. taxes and can credit foreign taxes against their U.S. taxes. However, federal employees are usually exempt from foreign taxes.

Specifically, section 912 excludes certain amounts received under provisions of the Foreign Service Act of 1980 (P.L. 96-465), the Central Intelligence Act of 1949 (P.L. 81-110), the Overseas Differentials and Allowances Act (P.L. 86-707), and the Foreign Service Act of 1946 (P.L. 79-724). The allowances are primarily for the higher cost of living abroad, housing, education, and travel. Section 912 also excludes cost-of-living allowances received by federal employees stationed in U.S. possessions, Hawaii, and Alaska. Travel, housing, food, clothing, and certain other

allowances received by members of the Peace Corps also are excluded. However, special allowances for hardship posts are not eligible for the exclusion.

Impact

Federal employees abroad may receive a significant portion of their compensation in the form of housing allowances, cost-of-living differentials, and other allowances. The income exclusions permitted under section 912 can substantially reduce their taxes. Data suggest that real incomes for federal workers abroad are generally higher than real incomes in the United States. Consequently, section 912 exclusions probably reduce the progressivity of the income tax.

Section 912's impact on horizontal equity (the equal treatment of similarly situated individuals) is more ambiguous. Without section 912 or a similar provision, federal employees in high-cost countries would likely pay higher taxes than persons with identical real incomes who work in the United States. The higher nominal income needed to offset higher living costs abroad could place federal employees stationed abroad in a higher tax bracket. It could also reduce the value of the standard deduction, which is set at the same nominal dollar amount, regardless of where the taxpayer lives or works.

The complete exclusion of cost-of-living allowances probably overcompensates for this effect. U.S. citizens employed abroad in the private sector are permitted to exclude up to \$112,000 in 2022, rather than an amount explicitly linked to cost-of-living allowances. Given the flat amount, whether the tax treatment of federal workers is more or less favorable than that of private-sector workers depends on the size of the federal worker's cost-of-living allowance.

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

Rationale

The section 912 exclusions were first enacted by the Revenue Act of 1943, in response to rising costs of living abroad. Congress determined that federal personnel overseas were engaged in “highly important” duties and that the allowances merely offset the extra costs of working and living abroad. Congress determined that the government should bear the full burden of the excess living costs, including any income taxes that would otherwise be imposed on cost-of-living allowances.

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

Assessment

The benefit from the section 912 exclusions is largest for federal employees abroad who receive a substantial part of their income as cost-of-living, housing, education, or other allowances. Beyond this, the effects of the exclusions are uncertain. The exclusions may encourage employees to request that a greater portion of their compensation be paid in the form of these tax-favored benefits, although there may be non-tax reasons as to why employees might not prefer this.

It could be argued that the federal agency that employs a person who claims a section 912 exclusion does not directly bear the cost of the exclusion. That is, the exclusion reduces the income tax revenue of the federal government in general, but that revenue cost is not reflected in the budgets of the particular federal agencies with overseas employees. As a consequence, section 912 may enable individual federal agencies to employ more U.S. citizens abroad than they otherwise would or could if they were held accountable for the full cost of those employees, including the income tax forgiven on qualifying allowances.

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International Affairs

REDUCED TAX RATE ON ACTIVE INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	45.4	45.4
2021	—	46.3	46.3
2022	—	62.6	62.6
2023	—	67.7	67.7
2024	—	73.1	73.1

Authorization

Sections 11(d), 91, 245A, 250, 882, and 951-964.

Description

The United States taxes firms incorporated in the United States on their worldwide income but taxes foreign-chartered corporations only on their U.S.-source income. Some firms that changed headquarters to foreign countries are treated as U.S. firms. These firms, called surrogate U.S. firms, are generally those where U.S. shareholders of the former U.S. firm retain 80 percent or more ownership. Firms where former U.S. shareholders retain at least 60 percent but less than 80 percent ownership are called inverted firms.

For U.S. persons (firms and individuals), some foreign source income (including branch income, certain dividends, and passive income such as royalties and interest) is subject to full U.S. taxes, and credits for foreign taxes are allowed to offset U.S. tax liability on that income.

There are, however, special rules for the profits of controlled foreign corporations (CFCs). A controlled foreign corporation is at least 50 percent owned by U.S. shareholders that each own at least 10 percent of the foreign corporation. CFC status is subject to so-called “downward attribution” rules so that stock that is owned in a foreign corporation by a foreign person that is

related to the U.S. person can be attributed to the U.S. person. This change was aimed at inverted firms to prevent subsidiaries of the former U.S. parent that would still be U.S. CFCs from being removed from that status by decontrolling transactions (such as selling stock to the new foreign parents). The rule is, however, applied generally.

Dividends paid from CFCs are exempt for U.S. corporate shareholders who own at least 10 percent of the CFC, and foreign tax credits are not allowed for dividends. Some overall income of these subsidiaries is subject to tax. Income subject to tax falls into two types: Subpart F income (Sections 951-964) and other income.

Income subject to Subpart F is generally income related to passive investment rather than income from active business operations. Also, certain types of sales, services, and other income whose geographic source is easily shifted is included in Subpart F. Foreign tax credits associated with that income are allowed to offset U.S. tax on that income and are allowed on an overall basis (combining income and credits from different countries).

For other income, a lower tax is imposed on what is referred to as global intangible low-taxed income (GILTI) and an exemption is provided for tangible investments. GILTI income is technically part of Subpart F but is subject to a separate foreign tax credit treatment and other rules. Two deductions are allowed in addition to deducting normal Subpart F income. First, a deemed return to tangible investments, 10 percent of the tax basis (cost less depreciation) for tangible assets net of interest deductions, is excluded so that no taxes are imposed on this income. Second, 50 percent of the remaining income is deducted for taxable years beginning after December 31, 2017, and through taxable years beginning before January 1, 2025. Thus, the tax rate on this income is 10.5 percent (half of the 21 percent corporate tax rate). After that period, a 37.5 percent deduction is allowed, resulting in a tax rate of 13.125 percent. This income is segregated into a separate foreign tax credit computation basket and 80 percent of foreign taxes paid are allowed, again on an overall basis. As a result, a residual U.S. tax is collected when overall foreign tax rates are below 13.125 percent in the initial years ($0.105/0.80$), and subsequently 16.406 percent ($0.13125/0.80$).

Foreign tax credits are limited to U.S. tax paid on foreign source income. Rules for computing foreign source income include allocating some deductions of the U.S. controlling shareholder to foreign sources (such as interest and research costs), which can reduce the amount of foreign source

income and therefore allowable foreign tax credits. If the source rules make foreign source income smaller than that as measured by foreign tax systems, a residual tax can apply at lower tax rates.

The tax expenditure measures the difference between taxing all income of CFCs at full rates (allowing foreign tax credits) and the current taxes, which are reduced due to GILTI deductions and the GILTI foreign tax credit rules.

The deduction for GILTI and another provision, the deduction for intangible income derived from foreign sources (FDII) discussed in the section on “Deduction for Foreign-Derived Intangible Income Derived from Trade or Business Within the United States,” is limited if the sum of these amounts exceeds taxable income excluding GILTI. The excess is not allowed as a deduction and is apportioned between GILTI and FDII according to their shares of the total amount of GILTI and FDII.

The revenue estimate also includes the taxation of income earned in prior years and not subject to tax due to the pre-existing deferral regime, where income of CFCs outside of Subpart F was taxed at normal rates but only when repatriated to the U.S. shareholder as a dividend. This income will be taxed at a 15.5 percent rate for cash and cash equivalent income and 8 percent for other income. This increased tax liability may be paid over an eight-year period.

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022, imposed a 15% global alternative minimum tax on worldwide financial statement income for corporations with profits over \$1 billion. This tax would increase the tax on foreign source income in some cases. The tax allows for credits for foreign taxes paid as recorded in the financial statement.

Impact

The exemption from tax for tangible investments creates an incentive to make tangible investments in lower-tax countries rather than in the United States. The deduction for GILTI income also creates an incentive to hold intangible assets abroad in low-tax countries. These effects interact with the U.S. deduction for certain intangible income derived from FDII, which encourages intangibles to be located in the United States but discourages tangible investment.

The formulaic treatment of FDII and GILTI and the discrepancy between tax effects also means that there is an incentive to locate low-margin tangible assets in the United States (so as to increase the share of income eligible for

the FDII deduction) and to locate high-margin tangible assets abroad, but this is likely to be a relatively minor issue given the narrow differentials.

Foreign tax credits are imposed in the GILTI basket on an overall basis. Thus, there is an incentive to make investments in low-tax countries for firms that would otherwise have excess foreign tax credits due to higher taxes in other countries. Firms that do not have enough foreign tax credits to offset income would have an incentive to locate investments in high-tax countries, as those foreign taxes would be offset by a reduction in U.S. tax.

IRS data for 2018 indicated that the share of earnings and profits that will be excluded from GILTI due to the exclusion for the return on tangible assets is 15% overall. The shares varied significantly by industry. Manufacturing, which accounted for 38% of GILTI income, had a 23% share, while information, which accounted for 27% of GILTI had 3.7%. Wholesale and retail trade, which together accounted for 12% of GILTI, had a 24% and 21% share, respectively.

Rationale

Prior to the tax law changes in 2017 (discussed below), there was a significant tax expenditure for deferral, since, under the prior regime, income from abroad was taxed at ordinary rates but in the case of foreign incorporated subsidiaries was not taxed until income was repatriated to the U.S. shareholder. Foreign tax credits were allowed on an overall basis but were separated into several baskets, the primary ones being passive and active baskets. Excess credits in one basket could not be used against lower-taxed income in another basket. Thus most of the history of the treatment of income from CFCs has related to deferral.

Deferral had been part of the U.S. tax system since the origin of the corporate income tax in 1909. While deferral was subject to little debate in its early years, it later became controversial. In 1962, the Kennedy Administration proposed a substantial scaling-back of deferral to reduce outflows of U.S. capital. Congress, however, was concerned about the potential effect of such a step on U.S. multinationals and on U.S. exports. Instead of repealing deferral, the Subpart F provisions were adopted in the Revenue Act of 1962 (P.L. 87-834), and were aimed at taxpayers who used deferral to accumulate funds in so-called “tax haven” countries. (Hence, Subpart F’s concern with income whose source can be easily manipulated.)

In 1975, Congress again considered eliminating deferral, and in 1978 President Carter proposed its repeal, but on both occasions the provision was left essentially intact. Subpart F, however, was broadened by the Tax Reduction Act of 1975 (P.L. 94-12), the Tax Reform Act of 1976 (P.L. 94-755), the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 87-248), the Deficit Reduction Act of 1984 (P.L. 98-369), the Tax Reform Act of 1986 (P.L. 99-514), and the Omnibus Budget Reconciliation Act of 1993 (OBRA93, P.L. 103-66). OBRA93 added section 956A to the tax code, which expanded Subpart F to include foreign earnings that firms retain abroad and invest in passive assets beyond a certain threshold.

In subsequent years, however, the trend had been incremental restrictions of Subpart F and expansions of deferral. For example, the Small Business Job Protection Act of 1996 (P.L. 104-188) repealed section 956A. The American Jobs Creation Act of 2004 (P.L. 108-357) relaxed Subpart F in the area of shipping income. Also while U.S. tax (less foreign tax credits) generally applies when tax-deferred income is repatriated to the United States, a provision of the American Jobs Creation Act of 2004 provided a temporary (one year) 85 percent deduction for repatriated dividends. For a corporation subject to the top corporate tax rate of 35 percent, the deduction had an effect similar to a reduction in the tax rate on repatriations to 5.25 percent. The deduction applied to a one-year period consisting (at the taxpayer's election) of either the first tax year beginning on or after P.L. 108-357's date of enactment (October 22, 2004) or the taxpayer's last tax year beginning before the date of enactment.

The Consolidated Appropriations Act, 2016 (P.L. 114-113) permanently extended an exception from Subpart F income tax rules for active financing income. This exception was originally enacted as a temporary provision by the Taxpayer Relief Act of 1997 (P.L. 105-34) and had been extended several times. See the entry for "Deferral of Certain Financing Income" for more information.

In 2017, P.L. 115-17, commonly referred to as the Tax Cuts and Jobs Act, substantially revised the international tax system, while at the same time reducing the corporate tax rate from 35 percent to 21 percent. In addition to creating the GILTI and FDII regimes, it included other provisions that affected international tax rules. These provisions included BEAT (see entry on "Base Erosion and Anti-Abuse Tax,") and a number of revisions to various definitions and rules. It included a deemed repatriation that imposes a tax on accumulated earnings abroad that have not been repatriated; this tax is

imposed at a lower rate of 8 percent on illiquid assets and 15.5 percent on liquid assets, which can be paid over a period of eight years. These rates are increased to 35 percent if a firm inverted (reorganized to have a foreign parent with former U.S. shareholders owning at least 60 percent of the new firm), but not firms that are treated as U.S. firms (at least 80 percent ownership).

The Inflation Reduction Act of 2022 (P.L. 117-169) imposed a global tax on financial statement income of large corporations with \$1 billion or more in profits.

Assessment

The new international tax system enacted under P.L. 115-97 ended deferral for CFCs and substituted a minimum tax on global intangible income. There were generally four issues surrounding the international tax debate: the location of investment in the United States or abroad, the accumulation of unrepatriated earnings abroad as a result of the deferral regime, concerns about the magnitude of artificial profit shifting both by U.S. and foreign multinationals which moved income outside of the U.S. tax jurisdiction, and the growth of inversions where firms changed headquarters to a foreign location to reduce taxes.

The lower tax rate and some other domestic revisions were the main reforms in P.L. 115-97 associated with concerns about investment in the United States, since the international regime continues to favor tangible investment abroad through CFCs in low-tax countries over domestic tangible investment. Under the new system, this income will never be subject to tax while under the old it would be taxed when repatriated. Thus, while the lower corporate tax rate may encourage more investment in the United States, the exclusion of tangible returns encourages more investment abroad. Also, by netting the deemed return on tangible assets against interest, the system also discourages debt financing for investments in intangibles abroad. The system also maintains an overall limit on the foreign tax credit for GILTI income which provides distortions in the allocation of investment depending on the foreign taxes paid on a firm's other investments. These rules create distortions in the allocation of investment. At the same time, since tangible investment usually requires other economic conditions (such as a labor force, other resources, and markets), it may not be as influenced by the exemption from U.S. tax as would be the case for intangibles.

The concern that a tax triggered by a dividend payment was discouraging taxpayers from repatriating income earned abroad to the United States was addressed, as repatriation as a tax trigger was eliminated for CFCs (where it was the principal concern).

Concerns that moving to a pure territorial tax (with no tax on foreign source income of CFCs beyond Subpart F) would increase artificial profit shifting (largely of intangible assets) to low-tax jurisdictions led to the GILTI, FDII, and BEAT regimes. Although the GILTI and FDII regimes, along with the lower corporate tax rate, create little or no tax advantage to locating intangibles abroad, and income from intangibles located abroad will be subject to a minimum global tax, how these provisions will work in practice is not yet clear. For example, the GILTI tax rate is below the FDII tax rate so that investment in zero-tax jurisdictions is still attractive, but in higher-tax jurisdictions, the tax on intangibles may be increased because of allocation of parent firm costs to foreign source income, thereby reducing the foreign tax credit limit.

New inversions will be discouraged by provisions to retroactively tax past earnings at 35 percent and by the downward attribution rules. The concerns about inversions were also addressed by some provisions of BEAT and by rules taxing dividends from these firms as ordinary income.

Evidence indicates continued profit shifting to low-tax countries, which may arise, in part, through the ability to shield this income from U.S. tax due to foreign tax credits in higher tax jurisdictions.

The OECD/G20 has proposed a global minimum tax of 15% based on financial income, imposed on a country-by-country basis with carveouts for capital income and payroll. The current form of GILTI is not consistent with that regime, as its rate is too low and it is not imposed on a country-by-country basis. The proposal would allow other countries to collect residual taxes, if the United States does not revise its regime. Changes were proposed to conform GILTI more closely to the OECD/G20 proposal, but have not been enacted.

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022, imposed a 15% global alternative minimum tax on worldwide financial statement income for corporations with profits over \$1 billion, which would increase the tax on foreign source income in some cases. The tax allows for credits for foreign taxes paid as recorded in the financial statement.

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International Affairs

DEFERRAL OF ACTIVE FINANCING INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	2.0	2.0
2021	—	3.0	3.0
2022	—	3.4	3.4
2023	—	2.5	2.5
2024	—	2.0	2.0

Authorization

Sections 953 and 954.

Description

Under current law, dividends from controlled foreign corporations (CFCs) are exempt from tax for corporate shareholders, but earnings of these corporations are subject to two types of taxes: a tax on easily shifted income at full rates (called Subpart F income) and a minimum worldwide tax on a share of the overall remaining income, termed a tax on global intangible low-taxed income, or GILTI. CFCs are firms that are more than 50 percent owned by U.S. stockholders, each of whom own at least 10 percent of the CFC's stock. See entry on "Reduced Tax Rate on Active Income of Controlled Foreign Corporations."

Under Subpart F, certain types of income earned by CFCs are taxed at full rates (21 percent for corporate shareholders). Subpart F subjects each 10 percent shareholder to U.S. tax on some (but not all) types of income earned by the CFC. In general, the types of income subject to Subpart F include income from a CFC's passive investment—for example, interest, dividends, and gains from the sale of stock and securities—and a variety of types of income whose geographic source is thought to be easily manipulated. Credits are allowed against U.S. tax due for any foreign taxes paid on this income.

For other income, a lower tax is imposed on what is referred to as global intangible low-taxed income (GILTI) and an exemption is provided for tangible investments. GILTI income is technically part of Subpart F but is subject to a separate foreign tax credit treatment and other rules. Two deductions are allowed in addition to deducting normal Subpart F income. First, a deemed return to tangible investments, 10 percent of the tax basis (cost less depreciation) for tangible assets net of interest deductions, is excluded so that no taxes are imposed on this income. Second, 50 percent of the remaining income is deducted for taxable years beginning after December 31, 2017, and through taxable years beginning before January 1, 2025. Thus, the tax rate on this income is 10.5 percent (half of the 21 percent corporate tax rate). After that period, a 37.5 percent deduction is allowed, resulting in a tax rate of 13.125 percent. This income is segregated into a separate foreign tax credit computation basket and 80 percent of foreign taxes paid are allowed, again on an overall basis. As a result, a residual U.S. tax is collected when overall foreign tax rates are below 13.125 percent in the initial years ($0.105/0.80$), increasing to 16.406 percent ($0.13125/0.80$) after 2024.

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

In short, Subpart F is an exception to the general rule taxing GILTI, and the tax expenditure at hand is an exception to Subpart F itself for a range of certain financial services income.

The tax expenditure estimate also includes the taxation of active financing income earned in prior years and not subject to tax due to the pre-2018 deferral regime, where income of CFCs outside of Subpart F was taxed at normal rates but only when repatriated to the U.S. shareholder as a dividend. This income will be taxed at a 15.5 percent rate for cash and cash equivalent income and 8 percent for other income. This increased tax liability may be paid over an eight-year period.

Impact

The exception poses an incentive in certain cases for firms to invest abroad, just as the general treatment of GILTI does. This incentive generally applies to low-tax countries and for some investments is partially offset by the U.S. incentive for foreign-derived intangible income (see entry “Deduction for Foreign-Derived Intangible Income Derived from Trade or Business Within the United States”). In other countries, the high foreign tax rates generally negate the U.S. tax benefit provided by deferral. In addition, the provision is moot (and provides no incentive) even in low-tax countries for U.S. firms that pay foreign taxes at high rates on other banking and insurance income. In such cases, the firms have sufficient foreign tax credits to offset U.S. taxes that would be due in the absence of deferral. (In the case of banking and insurance income, creditable foreign taxes must have been paid with respect to other banking and insurance income. This may accentuate the importance of the exception to Subpart F.)

Rationale

Subpart F itself was enacted in 1962 (P.L. 87-834) as an effort to curtail the use of tax havens by U.S. investors who sought to accumulate funds in countries with low tax rates—hence Subpart F’s emphasis on passive income and income whose source can be manipulated. At that time, income from foreign subsidiaries benefitted from deferral; that is, taxes were not imposed until income was repatriated to the U.S. shareholder as a dividend. The exception for banking and insurance was likewise in the original 1962 law (though not in precisely the same form as the current version). The stated rationale for the exception was that interest, dividends, and like income were not thought to be “passive” income in the hands of banking and insurance firms.

The exceptions for banking and insurance were removed as part of the broad Tax Reform Act of 1986 (P.L. 99-514). In removing the exception (along with several others), Congress believed they enabled firms to locate income in tax haven countries that have little “substantive economic relation” to the income. As passed by Congress, the Taxpayer Relief Act of 1997 (P.L. 105-34) generally restored the exceptions with minor modifications. In making the restoration, Congress expressed concern that without them, Subpart F extended to income that was neither passive nor easily movable. However, the Act provided for only a temporary restoration, applicable to 1998. Additionally, the Joint Committee on Taxation identified the

exceptions' restoration as a provision susceptible to line-item veto under the provisions of the 1996 Line-Item Veto Act (P.L. 104-130) because of its applicability to only a few taxpaying entities. President Clinton subsequently vetoed the exceptions' restoration. The Supreme Court, however, ruled the line-item veto to be unconstitutional, thus making the temporary restoration effective for 1998, as enacted.

The banking and insurance exceptions to Subpart F were extended with a few modifications for one year by the Tax and Trade Relief Extension Act of 1998. (The Act was part of P.L. 105-277, the omnibus budget bill passed in October 1998.) The modifications include one generally designed to require that firms using the exceptions conduct "substantial activity" with respect to the financial service business in question and added a "nexus" requirement under which activities generating eligible income must take place within the CFC's home country. In 1999, the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) extended the provision through 2001. In 2002, the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) extended the provision for five additional years, through 2006. The American Jobs Creation Act of 2004 (P.L. 108-357) added rules permitting, in some circumstances, certain qualifying activities to be undertaken by related entities. The Tax Increase Prevention Act (P.L. 109-222) extended the provision for two years, through 2008, and the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the provision through the end of 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312) extended the provision through 2011. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended it through 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the provision through 2014. The exceptions under Subpart F for active financing income were made permanent by the Consolidated Appropriations Act, 2016 (P.L. 114-113).

The nature of the exception changed with the enactment of the 2017 tax revisions, P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act, which replaced the deferral regime with GILTI and enacted a subsidy for intangible earnings derived from abroad for income earned in the United States.

Assessment

Subpart F attempts to deny the benefits of the lower tax on GILTI to income that is passive in nature or that is easily movable. It has been argued

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

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

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International Affairs

DEDUCTION FOR FOREIGN TAXES INSTEAD OF A CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.2	0.2
2021	—	0.3	0.3
2022	—	0.5	0.5
2023	—	0.6	0.6
2024	—	0.6	0.6

Authorization

Section 901.

Description

For taxes paid on income earned abroad, taxpayers may elect to either claim a deduction against taxable income or a credit against taxes due. In general, the credit is more advantageous than the deduction, because a credit reduces taxes due on a dollar-for-dollar basis, while a deduction only reduces income subject to tax. However, in cases where the taxpayer is facing the foreign tax credit limit claiming the deduction will result in a lower tax liability.

Foreign tax credits were limited in the 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act. For controlled foreign corporations, 80 percent of taxes paid on certain foreign source income can be credited, and no credits are allowed for dividends which are exempt going forward. These changes may make unused credits less likely. See entry on “Reduced Tax Rate on Active Income of Controlled Foreign Corporations.” At the same time, the corporate tax rate was reduced from 35 percent to 21 percent, reducing the value of the deduction by 40 percent.

Impact

The deduction reduces the U.S. taxes owed by some taxpayers who are either unable to claim the foreign tax credit or are constrained by the foreign tax credit limit.

Rationale

The opportunity to deduct foreign taxes paid was a feature in the original 1913 tax code. One possible motivation for the deduction could have been to recognize foreign taxes, like state taxes, as a possible cost associated with earning income. As such, the provision would help correct for mismeasurement of adjusted gross income and reflect on ability to pay or horizontal equity arguments.

Assessment

Deductibility of foreign taxes is consistent with the economic concept of national neutrality. Under this regime, foreign taxes are treated as a business expense and, thus, deductible from taxable income. This treatment results in the foreign return net of foreign tax equaling the domestic before tax return and a nationally efficient allocation of capital. While this provision maximizes the income or output in the domestic market, it also alters the division of income between capital and labor, shifting income towards labor and away from capital. Because national neutrality distorts the location of investment, it may produce an inefficient “deadweight” reduction in world economic welfare.

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International Affairs

**DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE
INCOME DERIVED FROM TRADE OR BUSINESS WITHIN
THE UNITED STATES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	12.6	12.6
2021	—	17.5	17.5
2022	—	26.3	26.3
2023	—	33.3	33.3
2024	—	37.4	37.4

Authorization

Section 250.

Description

The foreign derived intangible income (FDII) provision is aimed at providing a lower tax rate on intangible income produced in the United States but derived from abroad. FDII is based on a formulary measure of domestic intangible income (deemed intangible income), which is then multiplied by the estimated share of this income that is derived from foreign sales and use. “Deemed intangible income” is defined as deduction-eligible income in excess of 10 percent of tangible depreciable assets. Deduction-eligible income, in turn, is gross income minus excepted income minus deductions (including taxes) allocable to this income. Excepted income subtracted out is generally foreign-source income as well as active financial services income, and domestic oil and gas extraction income. The purpose of all of these deductions is to estimate a reasonable measure of intangible domestic source income.

To determine the share of this deemed intangible income that is eligible for the deduction, it is multiplied by the ratio of foreign-derived deduction-eligible income over the total deduction-eligible income. Foreign-derived deduction-eligible income is aimed at measuring income from the export of

goods and services; it includes any deduction-eligible income that is from the sale of property for foreign use and the provision of services used abroad, including leases and licenses (and therefore royalties, both those in the active foreign tax credit basket and those from unrelated firms).

FDII is eligible for a deduction of 37.5 percent for taxable years beginning after December 31, 2017, and through taxable years beginning before January 1, 2025, resulting in a 13.125 percent rate (the 21 percent corporate tax rate multiplied by $(1-0.375)$). For taxable years beginning after December 31, 2025, the deduction declines to 21.875 percent, resulting in a rate of 16.406 percent (21 percent multiplied by $(1-0.21875)$).

The deduction for FDII and another provision, global intangible low-taxed income (GILTI), discussed in the section on “Reduced Tax Rate on Active Income of Controlled Foreign Corporations,” is limited if the sum of GILTI and FDII exceeds taxable income excluding GILTI. The excess is not allowed as a deduction and is apportioned between GILTI and FDII according to their shares of the total amount of GILTI and FDII.

Impact

The FDII provision provides a lower tax rate for income from intangibles located in the United States and receiving foreign source income, and, thus, an incentive to locate intangibles in the United States. There are still incentives to locate intangibles abroad despite a tax on GILTI, because the GILTI tax is slightly lower and foreign intangible income might still be shielded by the foreign tax credit. If a firm operates only in countries without foreign taxes, then income derived (earned) in the United States will be taxed at 13.125 percent while intangible income abroad will be taxed at 10.5 percent (16.406 percent compared to 13.125 percent for taxable years beginning after December 31, 2025). When a firm is subject to foreign taxes, it is possible in some jurisdictions to offset the GILTI tax in no-tax jurisdictions with unused credits from other countries. (See discussion in “Reduced Tax Rate on Active Income of Controlled Foreign Corporations.”) FDII does not apply to intangibles with income derived from the U.S. market, whereas lower rates for intangible assets located abroad and selling to the U.S. market still apply.

The formulaic treatment of FDII and GILTI and the discrepancy between tax effects means that there is an incentive to locate low-margin tangible assets in the United States (so as to increase the share of income eligible for the FDII deduction) and to locate high-margin tangible assets abroad.

Dowd and Landefeld find that the industries that are expected to benefit most are U.S. firms with significant exports and intangible income, including manufacturing; information; and professional, scientific and technical services.

Rationale

FDII was added to the tax system as part of a major revision of the tax treatment of foreign source income by the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act). This revision moved the United States to a territorial tax but added provisions to reduce profit shifting. FDII, along with the tax on GILTI, was introduced to reduce profit shifting through transfer pricing of intangibles that led to large amounts of U.S. profits of multinationals being realized in low- or no-tax jurisdictions.

Assessment

The 2017 tax revision moved the U.S. method of taxing overseas investment from one of worldwide taxation with a credit for foreign taxes and deferral of tax until profits are repatriated to a territorial tax that eliminated tax on dividends received from foreign subsidiaries. One of the methods of profit shifting was to transfer intangible assets from the United States to subsidiaries in low- or no-tax foreign countries (such as the Cayman Islands or Bermuda, countries with no corporate tax). The new system provides a benefit (FDII) to income earned from intangible assets located in the United States deriving income from foreign sources. This change provides an incentive to locate intangible assets in the United States thereby reducing that profit shifting. The methods of profit shifting involve transferring assets at lower than arms-length prices and cost sharing arrangements that allow the foreign subsidiary to receive the right to new technology by providing part of the cost of research and development.

While FDII, in combination with GILTI, should reduce profit shifting, there are still incentives to locate intangibles abroad, as noted in the “Impact” section above, due to the slight differences in rates, the ability to use excess foreign tax credits to offset tax on GILTI, and the allowance of FDII only for an estimate of foreign derived income. Commentary has also pointed to mechanisms for a firm to increase the benefits of FDII, such as round tripping (selling abroad to an independent firm and then reimporting products), selling unfinished goods to foreign manufacturers, or buying goods from a foreign supplier for resale abroad.

There are still some incentives for firms to shift intangible assets (and thus profits) to low- or no-tax jurisdictions because, while income from intangibles located abroad (GILTI) is taxed, it is also eligible for a deduction. A formula approach makes an estimate of this income (GILTI, described in the entry “Reduced Tax Rate on Active Income of Controlled Foreign Corporations”) subject to tax but also allows a deduction. This deduction is slightly larger than the FDII deduction so that tax rates on income earned in foreign subsidiaries (without foreign tax credits) are lower than FDII tax rates. Also for firms operating in many locations, unused credits from high-tax jurisdictions may be used to shield profits from low-tax jurisdictions from the GILTI tax. In addition, FDII does not apply to income derived within the United States so there would be an advantage for firms to shift intangibles abroad but sell to the United States.

The movement of intangibles and their associated profits might take some time, as moving existing intangibles back to the United States would incur a tax (a provision allowing those assets tax-free status was in the Senate version of the 2017 tax revision but was eliminated in conference).

FDII also encourages more high-margin tangible investment in the United States to increase the base for FDII (just as GILTI encourages low-margin manufacturing abroad). At the same time, FDII would be available to firms with no manufacturing or employees in the United States.

Some have argued that FDII may violate the World Trade Organization (WTO) rules against export subsidies. Some have similarly argued that FDII might also be viewed abroad as a harmful tax regime (similar to some patent boxes), although it might be noted that its objective is to remove tax as a factor in locating intellectual property, as is the case of the OECD BEPS-compliant patent boxes. However, others have argued that FDII may be noncompliant because it has a mechanical rule, rather than being based on transfer pricing, and no nexus requirement (i.e., no direct connection against the cost of developing the intangible and revenue). Germany also has a provision for a royalty barrier that disallows a deduction for royalties paid to related firms that benefit from noncompliant patent box regimes. Loss of a deduction for royalties would more than offset the benefit of FDII in that case.

The potential for FDII violating WTO as an export subsidy has led some observers to argue that FDII should never have been enacted. Bringing together tax rates for U.S. and foreign locations could also be reached by eliminating both the FDII and GILTI deductions. If GILTI were also imposed

on a per-country basis, the incentive for locating intangibles abroad for foreign operations rather than in the United States would largely be eliminated, especially now that the United States has tax rates at or below those of most developed countries.

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International Affairs

**SPECIAL RULES FOR INTEREST-CHARGE DOMESTIC
INTERNATIONAL SALES CORPORATIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	1.4	1.4
2021	—	1.4	1.4
2022	—	1.8	1.8
2023	—	1.9	1.9
2024	—	2.0	2.0

Authorization

Sections 991-997.

Description

An Interest-Charge Domestic International Sales Corporation (IC-DISC) is a domestic corporation, usually formed by parent shareholders (e.g., corporations, individuals, and trusts) to be a tax-exempt subsidiary, which exports U.S. products. The parent company pays the IC-DISC a tax deductible commission attributable to qualified export sales. Because the IC-DISC pays no tax, distributions (actual or “deemed”) to IC-DISC shareholders are taxed only once, often at the lower individual dividend and capital gains tax rates. As a result, the after-tax return to shareholders is enhanced.

IC-DISC shareholders may defer up to \$10 million annually that is attributable to qualified export sales. An interest charge is imposed on shareholders, however, based on the distribution that would have occurred had deferral not been elected. The \$10 million deferral restriction was intended to limit the benefit of IC-DISC activity to smaller businesses.

Impact

IC-DISC reduces the effective tax rate on export income. The benefit therefore accrues to the owners of export firms as well as IC-DISC shareholders.

Rationale

IC-DISC was intended to increase U.S. exports and provide an incentive for U.S. firms to operate domestically rather than abroad. Additionally, IC-DISC (and DISC in general) was adopted as a way to partially offset export subsidies offered by foreign countries.

The provision allowing the formation of Domestic International Sales Corporations (DISCs) was enacted as part of the Revenue Act of 1971 (P.L. 92-178). Shortly after enactment, several European countries argued that the DISC provision violated the General Agreement on Tariffs and Trade (GATT) by allowing unlimited tax deferral. A GATT panel concluded that DISC was a prohibited export subsidy. The United States never formally recognized the illegality of DISC.

In response to the GATT panel ruling on DISC, the Tax Reform Act of 1986 (TRA86, P.L. 99-514) enacted a provision allowing for the creation of Interest Charge Domestic International Sales Corporations (IC-DISC) and Foreign Sales Corporations (FSC). A FSC was similar to a DISC in that exporters were required to establish a specially qualified subsidiary corporation to which they sold their products. Unlike DISC, FSC was designed to provide a GATT-compliant export benefit by classifying FSC income as foreign-source income not connected with U.S. trade or business, effectively exempting it from U.S. income tax. Although FSCs were foreign-chartered corporations, they were allowed a 100 percent dividends-received deduction, as well as having their income exempted from Subpart F's anti-deferral rules.

In early 2000, the WTO Appellate Body confirmed an earlier ruling that FSC were a prohibited export subsidy. As a result, the FSC provision was repealed and a provision excluding extraterritorial income (ETI) was included in the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (P.L. 106-519). The ETI provision provided U.S. exporters with a similar tax benefit offered by FSC, while no longer imposing the FSC foreign management requirement. The benefit, however, was based on "extraterritorial income," and therefore not based solely on exports, which some argued would make the ETI provision WTO compliant.

Amid complaints from the European Union and another finding that the ETI provision violated WTO rules, the ETI provision was repealed by the American Jobs Creation Act of 2004 (P.L. 108-357). A year earlier, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27) had cut taxes on dividend and capital gains, re-establishing the attractiveness of IC-DISC, which had been introduced nearly two decades earlier.

Assessment

IC-DISC is a tax incentive that is intended to increase U.S. exports and discourage U.S. corporations from establishing subsidiaries in foreign countries. Proponents argue that IC-DISC stimulates exports and job creation. Economic theory suggests a less optimistic view. With flexible exchange rates, an increase in U.S. exports resulting from IC-DISC likely causes an appreciation of the U.S. dollar relative to foreign currencies. In response, U.S. citizens could be expected to increase their consumption of imported goods, possibly at the expense of domestically produced substitutes. As a result, no improvement in the balance of trade occurs and domestic employment could decrease.

Economic theory also highlights the inefficiencies that IC-DISC may introduce into the allocation of productive economic resources within the U.S. economy, as only domestic exporters may benefit from the subsidy. Additionally, because the tax benefit is related to the production of exported goods and services, domestic consumers receive no direct consumption benefit. Foreign consumers, on the other hand, benefit from lower-priced goods.

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International Affairs

TONNAGE TAX

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.1	0.1
2021	—	0.1	0.1
2022	—	0.1	0.1
2023	—	0.1	0.1
2024	—	0.1	0.1

Authorization

Sections 1352-1359.

Description

Domestic corporations in the United States are subject to tax on their worldwide income. To limit double taxation, U.S. firms with foreign-source income are allowed a credit against U.S. tax for foreign-paid taxes. The United States only taxes foreign corporate income sufficiently connected to a trade or business in the United States. Such foreign corporate income is subject to the same tax as domestic corporate income.

Corporations involved in shipping trade and business operations may, as an alternative to the conventional corporate income tax, elect to pay the “tonnage tax.” The tonnage tax is a tax on a notional shipping income (rather than on corporate income); the tax rate is equal to the corporate income tax rate, which is currently 21 percent. Notional shipping income is calculated as daily notional shipping income multiplied by the number of days a vessel operates in U.S. foreign trade. Daily notional income is \$0.40 per 100 tons of a ship’s weight up to 25,000 net tons, and then \$0.20 per 100 tons in excess of 25,000 net tons. Corporations electing to pay the tonnage tax are not allowed deductions against notional shipping income, and cannot claim credits against tonnage taxes paid.

Impact

For corporations electing to pay the tonnage tax, the expected tax burden is smaller than under the conventional corporate income tax. The expected tax burden is reduced because taxes are no longer directly tied to profitability, but rather to a ship's fixed tonnage. Thus, as profitability increases, taxes remain constant.

While the expected tax burden is reduced under the tonnage tax, the actual tax burden may not be. Corporations that suffer losses or that are less profitable than expected may end up paying a tonnage tax that is higher than they would have under the corporate income tax. Again, this is because the tonnage tax is not directly related to profitability.

The direct benefit of a higher after-tax return to investment accrues to the owners and shareholders of domestic shipping operators involved in U.S. foreign trade. Owners and shareholders also benefit from increased certainty and clarity with respect to a company's future tax liabilities. U.S. consumers also benefit indirectly in the form of lower-priced traded goods. The estimated revenue losses reported in the table above indicate a relatively small budgetary impact from this provision.

Finally, because notional shipping income per ton decreases above the 25,000 net ton threshold, the tonnage tax is more beneficial to larger vessels.

Rationale

Enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357), the tonnage tax was intended to provide relief to U.S.-based shipping operators competing with foreign shipping operators registered in countries with tonnage tax regimes. Examples of other countries offering a tonnage-based corporate tax include: Belgium, China, Greece, India, Ireland, and the United Kingdom. Proponents of the provision believed U.S. shippers to be at a disadvantage without a comparable tax subsidy. Aside from several small technical changes made by the Gulf Opportunity Zone Act of 2005 (P.L. 109-135), the tonnage tax as enacted remains unchanged.

Assessment

The tonnage tax is intended to assist U.S.-based shipping operators by reducing the effective U.S. corporate tax to that found in other countries. By reducing the effective tax rate, economic theory predicts a positive effect on

the number of vessels that register within the United States. In addition, any investment in new vessels that occurs would be expected to also increase the number of U.S.-registered ships.

With respect to the tonnage tax's effect on employment, Section 8103 of Title 46, U.S. Code (pertaining to manning requirements) generally requires the officers of U.S.-registered ships and most other crew members to be U.S. citizens. Therefore, any increase in the number of U.S. registered vessels resulting from the tonnage tax could have a positive effect on employment among corporations involved in shipping trade and business. The net effect on aggregate employment within the U.S. economy, however, will be determined by the amount to which the increase in shipping trade and business employment represents new job creation.

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General Science, Space, and Technology

**EXPENSING OF RESEARCH AND
EXPERIMENTAL EXPENDITURES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	2.8	2.9
2021	(¹)	2.1	2.1
2022	(¹)	0.9	0.9
2023	—	—	—
2024	—	—	—

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 174 and 59(e).

Description

In general, under the federal tax code, the cost of a depreciable capital asset with a useful life longer than one year (e.g., a machine tool or computer) must be capitalized and recovered through taking depreciation deductions over the useful life of the asset (as specified in the federal tax code), or selling it.

There have been several exceptions to this general rule. One exception was section 174 of the Internal Revenue Code (IRC), which offered businesses investing in qualified domestic and foreign research three options for recovering the cost in pre-2022 tax years:

1. Deduct the full amount of qualified research expenditures (QREs) in the year when they were paid or incurred, an option known as expensing;
2. Treat the expenditures as a capital expense and amortize them over 60 or more months, beginning with the month when benefits from the expenditures were first realized; or

3. Amortize (or recover in equal annual amounts) the expenditures over 10 years, beginning with the tax year when the expenditures were paid or incurred.

Regardless of which option a taxpayer elected, the deductions had to be reasonable in amount, as determined by the Internal Revenue Service (IRS).

Treasury regulations define QREs as “research and development costs in the experimental or laboratory sense.” These include costs related to “the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of existing property.” QREs also had to stem from activities intended to discover information that reduces or eliminates uncertainty in the development or improvement of a process or product. Some software development expenses were deductible even if they did not meet the requirements of section 174 so long as treated in a uniform manner, according to a 2000 IRS ruling (Revenue Procedure 2000-50).

If a taxpayer did not recover the cost of QREs through one of the three options, then the expenses had to be capitalized. If any assets produced as a result of the expenditures have no determinable useful life, then the expenditures cannot be recovered through depreciation. In this case, the company incurring the research expenses can elect to abandon or sell the assets.

For tax years beginning in 2022, section 174 QREs must be amortized ratably over five years for domestic research and over 15 years in the case of foreign research. The other two options for cost recovery (including expensing) are no longer available. Software development expenses are also subject to 5- and 15-year amortization. This marks the first time since 1954 that companies are not allowed to expense their QREs.

How a business is organized for tax purposes also affected the tax treatment of its research expenditures under prior law. Subchapter C corporations were allowed to deduct eligible research expenditures under IRC section 174(a) against the regular tax. (They could also deduct such expenditures from the alternative minimum tax (AMT) for corporations, but Congress repealed this tax as of January 1, 2018.) Businesses organized as a pass-through entity (e.g., partnership, sole proprietorship, or S corporation) also could deduct the full amount of QREs incurred in a tax year under IRC section 174(a) against the regular income tax, but they were allowed to do so

against the individual AMT only if the owners “materially” (or directly) participated in qualified research activities. Without such participation, the expenses had to be amortized over 10 years under the individual AMT. In the 2020 and 2021 tax years, an election to expense research expenditures under section 174 had to be made separately by each partner in a partnership, or by each shareholder in an S corporation, according to the partner’s or the shareholder’s allocable share of those expenditures.

Not all of the costs associated with research projects could be expensed under section 174. Expenditures for the acquisition or improvement of land and for depreciable tangible property used in connection with research did not qualify. As a result, the cost of structures and equipment used in R&D was recovered over 15 years and 3 years, respectively, using the appropriate depreciation schedules in IRC section 167.

To prevent businesses from receiving a double tax benefit from the same QREs, a corporation that claims the section 174 deduction and the section 41 research tax credit is required to either, under section 41, reduce the deduction by the amount of the credit, or, under IRC section 280C, claim a credit that is 21 percent smaller than the maximum credit it could take in tax years beginning in 2018. There is considerable overlap between the expenditures that qualify for the section 174 deduction and those that qualify for the section 41 credit.

The remaining basis of retired, abandoned, or sold property developed through qualified research cannot be recovered in the year when the property is abandoned, sold, or retired. Instead, the adjusted basis must continue to be amortized until the amortization period ends.

Impact

The expensing of R&D costs under IRC section 174 effectively deferred taxes on the returns to R&D investments. Such a deferral yielded tax savings for eligible businesses, reflecting the time value of money. To illustrate this point, suppose a corporation, whose profits under current law are taxed at a marginal rate of 21 percent, spends \$1 million in the current tax year on wages and supplies for research that qualifies for the section 174 deduction. This expenditure would decrease the firm’s tax liability that year by \$210,000 ($0.21 \times \1 million in deductible expenses). The net tax benefit to the corporation would be equal to the amount by which the \$210,000 in current-year tax

savings exceeds the present value of the tax savings that would arise from deducting the same \$1 million in R&D costs over a 5-year amortization period.

Expensing is the most accelerated form of depreciation. In essence, it equalizes the after-tax and pre-tax rates of return for an investment, which has the effect of taxing the returns to an asset at a marginal effective rate of zero.

The main beneficiaries of the IRC section 174 expensing were larger manufacturing corporations engaged in developing, producing, and selling technologically advanced products, such as electronic equipment, transportation equipment, and new prescription drugs. They tend to invest more in R&D as a percentage of gross revenues than most other firms.

IRC section 174 expensing was considered a tax expenditure because it allowed owners of assets created through R&D investments to treat them for tax purposes as though the assets exhausted their economic value during the year when they were placed in service. Since these assets tended to be new technologies with useful lives extending beyond one year, the expensing allowance led to forgone tax revenue in the short run that may or may not have been recouped in the long run.

Rationale

IRC section 174 was enacted as part of a major revision of the Internal Revenue Code in 1954 (P.L. 83-591). The legislative history of the revision indicates that Congress was pursuing two objectives in adding IRC section 174 to the federal tax code. One was to encourage firms (especially smaller ones) to invest more in R&D than they otherwise would by reducing the marginal effective tax rate on the returns to such investment and boosting the firms' cash flow. The second objective was to decrease the delays, uncertainties, and litigation experienced by businesses seeking to write off their research expenditures under previous tax law and regulations.

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) modified the individual AMT to allow individuals to amortize research, mining exploration and development, and magazine circulation expenses over 10 years in computing their alternative minimum taxable income. Taxpayers who elected this option were not required to treat their research expenditures as an AMT preference item.

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) subjected the requirement that deductions of research expenditures must be

reasonable in amount to the same standard for reasonableness that applied to salaries and other compensation under IRC section 162(a)(1). Congress wanted to make it more difficult for taxpayers to re-classify dividends, gifts, loans, and similar payments as IRC section 174 QREs.

In July 2014, the IRS issued final regulations (T.D. 9680) to clarify the tax treatment of amounts paid or incurred in connection with the development of tangible property, including pilot models. Under the regulations, expenditures that qualified for IRC section 174(a) expensing could be deducted regardless of whether any resulting technology is ultimately sold by the taxpayer or used in its business. T.D. 9680 also modified the definition of a pilot model to apply to any representation of a product intended to evaluate and resolve uncertainties about the product during its development or improvement. The final regulations also clarified the general rule that costs incurred in developing a new technology after all uncertainty has been resolved were ineligible for IRC section 174 expensing, without explaining the meaning of uncertainty in this context.

Under the revision of the federal tax code enacted in 2017 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act), the option to deduct QREs in full in the year when they are paid or incurred ended in 2022. Beginning that year, qualified expenses from domestic research must be capitalized and amortized over five years, and the amortization period for qualified expenses from foreign research is 15 years.

Assessment

Section IRC section 174(a) expensing had several benefits for companies investing in qualified research. It simplified tax compliance and tax accounting for businesses by minimizing the recordkeeping needed to identify and track QREs, link them to specific sources of revenue, and determine the useful lives of assets developed through those expenditures.

In addition, the provision may have spurred more business R&D investment than otherwise would occur by lowering the cost of capital for this purpose and increasing the cash flow of firms investing in R&D.

The expensing allowance's stimulus for R&D investment addressed the concern of some that firms in general invest too little in R&D, relative to its overall economic benefits, when left to their own devices. This propensity seems to reflect the inability of companies to capture all the returns on their R&D investments, even in the presence of intellectual property laws. A variety

of economic studies have concluded that the social returns to R&D typically exceed the private returns by factors of two to four.

Although there may be a cogent economic rationale for subsidizing business R&D investments, it is not clear from available evidence that a tax preference like IRC section 174 expensing was an optimal way to do so. A potential drawback to QRE expensing is that it did not target the R&D investments (e.g., basic and applied research) likely to produce social returns far above their private returns.

The shift from expensing to five-year amortization in 2022 for eligible research expenses has its critics. Some are concerned it will lead some companies to move their research activities from the United States to countries that provide more liberal tax treatment for research expenditures. Others argue that many small and medium-size companies could respond to the loss of QRE expensing by reducing their domestic R&D investments. The Tax Foundation has estimated that the reinstatement of QRE expensing would increase gross domestic product by 0.15%, the domestic wage rate by 0.12%, and the domestic capital stock by 0.26%, over 10 years. A number of bills have been introduced in the 116th and 117th Congresses to reinstate IRC section 174 expensing.

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TAX CREDIT FOR INCREASING RESEARCH ACTIVITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.4	13.0	14.4
2021	1.5	13.2	14.7
2022	1.6	14.0	15.6
2023	1.7	15.5	17.2
2024	1.9	17.3	19.2

Authorization

Section 41.

Description

Section 41 of the Internal Revenue Code (IRC) allows companies to claim a non-refundable tax credit for qualified research expenditures (QREs) paid or incurred in connection with their trade or business. In the case of start-up firms, QREs related to possible future lines of business are eligible for the credit. Though often thought of as a single credit, the research credit is actually composed of four discrete credits: an incremental regular credit, an alternative simplified incremental credit (ASC), an incremental credit for contract university basic research, and a flat credit for contract energy research. Taxpayers may claim either the incremental regular credit or the ASC, and either or both of the other credits. The section 41 credit may be claimed against both the regular income tax and the individual alternative minimum tax (AMT). The 2017 tax revision (P.L. 115-97) repealed the corporate AMT for tax years beginning in 2018.

The credit was extended permanently in 2015, after having been a temporary provision since its inception in July 1981.

The regular credit is equal to 20 percent of a company’s current-year QREs above a base amount. The base amount depends on several

considerations. One consideration is whether a company qualifies as an established firm or a startup firm under the rules for the credit. An established firm is one that had both taxable income and QREs in three of the four years between 1984 and 1988, while a startup firm is one whose first year with taxable income and QREs occurred after 1983. The base amount for an established firm is the product of its “fixed-base percentage” (FBP) and its average annual gross receipts in the past four tax years. The FBP is the ratio of a company’s cumulative research expenditures to its cumulative gross receipts in its base period, expressed as a percentage; a company’s FBP cannot exceed 16 percent. Startup firms are assigned an FBP of 3 percent during their first five years with gross receipts and QREs. Over the next five tax years, a startup firm’s FBPs gradually adjusts according to a formula specified in IRC section 41(c)(3)(B)(ii). By the firm’s 11th tax year, its FBP is the ratio of its total QREs to total gross receipts in five of the previous six tax years chosen by the firm. For the regular credit, a company’s base amount must equal 50 percent or more of its current-year QREs.

Companies have the option of claiming the ASC rather than the regular credit. The ASC is equal to 14 percent of QREs above 50 percent of a company’s average annual QREs in the previous three tax years. If a company has no QREs in one or more of those years, it may claim an ASC equal to 6 percent of its current-year QREs. Companies using the ASC cannot switch to the regular credit without the permission of the Internal Revenue Service (IRS).

A company’s payments for basic research conducted under a written contract by universities and certain non-profit scientific research organizations are eligible for a basic research tax credit under IRC section 41(e). The credit is equal to 20 percent of those payments above a company’s “qualified organization base period amount (QOBPA).” The base period is 1981 to 1983, or the three years preceding a firm’s first tax year if it began to operate after 1983. A company’s QOBPA is equal to the sum of its “basic research amount” and its “maintenance-of-effort amount.” The former is the greater of (1) the amount of basic research payments treated as contract research during the company’s base period, or (2) one percent of its combined in-house and contract research spending in that period. The latter is equal to a company’s average annual “non-designated” university contributions during its base period, adjusted for inflation, less the amount of the company’s non-designated university donations in the current tax year. If the company’s total current-year donations are less than its annual average donations during its

base period, the company's QOBPA increases by the amount of the difference. If the company's contract research spending exceeds its QOBPA, the company may not take the excess into account when computing its regular credit or ASC, but expenditures below that amount may be used to compute either credit.

The fourth component of the section 41 research credit is a 20-percent credit for the entire amount of a firm's payments for contract research performed by energy research consortia under IRC section 41(a)(3). The research must be related to a taxpayer's trade or business. A company claiming this credit does not have to prove to the IRS that a consortium is engaged in qualified research, or that the consortium paid or incurred QREs in conducting it. Amounts used to compute the energy research credit may not be used to claim the regular credit, ASC, or university basic research credit. However, if a payment does not qualify for the energy research credit, it may be treated as a contract research payment for the regular credit or the ASC, if it qualifies.

The definition of qualified research has been a subject of at times contentious debate since the credit became available in July 1981. As it now stands, research must satisfy each of the following criteria in order to qualify for the credit:

- It must involve activities whose costs can be recovered under IRC section 174, which is to say that the research must be "experimental" in the laboratory sense;
- It must be done for the purpose of discovering information that is "technological in nature" and useful in the development of a new or improved product, process, computer software technique, formula, or invention that is to be sold, leased, licensed, or used by the firm financing the research; and
- It must entail a process of experimentation whose goal is the development of a product or process with a "new or improved function, performance, or reliability or quality."

Another key consideration in claiming the credit is the definition of QREs. The credit applies to some of the expenses a company may incur in conducting qualified research. Specifically, the regular research credit and the ASC apply to the following expenses only:

- Wages and salaries of employees (including immediate supervisors) directly involved in performing the research;
- Materials and supplies used in performing in-house qualified research;
- Time-sharing for computers used in research; and
- 65 percent of any amounts paid for qualified research conducted by an eligible organization under a written contract, 75 percent of payments for qualified research done by not-for-profit scientific research consortia, and 100 percent of the amount paid for qualified research performed by eligible small firms, certain universities, and federal laboratories.

According to figures published by the IRS, in 2014, qualified wages accounted for 70 percent of QREs, while contract research and materials and supplies each accounted for 15 percent. More recent figures are unavailable.

Expenditures for equipment and structures, fringe benefits for employees directly engaged in research, and overhead costs related to research activities (e.g., rent, utility costs, leasing fees, administrative and insurance costs, and property taxes) do not qualify for the regular credit or the ASC. On average, according to one study, spending on equipment and structures represents about 30 percent of the total direct cost of business R&D investments.

The regular credit and the ASC cannot be claimed for costs related to:

- Research done after the start of commercial production of a new or improved product;
- Research aimed at adapting existing products to a specific customer's needs;
- Research intended to duplicate existing products;
- Surveys and routine testing;
- Research to modify standardized computer software for a company's internal use;
- Foreign research and qualified research funded by others; and
- Research in the social sciences, arts, or humanities.

For tax years beginning after December 31, 2021, IRC section 280C(c)(1) requires that if the amount of the research credit a firm claims exceeds its deduction for amortized research expenditures under IRC section 174, the deduction must be reduced by the amount of the excess. Alternatively, IRC section 280C(c)(2) allows a business to claim a credit equal to the amount of the credit less that amount multiplied by the firm's statutory tax rate. For instance, instead of making the Section 280C(c)(1) adjustment, a C corporation could claim a reduced credit equal to 79 percent of its actual credit: $\text{Reduced credit} = \text{Total credit (TC)} - (\text{TC} \times 0.21)$). This provision is intended to keep companies from deriving two tax benefits from the same expenditures.

Owners of partnerships or subchapter S corporations that claim the credit may use their allocable share of the credit to offset any tax on their share of business income only.

The research credit is a component of the general business credit (GBC) under IRC section 38, and thus subject to the limitations on the GBC's use. The amount of the GBC a company may take in a tax year is limited to the excess (if any) of its net income tax over the greater of its tentative minimum tax for the year or 25 percent of the company's net regular tax liability above \$25,000. A taxpayer's net income tax is the sum of its regular tax liability and alternative minimum tax liability, less any non-refundable personal tax credits the taxpayer may take. A taxpayer's net regular tax liability is its regular tax liability reduced by the same credits. For tax years beginning after 2017, a company's corporate tentative minimum tax is treated as \$0. For tax years beginning before 2018, a company could not claim the GBC in a tax year when it had to pay the AMT because its tentative minimum tax always exceeded its net income tax. Even when a company paid the regular income tax, the GBC it claimed could not be larger than the amount by which its regular tax liability exceeded its tentative minimum tax liability. Any GBC that cannot be used in the current tax year may be carried forward 20 tax years or back one year. Companies that cannot use their accumulated GBCs after 20 years may deduct the full amount of unused credits in the following tax year.

Certain pass-through business owners can use the research tax credit to offset their AMT liability for tax years starting in 2016 and thereafter. Specifically, owners of S corporations, partnerships, and sole proprietorships whose average annual gross receipts in the past three tax years are \$50 million or less are allowed to use the full amount of their research tax credits to reduce or offset any individual AMT liability. The section 38 limitation on using the GBC still applies.

Since 2016, eligible small businesses have also had the option of applying up to \$250,000 of any research tax credit they may take against the employer share of Social Security payroll tax. To qualify for this treatment, a business must have gross receipts in the current tax year of \$5 million or less and no gross receipts in any tax year preceding the previous five tax years. For a qualified taxpayer electing this treatment for 2022, it must have had \$0 gross receipts or less in 2017 and earlier years. Starting in 2023, firms meeting the same eligibility criteria will have the option of applying up to \$250,000 in an unused research tax credit against the employer share of the Medicare Part A payroll tax. The two options combined mean that for an eligible small firm, as much as \$500,000 of any credit it can claim is effectively refundable.

In addition, the research tax credit is the only business credit that may be used in full against any Base Erosion Anti-Abuse tax (BEAT) an eligible corporation with foreign parents may owe in 2018 and thereafter. The tax is equal to 10 percent of the sum of taxable income and base-erosion payments by corporations with average annual gross receipts of \$500 million or above in the three previous tax years and with deductions for foreign payments exceeding 3 percent of their total deductions. The tax rate is 5 percent for 2018 to 2025, and 12.5 percent for tax years in 2026 and thereafter. Only firms with large base erosion payments relative to their taxable income are likely to pay the BEAT.

Impact

Two of the four components of the section 41 research tax credit have a broad influence over the investment behavior of companies: the regular credit and the ASC. Both credits lower the after-tax cost of performing qualified research above an amount intended to approximate how much a firm would spend on such research in the absence of the credit. While the statutory rates for the regular credit and ASC are 20 percent and 14 percent, respectively, their marginal effective rates (MER) are considerably lower because of certain rules governing the use of the two credits. Unless otherwise noted, the rules apply with equal force to the regular credit and the ASC.

One such rule applies to tax years starting after December 31, 2021. IRC section 280C(c)(1) requires that if the research tax credit exceeds the amount a company may deduct as an amortized expense under section 174, the deduction must be reduced by the amount of the excess. Alternatively, a reduced research credit may be claimed under Section 280C(c)(2); it is equal to a firm's total credit minus the product of the total credit and the firm's

statutory tax rate. For C corporations, which account for over 98 percent of the total amount of claims for the research tax credit and are taxed at a single rate of 21 percent, the IRC 280C(c)(2) adjustment lowers the credit's MER for an additional dollar of QRE above the base amount to 15.8 percent for the regular credit ($[0.20 \times (1-0.21)]$) and 11.1 percent for the ASC ($[0.14 \times (1-0.21)]$).

The ASC's MER is further reduced by a factor that does not affect the calculation of the regular credit. Since the ASC is determined on the basis of previous research expenses, each additional dollar of R&D investment in the current tax year raises the base amount in each of the three succeeding years by \$0.50 divided by 3, or \$0.17. Such a design lowers the MER for the ASC by a factor equal to the sum of $1/(1+R)$, $1/(1+R)^2$, and $1/(1+R)^3$, where R is the discount rate.

As noted above, a firm's base amount for the regular credit cannot be less than 50 percent of its current-year QREs. As a result, the MER for the regular credit drops to 7.9 percent for current-year QREs larger than 200 percent of the base amount. For example, if a company has a base amount of \$50 million in the current tax year and \$150 million in QREs, the regular credit it could claim would be equal to 20 percent of \$75 million, not 20 percent of \$100 million because of the 50-percent rule. In this case, \$25 million (or half of the company's current-year spending on qualified research over \$100 million) is added to the base amount and thus not subject to the credit. The base amount for the ASC is effectively subject to a 50-percent rule because it is equal to half of a firm's QREs in the three previous tax years.

Another rule affecting the size of the regular credit and ASC concerns expenditures that qualify for the credit. As noted earlier, business R&D investments often include expenses that do not qualify for the credit, such as purchases of structures and equipment and overhead expenses. Consequently, it can be argued that the credits' MER is reduced further when structures and equipment constitute a significant share of the overall cost of a qualified research project. For example, if structures and equipment account for half of that cost, then only 50 percent of the cost would qualify for the credit. As a result, the MER for the two credits would be half of what it would be for QREs above a company's base amount if the total cost consisted of QREs only, all other things being equal.

The regular credit and ASC do not benefit all firms undertaking qualified research equally. The ratio of a company's research expenditures to its gross income is a measure of its research intensity. In the case of companies that

invest less in R&D as a share of revenue today than they did during their base period, the regular credit is of no benefit. Such a decline in research intensity can result from faster growth in a company's revenue than its R&D spending since its base period and decreases in a company's R&D spending, while its revenue stays the same or increases.

Most of the benefits of the section 41 credit go to large C corporations in manufacturing. In 2014 (the most recent data year), these firms accounted for 59 percent of the total amount of claims for the credit. In 2013 (the most recent data year), C corporations with \$250 million or more in business receipts accounted for 85 percent of total amount of claims for the credit; claims for the ASC accounted for 64 percent of claims for the credit.

Rationale

Congress permanently extended the section 41 research tax credit at the end of 2015, ending 34 years of uncertainty over its availability. Since its inception in July 1981, the credit was extended 15 times and significantly modified five times.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) created the section 41 credit. Its initial rate was 25 percent, there was no basis adjustment, and the base amount was equal to a company's average annual research expenditures in the previous three tax years. Such a design was intended to give U.S.-based firms a robust incentive to invest more in domestic R&D than they otherwise would by offsetting some of the key costs associated with initiating or expanding R&D projects.

The original credit was set to expire at the end of 1985. Congress made the credit temporary so it could evaluate its effectiveness before deciding whether or not to extend and modify it. No such study was done. Instead, Congress extended the credit through 1988, at a reduced rate of 20 percent, in the Tax Reform Act of 1986 (P.L. 99-514).

The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) extended the credit for another year and a half and added a basis adjustment equal to 50 percent of the amount of the credit.

Additional changes were made to the credit by the Omnibus Reconciliation Act of 1989 (P.L. 101-239). The act extended the credit through 1990, allowed the base amount to increase according to rises in gross receipts rather than research expenditures, expanded the scope of the credit so that it

applied to research aimed at investigating future lines of business, and raised the basis adjustment to the full value of the credit.

The Omnibus Reconciliation Act of 1990 (P.L. 101-508) extended the credit through the end of 1991, and the Tax Extension Act of 1991 further extended it through June 1992. After the credit expired and remained unavailable for nearly a year, the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) retroactively extended it to June 30, 1995.

The credit expired on July 1, 1995, and Congress did not extend it until it passed the Small Business Job Production Act of 1996 (P.L. 104-188), which extended it from July 1, 1996 through May 31, 1997. This left a one-year gap (July 1, 1995 to June 30, 1996) in coverage that still exists. The act also established a three-tiered alternative incremental credit (AIRC) and allowed 75 percent of business payments to non-profit research consortia to qualify for the credit.

The Taxpayer Relief Act of 1997 (P.L. 105-34) further extended the credit through June 1998, and the omnibus budget bill passed in 1998 (P.L. 105-277) reset the expiration date for the credit to June 30, 1999. After expiring yet again, the credit was extended to June 30, 2004 by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170). In October 2004, President George W. Bush signed into law a tax bill (the Working Families Tax Relief Act of 2004, P.L. 108-311) that extended the credit to December 31, 2005.

Under the Tax Relief and Health Care Act of 2006 (P.L. 109-432), the credit was made available through 2007. The act also increased the AIRC rates for 2007 and created the ASC, with an initial rate of 12 percent.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the credit through 2009, increased the rate for the ASC to 14 percent, and suspended the AIRC for 2009.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the credit through 2011 and repealed the AIRC.

The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the credit through 2013, modified the rules regarding allocation of the credits among members of controlled groups and companies, and clarified the use of the credit by firms involved in acquisitions.

Under the Tax Increase Prevention Act of 2014 (P.L. 113-295), the credit was available through 2014.

Congress made three significant changes in the credit in the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113). First, the act permanently extended the credit, starting with the 2015. Second, it gave eligible small businesses the option of applying up to \$250,000 of unused research tax credits against the employer share of the Social Security payroll tax, starting in 2016. Third, the act allowed eligible pass-through businesses subject to the AMT to apply the full amount of any section 41 credit they claim against AMT liability.

Congress expanded the options available to eligible small firms to use at least part of their current-year section 41 credit even if they have insufficient income tax liability in P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022. Starting in 2023, such firms will be able to apply up to \$250,000 in unused research tax credits against the employer share of the Medicare Part A payroll tax.

Assessment

The economic rationale for the credit lies in a market failure associated with private investment in the discovery of new technical and scientific knowledge and its use in the development of new technologies with commercial applications. This knowledge can give rise to economic benefits that the entities undertaking the research cannot fully capture. These benefits can be considerable: several studies have estimated that the public or social returns to R&D investments are two to four times greater than the private returns. Such a discrepancy represents the spillover effects (or positive externalities) from investing in R&D. They constitute a market failure because the inability to capture them prevents the private sector from investing in R&D in socially optimal amounts.

To address such a failure, governments worldwide provide financial support for private-sector R&D, in an attempt to stimulate increased R&D investment. Among other things, the U.S. government offered the option to deduct eligible QREs as a current expense under section 174 from 1954 to 2021 and an incremental credit for increased QREs under section 41.

Since its enactment in 1981, the research tax credit has provided over \$1 billion a year in subsidies for business R&D investment; in 2014 (the most recent data year), corporations claimed a total of \$12.6 billion in research tax

credits. (The actual amount they ultimately received is not known because the results of IRS audits of these claims for the credit and legal challenges to those audits can take considerable time to resolve, and the final results are not publicly disclosed.)

The credit tries to boost R&D investment by lowering the user cost of capital for this purpose and increasing a company's cash flow, relative to other investments it might make. In theory, by lowering the cost of undertaking another unit of R&D, the credit allows companies to internalize the spillover benefits of their investments, encouraging them to invest more than they otherwise would.

There have been numerous studies of the credit's effectiveness in generating more R&D investment, and its cost-effectiveness relative to alternative policies for boosting private R&D investment, such as government research grants or patent boxes. A key measure of efficacy in this case is the additional research induced by \$1 of the credit.

In essence, the credit's effectiveness depends on two considerations: (1) the sensitivity (or responsiveness) of business R&D investment to a reduction in its after-tax cost, and (2) the credit's marginal effective rate. Multiplying one by the other indicates the extent to which \$1 of the credit reduces the after-tax cost of undertaking another \$1 of qualified research.

Economists measure the sensitivity of business R&D investment by the tax price elasticity of R&D investments. This elasticity indicates the extent to which business R&D investment changes in response to a change in its tax price. If the tax price elasticity were 1.0, then a 10-percent decline or rise in that price could be expected to trigger a 10-percent rise or fall in R&D investment, all other things being equal. There is considerable uncertainty about the actual tax-price elasticity for R&D investments and whether it changes systematically over time. Studies of the section 41 research credit's economic effects have suggested that the short-run elasticity falls in the range of 0.2 to 1.6, but none of these estimates is based on actual firm-level claims for the credit.

The credit's MER measures the extent to which it reduces the after-tax cost of undertaking qualified research. This rate is determined by applying the rules for the credit to its statutory rate. As noted earlier, one rule requires that the deduction for amortized research expenditures under section 174 be reduced by the amount of any credit claimed. This lowers the MER for the

regular credit by an amount equal to the product of its 20-percent statutory rate and a company's marginal tax rate; for a corporation, whose income is taxed at a rate of 21 percent, the MER drops to 15.8 percent: $[(.20 \times (1 - 0.21)) \times 100]$.

Another rule requires that a company's base amount for the regular credit equal 50 percent or more of its current-year QREs. For a corporation with QREs more than double the base amount, the MER drops to 7.9 percent: $[(0.50 \times .13) \times 100]$.

Many R&D investments involve the acquisition of structures and equipment. Companies making such investments include the cost of those inputs in their estimate of the cost of capital for the investments. There is some evidence that about 30 percent of domestic business R&D spending, on average, goes to expenditures for structures and equipment. Because the decision to invest in a research project presumably takes into consideration all relevant costs, it can be argued that the regular credit's MER should incorporate those cost exclusions. So for corporations subject to the 50-percent-base-amount rule, the cost exclusion rule reduces the MER to 5.5 percent: $[(0.70 \times .079) \times 100]$.

Among economists, the preferred method for determining the added business R&D investment stimulated by the credit is to apply the credit's weighted average MER to the tax price elasticity of demand for an additional unit of R&D. But such an approach is difficult to carry out since detailed data about claims for the credit are difficult to obtain. So they tend to take the next best approach, which is to use the credit's average effective rate (AER). This rate is the total amount of the credit claimed in a year divided by either total QREs or total U.S. business R&D spending in the same year. Based on total U.S. business R&D spending (as estimated by the National Science Foundation (NSF)), the credit's AER was 4.5 percent in 2014. This suggests that the credit lowered the after-tax cost of domestic business R&D investment (including R&D-related plant and equipment) that year by 4.5 percent, on the whole.

Assuming that the AER for the credit is 4.5 percent and the tax-price elasticity of demand for R&D lies between 0.5 and 1.5, the credit may be responsible for 2.25 percent to 6.75 percent of U.S. business R&D investment in recent years. In 2020, domestic business R&D spending totaled \$436.1 billion, according to the NSF; 4.5 percent of that amount is \$19.6 billion. The Joint Committee on Taxation put the revenue loss from the credit that year at \$14.4 billion. This implied that \$1 of the credit led to a \$1.36 increase in R&D

(including costs not covered by the credit) in 2020. Some studies have estimated that \$1 of the credit can be expected to lead to a \$1 increase in R&D investment, in the short run, but they are based on data on use of the credit from the late 1980s and early 1990s. It is possible that the short-run stimulus of the credit is stronger today.

The credit has its critics. Their main concern is that they think the credit is not as effective as it could or should be. They cite several reasons why this is so. One reason is the complex method for determining the base amount for the regular credit and lingering uncertainty over the definition and measurement of QREs for the regular credit and the ASC. Another reason is the recordkeeping required to verify claims for the credit during IRS audits. Both issues, according to critics, deter some companies from claiming the credit by making the cost of complying with the rules governing its use too high.

Critics say that two other issues diminish the credit's effectiveness. One is that the credit's MER is too low to boost business R&D investment to levels commensurate with its social benefits. The other issue is that the credit does too little to support the innovative activities of small start-up companies during critical stages in their development. In their view, more support is needed than the option to use unused credits to offset a portion of a start-up firm's share of its payroll tax liability. A better option would be to make the credit refundable for young firms under a certain size.

Some question whether the current credit is the best way to encourage increased investment in research that generates relatively high social returns. In their view, the credit is more likely to subsidize research that firms would undertake on their own than to stimulate increased private investment in basic or some applied research. They would modify the credit so that it provides a substantial subsidy for basic research and no subsidy or a reduced subsidy for applied research and development. Others argue that one way to simplify the credit and enhance its incentive effect, is to increase the statutory rate for the ASC to 20 or 25 percent and repeal the regular credit.

The 2017 tax revision commonly referred to as the Tax Cuts and Jobs Act (P.L. 115-97) did not modify the section 41 credit. But owing to certain changes the law made in the section 174, some are concerned that the law could have the unintended effect of lowering the tax incentive to invest in R&D. Starting in 2022, all section 174 QREs must be capitalized and amortized over five years; full expensing will no longer be possible. This

change may dampen the domestic climate for business R&D investment by raising the cost of capital and decreasing the cash flow for many projects eligible for the section 41 credit. There is interest among some in Congress in reinstating IRC section 174 QRE expensing; several bills to do so have been introduced in the 117th Congress.

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Energy

DEDUCTION OF EXPENDITURES ON ENERGY-EFFICIENT COMMERCIAL BUILDING PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(²)	(²)	(²)
2022	(²)	(²)	(²)
2023	(²)	(²)	(²)
2024	(²)	(²)	(²)

(¹) Positive tax expenditure of less than \$50 million.

(²) Negative tax expenditure of less than \$50 million.

This provision was permanently extended by P.L. 116-260 with the changes estimated to cost \$0.7 billion over FY2021 – FY2030. This provision was modified by P.L. 117-169 with the changes estimated to cost \$0.4 billion over FY2022 – FY2031.

Authorization

Section 179D.

Description

IRC section 179D provides a formula-based tax deduction for all or part of the cost of energy-efficient commercial building property (i.e., certain major energy-savings improvements made to domestic commercial buildings). Starting in 2023, this provision provides that to be able to claim a deduction a qualifying building must increase its efficiency relative to a reference building by 25 percent, reducing total annual energy and power costs of the building (with respect to interior lighting; heating, cooling, and ventilation; and hot water supply systems). The deduction is set at \$0.50 per square foot, and increased by \$0.02 for each percentage point by which the certified efficiency improvements reduce energy and power costs, with a maximum amount of

\$1.00 per square foot. For projects that meet prevailing wage and registered apprenticeship requirements, the base amount is \$2.50, and that amount is increased by \$0.10 for each percentage point increase in energy efficiency, with a maximum amount of \$5.00 per square foot. The maximum deduction amount is the total deduction a building can claim less deductions claimed with respect to the building in the preceding three years. The deduction amount is adjusted for inflation over time.

Effective in 2023, taxpayers making energy-efficiency retrofits that are part of a qualified retrofit plan on a building that is at least five years old are able to deduct their adjusted basis in the retrofit property (so long as that amount does not exceed a per-square foot value determined on the basis of energy usage intensity). To qualify, retrofit plans must be expected to reduce a building's energy use intensity by at least 25 percent.

Before 2023, the maximum cost of energy-efficient commercial building property that could be deducted in any tax year is limited to the product of \$1.80 and the square footage of the building, over deductions claimed for energy efficient commercial building property in any prior tax years (IRC section 179D(b)). In other words, the deduction is the lesser of: (1) the cost of the energy efficient commercial building property placed in service during the tax year; or (2) the product of \$1.80 and the square footage of the building, reduced by all deductions claimed with respect to the building in any prior tax years. The deduction could be claimed for energy-saving commercial building property installed as part of (1) the interior lighting system; (2) the heating, cooling, ventilation, or hot water system; or (3) the building envelope. Property could qualify if it was installed pursuant to a plan intended to reduce the total annual energy and power costs of the building (with respect to interior lighting, heating, cooling, ventilation and hot water supply systems) by 50 percent or more in comparison to a reference building that meets the minimum requirements of Standard 90.1-2007.

To qualify as “energy-efficient commercial building property,” costs must be associated with depreciable or amortizable property that is installed in a domestic building that is within the scope of Standard 90.1-2007 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (ASHRAE/IESNA). For buildings placed in service after 2020, the relevant standard is the most recent Standard 90.1, with the standards affirmed by the Treasury Secretary for this purpose not later than two years before the date that construction of such property began. Starting in 2023, the reference

standards are the most recent version of Standard 90.1 affirmed by the Department of Energy as of four years prior to the date of the building being placed in service. The basis or the depreciable cost of any property generating a deduction must be reduced by the amount deducted. Thus, depreciation may not be claimed on any amount that is deducted under the provision.

Before 2023, a limited deduction of up to 60¢ per square foot was available for improvements to one of the three energy-efficient commercial building property types described above, even if the overall 50 percent energy reduction standard is not satisfied. Energy savings percentage requirements for individual systems range from 10 percent to 25 percent, depending on the type of system being installed and the date of installation.

The taxpayer must receive a certificate with respect to the property before the deduction may be claimed. The required certification, which includes a statement that the applicable energy reduction requirement has been satisfied, must be provided by a professional engineer or contractor who is unrelated to the taxpayer and has represented in writing to the taxpayer that he or she has the qualifications necessary to provide the certification.

In the case of a federal, state, or local government building—in which case the owners of such buildings are tax-exempt entities and cannot therefore benefit from tax incentives—the person who designs the energy efficient commercial building property may claim the deduction. Starting in 2023, tax-exempt entities may transfer their deduction to the party responsible for designing the building or retrofit plan. Real estate investment trusts (REITs) may take deductions under Section 179D. Improvements to a residential rental building qualify for the deduction if the building has four or more stories above ground level.

Impact

In general, the types of commercial energy property that qualify for the deduction are part of a business's assets, and hence are depreciable in accordance with the guidelines established by law and regulation, which vary by type of business. Under current depreciation rules (the Modified Accelerated Cost Recovery System or MACRS), structures and structural components—such as heating/cooling systems and lighting—are depreciated over 39 years using the straight line method. Allowing a current deduction for energy efficient capital goods that would otherwise be depreciated over a long period of time—that is, allowing expensing of the costs of such property—

accelerates and increases the present value of the deductions. This reduces effective tax rates and would normally encourage investment. However, given the (1) long lead time for constructing commercial buildings, and (2) complexity of determining the deduction, there is some question of its effectiveness in inducing investment in qualifying property.

In recent years, there has been a decrease in commercial building's energy intensity. This has largely been driven by improvements in building operations, materials, and design, as well as heating, cooling, and lighting technologies. It is difficult to know how much of this may be attributable to tax incentives as opposed to other federal programs, such as more stringent performance standards or other forms of federal financial assistance (e.g., grants).

Rationale

This deduction was introduced by the Energy Policy Act of 2005 (P.L. 109-58) to encourage businesses to retrofit their commercial buildings with energy conserving components and equipment. The goal was to enhance the energy efficiency of commercial buildings. The Energy Tax Act of 1978 (P.L. 96-518) provided for a 10 percent investment tax credit for certain categories of property that conserved energy in industrial processes, which generally applied to the manufacturing and agricultural sectors. These types of property—there were actually 13 categories—were called specially defined energy property. However, none included property for conserving energy in commercial buildings. These credits generally expired at the end of 1982.

The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the deduction first enacted in 2005 by one year. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended it through December 31, 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the deduction for one year, through 2014. The deduction was extended for two years, through December 31, 2016, as part of the Consolidated Appropriations Act, 2016 (P.L. 114-113). Provisions in P.L. 114-113 also increased the efficiency standards for property placed in service after December 31, 2015. After 2015, qualifying buildings are determined relative to the ASHRAE/IESNA 90.1-2007 Standard (as opposed to the previously applicable 90.1-2001 Standard).

The provision was extended through December 31, 2017, as part of the Bipartisan Budget Act of 2018 (P.L. 115-123), and further extended through

2020 by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94).

The deduction was permanently extended in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260)). P.L. 116-260 also provided updated standards and an inflation adjustment for the deduction after 2020.

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022, modified the efficiency standards associated with the deduction, modified the deduction amount, provided a separate deduction for energy efficient building retrofit property, allowed tax-exempt entities to transfer the deduction to the entity responsible for designing the energy efficient property, and provided that REITs can claim the deduction. Providing a deduction intended for retrofits might address a past concern that the deduction did little to spur or support renovations of existing buildings and retrofits.

Assessment

Commercial buildings include a wide variety of building types—such as offices, hospitals, schools, factories, warehouses, hotels, and shopping malls. These different commercial activities all have unique energy needs but, as a whole, heating and lighting are generally the largest source of commercial buildings energy use.

The business profit maximizing (and cost minimizing) objective can promote an economically efficient level of investment in energy-saving capital when the rate of return on such investments is above the opportunity cost. From an economic perspective, allowing special tax benefits for certain types of investment or consumption can result in a misallocation of resources. There are, however, cases where the market outcome may result in an underinvestment in commercial building energy efficiency. Specifically, if consumption of energy results in negative effects on society, through the generation of carbon emissions or pollution, the deduction under IRC section 179D might be economically justified. In general, however, it would be more economically efficient to directly tax polluting energy fuels than to subsidize a particular method of achieving conservation.

Incentives designed to promote energy efficiency in the commercial building sector attempt to reduce capital market barriers to energy efficiency investments by reducing high up-front costs. If capital markets are functioning

efficiently and businesses have access to capital, and thus are able to make positive net present value investments, high up-front costs should not pose a barrier to energy efficiency investment. Technological uncertainty does increase the risk associated with certain energy efficiency investments, particularly in the case of unproven technologies.

The commercial sector may also under-invest in energy efficiency in cases where the person choosing the energy equipment for the building is not the same as the person paying the energy bills. In the case where building owners are not responsible for energy bills, building owners may install less efficient building components to minimize up-front capital costs, since the owner does not realize the energy savings directly. If, however, the building owner is able to recoup the higher installation costs associated with energy-efficient building components through higher rents, the market should determine the economically efficient level of investment in commercial building energy efficiency. Recent empirical evidence suggests that energy-efficient commercial buildings do command higher rents and sell at higher prices.

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Energy

DEPRECIATION RECOVERY PERIODS FOR ENERGY-SPECIFIC ITEMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	0.1	0.1
2021	(¹)	0.1	0.1
2022	(¹)	0.1	0.1
2023	(¹)	0.1	0.1
2024	(¹)	0.1	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 168(e).

Description

Through a series of laws passed between 1986 and 2008, several types of equipment were given favorable tax status related to their depreciation under the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, the cost of tangible depreciable property (capital goods) placed in service after 1986 is recovered (or “depreciated”) using (1) the applicable depreciation method; (2) the applicable recovery period; and (3) the applicable convention. Certain energy-related expenditures, including expenditures on renewable energy property, smart electric distribution and certain electric transmission property, and natural gas distribution lines, are allowed reduced depreciation recovery periods.

Most electric generating capacity is depreciated over 20 years. The recovery period for certain renewable energy equipment, including solar, wind, geothermal, fuel cell, combined heat and power (CHP), and microturbine property is 5 years. The costs of renewable energy generation property that is part of a “small electric power facility” and certain biomass property can also be recovered over 5 years. Costs of qualified smart meters

or qualified smart electric grid systems (which are essentially energy monitoring and management devices) can be recovered over 10 years. Certain electric transmission property originally placed in service after April 11, 2005, is MACRS property recovered over 15 years. A natural gas distribution line placed in service after April 11, 2005, and before January 1, 2011, also is MACRS 15-year property. Most of the loss in federal revenue due to the tax expenditure is due to the 15-year MACRS for natural gas distribution lines.

Both the 200-percent declining balance method and the straight-line method are used as the depreciation method under MACRS for specific energy property. The 200-percent declining balance method is used to determine the amount of depreciation qualified for deductions initially. In subsequent tax years, the straight-line method is used when it would yield a greater deduction for the taxpayer.

The applicable convention used for the energy property is the half-year convention, meaning that the taxpayer claims half of a year's depreciation for the first taxable year and subsequently claims the full year's deduction. This convention simplifies the depreciation calculation as the taxpayer does not have to prove when the property was placed in service.

As is discussed elsewhere in this compendium, businesses may also be eligible for an investment tax credit (ITC) for qualified investments in renewable energy property or a production tax credit (PTC) for electricity production using a renewable resource.

General provisions that allow for depreciation of equipment in excess of the alternative depreciation system (e.g., bonus depreciation) are also discussed elsewhere in this compendium. With full and immediate expensing (100 percent bonus depreciation) for equipment available through 2022, as added in the 2017 tax revision (P.L. 115-97), accelerated depreciation recovery periods for energy-related equipment do not provide any added incentive for investment.

Impact

The accelerated nature of MACRS allows firms to increase their deductions in the early years of an asset's life, which reduces taxable income in those years. The initial use of the declining balance method in MACRS allows firms to take advantage of the time value of money. Accelerated depreciation deductions may be especially helpful for certain energy industries, where there are substantial upfront costs associated with capital-

intensive activities. Deferring income taxes until later in an asset's life reduces the after-tax cost of investing in certain energy property, and may lead to additional investment in tax-favored assets.

Rationale

The Tax Reform Act of 1986 (P.L. 99-514) assigned a 5-year recovery period to solar, wind, geothermal and ocean thermal, and biomass property that is part of a small electric power facility. This assignment was part of a major depreciation revision, and no specific justification for this change was provided, although it was presumably to encourage investment in alternative energy sources that are less polluting than conventional fuels. The Energy Policy Act of 2005 (P.L. 109-58) reduced the recovery period for certain electric transmission property and natural gas distribution lines from 20 years to 15 years. The Energy Policy Act of 2005 also classified fuel cells, microturbines, and solar hybrid lighting systems as ITC-eligible property, thereby making such property 5-year property under MACRS. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) shortened the depreciation recovery period for smart electric meters and smart electric grid equipment from 20 years to 10 years, and made other changes that resulted in geothermal heat pumps, combined heat and power, and small wind being classified as 5-year property.

Assessment

Economic theory suggests that economic efficiency is maximized when capital investments are treated equally. Permanent investment subsidies, such as accelerated depreciation, may distort the allocation of capital in the long run, possibly reducing overall efficiency in the allocation of economic resources.

Some justifications may exist for providing tax expenditures for renewable energy producers to correct for existing market failures in the energy sector. Negative external costs associated with conventional fossil fuels, such as pollution, are not incorporated into the cost of production. If producers produce more electricity from polluting energy resources than is optimal, reduced prices can lead to over consumption of goods generated from fossil fuels. Subsidizing investment in renewable energy products allows those industries to better compete with the fossil fuel industry, and increases consumption of electricity from renewable sources. When the full costs of energy production and consumption are not realized, markets may also result

in too little investment in energy efficiency, thus providing a rationale for subsidizing energy efficiency technologies. Generally, economic efficiency is better enhanced by taxing energy sources that produce negative externalities, rather than subsidizing renewable alternatives.

Currently, full and immediate expensing (100 percent bonus depreciation) for equipment available through 2022 makes irrelevant any acceleration in cost recovery provided through special provisions for energy-related equipment.

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Energy

EXCEPTIONS FOR PUBLICLY TRADED PARTNERSHIPS WITH QUALIFIED INCOME DERIVED FROM CERTAIN ENERGY-RELATED ACTIVITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.3	—	0.3
2021	0.3	—	0.3
2022	0.3	—	0.3
2023	0.4	—	0.4
2024	0.4	—	0.4

Authorization

Section 7704.

Description

Under section 7704, firms that publicly trade their interests on financial markets are treated as corporations for tax purposes, and are therefore subject to both the corporate and individual income tax. Corporate shareholders also pay taxes on capital gains and dividends. Publicly traded partnerships (PTPs) trade their interests on financial markets, much like corporate stock, but are exempt from the corporate income tax provided that 90 percent of their income is considered qualifying passive-type income according to section 7704. Qualifying income sources include gains from interest, dividends, real property rents, disposition of real property, and mining and natural resource activities. Activities related to mining and natural resources include the exploration, development, mining or production, processing, refining, transportation, storage, and marketing of any depletable mineral or natural resource. Active income from qualifying natural resource-related activities is treated as qualifying income under section 7704. Qualifying income also includes income from the transportation and storage of certain renewable and alternative fuels, and activities involving industrial source carbon dioxide. The

tax expenditures in the table above are for certain energy-related PTPs. Most energy-related PTPs are in the oil and gas sector, although some PTPs are in the coal industry. Natural resource-related PTPs are discussed elsewhere in this compendium.

Impact

Firms that organize as PTPs receive a number of benefits, including increased access to capital and a lower tax burden. By publicly trading their interests, PTPs have greater access to capital and may be able to secure capital at a lower cost than other firms that organize differently. Access to capital has the potential to stimulate investment and growth in the energy sectors targeted within the definition of qualified income. The exemption from the corporate income tax also reduces a PTP's tax liability, which in turn can lead to increased profits and investment.

Rulings by the IRS, particularly in 2012 and 2013, spurred growth of firms organizing as PTPs. There were significant rulings supporting activities for hydraulic fracturing and the generation of real property rent. These decisions were perceived to have expanded which income streams could be considered as qualifying income under section 7704(d)(1)(E). Subsequent to these rulings, the number of PTPs increased. This growth was not sustained, and there was a sharp decline in the number of PTP initial public offerings (IPOs) by 2016.

The 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act, reduced the corporate tax rate from 35 percent to 21 percent. This change decreased the attractiveness of partnerships' tax attributes relative to corporations. Use of the master limited partnership (MLP) structure further declined following P.L. 115-97. There were no MLP IPOs in 2020 or 2021.

Rationale

The Revenue Act of 1987 (P.L. 100-203) established the general tax rules that classify PTPs as corporations, in part to address concerns about erosion of the corporate tax base through the use of partnerships. Congress's concern was that growth in PTPs signified that activities, which would otherwise be conducted by corporations and subject to both corporate and shareholder level taxation, were being done by PTPs purely for tax reasons.

The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) clarified the definition of qualified income to include income from the transportation of oil and gas and from depletable natural resources. Income from the marketing of oil and gas to retail customers was excluded from qualified income. The American Jobs Creation Act of 2004 (P.L. 108-357) made additional changes which made PTPs more attractive for mutual funds to invest in, and may have increased the pool of capital able to invest in PTPs. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) then further expanded the definition of qualified income to include income or gains from the transport or storage of certain renewable and alternative fuels and from certain activities related to industrial source carbon dioxide.

Assessment

Before the TCJA, pass-through business income generally faced lower tax rates than corporate income. Following the 2017 tax revision, it is less clear whether income in the corporate or non-corporate sector will face lower effective tax rates.

The fundamental issue, from a matter of tax policy, is whether some PTPs should be exempt from corporate level taxation, based upon the nature and type of their income. In general, Congress has enacted rules that limit the ability of untaxed entities to publicly trade their interests and/or restrict the entities' activities. Thus, the exemption of some PTPs from corporate level taxes may be seen as a departure from general congressional intent concerning pass-through entities. Others would argue that the industries targeted through the definition of qualified income have reason to be subsidized, and government policy should help spur investment and growth in the energy sector.

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Energy

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil & Gas	Other Fuels	Oil & Gas	Other Fuels	Oil & Gas	Other Fuels
2020	(¹)	(¹)	0.6	0.1	0.6	0.1
2021	(¹)	(¹)	0.6	0.1	0.6	0.1
2022	(¹)	(¹)	0.6	0.1	0.6	0.1
2023	(¹)	(¹)	0.6	0.1	0.6	0.1
2024	(¹)	(¹)	0.6	0.1	0.6	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

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

Description

Firms that extract oil, gas, or other minerals are permitted a deduction to recover their capital investment in a mineral reserve, which depreciates due to the physical and economic depletion or exhaustion as the mineral is recovered (section 611). Depletion, like depreciation, is a form of capital recovery: an asset, the mineral reserve itself, is being expended to produce income. Under an income tax, such costs are deductible.

There are two methods of calculating this deduction: cost depletion and percentage depletion. Cost depletion allows for the recovery of the actual capital investment—the costs of discovering, purchasing, and developing a mineral reserve—over the period during which the reserve produces income. Each year, the taxpayer deducts a portion of the adjusted basis (original capital investment less previous deductions) equal to the fraction of the estimated remaining recoverable reserves that have been extracted and sold. Under this method, the total deductions cannot exceed the original capital investment.

Under percentage depletion, the deduction for recovery of capital investment is a fixed percentage of the gross income—i.e., revenue—from the sale of the mineral. Under this method, total deductions typically exceed, despite the limitations, the capital invested to acquire and develop the reserve.

Section 613 states that mineral producers must claim the higher of cost or percentage depletion. The difference between percentage depletion and cost depletion is considered a subsidy. The percentage depletion rate for oil and gas is 15 percent and is limited to average daily production of 1,000 barrels of oil, or its equivalent in gas, and only for wells located in the United States. For producers of both oil and gas, the limit applies on a combined basis. For example, an oil producing company with 2022 oil production of 100,000 barrels, and natural gas production of 1.2 billion cubic feet (the equivalent of 200,000 barrels of oil) has average daily production of 821.92 barrels (300,000 ÷ 365 days).

Percentage depletion is not available to major integrated oil companies; it is available only for certain independent producers and royalty owners. An independent producer is one that does not have refinery operations that refine more than 75,000 barrels of oil per day, and does not have retail oil and gas operations grossing more than \$5 million per year.

Beginning in 1990, the percentage depletion rate on production from marginal wells—oil from stripper wells (those producing no more than 15 barrels per day, on average), and heavy oil—was raised. This rate starts at 15 percent and increases by one percentage point for each whole \$1 that the reference price of oil for the previous calendar year is less than \$20 per barrel (subject to a maximum rate of 25 percent). This higher rate is also limited to independent producers and royalty owners, and for up to 1,000 barrels, determined as before on a combined basis (including non-marginal production). However, since 2001, high market crude oil prices limited the percentage depletion rate to 15 percent. According to the National Stripper Well Association, there are about 760,000 stripper wells, which produce 7.4 percent of domestic oil production and 8.2 percent of domestic natural gas.

Percentage depletion is limited to 65 percent of the taxable income from all properties for each producer. However, for tax years beginning after December 31, 2008, and before January 1, 2012, this limitation was suspended for marginal properties. A second limitation is the 50 percent net-income limitation (100 percent for oil and gas properties), which applies to each individual property rather than to all the properties. From 1998-2007 and

2009-2011, the 100 percent net-income limitation was also suspended for marginal production. Since 1990, transferred properties have been eligible for percentage depletion.

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

Impact

Historically, generous depletion allowances and other tax benefits reduced effective tax rates in the fuel minerals industry significantly below tax rates on other industries, which provided additional incentives to increase investment, exploration, and output, especially of oil and gas. Oil and gas output, for example, rose from 16 percent of total U.S. energy production in 1920 to 71.1 percent in 1970 (the peak year). In 2021, oil and gas production accounted for roughly 60.2 percent of total U.S. energy production.

Under the percentage depletion allowance, a portion of gross revenues can be written off for the life of the investment. It is possible for cumulative depletion allowances to exceed, sometimes substantially, the amount of the original investment.

The 1975 repeal of percentage depletion for major integrated oil companies suggests that the value of this tax subsidy has been reduced in the last 30 years. The reduction in the depletion allowance to 15 percent in 1984 means that independent producers benefit from it much less than in the past.

Percentage depletion has little, if any, effect on oil prices, which are determined by supply and demand in the world oil market. However, it may encourage higher prices for drilling and mining rights.

Rationale

Provisions for a mineral depletion allowance based on the value of a mine were made under a 1912 Treasury Department regulation (T.D. 1742) but were never implemented. A court case resulted in the enactment, as part of the Tariff Act of 1913, of a “reasonable allowance for depletion” not to exceed 5 percent of the value of mineral output. Treasury regulation No. 33 limited total deductions to the original capital investment.

This system was in effect from 1913 to 1918, although in the Revenue Act of 1916 (P.L. 64-271) depletion was restricted to no more than the total value of output, and in the aggregate no more than capital originally invested or fair market value on March 1, 1913 (the latter so that appreciation occurring before enactment of income taxes would not be taxed).

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

In 1921 (Revenue Act of 1921, P.L. 67-98), because of concern with the size of the allowances, discovery depletion was limited to net income; it was further limited to 50 percent of net income in 1924 (Revenue Act of 1924, P.L. 68-176). Due to the administrative complexity and arbitrariness of the method, and due to its tendency to establish high discovery values, which tended to overstate depletion deductions, discovery value depletion was replaced in 1926 by the percentage depletion allowance, at the rate of 27.5 percent (Revenue Act of 1926, P.L. 69-20).

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

The Tax Reduction Act of 1975 (P.L. 94-12) eliminated the percentage depletion allowance for major oil and gas companies and reduced the rate for

independents to 15 percent for 1984 and beyond. This was in response to the Arab oil embargo of 1974, which caused oil prices to rise sharply. The continuation of percentage depletion for independents was justified by Congress on the grounds that independents had more difficulty in raising capital than the major integrated oil companies, that their profits were smaller, and that they could not compete with the majors.

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) limited the allowance for coal and iron ore. The Tax Reform Act of 1986 (P.L. 99-514) denied percentage depletion for lease bonuses, advance royalties, or other payments unrelated to actual oil and gas production.

The Omnibus Budget and Reconciliation Act of 1990 (P.L. 101-508) introduced the higher depletion rates on marginal production, raised the net income limitation from 50 percent to 100 percent, and made the allowance available to transferred properties. These liberalizations were based on energy security arguments. The Energy Policy Act of 1992 (P.L. 102-486) repealed the minimum tax on percentage depletion.

The Taxpayer Relief Act of 1997 (P.L. 105-34) suspended the 100 percent taxable income limitation for marginal wells for two years, and further extensions were made by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). The Working Families Tax Relief Act of 2004 (P.L. 108-311) retroactively suspended the 100 percent net-income limitation through December 31, 2005.

The Energy Policy Act of 2005 (P.L. 109-58) increased the per-day limitation on refining, for purposes of determining who is an independent producer, from 50,000 barrels per day to 75,000 barrels per day.

The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the suspension of the 100 percent net-income limitation through 2007. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the 100 percent net-income limitation for marginal properties for 2009. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the suspension of the 100 percent net-income limitation for marginal properties for an additional two years, through the end of 2011.

Assessment

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

As a production subsidy, percentage depletion is economically inefficient as it incorrectly measures the income of qualifying independent oil and gas producers. If percentage depletion affects production, the provision encourages development of existing properties at the expense of exploration for new ones. To the extent that it stimulates oil production, it reduces dependence on imported oil in the short-run, but it contributes to a faster depletion of the nation's resources in the long-run.

Tax provisions that encourage investment in a specific industry may be justified in cases where they address a positive externality associated with either production or consumption of certain goods. However, oil and gas production is not associated with positive externalities. Rather, oil and gas production is associated with negative externalities. For example, oil and natural gas prices do not reflect the environmental harm caused by the release of greenhouse gases in the atmosphere associated with oil and gas production and consumption.

Percentage depletion for oil and gas subsidizes independent producers who are primarily engaged in exploration and production. However, the percentage depletion does not approximate cost depletion adjusted for inflation.

Percentage depletion has been justified on national security grounds and the volatile nature of oil and gas prices. In either case, it is likely the concerns could be more adequately addressed through other means. For example, to address national security concerns, one alternative is an oil stockpile program such as the Strategic Petroleum Reserve.

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Energy

EXCLUSION OF ENERGY CONSERVATION SUBSIDIES PROVIDED BY PUBLIC UTILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 136.

Description

In general, this provision allows a customer to exclude from their gross income the value of any subsidy provided (directly or indirectly) by a public utility for the purchase or installation of any energy conservation measure. An energy conservation measure is any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit. To the extent that an energy conservation expenditure qualifies for this exclusion, the taxpayer cannot claim any other tax benefits on the same expenditure.

Impact

The exclusion of these energy subsidies from gross income reduces the total cost of energy-efficient devices provided under programs sponsored by public utilities to conserve energy. Absent this provision, the value of any rebates or other incentives provided by the utility could be included in the taxpayer's gross income and subject to taxation. The tax savings generated by this provision depend on the marginal tax rate of the taxpayer. This tax

provision is applicable to dwelling units such as houses, apartments, condominiums, mobile homes, boats, or similar properties.

Rationale

An exclusion for residential customers had originally been enacted as part of the National Energy Conservation Policy Act of 1978 (P.L. 95-619). This exclusion was amended by Title V of the Energy Security Act of 1980 (P.L. 96-294), and then expired in mid-1989. The current provision was adopted as part of the Energy Policy Act of 1992 (P.L. 102-486) to encourage residential and business customers of public utilities to participate in energy conservation programs sponsored by the utility. The goal was to enhance the energy efficiency of dwelling units and encourage energy conservation in residential and commercial buildings. The Small Business Job Protection Act of 1996 (P.L. 104-188) repealed the exclusion with respect to business property, effective on January 1, 1997 (unless a binding contract was in effect on September 13, 1995). The 1996 amendments also dropped a part of section 136 that allowed the exclusion to apply to industrial energy conservation devices and technologies.

Assessment

Utilities sometimes use rebates and other incentives to induce their customers to invest in more energy-efficient heating and cooling equipment, and other energy-saving devices. These programs can be justified on the grounds of conservation and load management, if they result in less pollution or more stable energy provisions during times of peak demand. In general, however, it would be more efficient to tax energy fuels directly than to subsidize a particular method of achieving conservation. From an economic perspective, allowing targeted tax benefits for certain types of investment or consumption can result in a misallocation of resources.

In rental housing, the tenant and the landlord may lack strong financial incentives to invest in energy conservation equipment and materials because the benefits from such conservation may not entirely accrue to the party undertaking the cost of the energy-saving expenditure and effort. Tenants do not generally have motivation to improve the energy efficiency of a residence that does not belong to them unless the rate of return (or payback) is sufficiently large. However, most tenants do not occupy rental housing long enough to reap the full benefits of the energy conservation investments. Alternatively, landlords may not be able to control the energy consumption

habits of renters to sufficiently recover the full cost of the energy conservation expenditures.

If the units are individually metered and the tenant pays for electricity separately, the landlord may not undertake energy conservation investments since all the benefits would accrue to the renters unless higher rents could be charged on apartments with lower utility costs. If the units are under centralized control (rather than individually metered), the benefits of conservation measures may accrue largely to the landlord, but even here the tenants may have sufficient control over energy use to subvert the accrual of any gains to the landlord. In such cases, from the landlord's perspective, it may be easier and cheaper to forgo the conservation investments and instead pass on energy costs as part of the rents. Individual metering can be quite costly, and while it may reduce some of the distortions, it is not likely to completely eliminate them. Even if the landlord can charge higher rents, he may not be able to recover the costs of energy conservation efforts or investments.

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

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Energy

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil & Gas	Other Fuels	Oil & Gas	Other Fuels	Oil & Gas	Other Fuels
2020	(1)	(1)	0.4	(1)	0.4	(1)
2021	(1)	(1)	0.3	(1)	0.3	(1)
2022	(1)	(1)	0.3	(1)	0.3	(1)
2023	(1)	(1)	0.3	(1)	0.3	(1)
2024	(1)	(1)	0.3	(1)	0.3	(1)

(1) Positive tax expenditure of less than \$50 million.

Authorization

Sections 263(c), 291, 616-617, 57(a)(2), 59(e), and 1254.

Description

Firms engaged in the exploration and development of oil, gas, or geothermal properties have the option of expensing (deducting in the year paid or incurred) rather than capitalizing (recovering such costs through depletion or depreciation) certain intangible drilling and development costs (IDCs). Expensing is an exception to general tax rules that provide for the capitalization of costs related to generating income from capital assets. In lieu of expensing, firms have the option of amortizing IDCs in equal amounts over a five-year period.

IDCs are amounts paid by the operator for fuel, labor, and repairs to drilling equipment, materials, hauling, and supplies. They are expenditures incident to and necessary for drilling wells and preparing a site for the production of oil, gas, or geothermal energy. IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Amounts paid for casings, valves,

pipelines, and other tangible equipment that have a salvage value are capital expenditures and they cannot be expensed; they are recovered through depreciation.

The option to expense IDCs applies to domestic properties, which include certain off-shore wells (essentially those within the exclusive economic zone of the United States), including generally offshore platforms subject to certain restrictions. Except for IDCs incurred in the North Sea, IDCs on foreign properties must be either amortized (deducted in equal amounts) over 10 years or added to the adjusted cost basis and recovered through cost depletion. An integrated oil company, generally a large producer that also has refining and marketing operations, can expense only 70 percent of the IDCs; the remaining 30 percent must be amortized over a five-year period. Dry hole costs for either domestic or foreign properties may be expensed or capitalized at the discretion of the taxpayer.

Independent (non-integrated) producers include 60 percent of their IDCs as a tax preference item. As noted above, instead of expensing, a taxpayer may choose to amortize IDCs over a five-year period and avoid the individual alternative minimum tax. The amortization claimed under IRC section 59(e) is not considered a tax preference item for individual alternative minimum tax purposes.

Impact

IDCs and other intangible exploration and development costs represent a portion of the costs of finding and developing a mineral reserve. In the case of oil and gas, which historically accounted for 99 percent of the revenue loss from this provision, IDCs in 2013 were estimated to account for between 60 and 90 percent of the total exploration and development costs—the cost of creating a mineral asset.

Historically, expensing of IDCs was a major tax incentive for the oil and gas industry, and, combined with other tax provisions such as the percentage depletion allowance, reduced effective tax rates below tax rates on other industries. These subsidies provided incentives to increase investment, exploration, and output, especially of oil and gas. The value of these subsidies has declined over time with reductions in corporate income tax rates, increased limits on expensing, and the alternative minimum tax.

Unlike percentage depletion, which may only be claimed by independent producers, this tax expenditure is shared by both independents and by the

integrated oil and gas producers. However, independent oil producers, many of which are large, drilled roughly 90 percent of the wells and undertook the bulk of the expenditures for exploration and development, thus receiving the bulk of the benefits from this tax expenditure in 2018. The at-risk, recapture, and minimum tax restrictions that have since been placed on the use of the provision have primarily limited the ability of high-income taxpayers to shelter their income from taxation through investment in mineral exploration. However, the exemption for working interests in oil and gas from the passive loss limitation rules still creates opportunities for tax shelters in oil and gas investments.

Rationale

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

In 1931, a court ruled that IDCs were capital costs, but permitted expensing, arguing that the 15-year precedent gave the regulation the force of a statute. In 1942, Treasury recommended that expensing be repealed, but Congress did not take action. A 1945 court decision invalidated expensing, but Congress endorsed it (on the basis that it reduced uncertainty and stimulated exploration of a strategic mineral) and codified it as section 263(c) in 1954 (P.L. 83-591). Continuation of expensing has been based on the perceived need to stimulate exploratory drilling, which can increase domestic oil and gas reserves, and (eventually) production, reduce imported petroleum, and enhance energy security.

The Tax Reform Act of 1976 (P.L. 94-455) added expensing of IDCs as a tax preference item subject to the alternative minimum tax. Expensing of IDCs for geothermal wells was added by the Energy Tax Act of 1978 (P.L. 95-618). The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) limited expensing for integrated oil companies to 85 percent; the remaining 15 percent of IDCs had to be amortized over three years.

The Deficit Reduction Act of 1984 (P.L. 98-369) limited expensing for integrated producers to 80 percent of IDCs. The Tax Reform Act of 1986 (P.L. 99-514) established uniform capitalization rules for the depreciation of property, but IDCs (as well as mine development and other exploration costs) are exempt from those rules. The Tax Reform Act further limited expensing

for integrated producers to 70 percent of costs, and also repealed expensing for foreign properties.

In 1990, a special energy deduction was introduced, against the alternative minimum tax, for a portion of the IDCs and other oil and gas industry tax preference items. For independent producers, the Energy Policy Act of 1992 (P.L. 102-486) limited the amount of IDCs subject to the alternative minimum tax to 60 percent (70 percent after 1993) and suspended the special energy deduction through 1998.

Assessment

IDCs are generally recognized to be capital costs, which, according to standard economic principles, should be recovered using depreciation or depletion (cost depletion adjusted for inflation). Lease bonuses and other exploratory costs (survey costs, geological and geophysical costs) are properly treated as capital costs. From an economic perspective, dry hole costs should also be depreciated or depleted, rather than expensed, as part of the costs of drilling a successful well.

Immediate expensing of IDCs provides a tax subsidy for capital invested in the mineral industry, especially for oil and gas producers, with a larger subsidy for independent producers. Technological innovation has reduced the percentage of dry holes in both exploratory and development drilling, thus reducing the tax benefits from immediate expensing of dry hole costs.

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

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

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Energy

**AMORTIZATION OF GEOLOGICAL AND GEOPHYSICAL
EXPENSES ASSOCIATED WITH OIL AND GAS
EXPLORATION**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	0.1	0.1
2021	(¹)	0.1	0.1
2022	(¹)	0.1	0.1
2023	(¹)	0.1	0.1
2024	(¹)	0.1	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 167(h).

Description

Geological and geophysical (G&G) costs—exploratory costs associated with determining the precise location and potential size of a mineral deposit—are amortized by independent producers over two years and by major integrated oil companies over seven years.

Impact

Geological and geophysical costs represent a share of the costs of finding and developing an oil or gas reserve. This subsidy provides an incentive to undertake geological and geophysical costs.

Rationale

The Energy Policy Act of 2005 (P.L. 109-58) included a provision to amortize geological and geophysical (G&G) costs over two years. The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) increased the amortization period for geological and geophysical costs to five years for

major integrated oil companies. The Energy Independence and Security Act of 2007 (P.L. 110-140) further raised the amortization period for geological and geophysical expenditures incurred by major integrated oil companies from five to seven years.

Assessment

Geological and geophysical costs are normally treated as capital costs that should be recovered over the life of the well through cost depletion.

Amortization periods that are less than the life of the well provide a tax subsidy for capital invested in the mineral industry, especially for oil and gas producers, with a relatively larger subsidy for independent producers.

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

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Energy

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR ENERGY PRODUCTION FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 103, 141, 142(f), and 146.

Description

Interest income on state and local bonds used to finance the construction of certain private energy facilities for a city and one contiguous county, or two contiguous counties, is tax exempt. These energy facility bonds are classified as private-activity bonds, rather than as governmental bonds, because a substantial portion of their benefits accrues to individuals or business rather than to the general public. These bonds are subject to the state private-activity bond annual volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003. Generally, only those entities that were operating such a facility on January 1, 1997, are eligible for this type of financing. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to provide the services of local energy facilities at lower cost, benefitting end users. Some, perhaps most of the benefits of the tax exemption, however, flow to bondholders. For a discussion of the factors that determine the shares of benefits going to users and bondholders as well as estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

There are a variety of tax preferences intended to encourage private entities to invest in energy infrastructure. Congress authorized the continued use of tax-exempt bonds to reduce the operating cost of electricity generating facilities for a limited number of facilities. The restrictions on the bonds, disallowing any new issuers after 1996, were part of the Small Business Job Protection Act of 1992 (P.L. 104-188). The rationale for grandfathering existing tax-exempt issuers was based on the original reason for allowing the tax-exempt financing: without the tax preference, local electricity generation may not have been viable in an open market for these producers. The entities cannot expand, however, without losing their authority to issue tax-exempt bonds. Thus, these local electric utilities are limited to their current size and service base. In addition, if a local entity wishes to expand or merge with a larger non-qualified entity, they must refinance all the outstanding tax-exempt debt with taxable debt.

Assessment

Any decision about changing the status of these entities would likely consider the nation’s need for local energy production. Even if a case can be made for a federal subsidy of energy production facilities based on underinvestment at the state and local level, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, those issued for energy production facilities increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the range

of assets available to individuals and corporations to shelter their income from taxation.

Federally subsidized financing for energy production facilities may be indirectly modified by provisions in the P.L. 117-169 (often referred to as the Inflation Reduction Act of 2022), which included changes to the interaction between tax-exempt bond financing and the use of Investment Tax Credits and Production Tax Credits in certain cases.

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Energy

RESIDENTIAL CLEAN ENERGY CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.8	—	1.8
2021	1.0	—	1.0
2022	0.7	—	0.7
2023	0.2	—	0.2
2024	—	—	—

Note: This score was made before passage of P.L. 117-169. The Joint Committee on Taxation estimated the changes in that bill would reduce revenues by an additional \$22 billion from FY2022 through FY2031 compared to the baseline at the time of passage.

Authorization

Section 25D

Description

The residential clean energy credit—previously known as the “tax credit for residential energy-efficient property”—lets taxpayers reduce their annual tax liability by an amount equal to 30 percent of the costs of purchasing and installing qualifying energy property.

Qualifying property includes residential solar electric property, solar water heating property (used for purposes other than heating swimming pools or hot tubs), geothermal heat pumps, small wind energy property, and fuel cell power plants. For fuel cell property, the maximum credit amount is limited to \$500 per half kilowatt (kW) of capacity. Battery storage technology placed in service in 2023 or later will also qualify, provided it has a capacity of not less than 3 kilowatt hours. Taxpayers can apply the credit to labor expenses associated with onsite preparation, assembly, and installation of the property. Only expenses for property installed in the United States and on or in

connection with a dwelling unit the taxpayer uses as a residence qualify. Fuel cell power plants must be installed in connection with the taxpayer's principal residence.

The tax credit is nonrefundable, but unused credits may be carried forward to the following year. The credit may also be claimed against the alternative minimum tax.

The credit is scheduled to expire after 2034. The size of the credit will fall to 26 percent of the value of qualified property placed in service in 2032 and 2033, and 22 percent for property placed in service in 2034.

Impact

The residential energy-efficient property tax credit reduces the costs of purchasing and installing qualifying energy property by reducing a taxpayer's tax liability. The credit encourages recipients to use renewable energy sources, which should reduce demand for electricity generated using polluting fossil-based energy resources.

The installation of residential solar electric property, the primary technology for which consumers claim the residential clean energy credit, has increased rapidly in recent years. It is difficult to estimate what portion of this increase federal tax incentives spurred, as several other factors may have encouraged solar panel adoption. The cost of installing residential solar energy property has fallen substantially in recent years, and there are other financial incentives and government programs supporting deployment of residential renewable energy property. Some evidence suggests that many adopters would still have installed solar panels without federal tax credits.

Residential energy efficiency tax credits are disproportionately claimed by higher-income households. Higher-income households are more likely to have tax liability to offset a non-refundable credit and more likely to make qualified investments, which are necessary to claim the credit. However, solar adoption has grown less skewed towards higher-income households in recent years.

Rationale

The tax credit for residential energy-efficient property, as it was then known, was introduced by the Energy Policy Act of 2005 (EPACT05, P.L. 109-58). It was always a temporary credit. EPACT05 implemented a 30

percent credit for residential solar electric, solar water heating, and fuel cell property. Lawmakers restricted the maximum credit allowed for all three types of property under EPACT05. The maximum credit allowed for photovoltaic property and solar water heating property was limited to \$2,000, and the credit was limited to \$500 per half kW of capacity for fuel cell property. The credits established under EPACT05 were originally set to expire January 1, 2008.

Lawmakers have extended the credit several times. The credit was first extended by the Tax Relief and Health Care Act of 2006 (P.L. 109-432) through the end of 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) then extended the credit through 2016, and added a 30 percent tax credit for small wind energy and geothermal heat pump property. This act also let taxpayers claim the credit against the alternative minimum tax.

The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) liberalized some of the restrictions placed on the credit, removing the maximum credit limit amounts for all property types under section 25D except fuel cell property. The credit available for fuel cell property remains limited to \$500 per half kW of capacity.

The Consolidated Appropriations Act, 2016 (P.L. 114-113) extended the credit for solar electric and qualified solar water heating property for five years, through 2021. The credit rate was to be reduced to 26 percent for property placed in service in 2020, and 22 percent for property placed in service in 2021. The credit for fuel cells, small wind energy property, and geothermal heat energy property was extended to this same phase-out schedule by the Bipartisan Budget Act of 2018 (P.L. 115-123).

The Consolidated Appropriations Act, 2021 (P.L. 116-260) delayed each of the phase-out dates by two years. The credit would be worth 26 percent of qualified expenses in 2022, 22 percent in 2023, and would expire in 2024. The law also made certain investments in biomass fuel property eligible for the credit while making such expenses ineligible for the tax credit for nonbusiness energy property (now known as the “energy efficient home improvement tax credit”).

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA), restored the size of the credit to 30 percent for investments placed in service in 2022. The 30 percent level is scheduled to remain in place through 2031, after which it will fall to 26 percent through 2033 and 22 percent in 2034. IRA also made expenditures for qualified battery technology property

placed in service after 2022 eligible, and made investments in biomass fuel property ineligible. The credit's name changed from the "tax credit for residential energy-efficient property" to the "residential clean energy credit."

Assessment

The goal of the residential clean energy tax credit is to promote investment in energy-efficient and renewable-energy property. Consumers of electricity will buy more electricity generated by polluting resources than is socially optimal if the prices they pay do not reflect the total social costs of generation, which include any costs imposed by pollution. Subsidizing the purchase of energy-efficient and renewable-energy property lowers the cost of energy produced from renewable sources. The reduced cost should compel beneficiaries to generate more electricity from clean and renewable sources, and reduce reliance on polluting fossil-based sources.

Empirical evidence of non-tax solar subsidies suggests that a large portion of the subsidy is "passed through" to consumers, lowering the price consumers pay for solar electric energy property, as opposed to the subsidy being captured by sellers via higher prices.

However, subsidizing clean energy through the tax code requires the government to make up lost revenue with additional taxes, lower spending, or debt. In contrast, taxing energy produced from polluting sources directly could make prices reflect the true social cost of generation. Doing so would achieve a more socially optimal mix of energy produced from clean and polluting sources while generating revenue, rather than costing it.

While the credit may encourage some to invest more in energy-efficient property, it also provides a windfall benefit to claimants that would have invested in energy-efficient property without the tax credit. Recent empirical work suggests that tax incentives do increase energy efficiency investments, but do not account for all adoption.

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Energy

ENERGY-EFFICIENT HOME IMPROVEMENT CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.5	—	0.5
2021	0.3	—	0.3
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This score was made before passage of P.L. 117-169. The Joint Committee on Taxation estimated the changes in that bill would reduce revenues by an additional \$22 billion from FY2022-FY2031 compared to the baseline at the time of passage.

Authorization

Section 25C.

Description

In 2022, the energy-efficient home improvement credit (previously known as the tax credit for nonbusiness energy property) lets taxpayers lower their annual tax liability by 10 percent of their qualified expenditures on energy-efficiency improvements and residential energy property.

Qualifying energy efficiency improvements include certain improvements to a building's envelope, as well as heating, cooling, and water-heating equipment. Improvements must be made on the taxpayer's principal residence.

A building's envelope is the physical structure of the home that provides a barrier from the outside elements, including resistance to air, water, heat, light, and noise. Changes and improvements to a building's envelope, otherwise known as weatherization, often includes improvements to insulation or replacement of windows and doors. The labor costs associated with

improvements to a building's envelope are not considered eligible expenditures for the purposes of claiming the tax credit.

Qualified energy property includes certain heating, cooling, and water-heating equipment, provided they meet specific efficiency criteria set forth in statute. Labor and installation costs associated with qualifying equipment are eligible expenditures for this tax credit.

Generally, taxpayers can claim no more than \$500 through this credit throughout their lifetimes. The credit is limited to \$300 for any single piece of energy-efficiency building property; \$150 for any qualified natural gas, propane or oil furnace and hot water boiler; and \$50 for any advanced main air circulating fans. A taxpayer cannot claim more than \$200 for investments in windows over his or her lifetime.

The credit will change considerably for property placed in service in 2023 or later. The credit rate will rise to 30 percent, and the lifetime limitations will no longer take effect. Expenditures on home energy audits will become qualifying expenses for the credit.

The credit will generally be capped at \$1,200 per tax filer per year. However, notwithstanding this limit, taxpayers will be able to claim up to \$2,000 for qualifying expenditures on biomass stoves or water heaters and/or heat pumps powered by electricity or natural gas. The amount of credit a taxpayer can claim will be limited to \$600 per item of residential energy property and to \$150 for expenses on home energy audits. In any given year, taxpayers will not be able to claim more than \$600 for spending on windows, \$500 for aggregate spending on exterior doors, and \$250 per interior door. Starting in 2025, taxpayers will need to include a qualifying property's product identification number when they claim the credit. The credit is nonrefundable and cannot be carried forward to subsequent tax years.

The credit is scheduled to expire on January 1, 2033.

Impact

This credit reduces the cost of installing energy-efficient residential property and making weatherization improvements, thus encouraging homeowners to undertake qualifying improvements.

Residential energy efficiency tax credits are disproportionately claimed by higher-income households. Higher-income households are more likely to

have tax liability to offset a non-refundable credit and more likely to make qualified investments, which are necessary to claim the credit.

Rationale

The Energy Tax Act (P.L. 95-618) introduced provisions similar to the current tax credit for energy-efficiency improvements to existing homes. These incentives were later expanded in the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223), but expired at the end of 1985.

New tax incentives for residential energy efficiency were enacted as part of the Energy Policy Act of 2005 (EPACT05; P.L. 109-58). EPACT05 allowed taxpayers to claim a 10 percent tax credit for expenditures related to weatherization improvements for their residence. Taxpayers could also claim specific credit amounts for different energy-efficiency property purchases. For example, a \$50 credit was available for advanced main air circulating fans, and a \$150 credit was available for efficient furnaces. For the tax years of 2006 and 2007, the tax credit was limited to a combined maximum of \$500 over both years. Additional limits were placed on specific property types, such as a \$200 limit for expenditures on windows. The tax credit was allowed to expire after 2007, and was not available in the 2008 tax year.

The Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343) reinstated and modified the credit for residential energy efficient property for the 2009 tax year. Specifically, EESA added biomass fuel stoves to the list of eligible property for the credit. Geothermal heat pumps were removed from the list of eligible property under section 25C, but they were added to the list of eligible property under section 25D. The \$500 lifetime limit on the credit remained in effect.

The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) made additional changes to the structure of the credit. While ARRA did not introduce additional tax credits for energy-efficient home improvements, ARRA expanded section 25C in a number of ways. The tax credit was increased from 10 percent to 30 percent, and the fixed dollar caps for certain property were removed. ARRA also increased the maximum credit amount to a combined \$1,500 for the 2009 and 2010 tax years, and changed the qualifying efficiency standards for the various types of energy property.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the section 25C tax credits for residential energy efficient property through 2011, but reduced the credit

amount to 10 percent of qualifying expenditures. P.L. 111-312 also reinstated the rule that expenditures made from subsidized energy financing were not qualified expenditures, increased certain efficiency standards for boilers and furnaces, and modified the efficiency standards for windows and doors to be consistent with Energy Star criteria.

This tax credit for energy-efficient improvements to existing homes was extended again by the American Taxpayer Relief Act of 2012 (P.L. 112-240) with an expiration date of December 31, 2013. The Protecting Americans from Tax Hikes Act (P.L. 113-295) extended the provisions through December 31, 2014. The provision was extended through December 31, 2016, as part of the Consolidated Appropriations Act, 2016 (P.L. 114-113). Along with this extension, efficiency standards for windows, skylights, and doors were modified, with the new requirements being the Energy Star 6.0 standards, for property placed in service after December 31, 2015.

The provision was extended through December 31, 2017, as part of the Bipartisan Budget Act of 2018 (P.L. 115-123), and through 2020 in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94).

The Consolidated Appropriations Act of 2021 (P.L. 116-260) extended the 25C credit one additional year, through 2021. The law also removed biomass stoves from the list of eligible property under section 25C, but added them to the list of eligible property under section 25D.

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA 2022), restored the credit for property placed in service after 2022. It raised the size of the credit to 30 percent of qualifying expenditures, and expanded the definition of such expenditures to include the cost of home energy audits. IRA 2022 repealed the \$500 lifetime limitation on the credit, introduced the limits on categories of expenditures, and modified the limits on individual items. Expenditures on residences that are not the taxpayer's primary residence were made eligible. The law also made several changes to the definition of qualified property expenditures, including once again making biomass stoves eligible property for this credit instead of the credit under section 25D. It also modified efficiency standards and scheduled them to update automatically. The credit's name was changed from the "nonbusiness energy property credit" to the "energy efficient home improvement credit."

Assessment

Congress enacted the residential energy efficiency tax credits in 2005 to address concerns that many existing homes were not adequately insulated. Investment in energy efficiency improvements is likely below the socially optimal level. Market failures in the production and consumption of electricity lead consumers to over-consume electricity derived from pollution-generating energy resources. Producers of electricity will generate more than the socially optimal level of electricity using polluting resources if the costs of production do not reflect the total social costs, which include any costs imposed by pollution.

By providing a subsidy to taxpayers for investments in energy-efficient property, taxpayers face a lower cost for improving the energy efficiency of their homes. These reduced costs should lead to more investment in energy-efficient property, improving energy efficiency in the residential sector.

However, subsidizing clean energy through the tax code requires the government to make up lost revenue with additional taxes, lower spending, or debt. In contrast, taxing energy produced from polluting sources directly could make prices reflect the true social cost of generation. Doing so would achieve a more socially optimal mix of energy produced from clean and polluting sources while generating revenue, rather than reducing it.

Consumers oftentimes pass on energy efficiency investments that have high expected rates of return (although it is unclear just how many high-expected-rate-of-return energy efficiency investment opportunities exist). One barrier to energy-efficient investments is the high initial costs associated with such investments. If consumers are unable to obtain credit, or if there are credit market failures, the result may be an underinvestment in energy efficiency. Other barriers to energy efficiency investments include a lack of information about energy efficiency improvements or behavioral issues that lead consumers to choose familiar and inefficient technologies over more efficient ones. Barriers to investment in residential energy efficiency may also exist when landlords make decisions about energy-efficiency property investments but tenants pay utility bills.

While these market barriers may explain the low adoption levels of certain energy efficient products, subsidies delivered through the tax code may or may not address them. For example, if credit constraints prevent residential

energy-efficiency investment, then non-refundable tax credits—which few low-income households can claim—do not address this barrier.

While the credit may encourage some to invest more in energy-efficient home improvements, it also provides a windfall benefit to claimants who would still have made such investments without the tax credit. Recent empirical work suggests that tax incentives do increase energy efficiency investments, but do not account for all adoption.

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Energy

CLEAN VEHICLE CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	0.3	0.7
2021	0.3	0.3	0.6
2022	0.3	0.3	0.6
2023	0.3	0.3	0.6
2024	0.3	0.3	0.6

Note: This provision was modified by P.L. 117-169 with the changes estimated to cost \$14.0 billion over FY2022 – FY2031.

Authorization

Section 30D.

Description

Taxpayers purchasing certain plug-in electric and fuel cell vehicles may be able to claim federal tax credits. Beginning in 2023, electric vehicles (EVs) may qualify for a tax credit if the vehicle’s battery meets certain conditions. The maximum potential credit is the sum of two amounts: the critical mineral amount and the battery component amount. The critical minerals amount is \$3,750. To qualify for this portion of the credit, at least 40 percent of the value of the battery’s applicable critical minerals must have been extracted or processed in the United States or in a country with which the United States has a free trade agreement, or recycled in North America. The 40 percent amount increases to 50 percent in 2024, 60 percent in 2025, 70 percent in 2026, and 80 percent in 2027 and thereafter.

The battery components amount is also \$3,750. To qualify for this portion of the credit, at least 50 percent of the value of the vehicle’s battery’s components must have been manufactured or assembled in North America. The 50 percent amount increases to 60 percent in 2024 and 2025, 70 percent in 2026, 80 percent in 2027, 90 percent in 2028, and 100 percent in 2029 and thereafter.

For vehicles purchased after August 16, 2022, only vehicles for which final assembly occurred in North America qualify. Additional restrictions apply to vehicle batteries starting in 2024 and 2025. Specifically, starting in 2024, an EV cannot qualify for the clean vehicle tax credit if any of the vehicle's battery components were manufactured or assembled by a foreign entity of concern. Starting in 2025, an EV cannot qualify for the clean vehicle credit if the vehicle's battery contains critical minerals that were extracted, processed, or recycled by a foreign entity of concern.

An EV must have a battery with 7 kilowatt hours (kWh) of capacity with external charging to be eligible for the tax credit. Further, no credit can be claimed for vans, SUVs, or pickup trucks with a manufacturer's suggested retail price (MSRP) of more than \$80,000, or \$55,000 for all other vehicle types.

Taxpayers cannot claim the credit if their modified adjusted gross income (MAGI) is more than \$300,000 (married filing jointly), \$225,000 (head of household), or \$150,000 (single). These income thresholds apply to the lesser of the current year or prior year MAGI. Taxpayers must report a vehicle identification number (VIN) on their tax returns. Sellers of vehicles are also required to report VINs to the Treasury. There is no carry forward or carryback for any unused portion of the credit. Starting in 2024, taxpayers will be able to elect to transfer the credit to a dealer selling the vehicle.

The clean vehicle credit can be claimed for fuel cell vehicles that satisfy the final assembly requirements and seller VIN reporting requirements.

The credit is scheduled to expire December 31, 2032.

Beginning in 2009, and before 2023, the plug-in EV tax credit provided a base credit of \$2,500 to vehicles with a 4 kWh capacity battery with external charging. An additional \$417 credit was awarded for each kWh of capacity above 5 kWh. The maximum credit amount was \$7,500 (before 2010, the credit limit was higher, up to \$15,000 for qualifying heavy vehicles). The credit phased out for a particular manufacturer once 200,000 qualifying vehicles have been sold.

Before 2023, if vehicles were purchased or leased by a tax-exempt organization, the seller of the vehicle may have been able to claim the credit so long as the seller clearly disclosed the amount of the allowable credit to the purchaser. Starting in 2023, tax-exempt entities may be able to claim the credit for commercial clean vehicles, discussed elsewhere in this compendium.

Impact

Tax credits for plug-in electric vehicles are disproportionately claimed by higher-income taxpayers. In 2019, nearly half of the plug-in vehicle credits were claimed on tax returns with adjusted gross income (AGI) of \$200,000 or more. Lower and moderate-income taxpayers have typically, in the past, been unable to claim the full amount of the credit due to having limited tax liability. Provisions that allow taxpayers to transfer the credit to dealers addresses this limitation.

The economic incidence of the credit depends on the buyer's and seller's relative responsiveness to changes in price. Even though the tax credit is claimed by buyers, sellers can be expected to potentially capture some of the tax benefit through higher prices. How much of the credit is captured through higher prices is an empirical question, and the evidence on tax credit incidence for highly efficient or clean vehicles is mixed. Economic incidence may also vary across sub-markets for EVs (differ for luxury versus mid-range vehicles, for example).

The market share for plug-in electric and other alternative-technology vehicles has increased in recent years. While federal tax incentives may have been partially responsible for the increasing market share of plug-in electric vehicles, fluctuating gas prices may also play a role in determining demand for fuel-efficient or non-gasoline powered vehicles. Another factor related to demand for plug-in vehicles is the prevalence of charging infrastructure. It is also possible that consumers choose vehicles for technological, performance, environmental, or symbolic features. If these other reasons, as opposed to financial reasons, are driving their decision making, then tax incentives do not cause additional purchases.

Rationale

Section 30D was added by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) to further stimulate the demand for a specific type of alternative-technology vehicle—the plug-in electric-drive vehicle—which is envisioned as a more fuel-efficient and environmentally clean automobile as compared with conventional vehicles. The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) modified the credit for plug-in electric vehicles, reducing the maximum credit amount to \$7,500 for all vehicles (previously, higher credit amounts were available for heavy vehicles), modifying battery capacity requirements, and replacing a 250,000 total plug-

in vehicle limitation with the 200,000 per-manufacturer limit. The act also created a temporary new credit (Section 30) for qualified low-speed and two- or three-wheeled plug-in vehicles.

The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) extended the tax credit for two- or three-wheeled plug-in electric vehicles through 2013, in the process essentially moving the credit from section 30 back to section 30D of the code. The credit lapsed for 2014. The Consolidated Appropriations Act, 2016 (P.L. 114-113) reinstated the credit for two-wheeled electric motorcycles for 2015 and 2016. The credit for three-wheeled electric-drive motor vehicles was not extended. The credit for two-wheeled electric vehicles was further extended in the Bipartisan Budget Act of 2018 (P.L. 115-123), the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), and through 2021 in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA 2022), as signed into law on August 16, 2022, modified tax credits for EVs and fuel cell vehicles. IRA 2022 removed the per-manufacturer cap, instead providing a December 31, 2032 termination date. IRA 2022 also imposed new critical mineral and battery component requirements, a North America final assembly requirement, and vehicle MSRP limits. Sellers and taxpayers are required to report VIN numbers to the Treasury. In an effort to address equity concerns, IRA 2022 also disallowed the tax credit for higher-income taxpayers and provided that starting in 2024, taxpayers can transfer the credit to dealers. IRA also added fuel cell vehicles as a qualifying vehicle under Section 30D of the code (previously, fuel cell vehicles had been eligible for a different alternative fuel vehicle credit) and changed the name of the credit from the plug-in electric vehicle credit to the clean vehicle credit.

Before the section 30D credit was enacted, the Energy Policy Act of 1992 (P.L. 102-486) had provided a 10 percent credit, up to \$4,000, for electric vehicles. The credit was enacted with a phase-out starting in 2002, with no credits available after 2004. The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) provided that taxpayers could receive full credit amounts for electric vehicles in 2002 and 2003, with the phase-out beginning in 2004. The Working Families Tax Relief Act of 2004 (P.L. 108-311) eliminated the phase-out for 2004 and 2005, and extended the credit through 2006 with phase-out in that year. The credit was allowed to expire after 2006. When the

Energy Policy Act of 2005 (P.L. 109-58) created tax credits for various types of alternative fuel vehicles, electric vehicles were not included.

Assessment

Tax incentives for plug-in electric and fuel cell vehicles may help address market failures in automobile markets. Specifically, since consumers fail to consider the negative environmental and potential energy security concerns associated with conventional gasoline- and diesel-fueled vehicles, the market may provide an inefficiently high level of such products. One way to address the negative externalities associated with fuel consumption through automobile use is to reduce the price of alternative technology or plug-in electric vehicles.

There are other barriers to adoption of plug-in electric and fuel cell vehicles a tax credit might address. These include, for example, (1) the high up-front cost, (2) the volatility of fuel prices, (3) technology risks associated with newer, unfamiliar technologies, and (4) a lack of complementary infrastructure (such as electric charging stations).

Because tax credits for clean vehicles reduce the price of such vehicles relative to gasoline- and diesel-powered alternatives, such tax credits are intended to address the previously noted market failures and market barriers. A tax credit approach, however, may not be the most economically efficient mechanism for addressing the negative externalities associated with gasoline consumption and market barriers to clean vehicle adoption. Gas prices also play a role in determining consumer demand for clean electric vehicles. Taxing gasoline directly—taxing the activity associated with the negative externality—is more economically efficient than subsidizing the purchase of select vehicles. High gasoline prices, particularly over sustained period of time, can lead to more demand for clean fuel vehicles.

Empirical evidence suggests that tax incentives lead to increased EV purchases. Research also suggests, however, that tax incentives for certain plug-in electric vehicles are not expected to have long-term effects on fuel efficiency of the fleet, and that tax incentives for vehicles are not particularly effective as a policy option for reducing emissions. Additionally, evidence also suggests that tax incentives are not driving purchase decisions in markets for high-end plug-in electric vehicles.

The changes in IRA 2022, particularly the North America final assembly requirement and critical minerals and battery components requirements, are

expected to reduce the number of vehicles that qualify for the Section 30D tax credit in the near term. The lack of tax credit eligible vehicles could temper demand for EVs, although an increase in the availability of lower-cost EVs could offset this effect.

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Energy

ENERGY CREDIT (SECTION 48)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	6.1	6.8
2021	0.8	6.9	7.7
2022	0.8	6.9	7.7
2023	0.7	6.6	7.3
2024	0.6	5.4	6.0

Note: This provision was extended and modified by P.L. 116-260 with the changes estimated to cost \$7.0 billion over FY2021 – FY2030. This provision was further extended and modified by P.L. 117-169 with the changes estimated to cost \$14.0 billion over FY2022 – FY2031.

Authorization

Sections 48, 6417, and 6418.

Description

The energy credit is an investment tax credit that can be claimed for investments in qualifying property that begin construction before January 1, 2025. For property placed in service after December 31, 2021, the base credit amount is either 2 percent or 6 percent, depending on the type of property. This base amount is multiplied by 5 (i.e., increased to 10 percent or 30 percent) for projects that satisfy prevailing wage and apprenticeship requirements (or begin construction before 60 days after the Secretary of the Treasury publishes guidance on the wage and registered apprenticeship requirements) or have a maximum net output of less than one megawatt of electrical or thermal energy.

Solar energy, solar lighting, qualified fuel cell, small wind, geothermal, combined heat and power (CHP), and waste energy recovery property that begins construction before January 1, 2025, qualifies for the 6 percent base credit (the base credit rate for geothermal and CHP is 2 percent before 2023). Qualified microturbine property that begins construction before January 1, 2025, qualifies for the 2 percent base credit. Ground and ground water thermal

property that begins construction before January 1, 2034, qualifies for a 6 percent base credit amount through 2032, with the base credit rate reduced to 5.2 percent in 2033 and 4.4 percent in 2034.

Energy storage, qualified biogas property, and microgrid controllers placed in service after December 31, 2022, that begin construction before January 1, 2025, are qualified energy credit property at the six percent base credit rate, as is interconnection property installed in connection with energy property with a maximum net output of no more than five megawatts. The definition of solar lighting property includes electrochromic glass and the definition of qualified fuel cell property includes linear generator assemblies for property placed in service after December 31, 2022.

Taxpayers may elect to treat a clean hydrogen production facility as energy credit property or property that qualifies for the renewable energy production tax credit (PTC) as energy credit property.

A “bonus credit” amount is available for projects that meet domestic content requirements to certify that certain steel, iron, and manufactured products used in the facility were domestically produced. The bonus credit amount would be 2 percentage points, or 10 percentage points for projects that meet wage and apprenticeship requirements.

A separate increased credit amount is available for projects in an “energy community,” with the credit increase being 10 percentage points for projects meeting wage and workforce requirements or 2 percentage points otherwise. An energy community is defined as being a brownfield site; an area which has or had certain amounts of direct employment or local tax revenue related to oil, gas, or coal activities and has an unemployment rate at or above the national average; or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009.

The IRS is directed to establish a program to allocate 1.8 gigawatts for “environmental justice solar and wind capacity” credits in each of calendar year 2023 and 2024. Taxpayers receiving a capacity allocation may be entitled to tax credits in addition to otherwise allowed ITCs. Specifically, projects receiving an allocation that are located in a low-income community or on Indian land would be eligible for a bonus investment tax credit of 10 percentage points, while projects that are part of a low-income residential building project or qualified low-income economic benefit project would be

eligible for a 20 percentage point bonus investment credit. Qualifying solar and wind facilities would include those with a nameplate capacity of 5 megawatts or less, and qualifying property would include energy storage property installed in connection with the solar property and interconnection property. Facilities receiving an allocation would be required to have the facility placed in service within four years.

After 2022, tax-exempt organizations, including state and local government and electric cooperatives, may be able to receive credit amounts as direct payments. In 2024, the amount of the credit that could be received as direct pay would be limited to 90% for large facilities not meeting domestic content requirements. This limit would be waived if materials are not available domestically or if including domestic materials would increase the facility's construction cost by more than 25 percent. Taxpayers can elect a one-time transfer of all or a portion of the tax credit.

The provision provides that for facilities financed with tax-exempt bonds, the credit amount would be reduced by the lesser of (1) 15 percent; or (2) the fraction of the proceeds of a tax-exempt obligation used to finance the project over the aggregate amount of the project's financing costs. Public utilities, under certain circumstances, would be able to elect out of normalization requirements for investments in energy storage technologies.

To qualify for the energy credit property must be depreciable. The energy credit is part of the general business credit, and as such unused credits may be carried back for one year and carried forward for up to 20 years. The taxpayer's basis in property eligible for the ITC must be reduced by one-half of the credit amount. The basis reduction does not apply for purposes of determining basis for purposes of the low-income housing tax credit (discussed elsewhere in this compendium). For construction projects with durations of two or more years, credits may be claimed as construction progresses rather than at the time the property is placed in service.

For property placed in service after 2024, the Section 48 ITC will be superseded by the clean electricity investment credit (discussed elsewhere in this compendium).

Impact

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. The energy credit reduces the cost of installing renewable energy equipment and increases the rate of return on

renewable energy system investments. Effective tax rates for ITC-eligible energy investments are lower than effective tax rates for investments in other forms of energy capital, which has likely increased investment in eligible technologies.

Investment tax credits that lead to additional deployment of solar and other renewable electricity generation capacity can contribute to both reduced electricity prices and reduced greenhouse gas emissions. Tax credits for clean and renewable electricity can reduce the price consumers pay for electricity, which benefits households across the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

There are many factors that influence decisions to invest in renewable energy capacity. Falling costs for solar property in recent years have led to increased investment. Further, state-level policies, including renewable portfolio standards, have also been credited with increasing renewable energy capacity. Thus, it is difficult to isolate the effects of tax credits.

Rationale

The energy tax credit was established as part of the Energy Tax Act of 1978 (P.L. 95-618), which created a refundable, temporary, 10 percent tax credit for alternative and renewable energy property. The rationale behind the credits at the time of enactment was primarily to reduce U.S. consumption of oil and natural gas by encouraging the commercialization of renewable energy technologies.

The 1980 Windfall Profit Tax Act (P.L. 96-223) extended the credit for solar and geothermal equipment, raised credit rates from 10 percent to 15 percent, converted them to nonrefundable credits for solar and wind energy equipment, and extended the credit beyond 1985 for certain long-term projects. The Tax Reform Act of 1986 (P.L. 99-514) retroactively extended the credits for solar, geothermal, ocean thermal, and biomass equipment through 1988 at lower rates.

The Miscellaneous Revenue Act of 1988 (P.L. 100-647) extended the solar, geothermal, and biomass credits at their 1988 rates—ocean thermal was not extended. The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) extended the credits for solar and geothermal and reinstated the credit for ocean thermal equipment, through December 31, 1991. The credit for biomass equipment was not extended, however. The Tax Extension Act of 1991 (P.L.

102-227) extended the credits for solar and geothermal through June 30, 1992. The Energy Policy Act of 1992 (P.L. 102-486) made the credits for solar and geothermal equipment permanent. After P.L. 102-486, the only tax credits remaining from the Energy Tax Act of 1978 (P.L. 95-618) were the solar and geothermal equipment credits.

The Energy Policy Act of 2005 raised the credit rate for solar equipment from 10 percent to 30 percent, and expanded it to fiber-optic distributed sun lighting, fuel cells, and microturbines. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the 30 percent tax credit for solar and the 10 percent credit for microturbines by one year, through 2008.

The Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343) extended the 30 percent investment tax credit for solar energy property and qualified fuel cell property, as well as the 10 percent investment tax credit for micro turbines, for eight years, through December 31, 2016. EESA added small commercial wind, geothermal heat pumps, and combined heat and power systems (at a 10 percent credit rate) as a category of qualified investment. EESA also increased the \$500 per half kW of capacity cap for qualified fuel cells to \$1,500 per half kW and allowed these credits to be used to offset the alternative minimum tax (AMT).

The American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5) made additional modifications to the ITC. First, credit limitations for entities receiving subsidized financing were removed. Second, dollar limitations for specific types of property were eliminated. Previously, the 30 percent credit for small wind property was capped at \$4,000, the 30 percent credit for solar water heating property had been capped at \$2,000, and the 10 percent credit for geothermal heat pumps had been capped at \$2,000. Additionally under ARRA, ITC-eligible property was eligible for a Section 1603 grant from the Treasury in lieu of the ITC. This option was scheduled to expire at the end of 2010, but was extended through the end of 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). ARRA also contained provisions allowing PTC-eligible property to claim the ITC in lieu of the PTC. The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) extended the ITC in lieu of the PTC option for property under construction before January 1, 2014.

The Consolidated Appropriations Act, 2016 (P.L. 114-113) extended the 30 percent rate for solar and further modified the ITC for solar. The 30 percent rate was extended through 2019, with a 26 percent rate set for 2020, and a 22

percent rate set for 2021. Additionally, under P.L. 114-113, the tax credit rate for investments in solar energy property is determined in the year construction begins, with the credit claimed when property is placed in service. Solar property must be placed in service by December 31, 2023, to qualify for a tax rate in excess of 10 percent.

The Bipartisan Budget Act of 2018 (P.L. 115-123) extended the ITC for five years for fiber-optic solar, fuels cell, small wind, microturbine, CHP, and geothermal heat pump property. For property eligible for a 30 percent credit through 2019, the credit rate is reduced following the reduction schedule for solar enacted in P.L. 114-113. All termination dates were changed to construction start deadlines.

The energy credit deadlines were generally extended by two years in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260). This legislation expanded the credit to include waste energy recovery property and to allow an ITC for offshore wind. For offshore wind, P.L. 116-260 allowed the credit for property that begins construction by the end of 2025. The tax credit rate for offshore wind was set at 30 percent with no phase down.

P.L. 117-169 extended and modified the ITC, with the credit generally extended through the end of 2024. In addition to extending the ITC, P.L. 117-169 expanded the credit to include energy storage technology (including thermal energy storage property), qualified biogas property, electrochromic glass, and microgrid controllers. Linear generator assemblies were added to the definition of qualifying fuel cells. The credit was also made available for interconnection property. P.L. 117-169 allowed tax-exempt entities to receive the credit as direct payments, allowed taxpayers to elect to transfer the credit, required that certain projects pay prevailing wages and meet registered apprenticeship requirements to receive larger credit amounts, provided bonus credits for projects meeting domestic content requirements or projects located in energy communities, and provided that projects receiving environmental justice allocations could receive additional credits. Under P.L. 117-169, after 2024, the ITC is superseded by the clean electricity investment tax credit.

Assessment

Generally, economic theory suggests that taxes and subsidies create distortions in markets, and reduce economic efficiency. However, market failures related to the energy sector result in inefficiencies that may be

improved through public policy. The generation of electricity from conventional sources, mainly coal and natural gas, can have negative impacts, which may not be taken into consideration when individuals make consumption decisions. This market failure results in demand for electricity generated from fossil fuels beyond the socially optimum level.

The tax credits provided for renewable energy equipment and property help to correct this market failure by reducing the relative price of electricity production from renewable sources and increasing the rate of return to investments in renewable energy technology. Increased investment in renewable energy property could shift the balance of electricity production closer to the socially optimal level. However, tax benefits that reduce the average price of electricity, thereby increasing overall demand, counter energy efficiency objectives. Further, tax incentives reduce federal tax collections, and may require higher tax rates on other market activities to finance these tax benefits. A more economically efficient policy option to correct for energy-related market failures would be to tax the source of the negative impacts (i.e., pollution and greenhouse gas emissions from conventional sources). This policy option could achieve a mix of electricity production between renewable and conventional sources closer to the socially optimal mix, while reducing federal tax expenditures.

The economic efficiency of investment tax credits for renewable energy is reduced if such credits fail to lead users to adopt targeted technologies. In states with renewable portfolio standards (RPS) mandates, federal tax benefits for renewable energy reduce the cost of complying with these state-level policies. If taxpayers would have invested in solar capacity, or other renewable technologies without the tax credit, then the tax credit provides a windfall benefit to the taxpayer without necessarily increasing renewable generation capacity. Tax credits for renewable energy might also be more economically efficient when they reward outcomes (i.e., the production of electricity from low- or zero-emissions resources) as opposed to the cost of investment. Allowing credits to be transferred could increase the value of these credits, making it easier for developers with limited tax liability and potentially new developers to make qualifying investments.

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Energy

**TAX CREDITS FOR ALTERNATIVE FUEL VEHICLE
REFUELING PROPERTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Note: This provision was extended by P.L. 116-260 with the changes estimated to cost \$0.2 billion over FY2021 – FY2030. This provision was further extended and modified by P.L. 117-169 with the changes estimated to cost \$1.7 billion over FY2022 – FY2031.

Authorization

Section 30C, 4617, and 4618.

Description

A 30 percent tax credit is provided for the cost of any qualified alternative fuel vehicle refueling property installed by a business or at a taxpayer's principal residence. The credit is limited to \$30,000 for businesses at each separate location, and \$1,000 for residences. Starting in 2023, the credit rate for business property will be set at a base rate of 6 percent. This credit rate can be 30 percent if prevailing wage and registered apprenticeship requirements are met. The credit limit will be increased to \$100,000, for business property, starting in 2023. Additionally, the credit is modified to apply to each item of depreciable property rather than each location.

Starting in 2023, charging or refueling property will only be eligible if it is placed in service within a low-income or rural census tract.

Clean fuel refueling property is generally any tangible equipment (such as a pump) used to dispense a fuel into a vehicle's tank. Qualifying property includes fuel storage and dispensing units and electric vehicle recharging equipment. A clean fuel is defined as any fuel at least 85 percent of the volume of which consists of ethanol (E85) or methanol (M85), natural gas, compressed natural gas (CNG), liquefied natural gas, liquefied petroleum gas, and hydrogen, or any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel. For the purposes of the credit, electricity is also considered a clean fuel. Starting in 2023, the definition of clean burning fuels is expanded to include fuel meeting certain emissions and biomass requirements, the definition of qualifying property is modified to include bidirectional charging equipment, and the credit can also be claimed for electric charging stations for two- and three-wheeled vehicles that are intended for use on public roads.

For business taxpayers, the taxpayer's basis in the property is reduced by the amount of the credit. The credit for business property is treated as a portion of the general business credit. As part of the general business credit, unused credits may be carried back for one year or carried forward for 20 years. No credit is available for property used outside the United States.

Starting in 2023, tax-exempt organizations and government entities may elect to be treated as making income tax payments equal to the credit amount, allowing the credit to then be received as direct pay. Taxpayers are not eligible for direct pay, but can elect to transfer all or a portion of the credit to an unrelated taxpayer. Before 2023, for property sold to a tax-exempt entity, the seller of the property may have been able to claim the credit.

Impact

Allowing a 30 percent investment tax credit for alternative fuel dispensing equipment reduces the after-tax cost, raises the pre-tax return, and reduces the marginal effective tax rate. Economic theory suggests this should increase investment in alternative fuel dispensing equipment and thus increase the availability of alternative fuels. The presence of alternative fueling stations may also stimulate the demand for alternative fuel vehicles. For example, the presence of hydrogen refueling stations is believed to increase demand for fuel cell vehicles.

There is limited uptake of this credit for individual taxpayers. On 2019 tax returns, the credit was claimed by 26,892 taxpayers, with the amount claimed totaling an estimated \$9.7 million. An estimated 77 percent of this amount went to taxpayers with adjusted gross income of \$100,000 or more.

Tax credits claimed by businesses tend to benefit the upper end of the income distribution. Business taxpayers may not receive the full economic value of the credit, as some of the value of the credit may be passed backward to equipment suppliers in the form of higher prices paid, or passed forward to consumers in the form of reduced alternative fuel costs.

Rationale

The Energy Policy Act of 1992 (P.L. 102-486) introduced a \$100,000 tax deduction for business investment in clean fuel refueling property. This tax deduction was set to expire on January 1, 2007, but the Energy Policy Act of 2005 (P.L. 109-58) accelerated the expiration date by one year and replaced the deduction with the 30 percent tax credit under Section 30C. Initially, the credit was set to terminate on December 31, 2014, for hydrogen, and December 31, 2009, in the case of other property. The provision complements tax credits for alternative technology vehicles and alternative fuels (both discussed elsewhere in this compendium). Congress held that further investments in alternative fuel infrastructure are necessary to encourage consumers to invest in alternative fuel vehicles. This investment, in turn, is necessary to transform the mode of transportation in the United States toward cleaner, fuel-efficient vehicles. Ultimately, this could reduce reliance on petroleum, particularly imported petroleum, which endangers U.S. energy and economic security.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the 30 percent alternative refueling property credit (capped at \$30,000) for one year, through 2010, for non-hydrogen property. The law also provided a tax credit to businesses (e.g., gas stations) that install alternative fuel pumps, such as fuel pumps that dispense fuels such as E85, compressed natural gas, and hydrogen. The law also added electric vehicle recharging property to the definition of alternative refueling property.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) temporarily increased, for the 2009 and 2010 tax years, the credit amount to 50 percent for non-hydrogen related property. In addition, maximum credit amounts were increased to \$50,000 for business property and \$2,000 for non-

business property. In the case of hydrogen-related property, the maximum credit amount was increased to \$200,000.

The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended this credit, at the lower credit rates and limits, through December 31, 2011, for non-hydrogen property. The credit was again extended through December 31, 2013, as part of the American Taxpayer Relief Act of 2012 (P.L. 112-240). The Tax Increase Prevention Act of 2014 (P.L. 103-295) extended the provision for one year, through December 31, 2014. The provision was extended for two more years, through December 31, 2016, for all fuel types, as part of the Consolidated Appropriations Act, 2016 (P.L. 114-113). The provision was extended through December 31, 2017, in the Bipartisan Budget Act of 2018 (P.L. 115-123), through the end of 2020 in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), and through the end of 2021 in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022, provided an 11-year extension of the credit. For businesses, the maximum credit amount was increased, although the law also provided that the prior-law credit rate can only be claimed by businesses paying prevailing wages and meeting registered apprenticeship requirements. The legislation also included the requirement that property was only eligible if placed in service in a low-income or rural census tract and modified the definition of qualifying property.

Assessment

To the extent that the credits are effective in increasing the availability of alternative fuels, and substitute for petroleum products (gasoline and diesel fuel), there is a decline in petroleum use. Alternative fuel vehicles are also generally less polluting, producing lower total fuel cycle emissions when compared to equivalently sized conventional vehicles.

The lack of alternative fuel infrastructure has been a market barrier to the expanded use of alternative fuels and alternative fuel vehicles. Lack of investment in alternative fuel supply is due, at least in part, to lack of consumer demand for the vehicles, which was in turn due to the lack of alternative fuel infrastructure. The tax credit for clean fuel refueling property was intended to address this obstacle to alternative fuel production and use.

There has been substantial investment in electric vehicle (EV) charging infrastructure in recent years. Access to public charging, however, is clustered in higher-income and urban areas. The lack of charging in lower-income communities or in multi-family dwellings is a potential barrier to widespread EV adoption. Another factor to consider with respect to EV charging is time; how taxpayers value their time could have implications for where and what speed EV charging infrastructure is prioritized.

From an economic perspective, allowing special tax credits for selected technologies distorts the allocation of resources, and may create economic inefficiencies. Tax credits encourage investments in high-cost technologies, ones that would not otherwise be economical at current and expected prices and rates of return. Economic theory suggests that taxes on conventional fuels and conventional fuel-using vehicles is more effective and efficient in stimulating the development of the least-cost alternatives to gasoline and diesel fuel. When conventional motor fuel prices are sufficiently high, motorists have financial incentives to purchase more fuel efficient vehicles and alternative fuel vehicles.

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Energy

CREDITS FOR ELECTRICITY PRODUCTION FROM RENEWABLE RESOURCES (SECTION 45)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	4.4	4.6
2021	0.2	3.7	3.9
2022	0.1	2.8	2.9
2023	0.1	2.6	2.7
2024	0.1	2.6	2.7

Note: This provision was extended by P.L. 116-260 with the changes estimated to cost \$1.7 billion over FY2021 – FY2030. This provision was further extended and modified by P.L. 117-169 with the changes estimated to cost \$51.1 billion over FY2022 – FY2031.

Authorization

Sections 45, 4617, and 4618.

Description

Taxpayers producing electricity from a qualified renewable energy resource may qualify for a tax credit for electricity produced during a facility's first 10 years in operation. To qualify, a facility must have started construction before January 1, 2025. Qualified energy resources include wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste (trash combustion), landfill gas, qualified hydropower production, and marine and hydrokinetic renewable energy sources. The credit amount in 2022 for electricity produced using wind, closed-loop biomass, and geothermal energy resources is 2.6¢ per kilowatt hour (kWh). Other resources qualify for a credit equal to half the full credit amount, or 1.3¢ per kWh in 2022. The credit amount is based on the 1993 value of 1.5¢ per kWh, which is adjusted annually for inflation.

For property placed in service after December 31, 2021, the base credit amount for the production tax credit (PTC) is set in statute at 0.3 cents per

kWh (0.5 cents per kWh in 2022, or 0.3 cents for half-credit technologies, after being adjusted for inflation). Facilities that pay prevailing wages during the construction phase and first 10 years of operation and meet registered apprenticeship requirements are eligible for a PTC that is five times the base amount, or 2.5 cents or 1.3 cents per kWh in 2021 after being adjusted for inflation. Facilities with a maximum net output of less than one megawatt are also eligible for the five times base credit amount (e.g., 2022 rates of 2.6 cents or 1.3 cents per kWh), as are facilities that begin construction before 60 days after the Secretary of the Treasury publishes guidance on the wage and registered apprenticeship requirements.

The amount of the credit is reduced for some wind facilities. Specifically, for wind facilities that began construction in 2017, the credit amount is reduced by 20 percent. For wind facilities that began construction in 2018, the credit amount is reduced by 40 percent. For wind facilities that began construction in 2019, the credit amount is reduced by 60 percent. The credit is reduced by 40 percent if construction began in 2020 or 2021. The credit is not reduced for wind facilities placed in service after 2021.

Electricity produced at qualified open-loop biomass, small irrigation power, landfill gas, trash combustion, qualified hydroelectric, and marine and hydrokinetic energy facilities qualifies for the half-rate tax credit. Electricity produced at qualified hydropower and marine and hydrokinetic renewable energy projects placed in service after December 31, 2022, qualifies for the full PTC amount.

The credit amount can be increased by 10 percent for facilities located in an energy community after December 31, 2022. An energy community is defined as being a brownfield site; an area which has or had certain amounts of direct employment or local tax revenue related to oil, gas, or coal activities and has an unemployment rate at or above the national average; or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009.

A “bonus credit” amount can be claimed for projects that meet domestic content requirements to certify that certain steel, iron, and manufactured products used in the facility were domestically produced. The bonus credit amount is 10 percent of the credit amount and available for facilities placed in service after December 31, 2022.

After 2022, tax-exempt organizations, including state and local government and electric cooperatives, may be able to receive credit amounts as direct payments. In 2024, the amount of the credit that could be received as direct pay would be limited to 90 percent for large facilities not meeting domestic content requirements. This limit would be waived if materials are not available domestically or if including domestic materials would increase the facility's construction cost by more than 25 percent. Taxpayers can elect a one-time transfer of all or a portion of the tax credit.

Certain cooperatives that are eligible for the PTC may elect to pass through any portion of the credit to their patrons. To be eligible for this election, the cooperative has to be more than 50 percent owned by agricultural producers or entities owned by agricultural producers. The election is made on an annual basis, and is irrevocable once made.

Effective August 16, 2021, for facilities financed with tax-exempt bonds, the credit amount is reduced by the lesser of (1) 15 percent; or (2) the fraction of the proceeds of a tax-exempt obligation used to finance the project over the aggregate amount of the project's financing costs. Before August 16, 2021, the amount that could be claimed as a PTC was reduced by up to 50 percent for projects receiving other federal tax credits, grants, tax-exempt bonds, or subsidized energy financing.

PTC eligible taxpayers can elect to claim the energy investment tax credit (ITC) in lieu of the PTC. Facilities eligible for the PTC qualified for a grant equal to 30 percent of a qualifying project's eligible basis. From 2009 through 2011 the PTC and ITC could have been received as a grant from the Treasury in lieu of tax benefits.

The PTC is phased out as the price of electricity exceeds a threshold level. Specifically, when the annual average contract price per kWh of electricity sold (the reference price) in the prior year exceeds 8¢ per kWh (adjusted annually for inflation), the credit phases out. To date, electricity prices have yet to exceed levels that would trigger phaseout.

Generally, the taxpayer must own the qualified facility and sell the electricity produced to an unrelated party to qualify for the tax credit. A lessee or operator may claim the credit in lieu of the owner for qualified open-loop biomass facilities. A lessee or operator may also claim the credit for qualified closed-loop biomass facilities modified to co-fire with coal, other biomass, or with a combination of the two. Electricity produced by the taxpayer after

December 31, 2022, is treated as being sold by the taxpayer to an unrelated taxpayer if the electricity was used at a qualified clean hydrogen production facility to produce qualified clean hydrogen.

The PTC is a component of the general business credit and is subject to the rules and limitations associated with the credit under Internal Revenue Code (IRC) Section 38. Under the general business credit, excess credits may be carried back for one year or carried forward for up to 20 years.

For property placed in service after 2024, the Section 45 PTC will be superseded by the clean electricity production credit (discussed elsewhere in this compendium).

Impact

The PTC was originally intended to encourage the generation of electricity using wind and biomass. While other technologies are now eligible for the PTC, the majority of revenue losses associated with this provision serve to benefit electricity production using wind. Between 2019 and 2023, about 93 percent of PTC tax expenditures are expected to benefit wind. Tax credits are also expected to be claimed for electricity produced using geothermal, qualified hydropower, municipal solid waste, and open-loop biomass.

Recent decades have seen substantial growth in the use of wind in the electric power sector. In 2001, net generation from wind was 6.7 billion kilowatt hours. In 2021, net generation from wind was 379.8 billion kilowatt hours. In 2020, 8.4 percent of utility-scale electricity generation came from wind. This figure was expected to increase to 10 percent for 2021.

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. The PTC encourages taxpayers to invest in renewable electricity generating capacity by reducing the cost of producing renewable electricity from qualifying facilities. Some of that benefit will likely accrue to the owners and developers of the renewable energy facility, whereas some of the benefit may show up in reduced electricity prices.

Tax credits that lead to additional deployment of renewable electricity generation capacity can contribute to both reduced electricity prices and reduced greenhouse gas emissions. Tax credits for clean and renewable electricity can reduce the price consumers pay for electricity, which benefits households across the income distribution. Over longer periods of time, tax

credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The PTC was adopted as part of the Energy Policy Act of 1992 (P.L. 102-486). Its purpose was to encourage the development and utilization of electric generating technologies that use specified renewable energy resources, as opposed to conventional fossil fuels. The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) extended the placed-in-service deadline from July 1, 1999, to January 1, 2002. It also added poultry waste as a qualifying energy resource. The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) extended the placed-in-service deadline to January 1, 2004. The Working Families Tax Relief Act of 2004 (P.L. 108-311) extended the placed-in-service dates for wind, closed-loop biomass, and poultry waste facilities so that those placed into service after December 31, 2003, would also qualify for the tax credit. The American Jobs Creation Act of 2004 (P.L. 108-357) expanded the renewable electricity credit to open-loop biomass, geothermal, solar, small irrigation power, and municipal solid waste facilities.

The Energy Policy Act of 2005 (P.L. 109-58) extended the placed-in-service deadline for all facilities except for solar energy facilities described in § 45(d)(4) to December 31, 2007. In addition, P.L. 109-58 extended the credit period to 10 years for all qualifying facilities placed in service after the date of enactment (August 8, 2005), eliminating the five-year credit period to which some facilities had been subject. Also, the definition of qualified energy resources that can receive the credit was expanded to include qualified hydropower production, although a qualified hydroelectric facility would be entitled to only 50 percent of the usual credit. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the placed-in-service date to the end of 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the placed-in-service date through December 31, 2009, in the case of wind, and through December 31, 2010, in the case of other sources. The 2008 law also expanded the types of facilities qualifying for the credit to new biomass facilities and to those that generate electricity from marine renewables (e.g., waves and tides). The law also updated the definition of an open-loop biomass facility, the definition of a trash combustion facility, and the definition of a non-hydroelectric dam.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended the placed-in-service deadline by three years for most technologies

(the placed-in-service deadline for marine and hydrokinetic facilities was extended for two years). P.L. 111-5 also introduced the Section 1603 Treasury grant program, allowing facilities eligible for the PTC to elect instead to receive the ITC or apply to the Treasury for a cash grant. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the Section 1603 grant program for one year, through 2011.

The PTC for wind, which was scheduled to expire at the end of 2012, was extended for one year, through 2013, as part of the American Taxpayer Relief Act (ATRA; P.L. 112-240). In addition to extending the PTC for wind, provisions in ATRA changed the credit expiration date from a placed-in-service deadline to a construction start date for all qualifying electricity-producing technologies.

The PTC was extended through 2014 for all qualifying technologies as part of the Tax Increase Prevention Act of 2014 (P.L. 113-295). The Consolidated Appropriations Act, 2016 (P.L. 114-113) included an extension of the PTC for all qualifying non-wind technologies through 2016. The PTC for wind was extended through 2019, but with a phaseout. Under the phaseout, the PTC for wind facilities would be reduced by 20 percent for facilities beginning construction in 2017, 40 percent for facilities beginning construction in 2018, and 60 percent for facilities beginning construction in 2019.

The PTC construction start date for non-wind technologies was extended for one year, through 2017, in the Bipartisan Budget Act of 2018 (P.L. 115-123). The PTC for non-wind technologies was extended through 2020 in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). P.L. 116-94 also extended the PTC for wind at 60 percent of the credit's full value (a 40 percent reduction). The PTC deadlines were generally extended by one year, through 2021, in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

P.L. 117-169 extended and modified the PTC, with the credit generally extended through the end of 2024. In addition to extending the PTC, P.L. 117-169 modified the credit to eliminate the credit reduction for wind and to allow full credit amounts for qualified hydropower or marine and hydrokinetic facilities. P.L. 117-169 allowed tax-exempt entities to receive the credit as direct payments, allowed taxpayers to elect to transfer the credit, required that certain projects pay prevailing wages and meet registered apprenticeship

requirements to receive larger credit amounts, and provided bonus credits for projects meeting domestic content requirements or projects located in energy communities. Under P.L. 117-169, after 2024, the PTC is superseded by the clean electricity production tax credit.

Assessment

Federal tax policy, and other federal energy policy, has played a role in the development of renewable electricity, particularly wind power. In the late 1970s and 1980s, the investment tax credits established under the National Energy Act of 1978, along with California state tax credits, contributed to the first installations of wind power generation capacity. There was a slowdown in wind power investments after the sunset of these investment incentives, and the decline in real oil prices, and a lagged response after the enactment of the PTC in 1992. Some also suggest that terminations of the PTC for wind power on various occasions created policy uncertainty, and probably adversely affected (if only temporarily) investment in the technology.

Empirical evidence suggests that the PTC influences the amount of installed wind capacity. The PTC reduces the user cost of capital for wind investment. Estimates suggest that reducing the user cost of capital by one percent increases investment in wind capacity by more than one percent. Research also finds that much of the current investment in wind capacity can be explained by the PTC. Other research has found that production credits likely encourage more renewable electricity production per tax-credit dollar than investment-based incentives.

As a production incentive, the PTC rewards production, as opposed to investment. In some instances, this can lead to producers supplying tax-credit generating electricity, even when wholesale electricity prices are negative. Some are critical of the PTC for this reason. Subsidizing renewable electricity production reduces the price of electricity for all forms of electricity produced, making it harder for unsubsidized forms of electricity to be competitive in electricity markets.

In addition to the PTC, other policies may also be responsible for increased installation of renewable energy capacity. For example, renewable portfolio standards at the state level also encourage renewable generation installations. To the extent that future policies at the state and federal level mandate renewable energy use, or increase the relative price of non-renewable energy alternatives, the share of renewables in U.S. energy production is

expected to increase. If renewable portfolio standards, or other policies, lead to additional investment in renewables, they can reduce the economic efficiency of the PTC. Taxpayers making investments in response to other incentives or mandates may be able to claim the PTC, even if the PTC did not change their behavior or cause additional investment.

Production subsidies for renewable electricity may promote an efficient allocation of economic resources. Electricity produced using renewable resources, in many cases, has limited negative environmental impacts. There are likely market failures in electricity production using coal and natural gas, as such resources are associated with pollution and carbon emissions. When electricity producers fail to fully account for negative environmental costs when making production decisions, the market produces an economically inefficient amount of energy using polluting resources. While subsidizing renewable energy resources is one policy option for increasing the share of renewables in the energy portfolio, some argue that taxing polluting energy resources directly may be a more economically efficient policy option.

A motivation for recent extensions of the PTC has been emissions reduction. Long-term tax credits for zero-emissions mature technologies, like wind, are expected to contribute to electric power sector reductions in greenhouse gas emissions in the coming decades.

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Energy

**CREDITS FOR INVESTMENTS IN CLEAN COAL
FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.2	0.2
2021	—	0.2	0.2
2022	—	0.2	0.2
2023	—	0.2	0.2
2024	—	0.2	0.2

Authorization

Sections 48A and 48B.

Description

An investment tax credit is available for certain advanced coal technologies. The Energy Improvement and Extension Act of 2008 (P.L. 110-343) allocated \$1.25 billion in credits for power generation projects that use integrated gasification combined cycle (IGCC) or other advanced coal-based electricity generation technologies. Qualifying taxpayers may be eligible for a 30 percent credit under section 48A. The Energy Improvement and Extension Act of 2008 also allocated \$250 million in credits for qualified gasification projects. The credit rate for gasification projects is also 30 percent under section 48B.

Prior allocations were awarded under the Energy Policy Act of 2005 (P.L. 109-58). These first-round allocations provided \$800 million in credits for IGCC projects and \$500 million in credits for other advanced coal-based electricity generation technologies. The credit rate for IGCC projects was 20 percent, while the credit rate for other advanced coal-based electricity generation projects was 15 percent. The Energy Policy Act of 2005 also allocated \$350 million in credits for qualified gasification projects. The credit rate for qualified investments in gasification projects was 20 percent.

Credits are only available for projects certified by the Secretary of the Treasury in consultation with the Secretary of Energy. Certifications are issued in a competitive bidding process. Highest priority is given to applicants who have a research partnership with an eligible educational institution. For funds allocated under the Energy Improvement and Extension Act of 2008, the identity of taxpayers receiving credits and the amount of the award is publicly disclosed.

Under the Energy Improvement and Extension Act of 2008, credits are awarded to projects with the greatest separation and sequestration percentage of total carbon dioxide emissions. At a minimum, qualifying IGCC and other advanced coal projects must include equipment that separates and sequesters at least 65 percent of the project's total carbon emissions to qualify for the credit under section 48A. Qualifying gasification projects must separate and sequester at least 75 percent of total carbon dioxide emissions under section 48B.

Impact

In recent years, the use of coal-fired electricity and consumption of coal energy has decreased. Despite the recent decrease, coal remains an important domestic energy source. Further, the United States is one of the world's largest coal producers. Power plants that use coal are also a major source of greenhouse gas emissions in the United States. Continued use of this plentiful domestic energy resource, while minimizing long-term compromises to the environment, has been a policy priority.

Technological developments in coal-fired power generation promise improved efficiency and reduced greenhouse gas emissions (primarily carbon dioxide). Carbon capture technology for coal power generation includes pre-combustion IGCC that burns hydrogen gas synthesized from coal (syngas) and separates the CO₂ during synthesis; oxy-fuel combustion that burns coal in a concentrated stream of oxygen creating only CO₂ combustion gas; and post-combustion capture that separates CO₂ from other combustion gases at the smokestack flue gas using chilled ammonia separation.

Investment tax credits, coupled with accelerated depreciation allowances, reduce after-tax capital costs to attract investment. Additionally, non-tax federal incentives, such as loan guarantees and research and development (R&D) grants, promote investment in clean coal technologies. While clean

coal technologies are technologically feasible, uncertainty surrounding commercial viability remains a factor inhibiting investment.

Few U.S. electric utilities are currently building coal-gasification power plants. The lack of comprehensive carbon legislation, as well as increased supplies of low-cost natural gas, are factors contributing to relatively slow deployment and commercialization of clean coal power generating facilities.

In late 2006, the Internal Revenue Service (IRS) announced that nearly \$1 billion in tax credits had been awarded to nine clean coal projects, located in nine different states. Reportedly, 49 companies from 29 states had requested \$5 billion in tax credits for projects totaling \$58 billion in cost.

During the 2009-10 allocation round, three advanced coal projects were awarded more than \$1 billion in tax credits under section 48A. The entire \$250 million allocated for qualified gasification projects (48B) was awarded to two projects during the 2009-10 allocation round. After the 2009-10 allocation round, \$241 million in credits under section 48A was available for projects seeking allocations during the 2010-11 allocation round. Ultimately, no allocations were made in the 2010-11 allocation round. Thus, a 2011-12 allocation was conducted, in which \$103.6 million was allocated to a single project.

In 2012, the IRS announced that \$658.5 million in section 48A tax credits were available for allocation. These credits were allocated to two projects. The funding available for the 2012-2013 allocation round included funding that had previously been allocated to projects that had their certification revoked.

Additional allocation rounds have been held to reallocate previously awarded credit amounts that were ultimately forfeited. In 2014, the IRS announced a reallocation of gasification credits (48B). A total of \$309.3 million in 48B credits were available for reallocation. In 2015, the IRS announced that \$1.1 billion in 48A credits were available for allocation or reallocation.

In 2016, the IRS announced \$324.0 million in 48A tax credits were allocated to a single project. It was also announced in 2016 that \$260.0 million in 48B tax credits were allocated to two projects. In 2020, the IRS announced that \$2.0 billion in 48A credits were available for reallocation in a round 3 phase III program.

The large amount 48A and 48B credits available for reallocation suggests that many of the projects allocated credits in the early allocation rounds were not completed as initially planned.

Rationale

The investment tax credits for clean coal technologies were established by the Energy Policy Act of 2005 (P.L. 109-58). As noted above, additional funds were allocated under the Energy Improvement and Extension Act of 2008 (P.L. 111-343). The investment tax credits for clean coal technologies are designed to encourage the burning of coal in a more efficient and environmentally friendly manner. The goal of clean coal tax incentives is to promote technologies that allow the United States to use an abundant domestic energy resource while minimizing negative environmental effects.

Assessment

Despite some successful demonstrations, clean coal technologies are still generally economically unproven technologies in the sense that commercial viability without significant subsidies is scant. As a result, utilities may not have the confidence in them as compared to conventional systems. Further, technologies have changed and evolved, and the tax credits for clean coal plants that were enacted in the 2000s were not designed to encourage investment in carbon capture and sequestration technologies. Separate tax incentives have been enacted to encourage investment in this technology, and new tax incentives designed to support electricity generated from any zero-emission resource are scheduled to become available in 2024.

Even with reduced capital costs, the unpredictability of the clean coal systems increases risks and possibly operating and maintenance costs to the utility, which may inhibit investment. In recent years, utilities have tended to invest in new generating capacity that relies on renewable energy resources or low-cost natural gas.

While investment incentives may be an effective mechanism for promoting clean coal technologies, such subsidies are not an economically efficient tool for reducing greenhouse gas emissions. Economic efficiency could be enhanced by directly taxing energy sources associated with greenhouse gas emissions, rather than subsidizing the alternative.

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Energy

CREDIT FOR HOLDERS OF CLEAN RENEWABLE ENERGY BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	0.1
2021	(¹)	(¹)	0.1
2022	(¹)	(¹)	0.1
2023	(¹)	(¹)	0.1
2024	(¹)	(¹)	0.1

Note: Estimates include outlay effects associated with the refundable portion of CREBs. These outlay effects are estimated to be \$0.2 billion FY2020-FY2024. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 54, 54C, and 54D.

Description

Clean renewable energy bonds (CREBs) were available to finance qualified energy production projects. These projects include: (1) wind facilities; (2) closed-loop bio-mass facilities; (3) open-loop bio-mass facilities; (4) geothermal or solar energy facilities; (5) small irrigation power facilities; (6) landfill gas facilities; (7) trash combustion facilities; and (8) refined coal production facilities. Holders of CREBs can claim a credit equal to the dollar value of the bonds held multiplied by a credit rate determined by the Secretary of the Treasury. Alternatively, *issuers* of “new” CREBs (explained below) could choose to receive the credit, typically identified as the “direct payment option.”

There are two types of CREBs. The original CREBs offered a credit rate equal to the percentage that will permit the bonds to be issued without discount

and without interest cost to the issuer. The national limit on the original CREBs was \$1.2 billion, of which a maximum of \$750 million could be granted to governmental bodies (the remainder would go to utilities). The original CREBs were issued before January 1, 2010. The credit rate is equal to the rate that will permit the bonds to be issued without discount and without interest cost to the issuer (or 100 percent of the interest cost).

The “new” CREBs were created by the Emergency Economic Stabilization Act of 2008 (EESA, P.L. 110-343) for the same purpose with an \$800 million capacity. The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) contained several bond provisions including an additional \$1.6 billion of new CREB capacity. In contrast to the original CREBs, the credit rate on new CREBs is 70 percent of the credit rate offered on the old CREBs. Up to \$2.4 billion of new CREBs could be issued up to three years after the allocation is approved. Not more than one-third of new CREBs could be allocated to any of the following: (1) public power providers, (2) governmental bodies, or (3) projects of cooperative electric companies. All authorized CREBs have been allocated, and the 2017 tax revision (P.L. 115-97) repealed issuing authority for all tax credit bonds beginning on January 1, 2018.

ARRA also created a new type of tax credit bond, Build America Bonds (BABs, see the entry *Build America Bonds*), that allowed issuers the option of receiving a direct payment from the U.S. Treasury instead of tax-exempt interest payments or tax credits for investors. Later in the 111th Congress, the Hiring Incentives to Restore Employment Act, (HIRE, P.L. 111-147) created the direct payment option for issuers of new CREBs and extended their issuance through 2010. Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rate for direct payment CREBs and all other direct payment tax credit bonds (TCBs) were subject to sequestration from FY2013 through FY2020. For FY2021, the sequestration reduced the direct payment CREB credit rate by 5.7 percent. Current law extends the 5.7 percent reduction to direct payment CREBs for all fiscal years through FY2030.

The maximum maturity of old and new CREBs is that which will set the present value of the obligation to repay the principal equal to 50 percent of the face amount of the bond issue. The discount rate for the calculation is the average annual interest rate on tax-exempt bonds issued in the preceding month, having a term of at least 10 years. CREBs are subject to arbitrage rules that require the issuer to spend 95 percent of the proceeds within five years of issuance.

Impact

The interest income on bonds issued by state and local governments usually is excluded from federal income tax (see the entry *Exclusion of Interest on Public Purpose State and Local Debt*). Such bonds result in the federal government paying a portion (approximately 25 percent) of the issuer's interest costs. The original CREBs are structured to have the interest paid by the federal government in the form of a tax credit to the bond holders or later (bonds issued after March 18, 2010) a direct payment to the issuer. The new CREBs are structured such that 70 percent of the interest cost is paid by the federal government. The cost is limited by the value of federal tax credits generated by the \$1.2 billion for the original CREBs and \$2.4 billion for the new CREBs.

Rationale

Proponents of CREBs have argued that the federal subsidy is necessary because private investors (potential CREB buyers) are unwilling to accept the risk and relatively low return associated with renewable energy and energy conservation projects. Proponents argue that the market has failed to produce investment in renewable energy and conservation because the benefits of these projects extend well beyond the service jurisdiction to the surrounding community and to the environment more generally. The ratepayers of the utility are not compensated for these external benefits, and it is unlikely, proponents argue, that private investors would agree to provide them without some type of inducement.

CREBs were introduced in 2005 by the Energy Policy Act of 2005 (P.L. 109-58). In December 2006, the Tax Relief and Health Care Act of 2006 (P.L. 109-432) increased the capacity amount by \$400 million and extended issuance authority through 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended CREBs issuing authority through 2009 and added \$800 million for a "new" CREB with a smaller federal subsidy (the credit is 70 percent of the credit amount on the original CREBs). P.L. 115-97 repealed issuing authority for all TCBs after tax year 2017.

Assessment

Evaluation of the CREB program can be viewed both in terms of the additional investment it induced and in terms of the greenhouse emissions reductions it achieved. Investors were induced to purchase these bonds if they received the same after-tax return from the credit that they would have from

the purchase of tax-exempt bonds. The value of the credit is included in taxable income, but is used to reduce regular or alternative minimum tax liability. Assuming the taxpayer is subject to the regular corporate income tax, the credit rate should equal the ratio of the purchaser's forgone market interest rate on tax-exempt bonds divided by one minus the corporate tax rate. For example, if the tax-exempt interest rate is 6 percent and the corporate tax rate is 21 percent, the credit rate would have to be equal to $0.06/(1-0.21)$, or about 7.6 percent to induce investment. Thus, an investor purchasing a \$1 million original CREB would need to receive a \$76,000 annual tax credit each year. For new CREBs, the tax credit is 70 percent of that amount or about \$53,200. The issuer would pay interest of at least \$22,800 to match the taxable bond alternative (e.g., the \$76,000). The Budget Control Act (P.L. 112-25), as amended, reduced the credit rate for direct payment new CREBs from FY2013 through FY2020 through sequestration. For FY2021, the sequestration reduced the direct payment CREB credit rate by 5.7 percent. Current law extends the 5.7 percent reduction to direct payment CREBs for all fiscal years through FY2030.

The direct payment option made available for new CREBs likely made the bonds more attractive to a broader investor pool. With the direct payment option, the *issuer* pays the investor the full taxable interest rate rather than the *investor* receiving a federal tax credit. This change likely made the bonds more attractive to non-taxed investors such as international investors and pension funds. As a result, the interest cost to the issuers was likely lower as the increased demand for the bonds put downward pressure on interest rates.

In contrast to tax-exempt bonds, where part of the federal revenue loss is a windfall gain for wealthy investors, the federal revenue loss matches more closely the benefit captured by the entity issuing tax credit bonds. According to analysis by Bloomberg (2014), as of 2014, CREB issuance represented 17 percent of the allocation. The mechanism does not appear to have lured more investment though outside factors may have contributed to the muted success of the tax credit bond mechanism.

The second goal of the bond programs, reducing greenhouse emissions, has not been validated empirically. A study published by the National Research Council (2013) surmised that U.S. tax policy generally has had little to no effect on the amount of greenhouse gas emissions.

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Energy

**CREDIT FOR HOLDERS OF QUALIFIED ENERGY
CONSERVATION BONDS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

Note: Estimates include outlay effects associated with the refundable portion of QECBs. These outlay effects are estimated to be \$0.1 billion for FY2020-FY2024. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 54, 54C, and 54D.

Description

Qualified Energy Conservation Bonds (QECBs) were created as a financing aid for certain energy production projects. These bonds are used for capital expenditures for the purposes of: (1) reducing energy consumption in publicly-owned buildings by at least 20 percent; (2) implementing green community programs; (3) rural development involving the production of electricity from renewable energy resources; (4) wind facilities; (5) closed-loop bio-mass facilities; (6) open-loop bio-mass facilities; (7) geothermal or solar energy facilities; (8) small irrigation power facilities; (9) landfill gas facilities; (10) trash combustion facilities; and (11) refined coal production facilities.

Also included are expenditures on research facilities and research grants, to support research in: (1) development of cellulosic ethanol or other nonfossil

fuels; (2) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (3) increasing the efficiency of existing technologies for producing nonfossil fuels; (4) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (5) technologies to reduce energy use in buildings. Energy saving mass commuting facilities and demonstration projects are also included in the list of qualified purposes.

QECBs were created by the Emergency Economic Stabilization Act of 2008 (EESA, P.L. 110-343), which established a national limit of \$800 million for QECBs. That limit was increased by \$2.4 billion by the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5). In the 111th Congress, the Hiring Incentives to Restore Employment Act, (HIRE Act, P.L. 111-147) created the direct payment option for issuers of QECBs and extended their issuance through 2010. Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rate for direct payment QECBs and all other direct payment tax credit bonds (TCBs) were subject to sequestration from FY2013 through FY2022. For FY2023, the sequestration reduced the direct payment QECB credit rate by 5.7 percent. Current law extends the 5.7 percent reduction to direct payment QECBs for all fiscal years through FY2030.

Holders of QECBs can claim a credit equal to the dollar value of the bonds held multiplied by a credit rate determined by the Secretary of the Treasury. These tax credit bonds offer a credit rate that is 70 percent of the credit rate offered on old Clean Renewable Energy Bonds (CREBs; see the entry *Credit for Holders of Clean Renewable Energy Bonds*). Alternatively, *issuers* of QECBs (explained below) can choose to receive the credit, typically identified as the “direct payment option.” The maximum maturity of QECBs is that which will set the present value of the obligation to repay the principal equal to 50 percent of the face amount of the bond issue. The discount rate for the calculation is the average annual interest rate on tax-exempt bonds issued in the preceding month, having a term of at least 10 years. QECBs are subject to arbitrage rules that require the issuer to spend 95 percent of the proceeds within five years of issuance. The QECB program is now fully subscribed, and the 2017 tax revision (P.L. 115-97) repealed issuing authority for all TCBs beginning on January 1, 2018.

Impact

The interest income on bonds issued by state and local governments is typically excluded from federal income tax (see the entry *Exclusion of Interest*

on Public Purpose State and Local Debt). Such bonds result in the federal government paying a portion (approximately 25 percent) of the issuer's interest costs. QECBs are structured such that 70 percent of the interest cost is paid by the federal government. The cost is limited by the value of federal tax credits generated by the \$3.2 billion for QECBs.

Rationale

Proponents of QECBs have argued that the federal subsidy is necessary because private investors are unwilling to accept the risk and relatively low return associated with renewable energy and energy conservation projects. Proponents argue that the market has failed to produce investment in renewable energy and conservation because the benefits of these projects extend well beyond the service jurisdiction to the surrounding community and to the environment more generally. The ratepayers of the utility are not compensated for these external benefits, and it is unlikely, proponents argue, that private investors would agree to provide them without some type of inducement.

Assessment

Evaluation of the QECB program can be viewed both in terms of the additional investment it induced and in terms of the greenhouse emissions reductions it achieved. Investors were induced to purchase these bonds if they received the same after-tax return from the credit that they would have from the purchase of tax-exempt bonds. The value of the credit is included in taxable income, but is used to reduce regular or alternative minimum tax liability. Assuming the taxpayer is subject to the regular corporate income tax, the credit rate should equal the ratio of the purchaser's forgone market interest rate on tax-exempt bonds divided by one minus the corporate tax rate. For example, if the tax-exempt interest rate is 6 percent and the corporate tax rate is 21 percent, the credit rate would have to be equal to $0.06/(1-0.21)$, or about 7.6 percent to induce investment. Thus, an investor purchasing a \$1 million original CREB would need to receive a \$76,000 annual tax credit each year. For QECBs, the tax credit is 70 percent of that amount or about \$53,200. The issuer would pay interest of at least \$22,800 to match the taxable bond alternative (e.g., the \$76,000).

The direct payment for QECBs likely made the bonds more attractive to a broader investor pool. With the direct payment option, the *issuer* pays the investor the full taxable interest rate rather than the *investor* receiving a federal

tax credit. This change likely made the bonds more attractive to non-taxed investors such as international investors and pension funds. As a result, the interest cost to the issuers was likely lower as the increased demand for the bonds put downward pressure on interest rates.

In contrast to tax-exempt bonds, where part of the federal revenue loss is a windfall gain for wealthy investors, the federal revenue loss matches more closely the benefit captured by the entity issuing tax credit bonds. According to analysis by Bloomberg (2014), as of 2014, QECB issuance was 31 percent of the allocation. The mechanism does not appear to have lured more investment though outside factors may have contributed to the muted success of the tax credit bond mechanism. The second goal of the bond programs, reducing greenhouse emissions, has not been validated empirically. A study published by the National Research Council (2013) surmised that U.S. tax policy generally has had little to no effect on the amount of greenhouse gas emissions.

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Energy

**AMORTIZATION OF AIR POLLUTION
CONTROL FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.4	0.4
2021	—	0.4	0.4
2022	—	0.4	0.4
2023	—	0.5	0.5
2024	—	0.5	0.5

Authorization

Section 169(d)(5).

Description

This provision makes the pre-1976, five-year option to amortize investments in pollution control equipment for coal-fired electric generation plants available to those plants placed in service on or after January 1, 1976. Before enactment of IRC section 169(d)(5), five-year amortization of pollution control equipment applied only to older coal-fired power plants—those placed in service before January 1, 1976. However, investments in pollution control equipment made in connection with post-1975 power plants now qualify for amortization over seven years rather than five years. The five-year amortization incentive for pre-1976 plants applies only to pollution control equipment with a useful life of 15 years or less. In that case, 100 percent of the cost can be amortized over five years. If the property or equipment has a useful life greater than 15 years, then the proportion of the costs that can be amortized over five years is less than 100 percent.

Qualifying pollution control equipment means any technology that is installed in or on a qualifying facility to reduce air emissions of any pollutant

regulated by the Environmental Protection Agency (EPA) under the Clean Air Act. This includes scrubber systems, particulate collectors and removal equipment (such as electrostatic precipitators), thermal oxidizers, vapor recovery systems, low nitric oxide burners, flare systems, bag houses, cyclones, and continuous emission monitoring systems. The pollution control equipment needs to have been placed in service after April 11, 2005.

Impact

In the federal tax code, amortization is a method of depreciation that recovers the total cost basis evenly (i.e., straight line depreciation) over the recovery period, in this case either five or seven years depending on the age of the power plant. In either case, however, because the two recovery periods are substantially less than the economic life of the assets, such amortization provides more accelerated depreciation deductions for pollution control equipment than would otherwise be the case under the Modified Accelerated Cost Recovery System (MACRS), in which the recovery period for the conventional type of electric generating equipment is either 15 or 20 years, depending on the type of equipment. The recovery period is 15 years for generating equipment that uses internal combustion, jet, or diesel engines; 20 years for most types of conventional electric utility tangible property such as steam or gas turbines, boilers, combustors, condensers, combustion turbines operated in a combined cycle with a conventional steam unit, and related assets. The shorter period for internal combustion engines is because this type of equipment typically deteriorates faster than conventional coal-fired equipment. Also the recovery method is one of the more accelerated types: either the double-declining balance method or the 150 percent declining balance method. Amortization in this way thus provides more accelerated depreciation deductions for pollution control equipment than does MACRS. Because of the time value of money, the earlier deduction is worth more in present value terms, which reduces the cost of capital and the effective tax rates on the investment returns. This provides an incentive for power plant companies (primarily the tax paying investor-owned utilities, or IOUs) to invest in pollution control equipment.

This provision targets electric utilities, a major source of air pollution. While older coal plants still emit a disproportionate amount of pollution among all coal-fired plants, the provision complements prior law by also targeting emissions from newer plants. The incentive facilitates utilities in meeting a new suite of EPA mandates to reduce emissions of sulfur dioxide (SO₂), nitrous dioxide (NO₂), and mercury (Hg).

A temporary provision enacted in the 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act, allows expensing for equipment through 2022, with that percentage reduced 20 percent per year starting in 2023. During the period of full expensing, electing amortization for pollution control facilities will not be beneficial compared to the general treatment of equipment.

Rationale

This provision was part of the Energy Policy Act of 2005 (P.L. 109-58). Before that, investments in pollution control equipment for pre-1976 coal-fired plants were amortizable over five years and pollution control equipment added to “newer” plants (those placed in service after 1975) was depreciated using the same MACRS methods that apply to other electric generating equipment on the date they are placed in service.

For installations in pre-1976 plants, the five-year amortization of pollution control equipment was added by the Tax Reform Act of 1969 (P.L. 91-172) to compensate for the loss of the investment tax credit, which was repealed by the same act. Prior to 1987, pollution control equipment could be financed by tax-exempt bonds. This benefitted all types of electric utilities and not just public power companies, because although the state or local government would issue the bonds, the facilities were leased back to the IOUs or cooperatives. Billions of dollars of pollution control equipment were financed in this way until the safe-harbor leasing tax rules were repealed by the Tax Reform Act of 1986 (P.L. 99-514).

Assessment

Pollution control equipment used in connection with coal-fired power plants is a significant fraction of a plant’s cost. Thus, the tax treatment of this type of equipment is important in determining the investment decisions of the electric utility. The Clean Air Act’s “New Source Review” provisions require the installation of state-of-the-art pollution-control equipment whenever an air-polluting plant is built or when a “major modification” is made on an existing plant. By creating a more favorable (in some cases much more favorable) regulatory environment for existing facilities than new ones, grandfathering creates an incentive to keep old, grandfathered facilities up and running.

The federal tax code has also provided an unintended incentive to retain—a disincentive to scrap—equipment and other business assets. One of

these tax provisions is the five-year amortization of pollution control equipment connected with older (pre-1976) power plants. This, and other provisions under prior law (such as accelerated depreciation and investment tax credits), and current tax penalties for premature dispositions of capital equipment under the recapture provisions may have provided a disincentive to invest in new equipment and other new assets.

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Energy

**COAL PRODUCTION CREDITS: REFINED COAL AND
INDIAN COAL**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Note: This provision was extended by P.L. 116-260 with the changes estimated to cost \$39 million over FY2021 – FY2030.

Authorization

Section 45.

Description

Producers of refined coal and Indian coal may be eligible for a production tax credit (PTC).

Refined coal is a synthetic fuel produced from coal (including lignite) or high-carbon fly ash that when burned emits 20 percent less nitrogen oxide and 40 percent less sulfur dioxide or mercury compared to feedstock coal available in 2003.

The credit for production of refined coal is available for facilities placed in service after October 22, 2004, and before January 1, 2012. Refined coal producers may claim the credit for 10 years after a facility is placed in service. The credit was \$7.384 per ton for calendar year 2021, and \$7.301 per for calendar year 2020 (\$4.375 per ton in 1992 dollars, adjusted annually for inflation). Qualifying coal must be sold to an unrelated party. The credit phases out as the reference price of the fuel used as a feedstock exceeds 1.7 times the

reference price for the feedstock fuel in 2002 (adjusted for inflation). There is no phase-out for 2020 or 2021; the reference price is below the phase-out level.

Qualified Indian coal facilities are those that produce coal from reserves owned by a federally recognized Indian tribe or held in trust by the United States for a tribe or its members. Qualifying facilities are those that produce coal from reserves that on June 14, 2005, were owned by an Indian tribe. The credit is for the sale of coal, and the coal does not necessarily need to be sold for the production of electricity. For coal produced and sold before January 1, 2016, an Indian coal production facility had to be placed in service before January 1, 2009. Currently, there is no placed-in-service deadline.

The taxpayer may claim a credit for sales of Indian coal produced by the taxpayer at an Indian coal production facility during the 16-year period beginning after 2005 and before 2022. The inflation-adjusted credit amount was \$2.60 per ton for calendar year 2021, and \$2.57 per ton for 2020.

The credits for refined coal and Indian coal are part of the general business credit. Unused credits may be carried back one year and carried forward for up to 20 years.

Impact

The tax credit for refined coal reduces the cost of producing refined coal which can then be used to generate electricity (the credit is not available for electricity produced from coal). Before 2008, production of coal-based synthetic fuel (a.k.a. refined coal) was eligible for a tax credit under Section 29 of the Internal Revenue Code. Under Section 29, coal that underwent a significant chemical change was eligible for a credit as a coal-based synthetic fuel. The credits previously available under Section 29 were generous relative to those awarded under the PTC. Further, the credit for refined coal under Section 45 requires that producers adhere to more stringent environmental standards than were imposed under Section 29. Currently, few producers meet the criteria under Section 45 to qualify for a tax credit for the production of refined coal. From 2010 through 2020, the number of returns filed per year claiming the refined coal production credit was 40 or less. The total amount of credits claimed from 2010 through 2020 was \$8.9 billion in refined coal production tax credits. Refined coal production dropped to nearly zero in the first quarter of 2022, which may be attributable to the expiration of the refined coal tax credit (facilities that were placed in service by 2011 reaching the end of their 10-year tax credit period).

The PTC for Indian coal is designed to encourage production of coal from resources owned by tribes. The credit is claimed by few taxpayers, and results in a small revenue loss.

Rationale

The PTC was expanded to include refined coal by the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357). Under the AJCA, qualifying refined coal facilities had to be placed in service before the end of 2008. The Energy Policy Act of 2005 (P.L. 109-58) added Indian coal production facilities as production eligible for the PTC. When introduced, taxpayers could claim a credit for sales of coal for a 7-year period beginning on January 1, 2006, and ending after December 31, 2012.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the placed-in-service deadline for refined coal through December 31, 2009. This legislation also increased the emissions standards on the refined coal credit and removed the market value test. The changes made under the 2008 legislation effectively added steel industry fuel to the list of qualifying fuels. For facilities that were producing steel industry fuel on or before October 1, 2008, the credit was available for fuel produced and sold between October 1, 2008, and January 1, 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the placed-in-service deadline for refined coal facilities, other than refined coal facilities producing steel industry fuel, through December 31, 2011.

The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the period during which Indian coal facilities could claim credits from seven to eight years. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the credit for the production of Indian coal for an additional year (through December 31, 2014).

The credit for the production of Indian coal was extended and modified by provisions in the Protecting Americans from Tax Hikes (PATH) Act, enacted as Division Q of the Consolidated Appropriations Act, 2016 (P.L. 114-113). Specifically, the credit was extended for two years, through the end of 2016. The placed-in-service date was also removed, allowing facilities placed in service after 2008 to qualify for the credit. The provision was also modified to relax third-party sales requirements and exempt the Indian coal credit from the alternative minimum tax (AMT). For corporations, the AMT was repealed as part of the 2017 tax revision (P.L. 115-97).

The Bipartisan Budget Act of 2018 (P.L. 115-123) extended the period during which Indian coal facilities could claim credits from 11 to 12 years. The period was further extended to 15 years in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) and 16 years in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

Assessment

The PTC for refined coal reduces the cost of this fuel relative to other fuel sources. Reducing the cost through a subsidy is intended to encourage the production of refined coal. In a 2021 report, the Government Accountability Office (GAO) concluded that there is not “a good understanding of the credit’s effectiveness in reducing emissions of certain harmful pollutants.” Alternatively, if the cost of other liquid-based fuels, such as petroleum, were to increase, coal to liquid technologies (including refined coal) would become more cost competitive. Since refined coal adheres to higher environmental standards, a tax on carbon-emitting fuels, which increases the cost of such fuels, would be an economically efficient mechanism for promoting the use of refined coal technologies. Taxing emissions directly, as opposed to subsidizing low-emissions technologies, would allow markets to select the optimal energy resources.

The PTC for Indian coal is designed to encourage the development of tribal coal reserves. Thus, unlike most other PTC-eligible technologies, the PTC for Indian coal is not designed to achieve an environmental objective. Proponents of the credit are in favor of support for tribal coal mining. Like other targeted tax provisions, the credit could reduce economic efficiency if it results in economic resources being diverted away from their most productive use.

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Energy

CREDIT FOR CARBON OXIDE SEQUESTRATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million. This provision was extended by P.L. 116-260 and is estimated to cost \$0.6 billion over FY2021 – FY2030. This provision was modified and further extended by P.L. 117-169 and is estimated to cost \$3.2 billion over FY2022 – FY2031.

Authorization

Sections 45Q, 6417, and 6418.

Description

A tax credit is available for the capture and transport of carbon oxide for use in enhanced oil recovery (EOR), for permanent storage in a geologic formation, or for another qualified use. (Before 2018, the credit was for carbon dioxide.) For the purposes of the credit, qualified facilities include point source emissions or direct air capture (DAC) facilities for which construction begins before 2033. DAC facilities must capture at least 1,000 metric tons of qualified carbon oxide per year to be tax credit eligible. Electricity generating facilities must capture at least 18,750 metric tons of qualified carbon oxide per year, and have a capture design capacity at least 75 percent of the unit's baseline carbon oxide production, and other industrial facilities must capture at least 12,500 metric tons.

For the purposes of the credit, qualified carbon oxide includes carbon oxide captured from an industrial source that would otherwise be released into the atmosphere that is measured at the source of capture and verified at the

point of disposal or injection. Qualified carbon oxide also includes the initial deposit of captured carbon oxide used as a tertiary injectant, but does not include carbon oxide that is re-captured, recycled, or re-injected. The credit may also be claimed for carbon dioxide captured directly from ambient air by a DAC facility. The credit can only be claimed for carbon oxide captured and disposed of or used within the United States or its possessions.

Taxpayers can claim tax credits for carbon oxide captured for a 12-year period, beginning when the equipment is first placed in service. Under recent changes made by P.L. 117-169 (commonly referred to as the Inflation Reduction Act of 2022 or IRA), for facilities or equipment placed in service after December 31, 2022, the base tax rate is \$12 per metric ton for captured carbon oxide that is used for EOR, and then disposed of, or utilized in a qualified manner; or \$17 per metric ton for captured carbon oxide that is disposed of in secure geologic storage. These amounts are adjusted for inflation beginning after 2026. The base credit amounts are increased by a factor of five, to \$60 and \$85, for projects that meet prevailing wage and registered apprenticeship requirements. The base tax credit amounts for carbon oxide captured using DAC are \$26 per metric ton if the carbon oxide is utilized or used for EOR and disposed of in secure geological storage or \$36 per metric ton if the carbon oxide is disposed of in secure geological storage. If wage and apprenticeship requirements are met, these amounts increase to \$130 and \$180 per metric ton, respectively.

Also under the IRA, beginning after 2022, tax-exempt entities will be able to receive the tax credit as direct pay. Taxpayers can elect to receive credits as direct pay for up to five years (but not after 2032) or transfer the credit to an unrelated taxpayer.

Before the changes made in the IRA, the carbon oxide sequestration credit was the sum of four components: (1) \$20 (adjusted to \$24.10 for 2021) per metric ton of carbon oxide captured using carbon capture equipment placed in service before February 9, 2018 that is disposed of in secure geologic storage; (2) \$10 (adjusted to \$12.05 for 2021) per metric ton of carbon oxide captured using carbon capture equipment placed in service before February 9, 2018 that is used as a tertiary injectant in EOR; (3) \$34.81 in 2021 per metric ton of carbon oxide captured using carbon capture equipment placed in service on or after February 9, 2018 that is disposed of in secure geologic storage, during the first 12 years following the facility being placed in service; and (4) \$22.68 in 2021 per metric ton of carbon oxide captured using carbon capture equipment placed in service on or after February 9, 2018 that is used as a

tertiary injectant in EOR, during the first 12 years following the facility being placed in service. For calendar years 2017 through 2026, for facilities placed in service on or after February 9, 2018, and before January 1, 2023, the applicable dollar amount is determined by linear interpolation between \$22.66 and \$50 for the storage portion of the credit, and \$12.83 and \$35 for the tertiary injectant or EOR portion of the credit.

Options for carbon oxide storage include appropriate deep saline formations, oil and gas reservoirs, and unminable coal seams. In 2021, the IRS promulgated regulations for qualified “secure geologic storage,” including disposal processes that follow U.S. Environmental Protection Agency requirements for carbon dioxide monitoring, reporting, and verification, or follow international industry standards for EOR. Tax credits claimed for captured and sequestered carbon oxide may be recaptured, meaning the taxpayer has to return the amount of the tax credit to the Treasury if the carbon oxide ceases to be captured, disposed of, or used in a qualifying manner (i.e., if it escapes into the atmosphere).

For carbon dioxide captured at facilities placed in service before February 9, 2018, the credit applies until the IRS, in consultation with the Environmental Protection Agency, certifies that 75 million metric tons of carbon dioxide has been captured or used as a tertiary injectant. As of June 2020, the total amount of carbon oxide taken into account for the purposes of section 45Q was 72,087,903 metric tons. As of October 26, 2021, the IRS does not certify that the aggregate amount of qualified carbon oxide taken into account for the purposes of Section 45Q has reached 75,000,000 metric tons.

For facilities placed in service before 2023, qualified facilities must also (1) in the case of a facility that emits no more than 500,000 metric tons of carbon oxide, capture at least 25,000 metric tons of carbon oxide that is either fixated through the growing of algae or bacteria, chemically converted into a material or chemical compound in which the carbon oxide is stored, or used for another commercial purpose (other than as a tertiary injectant); (2) in the case of an electricity generating facility not described in (1), capture at least 500,000 metric tons of carbon oxide per year; or (3) in the case of a direct air capture facility not described in (1) or (2), capture at least 100,000 metric tons of carbon oxide.

Who can claim the tax credit depends on when the facility capturing the carbon was placed in service. If the carbon oxide capture equipment was placed in service before February 9, 2018, the credit is attributable to the

person that captures and physically or contractually ensures the disposal or use of the carbon oxide (unless that person elects to allow the person who disposes of the captured carbon oxide to claim the credit). In the case of carbon oxide captured using equipment placed in service on or after February 9, 2018, the credit is attributable to the person that owns the carbon capture equipment and physically or contractually ensures the capture and disposal or use of the carbon oxide.

The credit is a component of the general business credit. As such, the credit may be carried forward for up to 20 years or carried back one year.

Impact

Carbon capture and sequestration (CCS) has the potential to reduce emissions generated by the use of coal and natural gas in the electric power sector. It is also possible that carbon capture and sequestration could reduce emissions from industrial applications, such as cement and steel. As of 2022, there were at least a dozen commercial-scale carbon capture facilities operating in the United States, with additional facilities under development. CCS is currently being used alongside ethanol production, fertilizer and chemical production, and natural gas processing. Projects under development are planning to capture carbon from these types of facilities as well as from hydrogen production and through DAC.

The tax credit for carbon oxide sequestration reduces the tax burden for taxpayers capturing carbon. Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. Over longer periods of time, tax credits that lead to additional climate-related investments and reduced emissions could have positive macroeconomic effects.

Rationale

The credit for carbon dioxide sequestration was introduced as part of the Energy Improvement and Extension Act of 2008, enacted as Division B of P.L. 110-343. The credit was enacted alongside several other provisions designed to encourage cleaner, more efficient, and environmentally responsible use of coal specifically and greenhouse gas emissions reductions more broadly.

The Bipartisan Budget Act of 2018 (P.L. 115-123) expanded and extended the 45Q tax credit. Specifically, the \$10 per ton tax credit for carbon that is used as a tertiary injectant is to increase to \$35 over time. The \$20 per

ton tax credit for carbon that is captured and not used as a tertiary injectant is to increase to \$50 over time. The 75 million ton cap is eliminated for facilities placed in service on or after February 9, 2018. Qualifying carbon capture equipment must be under construction before the end of 2023 for carbon captured to qualify. Further, tax credits can be claimed for 12 years after a carbon capture project is placed in service. This legislation also modified the credit to include other carbon oxides, not just carbon dioxide. The legislation also changed requirements for eligible taxpayers.

Additional changes were made in the 116th and early in the 117th Congresses. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260)) extended the start of construction deadline by two years, through the end of 2025. The Infrastructure Investment and Jobs Act (P.L. 117-58) provided that, after 2021, exempt facility bonds may be issued for carbon dioxide recapture facilities. The carbon oxide capture credit is reduced for projects financed by Section 142 exempt facility bonds.

The credit for carbon oxide sequestration was extended and substantially modified in the Inflation Reduction Act of 2022 (P.L. 117-169), legislation which was broadly intended to address climate risks and reduce greenhouse gas (GHG) emissions.

Assessment

Proponents of the CCS tax credits contend that the higher credit amounts enacted in 2018 and again in 2022 will push more marginal projects to go forward, further advancing CCS technology and project deployment. The high cost of CCS technologies has proven a barrier to broad commercial deployment. Proponents of CCS also assert that CCS projects are necessary to achieve emissions reduction goals, as shutting down all carbon-emitting facilities is not feasible.

Tax credits for low-carbon or carbon removal technologies are generally not an economically efficient policy mechanism for encouraging a lower carbon economy. Such tax credits reduce overall tax revenues by targeting selected technologies. A more economically efficient policy option for encouraging the adoption of low-carbon technologies would be a carbon tax or a carbon price. This policy would be technology neutral, and also raise revenue that could be used to reduce other distortionary taxes or reduce the deficit.

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Energy

CREDIT FOR ENERGY-EFFICIENT NEW HOMES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	0.1	0.2
2021	0.1	0.1	0.2
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	(¹)	(¹)	(¹)

Note: This provision was extended by P.L. 116-260 and was estimated to cost \$0.3 billion over FY2021 – FY2030. This provision was further extended and modified by P.L. 117-167 and was estimated to cost \$2.0 billion over FY2022 – FY2031.

(¹) Positive tax expenditure of less than \$50 million.

(²) Estimate includes an outlay to state and local governments. For the purposes of this table outlays are attributed to individuals.

Authorization

Section 45L.

Description

In 2022, contractors building energy-efficient new homes were eligible for a tax credit of up to \$2,000 per dwelling unit. Manufacturers of manufactured energy-efficient homes were eligible for a tax credit of up to \$1,000 per dwelling unit. A certified energy-efficient new home qualifying for the tax credit must have annual heating and cooling energy consumption that is at least 50 percent below that of a comparable dwelling unit. Contractors and manufacturers claiming tax credits must submit certification from an eligible certifier before claiming the credit.

Starting in 2023, contractors building energy-efficient new homes may be eligible for a tax credit of up to \$2,500 per dwelling unit that meets certain Energy Star Efficiency standards, with a \$5,000 credit available for new

homes that are certified as zero-energy ready homes. Multifamily dwellings that meet certain Energy Star efficiency standards are eligible for a \$500 credit per unit, with a \$1,000 per unit credit available for eligible zero-energy ready multifamily dwellings. The energy-efficiency criteria and testing requirements are changed to align with these programs. Contractors and manufacturers claiming tax credits will need to initiate and plan for the certification at an earlier stage in the development process because of inspections needed during the construction phase.

Starting in 2023, the credits for multifamily dwelling units is increased to \$2,500 and \$5,000, respectively, if the taxpayer ensures that the laborers and mechanics employed by contractors and subcontractors in the construction of the residence are paid prevailing wages. Taxpayers claiming the low-income housing tax credit would not have to reduce their basis for credits claimed under this section.

The energy-efficient new homes tax credit is part of the general business credit. Any unused credit may be carried back for one year and carried forward for 20 years. The tax credit is not available for energy-efficient new homes acquired after December 31, 2032.

Impact

The credit reduces the cost of building or manufacturing energy efficient new homes. To the extent that the credit is passed forward to consumers, it could reduce the cost of this type of home. The credit is small, however, relative to the total cost of most new homes.

Rationale

The tax credit for energy-efficient new homes is designed to encourage contractors building new homes and manufacturers of homes to install energy efficient technologies in new homes. Generally, it is less expensive to install energy-efficient components in new residences than to retrofit existing property to incorporate energy-efficient upgrades.

The tax credit for energy-efficient new homes was introduced under the Energy Policy Act of 2005 (P.L. 109-58). Initially, the credit was set to expire at the end of 2007. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the credit through December 31, 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the deadline for claiming the credit through December 31, 2009. The Tax Relief,

Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the deadline for claiming the credit through December 31, 2011, and the American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the deadline through December 31, 2013, and adopted the standards in the 2006 International Energy Conservation Code. The Consolidated Appropriations Act, 2016 (P.L. 114-113) extended the deadline through December 31, 2016. The credit was further extended through 2017 in the Bipartisan Budget Act of 2018 (P.L. 115-123); through December 31, 2020, in the Further Consolidated Appropriations Act, 2020 (P.L. 116-94); and through December 31, 2021, in the Consolidated Appropriations Act, 2021 (P.L. 116-260). P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022, extended the credit through December 31, 2032, updated the applicable energy efficiency standards, and increased the maximum amount of the credit.

Assessment

Oftentimes, tax incentives that promote specific types of investment are economically inefficient because they direct resources away from what would generally be their most productive use. Such interventions, however, may enhance economic efficiency if they address market failures.

There is a potential market failure in the market for energy-efficient new homes, including multi-family housing structures. Specifically, the potential market failure stems from the so-called principal-agent problem. In the case of a new home, builders make many of the decisions regarding energy-efficient property. Since the builders are not the ultimate users of such property, and do not realize the energy savings associated with the property, they may not decide to incur the higher up-front costs typically associated with energy-efficient property. The problem is most likely to occur if the builder is not able to recoup the costs associated with energy-efficient installations when selling the home. It is not clear if market prices accurately reflect or capitalize the value of energy-efficient improvements, especially in the resale market. If energy efficiency is not accurately reflected in housing prices, builders may underinvest in efficiency. Over time, if market forces direct builders to build more energy efficient homes, the size of the principal-agent problem would diminish. Limited evidence of a modest decline in the size of this issue may be seen in the growth in all-electric homes since this provision was enacted in 2005.

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Energy

**CREDIT FOR INVESTMENT IN ADVANCED
ENERGY PROPERTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Note: This provision was modified and extended by P.L. 117-169 and is estimated to cost \$6.3 billion over FY2022 – FY2031.

Authorization

Sections 48C, 6417, and 6418.

Description

The advanced energy manufacturing tax credit is an allocated tax credit, which allows taxpayers receiving allocations a tax credit for investments in projects that reequip, expand, or establish certain energy manufacturing facilities. P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA), provided \$10 billion for allocations, requiring that at least \$4 billion be allocated to projects in energy communities that are not tracts in which projects having received prior allocations under Section 48C are located. The base rate for the credit allocated under the IRA is 6%, with a 30% credit rate allowed for projects that pay prevailing wages and meet registered apprenticeship requirements. An energy community is defined as being a brownfield site; an area which has or had certain amounts of direct employment or local tax revenue related to oil, gas, or coal activities and has an unemployment rate at or above the national average; or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009.

Previously, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) provided \$2.3 billion in allocations for 30% tax credits. The amount has been fully allocated.

For current allocations, the definition of qualifying advanced energy projects includes projects (1) that reequip, expand, or establish a manufacturing or industrial facility for the production or recycling of renewable energy property; energy storage systems and components; grid modernization equipment and components; property designed to capture, remove, use, or sequester carbon oxide emissions; equipment designed to refine, electrolyze, or blend any fuel, chemical, or product which is renewable or low-carbon and low-emission; property designed to produce energy conservation technologies; electric or fuel-cell vehicles, including technologies, components, or materials for such vehicles and the associated charging or refueling infrastructure; and hybrid vehicles weighing less than 14,000 pounds, including technologies, components, or materials for such vehicles; (2) that reequip an industrial or manufacturing facility with equipment designed to reduce greenhouse gas emissions by at least 20%; or (3) that reequip, expand, or establish an industrial facility for the processing, refining or recycling of critical materials.

The IRS is directed to establish a program to certify projects and allocate credits by February 12, 2023. Applicants accepting certifications for credits will have two years to provide evidence that the requirements of the certification have been met and to place property in service.

Selection criteria for projects are to include commercial viability; potential for domestic job creation; impact on air pollution or greenhouse gas emissions; potential for technological innovation and commercial deployment; levelized cost for energy generation, storage, or conservation; and the project's expected time frame.

After 2022, tax-exempt organizations, including state and local government and electric cooperatives, may be able to receive credit amounts as direct payments. Taxpayers can elect a one-time transfer of all or a portion of the tax credit.

Taxpayers receiving an allocation are to be publicly disclosed. Taxpayers receiving a Section 48C tax credit for their investment cannot also receive certain other energy-related tax benefits for that same investment.

The credit is part of the general business credit, and can be carried back for one year or carried forward for 20 years.

Impact

On January 8, 2010, it was announced that 183 projects across 43 states had been selected to receive advanced energy manufacturing tax credits. In total, there were applications for \$10.9 billion in credits. The DOE and IRS determined that of these applications, \$8.1 billion of the funds requested were for eligible projects. The projects receiving the \$2.3 billion in tax credits awarded were selected using the criteria outlined above. The projects awarded tax credits under section 48C were expected to generate 17,000 jobs. As of August 24, 2016, the IRS had awarded nearly \$2.3 billion in tax credits to 139 recipients.

Tax credits awarded to businesses tend to benefit the upper end of the income distribution. If tax credits for advanced energy manufacturing meaningfully contribute to broader climate policy objectives there is the potential for broader economic growth and associated benefits.

Rationale

The advanced energy manufacturing tax credit was established under the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). The purpose of the tax credit was to promote the domestic green energy manufacturing sector with a focus on domestic job creation. All available credits (\$2.3 billion) were allocated in the first allocation round, in 2009. In February 2013, the IRS announced that \$150 million in credits were available for reallocation. Projects receiving Phase II allocations were required to be placed in service by 2017.

The Inflation Reduction Act of 2022 (P.L. 117-169) provided an additional \$10 billion in advanced energy manufacturing tax credit allocations and provided that at least \$4 billion be allocated to energy communities. The IRA does not allow credits to be allocated to projects located in census tracts in which projects having received prior allocations under Section 48C are located. The IRA also modified the definition of qualifying advanced energy projects and allowed credits to be received as direct pay or transferred. The manufacturing tax credits in the IRA were part of a range of policies intended to support accelerated deployment of clean energy technologies.

Assessment

The manufacturing sector plays an important role in the U.S. economy. The U.S. share of global manufacturing has declined in recent decades, as has the U.S. trade balance in advanced technology products. There are concerns that the United States may lack capacity to manufacture certain advanced technologies. Tax credits for investments in advanced energy manufacturing facilities could serve to address the U.S. position in the global advanced energy manufacturing marketplace. Supply chains and concerns regarding ongoing and potential future disruptions are another factor motivating the development of domestic manufacturing capacity. Manufacturing activity is also associated with spending on research and development (R&D). Investment in R&D and the associated technological development supports long-term economic growth.

As is the case with any investment tax credit, the effectiveness of the tax credit depends on how much additional investment was caused by the tax credit. Taxpayers that already had planned, but not yet started, renewable energy manufacturing projects may have been awarded tax credits, even if their projects would have moved forward without the tax incentive. Under this scenario, the tax credit represents a windfall benefit to the taxpayer and does not induce any additional installation of advanced energy manufacturing capacity.

Investment tax credits for advanced energy manufacturing projects reduce the cost of investment for qualifying projects, relative to other types of investment. Generally, investment subsidies that reallocate capital are economically inefficient, as such policies direct capital away from what would otherwise be its most productive use. Tax credits for renewable energy manufacturing may be justified to the extent such incentives address environmental and energy security concerns.

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Energy

**ZERO-EMISSION NUCLEAR POWER PRODUCTION
CREDIT**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$30.0 billion over FY2022 – FY2031.

Authorization

Sections 45U, 6417, and 6418.

Description

A tax credit is available for qualifying zero-emission nuclear power produced and sold after December 31, 2023. Qualified nuclear power facilities are taxpayer-owned facilities that use nuclear power to generate electricity that did not receive an advanced nuclear production tax credit allocation under Section 45J, and were placed in service before August 16, 2022 (i.e., are existing nuclear power plants). (Section 45J is the credit for production from advanced nuclear power facilities. In the past, this tax expenditure has been *de minimis*, as no new qualifying facilities have been completed.)

The credit amount is 0.3 cents per kWh. The credit is reduced as the price of electricity increases. Credits are reduced by a “reduction amount,” which is 16 percent of the excess of gross receipts from electricity produced by the facility and sold over the product of 2.5 cents times the amount of electricity sold during the taxable year. Thus, the credit phases down as annual average prices exceed 2.5 cents per kWh. Taxpayers that satisfy prevailing wage and registered apprenticeship requirements are eligible for a tax credit of five times

the base amount per kWh (i.e., up to 1.5 cents per kWh). Credit amounts and amounts in the reduction amount formula are adjusted for inflation.

Tax-exempt organizations, including state, local, and tribal governments, may elect to be treated as making a federal income tax payment equal to the amount of the zero-emission nuclear power production credit. This allows such entities to receive the credit as a direct payment. A taxpayer that is ineligible for direct pay may elect to transfer the credit to an unrelated taxpayer.

The credit terminates after December 31, 2032.

Impact

Starting in 2024, the tax credit for zero-emission nuclear power production could reduce taxes for businesses producing nuclear power, so long as electricity prices are not at levels that would cause the credit to be fully phased out. Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The zero-emission nuclear power production credit was enacted in P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022. The credit was intended to act as a revenue cushion for existing nuclear power facilities when electricity prices are low.

Assessment

Financial pressures have contributed to nuclear power plant retirements. Low natural gas prices and competition from renewables can lead existing nuclear power plants to retire. Nuclear power is a zero-emission source of electricity, and keeping existing nuclear power plants online can contribute to climate policy objectives. Some models suggest that the zero-emission nuclear power production credit will prevent nuclear power capacity retirements and increase the share of electricity generated from zero-emission resources.

Credits for nuclear power production might be of concern to those who would prefer to see more investments in renewables, including wind and solar energy. Investing in nuclear license renewals and continued nuclear power plant operations could come at the expense of investing in renewables.

Tax credits for clean electricity generation have a higher fiscal cost than policies that directly seek to reduce emissions, such as a carbon tax or other carbon price mechanism. Tax credits for zero-emissions nuclear power production decrease federal tax revenue, requiring that revenue loss to be made up with additional revenues or reduced spending elsewhere. Tax credits for zero-emissions electricity might be viewed as shifting costs from the ratepayer to the taxpayer. Clean electricity tax policies that reduce the price of electricity also reduce the market incentive for increased energy efficiency.

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Energy

CREDIT FOR PRODUCTION OF CLEAN HYDROGEN

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$13.2 billion over FY2022 – FY2031.

Authorization

Sections 45V, 6417, and 6418.

Description

A tax credit may be available for qualified clean hydrogen produced, after December 31, 2022, at a qualifying facility during the facility’s first 10 years of operation. The base credit amount is \$0.60 per kilogram (kg) times the applicable percentage. The credit is five times the base credit amount (i.e., up to \$3.00 per kg) if the clean hydrogen is produced at a facility that meets prevailing wage and registered apprenticeship requirements. Credit amounts are indexed for inflation. Taxpayers can only claim credits for hydrogen produced in the United States for sale or use.

The applicable percentage is determined by the lifecycle greenhouse gas emissions rate achieved in producing clean hydrogen. The applicable percentage is 100 percent for hydrogen achieving a lifecycle greenhouse gas emissions rate of less than 0.45 kilograms of carbon dioxide equivalent (CO₂e) per kg. The applicable percentage is 33.4 percent for hydrogen achieving a lifecycle greenhouse gas emission rate of less than 1.5 kilograms of CO₂e per kg (but not less than 0.45 kilograms). For hydrogen with a lifecycle greenhouse gas emission rate of less than 2.5 kgs of CO₂e per kg (but

not less than 1.5), the applicable percentage is 25 percent, and for hydrogen with a lifecycle greenhouse gas emissions rate of less than or equal to 4 kgs of CO₂e per kg (but not less than 2.5), the applicable percentage is 20 percent.

Qualifying clean hydrogen production facilities include new facilities that begin construction before January 1, 2033. Taxpayers may also be able to claim tax credits for hydrogen produced at facilities that are modified to produce clean hydrogen. Facilities existing before January 1, 2023, that did not produce clean hydrogen, may be able to qualify for the clean hydrogen production credit if the facility is modified to produce clean hydrogen after December 31, 2022.

The credit amount is reduced by the lesser of (1) 15%; or (2) the fraction of the proceeds of a tax-exempt obligation used to finance the project over the aggregate amount of the project's financing costs for facilities financed with tax-exempt bonds.

Taxpayers can elect to claim the energy investment tax credit (ITC) in lieu of the clean hydrogen production credit. The base ITC amount is 6% for facilities designed and expected to produce less than 0.45 kilograms of CO₂e per kilogram of hydrogen (decreasing to 2 percent, 1.5 percent, and 1.2 percent, following the production credit tiers based on the lifecycle greenhouse gas emissions rate). These amounts are multiplied by a factor of five for projects paying prevailing wages and meeting registered apprenticeship requirements, such that the facilities with the lowest lifecycle greenhouse gas emissions rate can claim an ITC of 30 percent.

Tax-exempt organizations, including state, local, and tribal governments, may elect to be treated as making a federal income tax payment equal to the amount of the credit for production of clean hydrogen. This allows such entities to receive the credit as a direct payment. For hydrogen produced at facilities placed in service after December 31, 2012, taxpayers can elect to receive the credit as direct pay. A taxpayer may separately elect to transfer the credit to an unrelated taxpayer.

Separately, taxpayers may claim the electricity production tax credit (PTC) for electricity produced from renewable resources by the taxpayer if the electricity is used at a qualified clean hydrogen facility to produce qualified clean hydrogen. Taxpayers cannot claim credits for clean hydrogen produced at facilities claiming credits for carbon capture under Section 45Q.

Impact

Starting in 2023, the tax credit for the production of clean hydrogen could reduce taxes for businesses producing qualifying clean hydrogen. The tax credit will reduce or potentially eliminate the difference in costs between producing “green” hydrogen (hydrogen produced via electrolysis using renewable energy) and hydrogen produced using other production pathways. Tax credits for the production of clean or green hydrogen directly addresses one of the barriers to deployment: cost.

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The credit for production of clean hydrogen was enacted in P.L. 117-169 (often referred to as the Inflation Reduction Act of 2022). This tax incentive for hydrogen complements other federal policies intended to support a hydrogen economy that relies on less carbon-intensive methods of hydrogen production.

Assessment

Clean hydrogen replacing other forms of hydrogen has the potential to contribute to emissions reductions goals in a variety of sectors and industrial applications. Tax credits for clean hydrogen can support innovation and technological advancement as various applications of this technology move towards commercialization.

Tax credits for clean electricity and fuels have a higher fiscal cost than policies that directly seek to reduce emissions, such as a carbon tax or other carbon price mechanism. Tax credits for clean hydrogen production decrease federal tax revenue, requiring that revenue loss to be made up with additional revenues or reduced spending elsewhere.

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Energy

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS FOR CARBON DIOXIDE CAPTURE FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-58, the Infrastructure Investment and Jobs Act, and was estimated to cost \$0.1 billion over the FY2022-FY2031 period.

Authorization

Sections 103, 141, 142(o), and 146.

Description

The Infrastructure Investment and Jobs Act (IIJA; P.L. 117-58), enacted in November 2021, created a new category of tax-exempt qualified private activity bonds for the financing of carbon dioxide capture facilities. Current law defines qualifying facilities as those with both the eligible components of an industrial carbon dioxide facility and a direct air capture facility, as described further in Section 142(o). Carbon dioxide capture facility bonds are classified as private-activity bonds, rather than as governmental bonds, because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

The IIJA stipulates that 25% of carbon dioxide capture facility bond issuances be subject to the state private-activity bond annual volume cap. The

private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003.

Impact

Since interest on the bonds is tax-exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to provide the services of carbon dioxide capture facilities at lower cost, benefitting end users. Some, perhaps most, of the benefits of the tax exemption, however, flow to bondholders. For a discussion of the factors that determine the shares of benefits going to users and bondholders as well as estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The creation of a new category of qualified private-activity bonds for carbon dioxide capture facilities was one of a number of changes made through the IJA that were intended to encourage investment in green infrastructure. By exempting the interest income earned on these bonds from federal taxation, these qualified private-activity bonds can be issued with interest rates lower than a comparable taxable bond. The reduction in the interest rates thereby reduces borrowing costs for the project and encourages general investment in carbon dioxide capture facilities.

Assessment

Policy discussions about the exemption for qualified carbon dioxide capture facilities may include analysis of their public benefit relative to both other classes of private-activity bonds and other environmental improvement technologies.

As one of many categories of tax-exempt private-activity bonds, those issued for energy production facilities increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the range of assets available to individuals and corporations to shelter their income from taxation. As a relatively new option in reducing greenhouse gas emissions, evidence of

the efficiency of carbon dioxide capture facilities in generating environmental improvement is somewhat uncertain.

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Energy

CLEAN ELECTRICITY PRODUCTION CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

This provision was added by P.L. 117-169 and is estimated to cost \$11.2 billion over FY2022 – FY2031.

Authorization

Sections 45Y, 6417, and 6418.

Description

A new clean electricity production tax credit (PTC) is available for electricity from facilities and property placed in service after December 31, 2024. This new PTC is for the sale of domestically produced electricity with a greenhouse gas emissions rate not greater than zero.

The base PTC amount is 0.3 cents per kilowatt hour (kWh), with the tax credit amount increased to 1.5 cents per kWh for facilities that pay prevailing wages and meet registered apprenticeship requirements (0.5 cents and 2.5 cents, respectively, in 2021, applying the inflation adjustment factor). Tax credit amounts are adjusted for inflation annually. Facilities with a maximum net output of less than 1 megawatt and that begin before 60 days after the Secretary of the Treasury publishes guidance on the wage and registered apprenticeship requirements qualify for the full 1.5 cents per kWh amount. The PTC can be claimed for electricity produced during the facility’s first 10 years of operation.

The credit amount is increased by 10 percent for electricity produced in an energy community. An energy community is defined as being a brownfield

site; an area which has or had certain amounts of direct employment or local tax revenue related to oil, gas, or coal activities and has an unemployment rate at or above the national average; or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009.

A 10 percent domestic content bonus will be available for electricity produced at facilities that certify that certain steel, iron, and manufactured products used in the facility were domestically produced. The ability to claim the credit as direct pay (discussed below) is subject to meeting domestic content requirements.

Taxpayers are not able to claim the clean electricity production credit if the facility or electricity produced from the facility claimed certain other energy-related investment or production tax credits. Taxpayers must choose between the clean electricity PTC and ITC, and cannot claim both.

For facilities financed with tax-exempt bonds, the credit amount is reduced by the lesser of (1) 15 percent; or (2) the fraction of the proceeds of a tax-exempt obligation used to finance the project over the aggregate amount of the project's financing costs.

Tax-exempt entities, including electric cooperatives and state and local or Indian tribal governments, can elect to treat Section 45Y tax credit amounts as payments of tax. Payments in excess of tax liability can be refunded to these organizations, allowing the credits to be received as direct pay. The ability to claim the credit as direct pay will depend on meeting domestic content requirements.

Taxpayers who are not tax-exempt entities will be allowed a one-time transfer of these tax credits. Any payments received in exchange for the transfer of credits is excluded from income, and any amounts paid to obtain a transferred credit is not deducted from income. Credits that can be transferred are given extended carryback and carryforward periods. The carryback period for these credits is extended from 1 to 3 years, and the carryforward period extended from 20 to 22 years.

The tax credit is to phase out when emissions reduction target levels are achieved or after 2032 (the later of the two). The emissions target phaseout is to begin after the calendar year in which greenhouse gas emissions from the electric power sector are equal to or less than 25% of 2022 electric power sector emissions. Once phaseout begins, the full credit amount remains

available for facilities that begin construction the following year. The credit amount for facilities beginning construction in the second year is to be 75 percent of the full credit amount. This is reduced to 50 percent for facilities beginning construction in the third year, and zero afterwards.

Impact

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. The PTC encourages taxpayers to invest in renewable electricity generating capacity by reducing the cost of producing renewable electricity from qualifying facilities. Some of that benefit will likely accrue to the owners and developers of the renewable energy facility, whereas some of the benefit may show up in reduced electricity prices.

Tax credits that lead to additional deployment of renewable electricity generation capacity can contribute to both reduced electricity prices and reduced greenhouse gas emissions. Tax credits for clean and renewable electricity can reduce the price consumers pay for electricity, which benefits households across the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The clean electricity production tax credit was added to the tax code by P.L. 117-169, commonly called the Inflation Reduction Act of 2022. This provision was a component of a package of policies intended to address climate concerns. The credit will effectively supersede the long-standing clean energy investment tax credit (PTC) (discussed elsewhere in this compendium).

Assessment

Tax credits for zero-emissions electricity production are intended to increase investment in clean electricity technologies leading to reduced greenhouse gas emissions in the electric power sector. Investments that address climate change can yield longer-term economic benefits, in part by mitigating climate-related economic risks. Assessing the effectiveness of the tax credit might consider how much additional clean electricity capacity is deployed and used because of the credit, relative to how much clean electricity capacity would have been deployed if the credit had not been available.

If producers and consumers of carbon-intensive goods fail to account for damages caused by greenhouse gas emissions when making production and consumption decisions, markets will tend to over-provide carbon-intensive goods and services. A carbon tax or price on emissions would be one option for addressing this market failure.

Clean energy tax credits can be viewed as an alternative to a carbon tax or carbon price. Tax credits that reduce the price of zero-emissions technologies, as opposed to a direct tax on emissions, are viewed by some as a second best policy. While a carbon tax or carbon price raises federal revenues that can fund other government activities, tax credits for clean energy technologies reduce federal revenues. Further, a price on carbon would tend to increase the cost of carbon-intensive goods and services, including electricity, and thereby further energy efficiency policy objectives. Tax credits for zero emissions technologies that decrease the cost of electricity can discourage investments in energy efficiency.

The scope of the clean electricity production tax credit expands beyond energy and climate policy. The prevailing wage and registered apprenticeship requirements are similar to labor requirements associated with other types of federally funded construction projects. The domestic content requirements are intended to support domestic manufacturing. The energy community bonus is intended to support investment in deployment of clean electricity in communities that could be disproportionately impacted by a transition away from fossil fuels in the electric power sector.

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Energy

CLEAN ELECTRICITY INVESTMENT CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

This provision was added by P.L. 117-169 and is estimated to cost \$30.0 billion over FY2022 – FY2031.

Authorization

Sections 48E, 6417, and 6418.

Description

A new clean electricity investment tax credit (ITC) is available for facilities and property placed in service after December 31, 2024. This new ITC can be claimed for investment in qualifying zero-emissions electricity generation facilities or energy storage technology. Interconnection property is eligible for the credit for clean electricity projects smaller than 5 megawatts.

The base ITC amount is 6 percent, with the tax credit rate increased to 30 percent for facilities that pay prevailing wages and meet registered apprenticeship requirements. Facilities with a maximum net output of less than 1 megawatt and that begin before 60 days after the Secretary of the Treasury publishes guidance on the wage and registered apprenticeship requirements qualify for the full 30 percent amount.

The clean electricity ITC is increased by one-third (2 percentage points or 10 percentage points) for property placed in service in an energy community. An energy community is defined as being a brownfield site; an area which has or had certain amounts of direct employment or local tax revenue related to oil, gas, or coal activities and has an unemployment rate at

or above the national average; or a census tract or any adjoining tract in which a coal mine closed after December 31, 1999, or in which a coal-fired electric power plant was retired after December 31, 2009.

A bonus credit amount is provided for projects that meet domestic content requirements which certify that certain steel, iron, and manufactured products used in the facility were domestically produced. The bonus credit amount is 2 percentage points, or 10 percentage points for projects that meet wage and workforce requirements.

There is an additional annual allocation of 1.8 gigawatts for environmental justice solar and wind capacity credits. Taxpayers receiving a capacity allocation may be entitled to tax credits in addition to otherwise allowed clean electricity ITCs. Specifically, projects receiving an allocation that are located in a low-income community or on Indian land are eligible for a 10 percentage point bonus investment tax credit, while projects that are part of a low-income residential building project or qualified low-income economic benefit project are eligible for a 20 percentage point bonus investment credit. Qualifying clean electricity projects include those with a nameplate capacity of 5 megawatts or less (other than facilities producing electricity through combustion or gasification). Facilities receiving an allocation are required to have the facility placed in service within four years.

For facilities financed with tax-exempt bonds, the credit amount is reduced by the lesser of (1) 15%; or (2) the fraction of the proceeds of a tax-exempt obligation used to finance the project over the aggregate amount of the project's financing costs.

Taxpayers are not able to claim the clean electricity production credit if the facility or electricity produced from the facility claimed certain other energy-related investment or production tax credits. Taxpayers must choose between the clean electricity PTC and ITC, and cannot claim both.

Tax-exempt entities, including electric cooperatives and state and local or Indian tribal governments, can elect to treat Section 48E tax credit amounts as payments of tax. Payments in excess of tax liability can be refunded to these organizations, allowing the credits to be received as direct pay. The ability to claim the credit as direct pay will depend on meeting domestic content requirements.

Taxpayers who are not tax-exempt entities will be allowed a one-time transfer of these tax credits. Any payments received in exchange for the

transfer of credits is excluded from income, and any amount paid to obtain a transferred credit is not deducted from income. Credits that can be transferred are given extended carryback and carryforward periods. The carryback period for these credits is extended from 1 to 3 years, and the carryforward period extended from 20 to 22 years.

The tax credit is to phase out when emissions reduction target levels are achieved or after 2032 (the later of the two). The emissions target phaseout is to begin after the calendar year in which greenhouse gas emissions from the electric power sector are equal to or less than 25 percent of 2022 electric power sector emissions. Once phaseout begins, the full credit amount remains available for facilities that begin construction the following year. The credit amount for facilities beginning construction in the second year is to be 75 percent of the full credit amount. This is reduced to 50 percent for facilities beginning construction in the third year, and zero afterwards.

Impact

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. The clean electricity ITC will reduce the after-tax cost of investing in zero-emissions electricity generation and energy storage, and is therefore likely to increase investment relative to what investment would have been without the tax credit.

Investment tax credits that lead to additional deployment of solar and other renewable electricity generation capacity can contribute to both reduced electricity prices and reduced greenhouse gas emissions. Tax credits for clean and renewable electricity can reduce the price consumers pay for electricity, which benefits households across the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The clean electricity investment tax credit was added to the tax code in P.L. 117-169, commonly called the Inflation Reduction Act of 2022. This provision was a component of a package of policies intended to address climate concerns. The credit will effectively supersede the long-standing clean energy investment tax credit (ITC) (discussed elsewhere in this compendium).

Assessment

The clean electricity investment tax credit is intended to increase investment in clean electricity technologies leading to reduced greenhouse gas emissions in the electric power sector. Investments that address climate change can yield longer-term economic benefits, in part by mitigating climate-related economic risks. Assessing the effectiveness of the clean energy investment tax credit might consider how much additional clean electricity capacity is deployed because of the credit, relative to how much clean electricity capacity would have been deployed if the credit had not been available.

If producers and consumers of carbon-intensive goods fail to account for damages caused by greenhouse gas emissions when making production and consumption decisions, markets will tend to over-provide carbon-intensive goods and services. A carbon tax or price on emissions would be one option for addressing this market failure.

Clean energy tax credits can be viewed as an alternative to a carbon tax or carbon price. Tax credits that reduce the price of zero-emissions technologies, as opposed to a direct tax on emissions, are viewed by some as a second best policy. While a carbon tax or carbon price raises federal revenues that can fund other government activities, tax credits for clean energy technologies reduce federal revenues. Further, a price on carbon would tend to increase the cost of carbon-intensive goods and services, including electricity, and thereby further energy efficiency policy objectives. Tax credits for zero emissions technologies that decrease the cost of electricity can discourage investments in energy efficiency.

The scope of the clean electricity investment tax credit expands beyond energy and climate policy. The prevailing wage and registered apprenticeship requirements are similar to labor requirements associated with other types of federally funded construction projects. The domestic content requirements are intended to support domestic manufacturing. The energy community and environmental justice allocations are intended to support communities that could be disproportionately impacted by a transition away from fossil fuels in the electric power sector.

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Energy

ADVANCED MANUFACTURING PRODUCTION CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$30.6 billion over FY2022 – FY2031.

Authorization

Sections 45X, 6417, 6418.

Description

Beginning in 2023, taxpayers may be able to claim a tax credit for the production and sale of qualifying solar and wind components, battery cells and modules, and critical minerals manufactured in the United States.

The amount of the credit is generally determined based on the particular component produced. Credit amounts for solar components are (1) for a thin film photovoltaic cell or crystalline photovoltaic cell, 4 cents per direct current watt of capacity; (2) for photovoltaic wafers, \$12 per square meter; (3) for solar grade polysilicon, \$3 per kilogram; (4) for polymeric backsheets, 40 cents per square meter; and (5) for solar modules, 7 cents per direct current watt of capacity.

For wind energy components, if the component is an offshore wind vessel, the credit amount is 10 percent of the sales price. Otherwise, credits for wind components are computed as an applicable amount times the total rated capacity of the completed wind turbine for which the component was designed. The applicable amount is 2 cents for blades, 5 cents for nacelles, 3

cents for towers, 2 cents for fixed platform offshore wind foundations, and 4 cents for floating platform offshore wind foundations.

Credits can also be claimed for torque tubes and longitudinal purlin (\$0.87 per kg) and for structural fasteners (\$2.28 per kg). There is a credit for inverters based on the inverter's capacity, with different types of inverters eligible for specified credit amounts ranging from 1.5 cents to 11 cents per watt. For electrode active materials, a credit can be claimed for 10 percent of the production cost. Battery cells may qualify for a credit of \$35 per kilowatt hour of capacity, and battery modules may qualify for a credit of \$10 per kilowatt hour of capacity (or \$45 in the case of a battery module which does not use battery cells).

For taxpayers producing critical minerals, there is a credit of 10 percent of the costs incurred in the production of the applicable critical mineral. Applicable critical minerals include minerals on the United States Geological Survey (USGS) 2022 critical minerals list, with minimum purity requirements.

The credit phases out for components sold after December 31, 2029. Components sold in 2030 will be eligible for 75 percent of the full credit amount. Components sold in 2031 and 2032 will be eligible for 50 percent and 25 percent of the full credit amount, respectively. No credits will be available for components sold after December 31, 2032. The phaseout does not apply to tax credits for the production of critical minerals.

Tax-exempt organizations, including state and local government and electric cooperatives, may be able to receive credit amounts as direct payments. Taxpayers who are not tax-exempt entities are allowed to elect direct pay for the advanced manufacturing production credit for the first five years starting with the year a facility is placed in service. Direct pay cannot be elected starting January 1, 2033. Taxpayers can separately elect a one-time transfer of all or a portion of the tax credit.

The credit cannot be claimed for components produced at a facility for which an advanced energy manufacturing tax credit was claimed under Section 48C. The credit is part of the general business credit, and unused credits can be carried back for one year or carried forward for 20 years.

Impact

Tax credits awarded to businesses tend to benefit the upper end of the income distribution. If tax credits for advanced energy manufacturing

meaningfully contribute to climate policy objectives there is the potential for broader economic growth and associated benefits.

Rationale

The advanced manufacturing production credit was added to the tax code in P.L. 117-169, commonly called the Inflation Reduction Act of 2022. This provision was a component of a package of policies intended to address climate concerns and develop a robust domestic clean energy economy.

Assessment

Tax credits that support investment in wind and solar, including the production tax credit (PTC) and investment tax credit (ITC) indirectly support the domestic manufacturing industry. Other policies, such as state-level renewable portfolio standards, can also generate additional demand for renewable energy manufactured components and products. There may be increased demand for domestically produced wind and solar components in the future, as domestic content bonuses for the PTC and ITC take effect.

Demand for domestically produced wind turbines in particular is expected to increase with domestic deployment growth, as utility scale wind turbines are extremely heavy and difficult to ship, making it beneficial to have final-stage manufacturing locations physically close to end markets. The domestic wind industry is highly concentrated, with the industry dominated by a few larger, diversified companies. These firms have had flexibility to withstand the past boom-and-bust cycles in wind investment resulting from a shifting policy landscape.

Increased deployment of solar domestically has led to strong demand for solar panels. Much of this demand has been met by low-cost Asian manufacturers. In recent years, tariffs have reduced solar panel imports from China, providing support to domestic producers, while also leading to increased imports from other low-cost foreign sources. Domestic production costs for solar tend to be higher than production costs abroad, and these higher costs have been an impediment to the development of domestic supply chains for solar.

Supporting the developing of domestic supply chains for critical minerals is consistent with economic and national security policy objectives. Tax incentives might, over time, encourage additional investment in critical mineral mining and production. Other federal programs, including Department

of Defense contract awards and various programs funded in the Infrastructure Investment and Jobs Act (IIJA, P.L. 117-58), also support investment in critical mineral mining and processing. The tax incentives are not designed to address other concerns in the industry, such as potential environmental implications. Another question is whether cost is the barrier, or whether the barrier is something a tax incentive will not directly address (i.e., permitting or other regulatory barriers).

Tax credits reduce the cost of qualifying activities, relative to other types of investment. Generally, subsidies that reallocate capital are economically inefficient; as such policies direct capital away from what would otherwise be its most productive use. Tax credits for renewable energy manufacturing may be justified to the extent such incentives address environmental and national security concerns. Supply chains and concerns regarding ongoing and potential future disruptions are a factor motivating the development of domestic manufacturing capacity. Manufacturing activity is also associated with spending on research and development (R&D). R&D generates positive external benefits, and as such, markets tend to devote less capital than is optimal to R&D-intensive activities. Investment in R&D and the associated technological development supports long-term economic growth.

As is the case with any tax credit, the effectiveness of the tax credit depends on how much additional economic activity was caused by the tax credit. Taxpayers that have already invested in renewable energy component manufacturing facilities, and would have manufactured qualifying components absent the tax credit, will receive windfall benefits. Incumbent firms can claim tax credits for components produced and sold in the United States starting in 2022.

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Energy

PREVIOUSLY-OWNED CLEAN VEHICLES CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$1.3 billion over FY2022 – FY2031.

Authorization

Section 25E.

Description

Starting in 2023, taxpayers may claim a 30 percent tax credit, up to \$4,000, for the purchase of qualifying previously owned clean vehicles. This tax credit is nonrefundable.

Credits are allowed for vehicles with a sale price of \$25,000 or less and with a model year that is at least two years earlier than the calendar year in which the vehicle is sold. Qualifying vehicles include plug-in electric and fuel cell vehicles with a gross vehicle weight rating (GVWR) of less than 14,000 pounds. This credit can only be claimed for vehicles sold by a dealer and on the first transfer of a qualifying vehicle. Taxpayers can only claim this credit once every three years and are required to include the vehicle identification number (VIN) on their tax return to claim a tax credit.

The credit is disallowed for taxpayers above modified AGI thresholds. Married taxpayers filing a joint return cannot claim the credit if their modified AGI is above \$150,000 (\$112,500 in the case of head of household filers; \$75,000 in the case of other filers). For the purposes of this credit, the

taxpayer's modified AGI is the lesser of modified AGI in the taxable year or prior year.

Starting in 2024, taxpayers purchasing eligible vehicles will be able to elect to transfer the tax credit to the dealer, so long as the dealer meets registration, disclosure, and other requirements. Amounts provided as direct spending will be grossed-up (increased) by 6.0445 percent.

Impact

The modified AGI limits provide that the tax credit will be claimed by low- and moderate-income taxpayers. The economic incidence, or who receives the true benefit of the previously-owned clean vehicle credit, will be determined by markets. The availability of tax credits may allow sellers of used clean vehicles to increase the price at which such vehicles are sold, thereby allowing sellers to capture some of the credit's economic benefits.

Rationale

P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022 (IRA 2022), added this credit to the tax code. A credit for used clean vehicles was likely motivated by a desire to increase affordability for lower-income households.

Assessment

Low-income households are more likely to purchase a used vehicle. A challenge in making clean technology vehicles available and affordable to individuals across the income distribution has been the lack of a robust used clean vehicle market. Tax credits for used clean vehicles, primarily plug-in electric vehicles (EVs), will likely have a limited effect. The lack of affordable used EVs can largely be explained by the lack of sales of affordable new EVs. Policies that encourage taxpayers to purchase non-luxury new plug-in EVs, or ones that encourage dealers to offer EV leasing options, could make used EVs more affordable by increasing the supply of such vehicles.

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Energy

SUSTAINABLE AVIATION FUEL CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$0.5 billion over FY2022 – FY2031.

Authorization

Sections 40B, 6426, and 6427.

Description

Starting in 2023, taxpayers can claim a tax credit for the sale or mixture of sustainable aviation fuel (SAF). The tax credit base amount is \$1.25 per gallon, with a supplemental credit amount of \$0.01 per gallon for each percentage point by which the lifecycle greenhouse gas emissions reduction percentage for the fuel exceeds 50 percent. There is a maximum supplemental credit of \$0.50 per gallon, making the maximum potential per gallon credit \$1.75.

Sustainable aviation fuel is defined as liquid fuel that (1) meets the requirements of either ASTM International Standard D7566 or the Fischer Tropsch provisions of ASTM International Standard D1655, Annex AI; (2) is not derived from coprocessing an applicable material with a feedstock which is not biomass; (3) is not derived from palm fatty acid distillates or petroleum; and (4) has been certified to achieve at least a 50% lifecycle greenhouse gas reduction percentage as defined according to the most recent Carbon Offsetting and Reduction Scheme for International Aviation adopted by the

International Civil Aviation Organization and agreed to by the United States (or a similar methodology which satisfies criteria in the Clean Air Act Section 211(o)(1)(H)), as compared with petroleum-based jet fuel.

The sustainable aviation fuel credit requires claimants to be registered with the Secretary of the Treasury, and can be used to offset fuel excise tax liability or, in the case of insufficient fuel excise tax liability, be received as a payment. Like the tax credit for biodiesel and renewable diesel, there would be a coordinated income tax credit. Credit amounts are included in a taxpayer's gross income for income tax purposes.

To prevent taxpayers from potentially claiming multiple credits for SAF, the \$1.00 per gallon tax credit for aviation fuel produced from biodiesel (under Section 40A) is repealed after December 31, 2022.

The credit terminates after December 31, 2024. The credit is superseded by the clean fuel production credit, discussed elsewhere in this compendium.

Impact

In 2022, there was limited commercial SAF production in the United States. While tax credits are claimed by sellers of SAF, those benefits may be shared with numerous stakeholders, including (but not limited to) agricultural feedstock suppliers and airlines. Broadly, tax credits claimed by businesses tend to benefit the upper end of the income distribution. Over longer periods of time, tax credits that lead to reduced emissions and confer climate-related benefits could have positive macroeconomic effects.

Rationale

The sustainable aviation fuel credit was enacted in P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022. This credit was one of several tax credits for low-emissions transportation fuels included in the legislation.

Assessment

The sustainable aviation fuel credit could spur wider adoption of lower-carbon aviation fuels. The efficacy of tax credits for SAF will depend, in part, on how much additional fuel becomes available because of the credit. Some portion of the revenue loss associated with the credit will likely be in windfall benefits, or credits claimed by taxpayers that would have sold or blended sustainable aviation fuel absent the tax incentive. If emissions reduction is the objective, it may be more economically efficient to tax or impose a fee on emissions directly. Tax credits for lower-emissions alternatives are less economically efficient since instead of raising revenue such policies reduce federal revenues, requiring that taxes be increased elsewhere to meet revenue objectives.

There is limited information available regarding SAF production and costs, as the industry is still developing. In evaluating SAF, there may be questions around what “sustainable” means for the aviation sector. There could be land use and feedstock implications if SAF production is encouraged. Some have argued that diverting feedstocks from biodiesel to sustainable aviation fuel can increase emissions, since producing SAF is more energy-intensive. Another potential question could be if SAF might be a “bridge” to a more advanced aviation fuel or technology (e.g., electrified aircraft). Potentially separate from the environmental considerations, another question may be whether SAF has the potential to reduce aviation fuel costs and dependence on foreign oil sources in the long-term by creating a substitute for conventional jet fuel.

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Energy

QUALIFIED COMMERCIAL CLEAN VEHICLE CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$3.6 billion over FY2022 – FY2031.

Authorization

Sections 45W and 6417.

Description

Starting in 2023, taxpayers can claim a tax credit for the purchase of qualified commercial clean vehicles in the year such vehicles are placed in service. The maximum credit amount is the lesser of (1) 15 percent of the vehicle's cost (30 percent for vehicles not powered by a gasoline or diesel internal combustion engine); or (2) the incremental cost of the vehicle relative to a comparable vehicle. Credit amounts cannot exceed \$7,500 for vehicles weighing less than 14,000 pounds, or \$40,000 otherwise. Eligible vehicles include those that have a battery capacity of not less than 15 kilowatt hours (7 kilowatt hours in the case of vehicles weighing less than 14,000 pounds) and can be charged by an external source of electricity. Mobile machinery and qualified commercial fuel cell vehicles are eligible for this credit. Qualifying vehicles must be depreciable property.

To be a qualifying vehicle, the vehicle must be made by a qualified manufacturer who has a written agreement with and provides periodic reports to the Treasury. Taxpayers are required to include the VIN on their tax return to claim a tax credit. Tax-exempt entities have the option of electing to receive the tax benefit as a direct payment.

The credit is scheduled to expire after December 31, 2032.

Impact

Tax credits that are claimed by businesses tend to benefit the upper end of the income distribution. To the extent that tax credits for clean commercial vehicles contribute to emissions reduction and broader climate policy objectives, there may be macroeconomic benefits that are more widely shared. The adoption of clean commercial vehicles may also lead to cleaner air. Avoiding harmful pollutants from heavy transportation may also confer benefits via reduced air pollution, which is associated with various health risks.

Rationale

The clean commercial vehicle credit was enacted in P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022. Before 2023, businesses and tax-exempt entities may have been able to claim the plug-in electric vehicle credit for light-duty electric vehicles (Section 30D). Tax-exempt entities were able to transfer the credit to the seller of qualified vehicles.

Tax credits for fuel cell vehicles have been available since 2006 under Section 30B. Section 30B was enacted as part of the Energy Policy Act of 2005 (P.L. 109-58) to stimulate the demand for more fuel-efficient and environmentally clean automobiles. The credit for fuel cell vehicles was scheduled to terminate December 31, 2014, but was subsequently extended in various pieces of tax extender legislation, last expiring at the end of 2021. The Section 30B tax credit could be claimed for fuel cell vehicles placed in service after December 31, 2005, and before January 1, 2022. In 2021, the tax credit for fuel cell vehicles was \$4,000 for vehicles with a gross vehicle weight of not more than 8,500 pounds; \$10,000 for vehicles with a gross vehicle weight of not more than 14,000 pounds (but more than 8,500 pounds); \$20,000 for vehicles with a gross vehicle weight of not more than 26,000 pounds (but more than 14,000 pounds); and \$40,000 for vehicles with a gross vehicle weight of more than 26,000 pounds. This tax credit could have been claimed by

individual or business taxpayers, and tax-exempt entities were able to transfer the credit to the seller of qualified vehicles.

The credits initially enacted in 2005 expanded upon previous incentives for hybrid and alternative-technology vehicles. The Energy Policy Act of 1992 (P.L. 102-486) introduced a \$2,000 tax deduction for passenger vehicles that run on alternative fuels (up to \$50,000 for heavy-duty trucks), and also established a tax credit for electric vehicles.

Assessment

Medium- and heavy-duty vehicles are a major source of transportation-sector emissions and local air pollution. In recent years, declining costs as well as federal, state, and local government policies have led to an increase in the number of clean vehicles in the commercial vehicle sector. Many bus fleets have transitioned to zero-emission vehicles. Over time, battery electric vehicles are expected to become cost competitive with smaller diesel trucks or trucks used for shorter hauling. Hydrogen fuel cell electric vehicles are expected to become cost competitive with diesel-fueled long-haul heavy trucks. Tax credits for commercial clean vehicles could help accelerate the transition away from conventional internal combustion engine (ICE) vehicles.

The efficacy of the new commercial clean vehicle tax credit will depend, in part, on how much the market share of clean commercial vehicles increases because of the tax credit. For taxpayers and tax-exempt entities that would have purchased clean vehicles absent the tax incentives, the tax incentive provides a windfall benefit. Another consideration is that the tax credit can be claimed for a wide range of commercial vehicle types. There are greater challenges to decarbonization in heavy-duty long-distance fleets. It is possible that a more targeted tax credit could achieve emissions-reductions goals at a reduced cost.

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Energy

CLEAN FUEL PRODUCTION CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-169 and is estimated to cost \$2.9 billion over FY2022 – FY2031.

Authorization

Sections 45Z, 6417, and 6418.

Description

Taxpayers can claim a tax credit for domestic clean fuel production starting in 2025. Fuel must be produced by the taxpayer at a qualified facility and sold by the taxpayer to qualify for the credit. Facilities that receive credits for producing clean hydrogen or carbon oxide sequestration, or the investment credit for energy produced in clean hydrogen facilities, are not qualified facilities. Qualified producers must be registered with the IRS.

The tax credit per gallon of transportation fuel will be calculated as the applicable amount multiplied by the emissions factor of the fuel. The “applicable amount” is determined by the type of fuel and the producer’s labor practices. The base credit amount for zero-emissions fuels is \$0.20 for nonaviation fuel and \$0.35 for sustainable aviation fuel. If the producer meets prevailing wage and registered apprenticeship requirements, then the applicable amount would be \$1.00 for nonaviation fuel and \$1.75 for

sustainable aviation fuel. Qualifying aviation fuel must meet American Society for Testing and Materials (ASTM) standards and not be derived from palm oil. The tax credit amounts will be adjusted annually for inflation beginning in 2025.

The “emissions factor” is calculated according to the following formula: [(50 kilograms of CO₂-equivalent (CO₂e) global warming potential per metric million British Thermal Units (mmBTU) – emissions rate of fuel produced) / 50 kilograms of CO₂e per mmBTU]. The Treasury Secretary is to publish tables of emissions rates for various fuel types to be used in the calculation. Qualifying transportation fuel is fuel with an emissions rate not greater than 50 kilograms of CO₂e per mmBTU.

Tax-exempt organizations, including governmental entities, may elect to be treated as making a federal income tax payment equal to the amount of the clean fuel production credit, allowing them to receive the credit as direct pay. Taxpayers ineligible for direct pay may elect to transfer all or a portion of the credit to an unrelated taxpayer.

The credit is not available for transportation fuel sold after December 31, 2027.

Impact

Tax credits claimed by business and corporate taxpayers tend to benefit the upper end of the income distribution. The clean fuel production credit encourages taxpayers to invest in clean fuel production capacity by reducing the cost of producing qualifying fuels. Some of that benefit will likely accrue to those producing qualifying fuels, whereas some of the benefit may show up in increased prices paid for feedstocks or reduced fuel prices.

U.S. production capacity for renewable fuels, renewable diesel in particular, has increased in recent years and is expected to continue increasing. Prior tax credits for biomass-based diesel have been identified as a policy support for this increase. Some U.S. refiners are converting existing petroleum processing capacity to renewable diesel production capacity.

Rationale

The clean fuel production tax credit was added to the tax code in P.L. 117-169, commonly called the Inflation Reduction Act of 2022. This provision was a component of a package of policies intended to address climate concerns. The credit will effectively supersede tax credits for specific types of fuels (e.g., biodiesel, renewable diesel, second generation biofuels, and sustainable aviation fuel).

Assessment

Moving away from using petroleum to transport people and products can achieve both environmental and national security policy objectives. Tax credits for clean fuels can lead to reduced emissions in the transportation sector. Investments that address climate change can yield longer-term economic benefits, in part by mitigating climate-related economic risks. Assessing the effectiveness of the tax credit might consider avoided emissions in the transportation sector because of the credit, relative to transportation-sector emissions that would have occurred if the credit had not been available. Taxpayers that would have produced clean fuels absent the tax benefits, perhaps in response to another federal policy or general market conditions, stand to receive windfall benefits (benefits accrued without inducing any change in behavior).

If producers and consumers of carbon-intensive fuels fail to account for damages caused by greenhouse gas emissions when making production and consumption decisions, markets will tend to over-provide carbon-intensive fuels. A carbon tax or price on emissions would be one option for addressing this market failure.

Tax credits for clean fuels can be viewed as an alternative to a carbon tax or carbon price. Tax credits that reduce the price of clean fuels, as opposed to a direct tax on emissions, may be viewed as a second best policy. While a carbon tax or carbon price raises federal revenues that can fund other government activities, tax credits for clean alternatives reduce federal revenues. Further, a price on carbon would tend to increase the cost of carbon-intensive goods and services, including transportation fuels, and thereby further energy efficiency policy objectives. Tax credits for low-emissions fuels can decrease the overall cost of fuel use, potentially countering efficiency objectives. Further, if clean fuels tend to be used alongside, as opposed to

displacing, fossil fuels, the goal of reduced fossil fuel use may not be achieved or achieved in full.

Another consideration in using clean fuels (biofuels, specifically) relates to fuel feedstock. If biofuel feedstock is crops that would otherwise be used for human or animal consumption, diverting these resources to produce biofuels could lead to higher food prices or require that more resources be devoted to agriculture (and potentially to harmful agricultural practices). There can also be emissions associated with land use changes in response to increased demand for agricultural products.

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Natural Resources and Environment

**SPECIAL DEPRECIATION ALLOWANCE FOR CERTAIN
REUSE AND RECYCLING PROPERTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 168(m).

Description

Certain reuse and recycling property is eligible for a special depreciation allowance that allows 50 percent of the cost to be expensed when incurred. The remainder is depreciated based on the regular class life. To qualify, the property must be machinery and equipment (not including buildings but including software necessary to operate the equipment) and used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials. Recycling equipment includes property used for sorting. It does not include rolling stock or other equipment used to transport reuse and recyclable materials. Reuse and recyclable material means scrap plastic, scrap glass, scrap textiles, scrap rubber, scrap packaging, recovered fiber, scrap ferrous and nonferrous metals, or electronic scrap generated by an individual or business. Electronic scrap includes cathode ray tubes, flat panel screens or similar video display devices with a screen size greater than four inches

measured diagonally, or central processing units. Property must have a useful life of at least five years. The provision applies to property placed into service (or with construction begun in the case of self-constructed property) after August 31, 2008.

A temporary provision enacted in the 2017 tax revision, P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act, allows full expensing for equipment through 2022, with that percentage reduced 20 percent per year starting in 2023. During the period of full expensing and during part of the phase-out, the special depreciation allowance for reuse and recycling property will not be beneficial compared to the general treatment of equipment.

Impact

Allowing half the cost to be expensed when incurred provides a benefit because a tax deduction today is worth more than a tax deduction in the future, due to the time value of money (interest). Expensing produces the same reduction in effective tax rate regardless of the durability of the asset as long as current depreciation reflects economic decline and thus is neutral. The effective tax rate is $u(1-x)/(1-ux)$, where x is the share expensed and u is the statutory tax rate. In the case of 50 percent expensing and a 21 percent tax rate, the effective tax rate falls by 44 percent, to an effective 12 percent rate. Since most equipment assets are estimated to have depreciation more generous than economic depreciation, both beginning and effective tax rates are lower and the reduction is proportionally less. The deduction will not provide a benefit during the period when expensing or partial expensing of more than 50% is allowed, relative to the treatment of equipment in general.

Although they produce a relatively neutral reduction in the tax rate, reductions in tax burden reduce the cost of operating proportionally more for long-lived assets, because the rate of return is a more important part of the “user cost” or “rental price” for more durable facilities. The investment must earn enough to cover the return to capital, taxes, and the depreciation of the asset. One way to express this difference is in the rental price (or payment that would be required to rent an asset). It is closely related to an equivalent reduction in acquisition cost. For example, for five-year assets, the present value of depreciating the asset at a 5 percent real rate of return and a 2 percent inflation rate is 87 cents for each dollar of cost. Allowing half of the cost to be deducted immediately (with a value of \$1) at a 35 percent tax rate would be the equivalent of a 2.3 percent reduction in acquisition cost. For seven-year property, the most common depreciation class for equipment, the present value

is 83 cents for each dollar of investment and the expensing is equivalent to a 3 percent reduction in cost. Thus, the reduction in overall cost of recycling (which also requires labor and material as well as the use of capital) is relatively small due to this provision.

Rationale

The recycling provision was adopted by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), which included a number of provisions relating to energy conservation. Although no specific rationale was provided, stand-alone bills introduced to provide this benefit referred to the energy savings from recycling.

Assessment

In the absence of external effects, it is efficient for investments to face the same effective tax rate. Subsidies to recycling would be justified if recycling reduces external effects such as pollution. Initial concerns about land use that were originally used to justify recycling have now been supplanted largely by benefits for energy use and pollution from recycling. While there was an initial debate about whether recycling was not only cost effective, but whether it actually reduced energy consumption, studies have indicated that it does. Energy saving is, however, greater for some commodities than others (e.g., aluminum as opposed to glass).

Another justification for subsidies to recycling is that many of the industries that produce virgin materials are eligible for tax subsidies as well (paper and mining). An alternative policy would be to reduce those existing subsidies rather than grant new ones for recycling. Certain industries (e.g., aluminum) also benefit from inexpensive hydroelectric power.

If a subsidy is justified for reuse and recycling property, it is not clear that a tax subsidy is the best alternative. Recycling issues are largely in the domain of local governments, and the cost effectiveness depends on many other factors (such as population density). Local governments have alternative methods of addressing recycling, such as requiring recycling and, in some cases, imposing taxes on trash by quantity (although the evidence does not suggest the latter approach is very successful). At the same time, some of the pollution effects of using energy are national (or even global). Providing a federal subsidy to lower costs might induce more localities to be involved in recycling. The subsidies should result in a greater demand and higher price for scrap. However, for communities already involved in recycling, these benefits

would appear in lower costs for trash collection overall, with no specific incentive for recycling.

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Natural Resources and Environment

EXPENSING OF TIMBER-GROWING COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	0.2	0.2
2021	(¹)	0.3	0.3
2022	(¹)	0.3	0.3
2023	(¹)	0.3	0.3
2024	(¹)	0.3	0.3

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 263A(c)(5).

Description

Under Section 263A(c)(5), most of the production costs of growing timber may be expensed (fully deducted in the year incurred). Production costs include indirect carrying costs, such as property taxes, as well as direct costs, such as disease and pest control and clearing brush. Most other industries follow the uniform capitalization rules, under which production costs are capitalized (added to the basis), recovered through depreciation, and deducted when the product is sold.

Impact

Expensing production costs rather than capitalizing them accelerates cost recovery. The time-value of taxes saved in earlier years lowers the average effective tax rate on timber-growing, calculated over the multi-year production period for timber. Most of the tax benefit goes to corporations, and is thereby likely to mostly benefit higher-income individuals.

Rationale

Permitting the costs of timber-growing to be expensed was part of a perception that these were maintenance costs, and thus deductible as ordinary costs of a trade or business. A series of revenue rulings and court cases over the years distinguished between which expenses could be deducted and which expenses had to be capitalized (for example, I. T. 1610 in 1923, an income tax unit ruling; Mim. 6030 in 1946, a mimeographed letter ruling; Revenue Ruling 55-412 in 1955; and Revenue Ruling 66-18 in 1966).

The Tax Reform Act of 1986 (P.L. 99-514) included uniform capitalization rules which required production expenses to be capitalized in most cases. Timber was among the few categories of property exempted from these rules. No specific reason was given for exempting timber, but the general reason given for exceptions to the uniform capitalization rules was that they were cases where its application “might be unduly burdensome.” Although the 1986 act repealed the 10-percent investment tax credit for most property placed in service after 1985, it retained the credit for expenditures that qualify for 84-month amortization, which includes reforestation expenditures.

Assessment

Supporters of the tax subsidy argue that timber-growing provides benefits to society in general, such as an improved environment, recreational opportunities, and natural vistas (economists call these positive externalities). Because private investors are not compensated for these external benefits, they would tend to invest less in timber-growing than may be socially desirable. A tax subsidy may encourage increased forestry investment.

Opponents of the tax subsidy argue that the tax-incentive approach should be compared with alternatives such as direct subsidies or direct ownership of timber lands by the government. Others may argue that, instead of positive externalities, increased timber production and use may impose negative externalities (such as overconsumption of natural resources or land use changes), so subsidizing timber production may reduce market efficiency.

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Natural Resources

EXCLUSION OF EARNINGS OF CERTAIN ENVIRONMENTAL SETTLEMENT FUNDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 468B.

Description

The cleanup of hazardous waste sites under the Superfund program sometimes is paid for out of environmental settlement funds, which serve the same purpose as escrow accounts. These funds arise out of consent decrees involving the Environmental Protection Agency (EPA) and parties held responsible for the site contamination. The consent decrees are issued by federal district courts. The EPA uses the funds in the accounts to resolve claims against responsible parties under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA, P.L. 96-510).

An environmental settlement fund will be exempt from taxation if the following conditions are satisfied: (1) it is established by a court order; (2) it is created to receive settlement payments as directed by a government entity for the sole purpose of resolving and satisfying one or more liability claims brought under CERCLA; (3) a government entity has the authority and control over the expenditure of the fund; and (4) any remaining funds at termination will be disbursed to the government entity.

Impact

The tax expenditure tied to the provision lies in the fund income that escapes taxation. In effect, the provision lowers the after-tax cost to a taxpayer of reaching a settlement with the EPA to clean up hazardous waste sites identified through the Superfund program.

Rationale

The provision entered the tax code through the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222). Proponents said it was needed to clarify the tax status of income earned by an environmental escrow account and to give parties deemed responsible for hazardous waste sites an incentive to enter promptly into an agreement with the EPA over cleaning up those sites. The funds in such an account are used to pay for the cost of cleanup operations. Further, because these environmental settlement funds are controlled by the government, and upon termination, any remaining balance belongs to the government, it was believed to be appropriate to treat funds as being beneficially owned by the United States, and thus not subject to tax.

When first enacted, the provision did not apply to accounts or funds established after December 31, 2010. The provision was later made permanent in the Tax Relief and Health Care Act of 2006 (P.L. 109-432).

Assessment

Many would agree that it is in the public interest for the parties responsible for hazardous waste sites to act quickly to clean up the sites at their own expense. The provision is intended to promote such a result. It is unclear, however, to what extent this provision has aided or expedited the cleanup of Superfund hazardous waste sites. Responsible parties end up paying for the cleanup of most of these sites. In cases where the EPA cannot locate responsible parties, the EPA may draw on funds in the Superfund trust fund to pay for cleanup. The provision may remove a barrier to increasing the proportion of contaminated sites cleaned up by responsible parties. If this proportion were to rise, less federal money might be needed to do the cleanup.

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Natural Resources and Environment

**EXCESS OF PERCENTAGE OVER COST DEPLETION,
NONFUEL MINERALS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 611, 612, 613, and 291.

Description

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

There are two methods of calculating this deduction: cost depletion and percentage depletion. Cost depletion allows for the recovery of the actual capital investment—the costs of discovering, purchasing, and developing a mineral reserve—over the period during which the reserve produces income. Each year, the taxpayer deducts a portion of the adjusted basis (original capital investment less previous deductions) equal to the fraction of the estimated remaining recoverable reserves that have been extracted and sold. Under this method, the total deductions cannot exceed the original capital investment.

Under percentage depletion, the deduction for recovery of capital investment is a fixed percentage of the “gross income”—i.e., sales revenue—

from the sale of the mineral. Under this method, total deductions typically exceed the capital invested.

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

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

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

Impact

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

There has been relatively little analysis of the effect of percentage depletion on industries—other than oil and gas prior to the 1975 repeal for major oil companies. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers depends on a number of factors, including the statutory percentage depletion rate, income tax rates, and the effect of the net income limitation.

Rationale

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

A court case resulted in the enactment, as part of the Tariff Act of 1913, of a “reasonable allowance for depletion” not to exceed 5 percent of the value of output. This statute did not limit total deductions. Treasury regulation no. 33 limited total deductions to the original capital investment.

This system was in effect from 1913 to 1918, although in the Revenue Act of 1916 (P.L. 64-271) depletion was restricted to no more than the total value of output, and, in the aggregate, to no more than capital originally invested or fair market value on March 1, 1913 (the latter so that appreciation occurring before enactment of income taxes would not be taxed).

On the grounds that the newer mineral discoveries that contributed to the war effort were treated less favorably, discovery value depletion was enacted in the Revenue Act of 1918 (P.L. 65-254). Discovery depletion, which was in effect through 1926, allowed deductions in excess of capital investment because it was based on the market value of the deposit after discovery. In 1921, because of concern with the size of the allowances, discovery depletion was limited to net income; it was further limited to 50 percent of net income in 1924.

For oil and gas, discovery value depletion was replaced in the Revenue Act of 1926 (P.L. 69-20) by the percentage depletion allowance, at the rate of 27.5 percent. This was due to the administrative complexity and arbitrariness, and due to its tendency to establish high discovery values, which tended to overstate depletion deductions.

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

From 1932 to 1950, percentage depletion was extended to most other minerals. In 1950, President Truman recommended a reduction in the top depletion rates to 15 percent, but Congress disagreed. The Revenue Act of 1951 (P.L. 82-183) raised the allowance for coal to 10 percent and granted it to more minerals.

In 1954, still more minerals were granted the allowance, and foreign mines were granted a lower rate. In 1969, the top depletion rates were reduced and the allowance was made subject to the minimum tax. The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) reduced the allowance for corporations that mined coal and iron ore by 15 percent. The Tax Reform Act of 1986 (P.L. 99-514) raised the cutback in corporate allowances for coal and iron ore from 15 percent to 20 percent.

Assessment

Standard accounting and economic principles suggest that the appropriate method of capital recovery in the mineral industry is cost depletion adjusted for inflation. The percentage depletion allowance permits mineral producers to continue to claim a deduction even after all the investment costs of acquiring and developing the property have been recovered. Thus it is a mineral production subsidy rather than an investment subsidy. In cases where a taxpayer has obtained mining rights relatively inexpensively under the provisions of the Mining Law of 1872, it can be argued that such taxpayers should not be entitled to the additional benefits of the percentage depletion provisions. (The Mining Law of 1872 permits U.S. citizens and businesses to freely prospect for hard rock minerals on federal lands. If economically recoverable deposits are found, no federal rents or royalties are imposed on the sale of extracted minerals.)

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

Arguments have been made to justify percentage depletion on grounds of national security and to protect domestic producers. Other factors cited in favor of allowing percentage depletion include: unusual risks, price volatility, and the distortions in the corporate income tax. These factors are not typically thought to constitute market failures that can be mitigated through a subsidy, such as percentage depletion.

Percentage depletion may not be the most efficient way to increase mineral output. Percentage depletion may also have adverse environmental consequences, encouraging the use of raw materials rather than recycled substitutes.

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Natural Resources and Environment

**EXPENSING OF EXPLORATION AND DEVELOPMENT
COSTS, NONFUEL MINERALS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

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

Description

Firms engaged in mining are permitted to expense (to deduct in the year paid or incurred) rather than capitalize (i.e., recover such costs through depletion or depreciation) certain exploration and development (E&D) costs. This provision is an exception to general tax rules.

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

Development costs generally are those incurred for the development of a mine or other natural deposits after the existence of ores in commercially marketable quantities has been determined. Development expenditures generally include those for construction of shafts and tunnels, and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such costs. Expensing of mine E&D costs may be taken in addition to percentage

depletion (see chapter titled “Excess of Percentage Over Cost Depletion, Nonfuel Minerals”), but it subsequently reduces percentage depletion deductions (i.e., is recaptured). The costs of tangible equipment must be depreciated.

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

Impact

E&D costs for non-fuel minerals are not as large a portion of the costs of finding and developing a mineral reserve as is the case for oil and gas, where they typically account for over two-thirds of the costs of creating a mineral asset. Expensing of such costs is also less of a benefit than percentage depletion allowances.

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

This tax expenditure is largely claimed by corporate producers. The at-risk and recapture restrictions that have since been placed on the use of the provision have primarily limited the ability of high-income taxpayers to shelter their income from taxation through investment in mineral exploration.

Rationale

Expensing of mine development expenditures was enacted in the Revenue Act of 1951 (P.L. 82-183) to encourage mining and reduce ambiguity in its tax treatment. The provision for mine exploration was added in 1966.

Before the Tax Reform Act of 1969 (P.L. 91-172), a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States (which subsequently reduced percentage depletion benefits), or to deduct up to \$100,000 a year with a total not to exceed \$400,000 of foreign and domestic exploration expenditures without recapture. The 1969 Act subjected all post-1969 exploration expenditures to recapture. The Tax Equity

and Fiscal Responsibility Act of 1982 (P.L. 97-248) added mineral exploration and development costs as tax preference items subject to the alternative minimum tax, and limited expensing for corporations to 85 percent. The corporate alternative minimum tax has been repealed for taxable years after December 31, 2017. The Tax Reform Act of 1986 (P.L. 99-514) required that all exploration and development expenditures on foreign properties be capitalized.

Assessment

E&D costs are generally recognized to be capital costs, which, according to standard economic principles, should be recovered through depletion (cost depletion adjusted for inflation).

Lease bonuses and other exploratory costs (survey costs, geological and geophysical costs) are properly treated as capital costs, although they may be recovered through percentage rather than cost depletion. Immediate expensing of E&D costs provides a tax subsidy for capital invested in the mineral industry with a relatively large subsidy for corporate producers.

By expensing rather than capitalizing these costs, the tax code effectively sets taxes on the return to such expenditures at zero. As a capital subsidy, however, expensing is inefficient because it makes investment decisions based on tax considerations rather than inherent economic considerations.

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

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

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Natural Resources and Environment

**TREATMENT OF INCOME FROM EXPLORATION AND
MINING OF NATURAL RESOURCES AS QUALIFYING
INCOME UNDER THE PUBLICLY TRADED
PARTNERSHIP RULES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 7704.

Description

Under section 7704, firms that publicly trade their interests on financial markets are treated as corporations for tax purposes, and are therefore subject to the corporate tax. Shareholders realizing capital gains or receiving dividends may also pay income tax on these distributions. Publicly traded partnerships (PTPs) trade their interests on financial markets, much like corporate stock, but are exempt from the corporate income tax provided that 90 percent of their income is considered qualifying passive-type income according to section 7704. Qualifying income sources include gains from interest, dividends, real property rents, disposition of real property, and mining and natural resource activities. Activities related to mining and natural resources include the exploration, development, mining or production, processing, refining, transportation, storage, and marketing of any depletable mineral or natural resource. Active income from qualifying natural resource-related activities is treated as qualifying income under section 7704.

Qualifying income also includes income from the transportation and storage of certain renewable and alternative fuels, and activities involving industrial source carbon dioxide. The tax expenditures in the table above are for certain natural resource-related PTPs. Natural resource PTPs include those in the timber and other nonfuel mineral industries, for example. Energy-related PTPs are discussed elsewhere in this compendium, in *Exceptions for Publicly Traded Partnerships with Qualified Income Derived from Certain Energy-Related Activities*.

Impact

Firms that organize as PTPs receive a number of benefits, including increased access to capital and a lower tax burden. By publicly trading their interests, PTPs have greater access to capital and may be able to secure capital at a lower cost than other firms that organize differently. Access to capital has the potential to stimulate investment and growth in the energy and natural resource sectors targeted within the definition of qualified income. The exemption from the corporate income tax also reduces a PTP's tax liability, which in turn can lead to increased profits and investment.

Rulings by the IRS, particularly in 2012 and 2013, spurred growth of firms organizing as PTPs. There were significant rulings supporting activities for hydraulic fracturing and the generation of real property rent. These decisions expanded which income streams could be considered as qualifying income. Subsequent to these rulings, the number of PTPs has increased. This growth was not sustained, and there was a sharp decline in the number of PTP initial public offerings (IPOs) by 2016.

The 2017 tax revision commonly referred to as the Tax Cuts and Jobs Act (TCJA, P.L. 115-97) reduced the corporate tax rate from 35 percent to 21 percent. This change decreased the attractiveness of partnerships' tax attributes relative to corporations. Use of the master limited partnership (MLP) structure further declined following P.L. 115-97. There were no MLP IPOs in 2020 or 2021.

Rationale

The Revenue Act of 1987 (P.L. 100-203) established the general tax rules that classify PTPs as corporations, in part to address concerns about erosion of the corporate tax base through the use of partnerships. Congress's concern was that growth in PTPs signified that activities, which would otherwise be conducted by corporations and subject to both corporate and shareholder-level

taxation, were being done by PTPs purely for tax reasons and eroding the corporate tax base.

The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) clarified the definition of qualified income to include income from the transportation of oil and gas and from depletable natural resources. Income from the marketing of oil and gas to retail customers was excluded from qualified income. The American Jobs Creation Act of 2004 (P.L. 108-357) made additional changes which made PTPs more attractive for mutual funds to invest in, and may have increased the pool of capital able to invest in PTPs. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) then further expanded the definition of qualified income to include income or gains from the transport or storage of certain renewable and alternative fuels and from certain activities related to industrial source carbon dioxide.

Assessment

Before the TCJA, pass-through business income generally faced lower tax rates than corporate income. Following the 2017 tax revision, it is less clear whether income in the corporate or non-corporate sector will face lower effective tax rates.

The fundamental issue, from a matter of tax policy, is whether some PTPs should be exempt from corporate level taxation, based upon the nature and type of their income. In general, Congress has enacted rules that limit the ability of untaxed entities to publicly trade their interests and/or restrict the entities' activities. Thus, the exemption of some PTPs from corporate level taxes may be seen as a departure from general congressional intent concerning pass-through entities. Others may argue that the industries targeted through the definition of qualified income have reason to be subsidized, and government policy should help spur investment and growth in the exploration and mining of natural resources.

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Natural Resources and Environment

**AMORTIZATION AND EXPENSING OF REFORESTATION
EXPENSES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 194.

Description

Section 194(b) allows all taxpayers, except trusts, to expense up to \$10,000 per year (\$5,000 if married filing separately) of reforestation costs per qualified timber property (QTP). Any excess amount, of more than the \$10,000, without limit, may be deducted (amortized) over an 84-month period under Section 194(a) for all taxpayers (including trusts). In the year of reforestation, the taxpayer can deduct one-fourteenth of the excess costs. In the second through seventh years, the taxpayer can deduct one-seventh of the excess costs, and in the eighth year, the taxpayer can deduct the final one-fourteenth.

Reforestation expenses are direct costs incurred for reforestation by planting, or by artificial or natural seeding. This includes costs for the preparation of the site, seeds or seedlings, labor and tools, tree planters, and similar machines and equipment used in seeding. Expenditures for timber stand improvement (TSI) practices in established stands do not qualify for either the deduction or amortization.

In general, these expenses are incurred for maintenance of the stand, however, and thus are eligible for deduction as a current expense, subject to the passive loss rules. Alternatively, they may be capitalized and deducted when the timber is cut, sold, or disposed.

Impact

Being able to expense reforestation costs rather than capitalize them accelerates cost recovery. The time-value of taxes saved in earlier years lowers the average effective tax rate on reforestation, calculated over the multi-year production period for timber.

Rationale

Expensing of the first \$10,000 of reforestation expenditures was introduced by the Recreational Boating Safety and Facilities Improvement Act of 1980 (P.L. 96-451). The expensing provision replaced an existing reforestation credit (Code Sec. 48). The change was made to simplify the treatment of reforestation costs. The basic purpose of the incentive was to encourage reforestation. The American Jobs Creation Act of 2004 (P.L. 108-357) provided for an election to claim the reforestation deduction effective in October 23, 2004. The 2004 act also granted taxpayers the ability to revoke an election made before the Act to treat the cutting of timber as a sale or exchange. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) temporarily raised the cap on the reforestation deduction from \$10,000 to \$20,000 for small timber producers for expenditures undertaken in the GO Zone through the end of 2007; taxpayers holding 500 or more acres of qualified timber property at any time during the taxable year were not eligible.

Assessment

Proponents of the tax subsidy argue that timber-growing provides benefits to society in general, such as an improved environment, recreational opportunities, and natural vistas (economists call these positive externalities). Because private investors are not compensated for these external benefits, they may invest less in timber-growing and reforestation than may be socially desirable. A tax subsidy may encourage increased forestry investment.

Opponents of the tax subsidy may argue that the tax-incentive approach should be compared with alternatives such as direct subsidies or direct

ownership of timber lands by the government. Economic analysis also indicates that the amendments to Section 194 enacted by P.L. 108-357 in 2004 provide the largest tax benefits to forest owners with high levels of non-timber income and large forest properties, and are least favorable to forest owners with small holdings. The tax savings from the \$10,000 reforestation deduction and unlimited amortization provisions is greatest for owners in high marginal tax brackets. Since the deduction is allowed against taxable income for income taxes, the incentive will only benefit entities with an income tax liability.

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Natural Resources and Environment

SPECIAL RULES FOR MINING RECLAMATION RESERVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 468.

Description

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

For federal income tax purposes, the amounts deducted before economic performance are deemed to earn interest at a specified interest rate. Upon election of Section 468, the taxpayer establishes a reserve account for the reclamation and closing costs of the mine or waste disposal site. In each year, the taxpayer may deduct the current year reclamation costs. In addition, the balance of the reserve is increased by an amount of interest computed using the applicable federal rates (see Section 1274). When the reclamation has been completed, any excess of the amounts deducted plus deemed accrued interest over the actual reclamation or closing costs is taxed as ordinary income.

Impact

Section 468 permits reclamation and closing costs to be deducted at the time of the mining or waste disposal activity that gives rise to the costs. Absent this provision, the costs would not be deductible until the reclamation or closing actually occurs and the costs are paid. Any excess amount deducted in advance (plus deemed accrued interest, as computed using applicable federal rates, see Section 1274) is taxed at the time of reclamation or closing.

Rationale

This provision was introduced by the Deficit Reduction Act of 1984 (P.L. 98-369). Proponents argued that allowing current deduction of mine reclamation and similar expenses is necessary to encourage reclamation, and to prevent the adverse economic effect on mining companies that might result from applying the general tax rules regarding deduction of future costs. For example, if mining companies could not deduct the current-value equivalent of future reclamation expenses, then their current-year income would be higher. Under a progressive income tax system, that higher income may be taxed at higher rates.

Assessment

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

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

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Natural Resources and Environment

**SPECIAL TAX RATE FOR NUCLEAR
DECOMMISSIONING RESERVE FUND**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 468A.

Description

Taxpayers who are responsible for the costs of decommissioning nuclear power plants (e.g., utilities) can elect to create reserve funds to be used to pay for decommissioning. The funds receive special tax treatment. Amounts contributed to a reserve fund are deductible in the year made and are not included in the taxpayer's gross income until the year they are distributed, thus effectively postponing tax on the contributed amounts. Amounts actually spent on decommissioning are deductible in the year they are made. The fund's investment earnings, however, are subject to a 20 percent tax rate—a slightly lower rate than that which applies to most other corporate income, which is taxed at 21%. The amount that can be contributed to an account is the amount the Internal Revenue Service (IRS) determines would provide funding for the actual decommissioning costs when they occur.

Impact

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

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

Rationale

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

The reduced tax rate was enacted by the Energy Policy Act of 1992 (P.L. 102-486). The rate was reduced to provide "a greater source of funds" for decommissioning expenses. Congress in 2000 approved a measure that would eliminate the "cost of service" limitation on contributions to funds (leaving intact the limit posed by the IRS determination). The Energy Tax Incentives Act of 2005 (P.L. 109-58) modified the rules on the contribution limits to allow larger deductible contributions to a decommissioning fund.

Assessment

As noted above, the reduced tax rates may provide a tax benefit linked with amounts contributed to qualified funds. The impact of the resulting tax benefit on economic efficiency depends in part on the effect of non-tax

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

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Agriculture

**EXPENSING OF SOIL AND WATER CONSERVATION
EXPENDITURES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 175.

Description

Taxpayers in the business of farming can elect to expense expenditures for soil and water conservation, to prevent the erosion of land, or for endangered species recovery on land used in farming. The deduction is limited to 25 percent of the taxpayer's gross income from farming in the current year. Deductible expenses above the 25 percent limit can be carried forward into subsequent taxable years, but the total value of deductions under Section 175 is limited to 25 percent of gross farm income for any subsequent taxable year. To be eligible, the soil and water conservation expenditures must be consistent with an appropriate public agency conservation plan. Certain specific expenditures are not eligible.

Impact

Expensing allows taxpayers to deduct the full cost of investments with a multi-year service life (which would generally have to be depreciated over several years). This allows a greater deduction from gross income in the year of the investment. For taxpayers with a tax liability, this will reduce the tax they owe. This may encourage taxpayers to make more soil and water conservation expenditures than they otherwise would.

Rationale

Specific regulations relating to soil and water conservation expenditures were adopted in the Internal Revenue Code of 1954. The Tax Reform Act of 1986 (P.L. 99-514) placed limits on soil and water conservation expenditures that could be expensed. Specifically, the law added the requirements that (1) expenses be consistent with a public agency conservation plan; and (2) expenditures for draining or filling wetlands or for preparing land for the installation of center pivot irrigation systems do not qualify.

Assessment

The provisions allowing taxpayers to expense soil and water conservation expenditures may allow farmers to reduce their tax liability. This may encourage farmers to devote additional resources to these tax-favored activities. If there are positive external benefits (benefits that do not accrue to the taxpayer farmer making the investment) associated with soil and water conservation, the provision could help promote economic efficiency. If there are not, then the provision may result in a misallocation of resources and reduced economic efficiency.

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Agriculture

EXCLUSION OF COST-SHARING PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 126.

Description

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

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

Impact

The exclusion of these grants and payments from tax provides a general incentive for various conservation and land improvement projects that might not otherwise be undertaken. The tax benefit (i.e., tax savings) associated with the exclusion increases with a taxpayer's marginal tax rate, and thus is greater for higher-income taxpayers.

Rationale

The income tax exclusion for certain cost-sharing payments was part of the tax changes made under the Revenue Act of 1978 (P.L. 95-600). The rationale for this change was that in the absence of an exclusion many of these conservation projects would not be undertaken. In addition, since the grants are to be spent by the taxpayer on conservation projects, the taxpayer would not necessarily have the additional funds needed to pay the tax on the grants if they were not excluded from taxable income.

Assessment

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

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

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

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Agriculture

**EXCLUSION OF CANCELLATION OF INDEBTEDNESS
INCOME OF FARMERS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	—	0.1
2021	0.1	—	0.1
2022	0.1	—	0.1
2023	0.1	—	0.1
2024	0.1	—	0.1

Authorization

Sections 108 and 1017(b)(4).

Description

This provision allows farmers who are solvent to treat the income arising from the cancellation of certain indebtedness as if they were insolvent taxpayers. Under this provision, income that would normally be subject to tax, the cancellation of a debt, is excluded from tax if the discharged debt is “qualified farm debt” discharged or canceled by a “qualified person.” Generally, this exclusion allows certain farmers to apply discharged indebtedness to reduce tax attributes and/or reduce the basis of property used in farming, rather than recognizing the canceled debt as income.

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

Additionally, those canceling the qualified farm debt must participate regularly in the business of lending money, cannot be related to the taxpayer

who is excluding the debt, cannot be a person from whom the taxpayer acquired property securing the debt, and cannot be a person who received any fees or commissions associated with acquiring the property securing the debt. Qualified persons (or creditors) include federal, state, and local governments.

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

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

Impact

This exclusion allows solvent farmers to defer the tax on the income resulting from the cancellation of a debt.

Rationale

The exclusion for the cancellation of qualified farm indebtedness was enacted as part of the Tax Reform Act of 1986 (P.L. 99-514). At the time, the intended purpose of the provision was to avoid tax issues that might arise from other legislative initiatives designed to alleviate the credit crisis in the farm sector. Congressional intent was to allow a deferral of tax rather than a complete exclusion for solvent farmers.

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

Assessment

The exclusion of cancellation of qualified farm income indebtedness does not constitute a forgiveness of tax but rather a deferral of tax. By electing to offset the canceled debt through reductions in the basis of property, a taxpayer can postpone the tax that would have been owed on the canceled debt until the

basis reductions are recaptured when the property is sold or through reduced depreciation in the future. Since money has a time value (a dollar today is more valuable than a dollar in the future), however, the deferral of tax provides a benefit in that it effectively lowers the tax rate on the income realized from the discharge of indebtedness.

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Agriculture

CASH ACCOUNTING FOR AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 162, 446, 448, and 461.

Description

Most farm businesses (with the exception of certain farm corporations and partnerships or any tax shelter operation) may use the cash method of tax accounting, by which revenues are accounted for when they are received and expenses when they are paid (“Cash Accounting, Other Than Agriculture” is discussed elsewhere in this compendium). There are also provisions that allow businesses to expense some costs associated with developing certain agriculture-related assets that will produce income in future years. Both of these rules allow deductions to be claimed before the income associated with the deductions is realized.

Costs that may be deducted before income attributable to them is realized include livestock feed and the expenses of planting crops for succeeding years’ harvests. Costs that otherwise would be considered capital expenditures but that may be deducted immediately by farmers include: (1) costs incurred for the purpose of soil or water conservation with respect to land used in farming,

or for the prevention of erosion of land used in farming as expenses not chargeable to a capital account; (2) costs of raising dairy and breeding cattle; and (3) costs of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to such land. For more information on these expensing provisions, see the separate entries on each in this section of the compendium.

Impact

For income tax purposes, the cash method of accounting is less burdensome than the accrual method of accounting, which requires revenues and expenses to be accounted for when they are earned and incurred rather than when they are received or paid. The cash method also provides benefits in that it allows taxes to be deferred into the future. Expensing is the most accelerated form of depreciation; the marginal effective tax rate on expensed capital asset investments is zero. Farmers who use the cash method of accounting and the special expensing provisions receive tax benefits not available to taxpayers required to use the accrual method of accounting or standard depreciation schedules.

Rationale

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

The Tax Reform Act of 1976 (P.L. 94-455) required that certain farm corporations and some tax shelter operations use the accrual method of accounting rather than cash accounting. The Tax Reform Act of 1986 (P.L. 99-514) further limited the use of cash accounting by farm corporations and tax shelters and repealed the expensing rules for certain land clearing operations. The 1986 Act also limited the use of cash accounting for assets that had pre-productive periods longer than two years. The restriction on assets that had pre-productive periods longer than two years, however, was later repealed by the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647). The 2017 tax revision, P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act, allowed cash accounting for farm corporations with less than \$25 million in gross receipts on average in the last three years.

Assessment

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

The cash method of accounting allows more control over the recognition of receipts and expenses for tax purposes. By shifting income or deductions, agriculture-related businesses using cash accounting may have more control over the timing of tax payments than businesses required to use the accrual method. Cash accounting is often simpler and thus may be associated with reduced compliance costs.

The provisions allowing taxpayers to expense soil and water conservation expenditures, fertilizer, and soil conditioner costs, and the costs of raising and breeding livestock reduce the effective tax rate on these investments relative to other types of investments. This may encourage farmers to devote additional resources to these tax-favored activities.

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Agriculture

INCOME AVERAGING FOR FARMERS AND FISHERMEN

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	0.2	—	0.2
2023	0.2	—	0.2
2024	0.2	—	0.2

Authorization

Section 1301.

Description

Taxpayers have the option to calculate their current year income tax by averaging over the prior three-year period all or a portion of their income from farming or commercial fishing. Taxpayers can designate all or a part of their current year income from farming business or fishing business as “elected farm income” to each of the prior three taxable years.

The current year income tax for taxpayers making this election is calculated by taking the sum of their current year tax calculated without including the elected farm income and the extra tax in each of the three previous years that results from including one-third of the current year’s elected farm income. Elected farm income can include the gain on the sale of farming or fishing assets with the exception of the gain on the sale of land.

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

In addition, taxpayers who receive settlement- or judgment-related income (after October 3, 2008) from the litigation surrounding the 1989 Exxon Valdez oil spill may use three-year income averaging for reporting such amounts to eligible retirement plans without having the income treated as taxable.

Impact

This provision provides tax relief primarily to taxpayers whose main source of income derives from agricultural production or commercial fishing. It allows these taxpayers to mitigate volatility of their taxable incomes and hence their tax liabilities in those years that they experience fluctuations in their incomes.

Rationale

Income averaging for farmers was enacted as part of the Taxpayer Relief Act of 1997 (P.L. 105-34). Congress recognized that the income from farming may fluctuate dramatically from year to year and that these fluctuations may be outside the control of the taxpayers. To address these fluctuations, Congress voted to allow taxpayers who derive their income from farming business to elect to average farm income and mitigate the adverse tax consequences of fluctuating incomes under a progressive tax structure.

Under pre-1986 income tax law, income averaging provisions were designed to help avoid the over-assessment of tax that might occur under a progressive tax when a taxpayer's income fluctuated from year to year. These pre-1986 tax provisions were especially popular with farmers who, due to market or weather conditions, might experience significant fluctuations in their annual incomes.

The Tax Reform Act of 1986 (P.L. 99-514) repealed income averaging. At the time, it was argued that the reduction in the number of tax brackets and the level of marginal tax rates reduced the need for income averaging. Farmers argued that even though the tax brackets had been widened and tax rates reduced, the fluctuations in their incomes could be so dramatic that without averaging they would be subject to an inappropriately high level of income taxation.

As marginal income tax rates were increased in 1990 and 1993, Congress became more receptive to the arguments for income averaging and reinstated limited averaging in the Taxpayer Relief Act of 1997 (P.L. 105-34). Under

this act, income averaging for farmers was a temporary provision and was to expire after January 1, 2001. The Tax and Trade Relief Extension Act of 1998 (part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999; P.L. 105-277) made income averaging for farmers permanent.

The American Jobs Creation Act of 2004 (P.L. 108-357) expanded income averaging to include commercial fishermen. It also coordinated income averaging with the individual alternative minimum tax so that the use of income averaging would not cause farmers or fishermen to incur alternative minimum tax liability.

Assessment

Under an income tax system with progressive tax rates and an annual assessment of tax, the total tax assessment on an income that fluctuates from year to year will be greater than the tax levied on an equivalent amount of income that is received in equal annual installments.

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

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

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Agriculture

**EXPENSING BY FARMERS FOR FERTILIZER AND SOIL
CONDITIONER COSTS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 180 and 464.

Description

Taxpayers in the business of farming (other than certain types of timber production) can expense expenditures (fully deduct them in the year they are incurred) for fertilizer, lime, ground limestone, marl, or similar materials used to enrich, neutralize, or condition farming land. Taxpayers can also deduct the cost of applying these materials. Taxpayers are subject to a limitation on the amount of all *prepaid* farm expenses incurred in the current year for use in future years that may be deducted in the current year. This limit applies to all prepaid expenditures (e.g., feed, seed, and fertilizer) and limits prepaid expenses to 50% of deductible farm expenses.

Impact

Expensing is the most accelerated form of depreciation; the marginal effective tax rate on expensed capital asset investments is zero. The zero

effective tax rate on fertilizer and soil conditioner investments encourages taxpayers to invest in fertilizing and conditioning land.

Rationale

Provisions governing the treatment of fertilizer costs were added to the Internal Revenue Code in 1960 (P.L. 86-779).

Assessment

The provision allows taxpayers to fully deduct fertilizer expenditures in the year that costs are incurred. Expenditures for fertilizer and lime applications that have multi-year effects would otherwise be subject to a more neutral tax treatment if they were treated as a capital investment. Expensing for fertilizer that has multi-year effects may encourage farmers to devote additional resources to this tax-favored activity. If excess fertilization raises environmental concerns, these concerns could be exacerbated by provisions that further encourage fertilizer use.

It may be difficult for taxpayers or tax administrators to determine which types of fertilization activities should be treated as capital investments, as opposed to ordinary and necessary business expenses. Thus, allowing all fertilizer expenses to be deducted in the year incurred could simplify taxes for affected taxpayers.

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Agriculture

**TWO-YEAR CARRYBACK PERIOD FOR NET OPERATING
LOSSES ATTRIBUTABLE TO FARMING**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

(²) This provision was modified by the Consolidated Appropriations Act, 2021 with a negligible revenue effect in FY2019-FY2030.

Authorization

Section 172(b)(1)(B).

Description

A net operating loss (NOL) is the amount by which business and certain other expenses exceed income for the year. Under previous law, losses could be generally carried forward and deducted from other income for 20 years following the loss year, or carried back to the previous two years (five years for farming losses). The 2017 tax revision (P.L. 115-97) eliminated carrybacks on most losses but allows taxpayers to carry losses forward indefinitely and offset 80 percent of taxable income. The law also replaced the five-year carryback on losses attributed to the trade or business of farming (as defined in section 263A(e)(4)) with a two-year carryback period. The revision also limited the amount of business losses that could offset other income to \$500,000 for joint returns (\$250,000 for other returns). These provisions apply

to losses incurred in taxable years beginning after December 31, 2017. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) modified rules relating to NOLs to allow taxpayers to carry back losses in 2018, 2019, and 2020 for up to five years, and to offset 100 percent of business losses against other income during the same time period, though farmers may elect to waive the extended carryback period. For more general information on changes made to the NOL deduction provision, see the section titled “Limit NOL Deduction” in this compendium.

Impact

For farm businesses that have paid taxes within the allowed carryback period, making use of the carryback rather than the carryforward option for operating losses means receiving an immediate refund rather than waiting for a future tax reduction. Although the special two-year carryback applies to losses incurred in a farming business, the losses may be used to offset taxes paid on any type of income. Thus the beneficiaries of this provision are farmers who have either been profitable in the past or who have had non-farm income on which they paid taxes. For the years eligible for five-year carryback under the CARES Act, this provision would have no effect compared to the general rule, and there would be no revenue loss from the tax expenditure.

Rationale

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

The five-year carryback for farm losses was enacted as a part of the Tax and Trade Relief Extension Act of 1998 (P.L. 105-277). The accompanying committee report stated that a special provision for farmers was considered appropriate because of the exceptional volatility of farm income.

The 2017 tax revision (P.L. 115-97) eliminated the two-year carryback period on most losses, and changed the 20-year carryforward to an indefinite carryforward period limited to 80 percent of taxable income. The law also decreased the farm loss carryback from five to two years. It also limited the amount of nonbusiness losses that could offset other income to \$500,000 for

joint returns (\$250,000 for other returns). These provisions apply to losses incurred in taxable years beginning after December 31, 2017.

Congress has responded to the COVID-19 pandemic with various relief measures—one of which, the CARES Act, modifies the rules relating to NOLs arising in 2018, 2019, and 2020. Specifically, the provision provides that any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, may be carried back to the five taxable years preceding the taxable year of such loss. NOLs eligible for the five-year carryback period include those arising with respect to farming losses, which would otherwise be subject to a two-year carryback period. The provision also suspends the application of the 80 percent taxable income limitation for the same time period, effectively allowing an offset of 100 percent of income. The limit on business losses that could be offset against other income was suspended for those years. The Consolidated Appropriations Act, 2021 (P.L. 116-260) allowed farmers to irrevocably waive these changes.

Assessment

In a pure income tax system, the government would refund taxes in loss years and collect them in profit years. Under such a system, a carryback of losses would not be considered a deviation from the normal tax structure. Since the current system deviates from a pure income tax in many ways, however, it is difficult to say whether the loss carryover rules bring it closer to or move it further away from the pure form.

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

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Commerce and Housing

EXEMPTION OF CREDIT UNION INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	2.0	2.0
2021	—	2.0	2.0
2022	—	2.0	2.0
2023	—	2.0	2.0
2024	—	2.1	2.1

Authorization

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

Description

Credit unions without capital stock, organized and operated as mutual cooperatives, do not issue common equity stock and are not subject to federal income tax.

Impact

Credit unions, which may accept federally insured deposits, are exempted from federal income taxes. If this exemption were repealed, both federally chartered and state chartered credit unions would become liable for payment of federal corporate income taxes on their retained earnings but not on earnings distributed to depositors. Depositors, however, would continue to pay taxes on the distribution (interest) paid on the checking and savings accounts.

For a given addition to retained earnings, this tax exemption may translate into higher dividends and lower interest rates on loans for credit union members relative to for-profit banks.

Rationale

Credit unions have never been subject to the federal income tax. Initially, the Attorney General of the United States ruled that credit unions were exempt from income tax because of their similarity to domestic building and loan associations—whose business was at one time confined to lending to members—and cooperative banks operated for mutual purposes, which were specifically exempt by Revenue Acts. The income tax exemption for mutual banks and savings and loan institutions was removed in the Revenue Act of 1951 (P.L. 82-183), but the Act, for the first time, designated credit unions by name as being exempt from federal income tax. No specific reason was given for continuing the exemption of credit unions.

Assessment

Supporters of the credit union exemption emphasize the uniqueness of credit unions compared to other depository institutions. Credit unions are directed by volunteers for the purpose of serving their members. Furthermore, supporters argue that credit unions are subject to certain regulatory constraints not required of other depository institutions and that these constraints reduce the competitiveness of credit unions. For example, credit unions may only accept deposits of members and lend only to members, other credit unions, or credit union organizations. Also, studies have shown that in other countries where the tax exemption of credit unions was eliminated, consumers faced higher interest rates on consumer loans and lower interest rates on deposits.

Proponents of removing the taxation exemption argue that deregulation has led to increased competition among all depository institutions, including credit unions, and the tax exemption gives credit unions an unwarranted advantage over other depository institutions. Large credit unions may have tax advantages over similar sized banks as a result of the exemption. They argue that depository institutions should have a level playing field for market forces to allocate resources efficiently.

Some banks meet the eligibility requirements to be taxed as S corporations (meaning that their income is taxed only at the individual income tax rates), thus shrinking the tax disadvantage relative to credit unions. Smaller institutions generally face greater cost disadvantages relative to larger

institutions, which benefit from having greater volume of transactions and product lines. Hence, some may favor lessening (rather than completely eliminating) the tax exemption for those institutions of a minimum asset threshold that engage in non-traditional credit union activities.

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Commerce and Housing

**EXCLUSION FROM UBTI OF CERTAIN PAYMENTS TO
CONTROLLING EXEMPT ORGANIZATIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 512(b)(13)

Description

Tax-exempt organizations are required to pay taxes on unrelated business taxable income (UBTI), which is defined as income resulting from business activities that are unrelated to their charitable or tax-exempt purpose. UBTI is taxed at the corporate income tax rate, which is 21 percent. Rents, royalties, interest, and annuities (passive income) are generally not considered business taxable income, except when such payments are received from a “controlled entity.” A controlled entity is one that is more than 50 percent owned (or otherwise controlled) by the parent organization.

Special rules provide that certain payments, including rents and royalties received by a tax-exempt entity from a controlled entity or subsidiary pursuant to a binding written contract, are not considered unrelated business income. Payments that are in excess of an arms-length (or fair market) price cannot be

excluded from UBTI. Further, payments in excess of an arms-length price are subject to a 20 percent penalty.

Impact

The special rule excludes from UBTI, and thus excludes from tax, payments received by controlling exempt organizations from controlled entities. The exclusion allows for flexibility with respect to inter-organizational transactions, by preventing arm's length transactions from generating UBTI.

Rationale

The Pension Protection Act of 2006 (P.L. 109-280) included special rules temporarily providing that certain payments, including rents and royalties received by a tax-exempt entity from a controlled entity or subsidiary, are not considered unrelated business income. When enacted, the special rules were effective for payments received or accrued before January 1, 2008. The provision was extended through 2009 in the Emergency Economic Stabilization Act (P.L. 110-343), through 2011 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), through 2013 in the American Taxpayer Relief Act (P.L. 112-240), and through 2014 in the Tax Increase Prevention Act of 2014 (P.L. 113-295).

The provision was made permanent in the Consolidated Appropriations Act, 2016 (P.L. 114-113).

Assessment

Treating rent, royalty, interest, and annuity payments from controlled organizations as UBTI while similar types of payments from third parties are not taxed may raise questions related to fairness. Tax-exempt entities could claim that as long as tax-exempt parents' dealings with controlled subsidiaries are done at arm's length or fair market value, the scope for abuse should be limited. It is this logic that led to the enactment of the provision modifying the tax treatment of certain payments to controlling exempt organizations.

Including payments received from controlled entities in unrelated business taxable income could prevent tax-exempt organizations from using separate but controlled entities to avoid unrelated business income taxes. For example, one concern is that a 501(c)(3) charitable organization could set up a controlled subsidiary to engage in a profitable activity (e.g., selling

merchandise). If the charity had sold the merchandise itself, the income would be subject to the unrelated business income tax. To avoid the tax, the charity could set up a controlled subsidiary to sell the merchandise, which would pay royalties to the charity (lease the charity's logo, for example). The controlled subsidiary would deduct the royalty payments as a cost of doing business, and the charity would receive royalty income, which would not be considered unrelated business income. In this scenario, the charity would avoid paying tax on business activities.

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Commerce and Housing

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.3	0.2	0.5
2021	0.3	0.2	0.5
2022	0.3	0.2	0.5
2023	0.3	0.3	0.6
2024	0.3	0.3	0.6

Authorization

Sections 167 and 168.

Description

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

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

depreciated. Prior depreciation methods imposed various types of accelerated depreciation on buildings other than rental housing, as discussed further in the “Rationale” section below.

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

Impact

Accelerated depreciation provides a tax incentive to the extent it is faster than economic (i.e., actual) depreciation. Data indicate that the economic decline rate for nonresidential buildings is slower than that reflected in tax depreciation methods. The present value of tax depreciation deductions, however, is reduced because deductions are not indexed for inflation, although that effect varies by type of building. Most estimates suggest that buildings are taxed at close to the statutory rate at current rates of inflation.

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

Rationale

Before 1954, administrative practices and rulings dictated depreciation policy. The straight-line method was favored by IRS and generally used. Tax lives (i.e., write-off periods) were recommended for assets through “Bulletin F,” but taxpayers were also able to use a facts and circumstances justification.

A ruling issued in 1946 authorized the use of the 150-percent declining balance method (where a rate 1.5 times as large as straight line is applied to the un-depreciated balance, with a switch to straight line when the straight line method produces more depreciation). Statutory authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and

equipment declined faster in their earlier years. When the accelerated methods were adopted, however, real property was included as well.

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

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

In the Economic Recovery Tax Act of 1981 (P.L. 97-34), buildings were assigned specific write-off periods that were roughly equivalent to 175-percent declining balance methods (200 percent for low-income housing) over a 15-year period under the Accelerated Cost Recovery System (ACRS). These changes were intended as a general stimulus to investment.

Taxpayers could elect to use the straight-line method over 15 years, 35 years, or 45 years. The Deficit Reduction Act of 1984 (P.L. 98-369) increased the 15-year life to 18 years; in 1985, it was increased to 19 years. The acceleration of depreciation that results from using the shorter recovery period under ACRS was not subject to recapture as accelerated depreciation.

The current straight-line treatment was adopted as part of the Tax Reform Act of 1986 (P.L. 99-514), which lowered tax rates, broadened the base of the income tax and imposed a 31.5-year tax life. The tax life was increased to 39 years by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

In the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), certain qualified leasehold improvements in nonresidential buildings were made eligible for a temporary bonus depreciation (expiring after 2004) allowing 30 percent of the cost to be deducted when incurred. The percentage was increased to 50 percent in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27). Leasehold improvements were also included in the temporary one-year 50 percent bonus depreciation for 2008, enacted by the Emergency Economic Stabilization Act of 2008, the fiscal stimulus bill passed in February 2008 (P.L. 110-185).

A temporary provision allowing a 15-year recovery period for qualified leasehold improvements and restaurant improvements was adopted in the American Jobs Creation Act of 2004 (P.L. 108-357) and expired after 2005. The arguments made for this treatment were that such investments had a shorter useful life than buildings in general. The Tax Relief and Health Care Act of 2006 (P. L. 109-432) extended the provision through 2007 and the Emergency Economic Stabilization Act (P.L.110-343), enacted in October 2008, extended it through 2009. The Protecting Americans from Tax Hikes (PATH) Act, enacted as part of the Consolidated Appropriations Act, 2016 (P.L. 114-113) made this provision a permanent part of the tax code. The allowance of a 15-year recovery period for qualified leasehold improvements and restaurant improvements was eliminated by the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act). This provision was restored in 2020 by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136).

Assessment

In present value terms, current depreciation rates provide values close to economic depreciation, so that most buildings receive little or no subsidy. Much of the previous concern about the role of accelerated depreciation in encouraging tax shelters in commercial buildings has faded because the current depreciation provisions are less rapid than those previously in place and because there is a restriction on the deduction of passive losses.

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Commerce and Housing

**SPECIAL TREATMENT OF LIFE INSURANCE
COMPANY RESERVES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	2.0	2.0
2021	—	2.0	2.0
2022	—	2.1	2.1
2023	—	2.1	2.1
2024	—	2.1	2.1

Authorization

Sections 803(a)(2), 805(a)(2), and 807.

Description

Life insurance companies can deduct net additions to reserves used to pay future liabilities and must add net subtractions from reserves to their income, subject to certain requirements on reserves set out in section 807 of the Internal Revenue Code (IRC). Deducting net additions to reserves allows life insurance companies to defer paying some taxes, thus reducing those companies' tax burden by allowing them to offset current income with future expenses. The match between the timing of taxable income and deductible expenses is, in general, closer for other businesses.

Special provisions govern the taxation of life insurance companies, which reflect the nature of the life insurance market. First, a life insurance company must count all premiums paid by insurance customers as income. Second, a company may deduct net additions to its life insurance reserves.

For example, once a customer signs an insurance contract and pays a one-time premium of \$5,000, the company records that amount as income. If the policy promises the beneficiary a payment of \$100,000 when the customer dies, then the company puts a portion of the premium aside into a reserve to cover that payment, which is deducted from the insurer's income. The insurer's actuaries calculate the present value of the insurance benefit, which is the minimum investment needed to fund the expected costs of a \$100,000 payout when the customer dies. If the insurer calculates that the present value of the life insurance benefit is \$3,000 then it earns an underwriting profit of \$2,000, net of other expenses. If, when the customer dies, the portion of the insurance reserve tied to that contract were \$95,000, the insurer would show a net deduction of \$5,000 (i.e., the \$100,000 payout minus the \$95,000 reserve).

If the insurer used more conservative actuarial assumptions, so that the present value of the life insurance benefit were calculated to be \$4,000, then the underwriting profit would be only \$1,000. Thus, using more conservative actuarial assumptions reduces the insurer's taxable income by \$1,000 in the current tax year, and increases the size of the accumulated reserve at the time of the customer's death, which increases the insurer's taxable income in the future. More conservative actuarial assumptions tend to reduce underwriting profits (taxable now) and increase the surplus of the accumulated reserves over payouts in the future, allowing insurers to defer taxation by converting underwriting profits into reserves.

Rules for allowable reserves reflect a balance between the need to ensure insurer solvency, which is the aim of statutory accounting standards, and the policy goal of constraining the deferral of taxes through insurance contracts. Section 807 therefore constrains levels of reserves that can be used to reduce income while setting minimums consistent with solvency considerations.

In general, the allowable reserve is calculated by taking 92.81% of the net value of the insurance contract using the Commissioners' Annuities Reserve Valuation Method specified by the National Association of Insurance Commissioners (NAIC). The allowable reserve level, however, must be at least as much as the net surrender value of the policy—that is, the cash a policyholder would receive were the policy to be surrendered—but cannot exceed the level of statutory reserves, which state insurance regulators typically require to ensure solvency. NAIC provides different methods for calculating reserves for different lines of insurance.

Impact

Reserves are accounts recorded in the liabilities section of balance sheets to indicate a claim against assets for future expenses. When life insurance companies can deduct additions to the reserve accounts when computing taxable income, they can purchase assets using tax-free or tax-deferred income. Reserve accounting shelters both premium and investment income from tax because amounts added to reserves include both premium income and the investment income earned by the invested assets. A large part of the reserves of life insurance companies is credited to individual policyholders, who also pay no tax on this investment income (see entry under “Exclusion of Investment Income on Life Insurance and Annuity Contracts”).

Competition in the life insurance market could compel companies to pass along corporate tax reductions to policyholders. Thus, this tax expenditure may benefit life insurance consumers as well as shareholders of private stock insurance companies. For mutual life insurance companies, policyholders may benefit either through lower premiums, better service, or higher policyholder dividends. Changes enacted in 2017 (P.L. 115-97) may affect profits of foreign-owned insurers, which could affect competitive conditions.

Rationale

The 1909 corporate income tax (P.L. 61-5) allowed insurance companies to deduct additions to reserves required by law and sums (besides dividends) paid on claims and annuities within the year. Some form of reserve deduction has been allowed ever since. Originally, the accounting rules of most regulated industries were adopted for tax purposes, while all state insurance regulators required reserve accounting. The many different methods of taxing insurance companies used since 1909 have all allowed some form of reserve accounting.

Before the Deficit Reduction Act of 1984 (P.L. 98-369), life insurance reserves were those required by state law and generally computed by state regulatory rules. Congress, concluding that the conservative regulatory rules allowed a significant overstatement of deductions, set rules for tax reserves that specified what types of reserves would be allowed and what discount rates would be used.

Tax changes enacted in 2017 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) simplified many requirements for calculating reserves for tax purposes and allow for updating of reserve calculations, rather than tying calculations and assumptions to the date when a policy was issued. Those

changes in federal tax rules, which allow more modern methods of calculating reserves, are estimated to reduce the value of insurance industry deductions. In the fall of 2020, the IRS issued a final rule on the treatment of life insurance reserves, conforming regulatory guidelines to the 2017 tax changes and changes in reserve calculations specified by NAIC.

Assessment

Reserve accounting allows the deduction of expenses relating to the future from current income. Reserve accounting—using statutory accounting methods—gives state insurance regulators a means of overseeing life insurance companies to ensure actuarial solvency: that is, ensuring that companies will be able to pay promised benefits. The conservative actuarial assumptions embedded in statutory accounting were designed with that aim in mind. Under the federal income tax, however, understating current income provides a tax advantage. Combined with the virtual tax exemption of life insurance product income at the individual level, this tax advantage makes life insurance a more attractive investment vehicle than it would otherwise be and may lead to overpurchase of insurance and overinvestment in insurance products.

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Commerce and Housing

**SPECIAL DEDUCTION FOR BLUE CROSS AND
BLUE SHIELD COMPANIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.3	0.3
2021	—	0.3	0.3
2022	—	0.3	0.3
2023	—	0.3	0.3
2024	—	0.3	0.3

Authorization

Section 833.

Description

Blue Cross and Blue Shield and a number of smaller health insurance providers that existed on August 16, 1986, when the Tax Reform Act of 1986 (P.L. 99-514) was enacted, can benefit from a special tax deduction. Other nonprofit health insurers that meet certain community-service and medical loss ratio standards also receive special tax treatment. A medical loss ratio (MLR), also called a loss ratio or health benefit ratio, is total health benefits paid divided by premium income and is a common, albeit rough, indicator of profitability and administrative efficiency.

The Blue Cross and Blue Shield special deduction has two main features. First, eligible health insurers are treated in the tax law as stock property and casualty insurance companies. Eligible organizations, however, can fully deduct unearned premiums, unlike other property and casualty insurance companies. Second, eligible companies may take a special deduction of 25 percent of the year's health-related claims and expenses minus its accumulated

surplus at the beginning of the year (if such claims and expenses exceed the accumulated surplus). For example, if an eligible health insurer had claims and related expenses of \$150 million and an accumulated surplus of \$110 million during a tax year, it could take a special deduction of \$10 million (i.e., 25 percent of the difference between \$150 million and \$110 million). The special deduction is also known as the “three-month” deduction because when an eligible insurer’s health-related claims and expenses exceed its accumulated surplus, it may deduct a quarter of the difference for the year.

Impact

Blue Cross/Blue Shield organizations traditionally had provided community-rated health insurance. The special deduction for Blue Cross/Blue Shield plans may help offset costs of providing high-risk and small-group coverage. Blue Cross/Blue Shield affiliates had been barred from organizing as for-profits, but in 1994, Blue Cross/Blue Shield guidelines were amended to let affiliates reorganize as for-profit insurers. More than a dozen Blue Cross/Blue Shield affiliates then converted to for-profit status. Blue Cross/Blue Shield affiliates that reorganized after August 16, 1986, are ineligible for the special deduction. Investor-owned affiliates are also ineligible for the special deduction. Thus, the special deduction could also benefit either their subscribers or all health insurance purchasers (through reduced premiums), their managers and employees (through increased compensation), or affiliated hospitals and physicians (through increased fees). Some have raised concerns that management and investors involved in Blue Cross/Blue Shield conversions to for-profit organizations have gained enormous benefits from previous tax advantages, even as most conversions have included establishment of a foundation to fund civic interests in the area of health. In 2002, New York State absorbed an estimated \$2 billion in social assets accumulated by Empire Blue Cross/Blue Shield and promised to use those resources to fund health programs. One 2019 study of conversions in 11 states found that premiums rose after Blue Cross affiliates switched to for-profit status.

Rationale

The “Blues” had been ruled tax-exempt by Internal Revenue regulations since their inception in the 1930s, apparently because they were regarded as community service organizations. The Tax Reform Act of 1986 (P.L. 99-514) removed Blue Cross/Blue Shield plans’ tax exemption because Congress believed that “exempt charitable and social welfare organizations that engage

in insurance activities are engaged in an activity whose nature and scope is inherently commercial rather than charitable,” and that “the tax-exempt status of organizations engaged in insurance activities provided an unfair competitive advantage.” The 1986 Act, however, introduced the special deduction described above, in part because of their continuing, albeit more limited, role in providing community-rated health insurance. In particular, section 833(c)2(c) of the Internal Revenue Code (IRC) links the special deduction for Blue Cross/Blue Shield plans to the provision of high-risk and small-group coverage.

The Patient Protection and Affordable Care Act (PPACA; P.L. 111-148, § 9016) links special deduction tax benefits enjoyed by Blue Cross/Blue Shield organizations to a medical loss ratio threshold. Blue Cross/Blue Shield organizations have to maintain an MLR of at least 85 percent for tax years starting after December 31, 2009. More generally, PPACA requires private health plans to meet minimum MLR requirements (80 percent in the individual and small group business, and 85 percent in the large group market) for plan years starting after September 2010. In January 2014, the IRS issued final regulations regarding the computation of MLRs, which specified that if the 85 percent MLR requirement is not met in a given year then section 833 benefits become inapplicable for that year. The Consolidated and Further Continuing Appropriations Act, 2015 (P.L. 113-235) allowed certain health quality improvement expenses in the MLR calculation and clarified the consequences of not meeting the MLR standard.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) left section 833 tax preferences in place, although some eligible insurers benefit from lower corporate tax rates. In particular, the elimination of the corporate alternative minimum tax (AMT) enhanced the value of the section 833 deduction. Changes in the CARES Act (P.L. 116-136; § 2305) that modified net operating loss carrybacks also increased the value of the deduction. One 2022 analysis of audited financial statements of 32 Blue Cross/Blue Shield organizations found that a dozen had paid no federal taxes since 2018 and in total had received \$6.6 billion in tax refunds since then.

In 2022, the U.S. Court of Federal Claims denied one plan’s attempt to bolster its tax deduction based on claims costs reimbursed by other plans.

Assessment

Differences in price and coverage between the health insurance products offered by Blue Cross and Blue Shield plans and those offered by commercial insurers, in the view of Congress, have faded. Some plans have accumulated enough surplus to purchase unrelated businesses. Many receive a substantial part of their income from administering Medicare or self-insurance plans of other companies. These tax preferences may have benefitted their managers and their affiliated hospitals and physicians more than their communities.

Some Blue Cross and Blue Shield organizations' charters retain a commitment to offer high-risk and small-group insurance coverage. Some continue to offer policies with premiums based on community payout experience ("community rated"). The tax exemption previously granted to the "Blues," as well as the current special deduction, might have helped support these community-oriented activities. In past decades, however, many health care providers and insurers have consolidated, reducing competition in many market areas. In recent years, consolidations among health insurers have continued, including initiatives to vertically integrate the health sector. One 2012 analysis found that health insurer consolidation in the 1996-2006 period increased premiums by about 7%. Whether providing special tax benefits to large, consolidated insurers with substantial market power advances public policy interests is unclear.

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Commerce and Housing

**TAX-EXEMPT STATUS AND ELECTION TO BE TAXED
ONLY ON INVESTMENT INCOME FOR CERTAIN SMALL
PROPERTY AND CASUALTY INSURANCE COMPANIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 831, 832, 834, and 501(c)(15).

Description

Insurance companies not classified as life insurance companies, which for the most part are property and casualty insurers, are tax-exempt if their gross receipts for a tax year are \$600,000 or less and if premiums account for 50 percent or more of those gross receipts. Mutual insurance companies may enjoy tax-exempt status if their gross receipts for a tax year are \$150,000 or less, and if more than 35 percent of those gross receipts consist of premiums. This tax-exempt status under Internal Revenue Code (IRC) section 501(c)(15) is subject to a controlled group rule. Legislation enacted in 2004 (P.L. 108-218) required that premium income flowing to members of the same controlled group as the insurance company must be aggregated, which limited certain tax sheltering strategies using 501(c)(15) insurers.

Slightly larger insurance companies not classified as life insurance companies may elect to be taxed only on their taxable investment income so long as net written premiums and direct written premiums each do not exceed a limit set at \$2.2 million for 2015 and indexed to inflation for later years. Small non-life insurance companies that elect to receive this tax treatment can reverse that decision only with a waiver from the Treasury Secretary. The small non-life insurance election provision is subject to a 50 percent controlled group rule and to a diversification test.

Impact

Some very small non-life insurance companies are exempted from taxation entirely, while slightly larger non-life insurance companies may choose a potentially advantageous tax status instead of being taxed at the regular corporate tax rate of 21 percent.

Determining how benefits of the small non-life insurance company deduction are distributed is difficult because ownership of some of these companies may be dispersed. Competitive pressures may force companies to pass some of these benefits on to insurance policyholders via lower premiums. In other cases, a group of companies may set up a “captive” or “microcaptive” insurance company, which provides insurance policies in exchange for premiums. In these cases, stakeholders in the parent companies benefit from the tax exemption. The insurance company, however, must accomplish bona fide “risk shifting” and “risk distribution” in order to qualify as an insurance company under tax law. Some business owners and professionals have created microcaptive insurance companies as part of tax avoidance strategies.

Rationale

Early 20th century tax laws, such as the 1909 law (Corporation Excise *Tax Act*; P.L. 61-5, §38), excluded “fraternal beneficiary societies, orders, or associations operating under the lodge system,” which according to some estimates, provided life insurance to about 30 percent of the adult population. Such groups typically now are classified as IRC 501(c)(8) organizations. Since that time, small insurance companies of all types have received various tax advantages. The Revenue Act of 1954 (P.L. 83-591) included mutual non-life and non-marine insurance companies with gross receipts of \$150,000 or less among the tax-exempt institutions set out in section 501(c). These provisions may have been included to encourage formation of small insurance companies

to serve specific groups of individuals or firms that could not easily obtain insurance through existing insurers.

The Tax Reform Act of 1986 (P.L. 99-514) broadened the exemption by allowing individuals and corporations to take advantage of the exemption, and increased the cap on gross receipts to \$350,000. Congress held that previous provisions affecting small insurers were “inordinately complex” and the “small company provision [should be extended] to all eligible small companies, whether stock or mutual.” After the 1986 change, several wealthy individuals and corporations avoided large amounts of taxes by creating 501(c)(15) insurers that held reserves in excess of levels required to pay claims. Legislation enacted in 2004 (P.L. 108-218) changed the gross-receipts requirements for these 501(c)(15) insurance company tax sheltering strategies. A diversification test is also required. The Consolidated Appropriations Act, 2016 (P.L. 114-113) expanded eligibility for non-life insurers to elect for alternative tax treatment by raising the section 831(b) upper limit on premium income from \$1.2 million to \$2.2 million for 2015 and mandated that the limit be indexed to inflation for later years. For 2022, the limit is \$2.45 million. In 2018, certain technical changes were made (P.L. 115-141).

Assessment

The principle of basing taxes on the ability to pay, often put forth as a requisite of an equitable and fair tax system, provides no justification for reducing taxes on business income for firms below a certain size. Persons such as business owners, customers, employees, or other individuals, bear the burden of taxation. Thus, the case for progressive taxation of persons gives no basis for tax advantages to smaller businesses.

Imposing lower tax rates on smaller firms distorts the efficient allocation of resources, since it offers a cost advantage based on size and not economic performance. This tax reduction serves no simplification purpose, since it requires an additional set of computations and some complex rules to prevent abuses. Special tax treatment of small insurers might conceivably help newer firms, although that may perpetuate entities more geared to tax avoidance than the efficient provision of insurance. In some lines of insurance, such as auto coverage, new entrants have quickly achieved significant market shares without special tax advantages. Moreover, other types of firms more adept at data analysis or that may have stronger links with customers may compete more effectively in the property and casualty insurance sector than insurers small enough to qualify for these special tax treatments.

Special tax rules for small non-life insurance companies may expand strategies available to very wealthy individuals to avoid or reduce tax liabilities. The extent of these strategies is unclear. In 2015 and 2016, the IRS outlined characteristics of abusive captive insurance arrangements. In 2019, the IRS offered settlements to 200 parties, nearly 80% of which were accepted. Wider enforcement initiatives followed in 2020. In recent court cases (e.g., *Szygy*, *Reserve Mechanical*), captive insurance arrangements were met with skepticism. The Government Accountability Office (GAO), however, argued that IRS enforcement could be more systematic.

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Commerce and Housing

**INTEREST RATE AND DISCOUNTING PERIOD
ASSUMPTIONS FOR RESERVES OF PROPERTY AND
CASUALTY INSURANCE COMPANIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	1.6	1.6
2021	—	1.6	1.6
2022	—	1.6	1.6
2023	—	1.6	1.6
2024	—	1.6	1.6

Authorization

Sections 831, 832(b), 846

Description

How a property and casualty insurance company calculates present values of future losses may generate a tax advantage. A present value is the current equivalent value of a given cash flow and is calculated using interest rates or discount factors and projections of the timing of income and losses. Most businesses calculate taxable income by deducting expenses when the business becomes liable for paying them. A significant portion of losses paid by property and casualty insurance companies are paid years after premiums were collected. Funds held by an insurer between payment of premiums and disbursement of loss claims are known as “float.” In some lines of insurance, investment earnings on those funds are an important revenue source.

State regulators typically require insurers to maintain minimum levels of loss reserves to ensure solvency; that is, the ability to pay all future claims. On

the other hand, if loss reserves exceed levels needed to ensure solvency, an insurer thereby shifts current earnings into future years, thus deferring tax payments. In other words, matching premium income received when a policy is written with associated losses that occur later necessitates some form of discounting. If losses in future years are not fully discounted, the insurer may enjoy a tax advantage through the ability to defer loss payments. Some research finds that insurers may manage reserve levels to smooth income.

Tax changes enacted in 2017 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) required insurers to employ discount rates calculated by the IRS from an average of yields of high-quality corporate bonds, although transition rules allowed a blended treatment for up to eight years. Before those 2017 changes, property and casualty insurers could use discount rates reflecting their own claims experience or use discount factors specified by the Treasury Secretary for various lines of insurance.

The 2017 changes constrain insurers' ability to shift net earnings into the future, thus deferring and lowering its tax burden. Those changes are estimated to reduce the size of deductible reserves, which could increase tax liabilities of some insurers. In June 2019, the IRS issued a final rule to implement modifications in discounting rules conforming to the 2017 legislation. That rule applies a single annual rate to all lines of business, calculated from a five-year average of yields on high-quality corporate bonds with maturities ranging from 4½ years to 10 years, with an average maturity of 7¼ years. The IRS also simplified consent procedures for making related accounting changes.

Impact

If the net present value of losses payable by property and casualty insurers calculated for tax purposes is greater than the true net present value of those losses based on efficient financial strategies, then those insurance companies may enjoy some managerial discretion on how net earnings are allocated over time. That discretion may allow management of insurers to reduce their federal tax burden, or to smooth earnings to make the insurer's stock more attractive to investors. Some argue, however, that current tax rules could discourage insurers from setting aside sufficient reserves for catastrophic losses.

Determining the distribution of benefits of this tax provision is difficult because ownership of most property and casualty insurance companies is widely dispersed, either among shareholders in stock companies or

policyholders in mutual companies. Competitive pressures may force companies to pass some of these benefits on to property and casualty insurance policyholders via lower premiums.

Rationale

Property and casualty insurers' loss reserve deductions before the Tax Reform Act of 1986 (P.L. 99-514) were based on the simple sum of expected payments for claim losses. Congress determined that this practice did not accurately measure the costs of these insurers, because property and casualty insurance companies, unlike other taxpayers, could deduct losses before they were paid. Because the time value of money makes current dollars more valuable than future dollars, allowing insurers to deduct losses ahead of actual payment reduced insurers' tax burden.

Since 1987, the loss reserve deduction has been calculated using a discounted loss reserve. The allowable current-year deduction for loss reserves since 1987 has been the accident-year's discounted loss reserve at the beginning of the tax year plus the strengthening in all prior accident-year discounted loss reserves. While these discounting rules reduced insurers' tax advantages, the discounting methodology implemented by the Tax Reform Act of 1986 probably overstated the true market-based present value of future losses of these insurers. Requiring most property and casualty companies to calculate the present value of future losses using a methodology given by the Tax Reform Act of 1986 with discount rates specified by the Treasury simplified the tax liability calculation and helped ensure more uniform tax treatment of property and casualty companies. One analysis found that the magnitude of loss reserve errors among property and casualty companies decreased after 2000.

Changes enacted in 2017 (P.L. 115-97) tied the discounting rules to yields of high-quality corporate bonds. Insurers also lost the option to use firm-specific loss history to compute allowable reserves, apart from transition rules permitting a blended calculation. Standardizing loss reserve calculations may simplify calculations and prevent some insurers from gaining a competitive advantage by using idiosyncratic loss patterns.

Assessment

Allowing some firms, such as property and casualty insurance companies, to defer certain tax liabilities requires other taxpayers to bear higher burdens, or reduces federal revenues. A potential mismatch between

simple tax rules and actual financial management practices may allow those insurers to attract economic resources from other sectors of the economy, thus creating economic inefficiencies.

Over time, Congress has narrowed the discretion allowed by insurers when calculating loss reserves. While determining how closely statutory assumptions match true economic costs of holding loss reserves may be difficult, the standardizing of discounting calculations and tying them to market interest rates simplify calculations and promote a more level playing field among firms. The 2019 IRS final rule, which set out a calculation based on a narrower range of maturities than the 2018 proposed rule, had the likely effect of lowering discount rates and increasing the value of loss reserve deductions.

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Commerce and Housing

**PRORATION FOR PROPERTY AND CASUALTY
INSURANCE COMPANIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.2	0.2
2021	—	0.2	0.2
2022	—	0.2	0.2
2023	—	0.2	0.2
2024	—	0.2	0.2

Authorization

Section 832(b).

Description

A property and casualty insurance company's taxable income during a tax year is its underwriting income (i.e., premiums minus incurred losses and expenses) plus investment income and certain other income items minus allowable deductions. Additions to loss reserves, held to pay future claims, can also be deducted from taxable income under certain conditions. The Tax Reform Act of 1986 (P.L. 99-514) imposed a 15 percent proration provision, as Congress held that using tax-exempt investments to finance additions to loss reserves was "inappropriate." Therefore, the allowable deduction for additions to loss reserves was reduced by 15 percent of (i) the insurer's tax-exempt interest, (ii) the deductible portion of dividends received (with special rules for dividends from affiliates), and (iii) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts. Tax changes enacted in 2017 (P.L. 115-97) modified the 15 percent proration provision to reflect a lowering of the corporate income tax rate. In particular,

the proration provision is now calculated as 5.25 divided by the highest corporate tax rate, which was lowered to 21 percent. Thus, the current proration provision is 25 percent.

In October 2020, the IRS issued final regulations clarifying application of proration and related treatment of insurers' income, in particular in relation to provisions aimed at limiting tax base erosion.

Impact

The proration provision does not remove all of the benefit of holding tax-exempt investment to property and casualty insurance companies. In the simplest case, at the typical 21 percent statutory corporate income tax rate, a property or casualty insurance company would pay an effective tax rate of 25 percent \times 21 percent = 5.25 percent on income from tax exempt investments. The corporate alternative minimum tax, which was removed in 2017, may have capped the gains from holding a higher share of tax-exempt securities.

Rationale

The 15-percent proration requirement was included in the Tax Reform Act of 1986 (P.L. 99-514) because Congress believed that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends." The Taxpayer Relief Act of 1997 (P.L. 105-34) expanded the 15-percent proration rule to apply to the inside buildup on certain insurance contracts.

Various modifications of proration rules have been considered since 1997. In 1999, the Clinton Administration proposed increasing proration for insurance companies from 15 percent to 25 percent. A Senate version of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) included a provision to change in the proration treatment of life insurance subsidiaries of property and casualty firms, but the enacted measure (P.L. 108-27) did not. A January 2005 Joint Committee on Taxation report recommended substituting the allocation rule of section 265(b) of the Internal Revenue Code for the 15 percent proration rule. The Obama Administration proposed modifications of proration rules for life insurance companies in its budget submissions. Tax changes enacted in 2017 (P.L. 115-97), as noted above, adjusted the proration rules so that the effective tax rate would stay the same

when the corporate income tax changes. A House-passed 2021 reconciliation bill proposed changes in section 832 income calculations; the enacted measure (P.L. 117-169) did not include that provision.

Assessment

The proration provision allows property and casualty insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income. Life insurance companies, banks and brokerage firms, and other financial intermediaries, face more stringent proration rules that prevent or reduce the use of tax-exempt or tax-deferred investments to fund currently deductible reserves or deductible interest expense. Allowing property and casualty insurance companies an advantageous tax status, based on the ability to use tax-exempt income to reduce tax liabilities, may allow those insurers to attract economic resources from other sectors of the economy, thus creating economic inefficiencies.

A more stringent allocation rule, which would reduce the attractiveness of investing reserves in tax-preferred assets, could reduce insurance companies' demand for tax exempt bonds issued by state and local governments, which could raise financing costs for those governments. On the other hand, a more stringent allocation rule would allow Congress to target tax incentives for state and local governments more effectively.

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Commerce and Housing:
Housing

**DEDUCTION FOR MORTGAGE INTEREST ON OWNER-
OCCUPIED RESIDENCES**

Estimated Revenue Loss
[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	25.5	—	25.5
2021	23.7	—	23.7
2022	24.1	—	24.1
2023	25.3	—	25.3
2024	26.6	—	26.6

Authorization

Section 163(h).

Description

A taxpayer may claim an itemized deduction for “qualified residence interest,” which includes interest paid on a mortgage secured by a principal residence and a secondary residence. The amount of interest that may be deducted is limited to the interest incurred on the first \$750,000 (\$375,000 for married filing separately) of combined mortgage debt for taxable years 2018 through 2025. For mortgage debt incurred on or before December 15, 2017, the combined mortgage limit is \$1 million (\$500,000 for married filing separately) during the same time period. Refinanced mortgage debt will be treated as having been incurred on the date of the original mortgage for purposes of determining which mortgage limit applies (\$750,000 or \$1 million).

Mortgage debt includes home equity loans secured by a principal or second residence that are used to buy, build, or substantially improve a

taxpayer's home. Mortgage debt *does not include* home equity loans that are used for purposes unrelated to the property securing the loan, such as paying off a credit card balance or financing a child's college education. The restrictions on the use of home equity loans apply irrespective of when the loan was originated.

After 2025, the mortgage limit for all qualifying mortgage interest will be \$1 million, plus \$100,000 in home equity indebtedness regardless of its use.

Impact

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

Renters and the owners of rental property do not receive a comparable benefit. Renters may not deduct any portion of their rent under the federal income tax. Landlords may deduct mortgage interest paid for rental property, but are subject to tax on the rental income they earn.

For taxpayers who can itemize, the home mortgage interest deduction may encourage home ownership by reducing the cost of owning compared with renting. Because a minority of taxpayers itemize, and because the mortgage interest deduction does not address the biggest barrier to homeownership—the down payment—its impact on the homeownership rate is likely small. The deduction, however, may encourage individuals to spend more on housing via larger home purchases, and to borrow more than they would in the absence of the deduction.

The mortgage interest deduction primarily benefits upper-income households. Higher-income taxpayers are more likely to itemize deductions. As with any deduction, a dollar of mortgage interest deduction is worth more the higher the taxpayer's marginal tax rate. Higher-income households also tend to have larger mortgage interest deductions because they can afford to spend more on housing and can qualify to borrow more.

***Distribution by Income Class of the Tax Expenditure for
the Mortgage Interest Deduction, 2020***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.1
\$30 to \$40	0.2
\$40 to \$50	0.5
\$50 to \$75	2.9
\$75 to \$100	5.8
\$100 to \$200	27.6
\$200 and over	62.8

Rationale

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

Before the Tax Reform Act of 1986 (TRA86, P.L. 99-514), there were no restrictions on either the dollar amount of the mortgage interest deduction or the number of homes on which the deduction could be claimed. The limits placed on the mortgage interest deduction in 1986 and 1987 were part of the effort to limit the deduction for personal interest.

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

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) placed new dollar limits on mortgage debt incurred after October 13, 1987, upon which interest payments could be deducted. An upper limit of \$1 million (\$500,000 for married filing separately) was placed on the combined “acquisition indebtedness” for a principal and second residence. Acquisition indebtedness includes any debt incurred to buy, build, or substantially improve the residence(s). The ceiling on acquisition indebtedness for any residence is reduced to zero as the mortgage balance is paid down, and can only be increased if the amount borrowed is used for improvements.

The 1987 Omnibus also replaced the exception for qualified medical and educational expenses included in TRA86 with an explicit provision for home equity indebtedness: in addition to interest on acquisition indebtedness, interest could be deducted on loan amounts up to \$100,000 (\$50,000 for married filing separately) for other debt secured by a principal or second residence, such as a home equity loan, line of credit, or second mortgage. The sum of the acquisition indebtedness and home equity debt could not exceed the fair market value of the home(s). There was no restriction on the purposes for which home equity indebtedness could be used.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) temporarily modified the mortgage interest deduction from 2018 through 2025. The 2017 tax revision limits the deduction to interest incurred on the first \$750,000 (\$375,000 for married filing separately) of combined mortgage debt for a principal and second residence. For mortgage debt incurred on or before December 15, 2017, the combined mortgage limit is \$1 million (\$500,000 for married filing separately) during the same time period. The mortgage limits include home equity loans secured by a principal or second residence that are used to buy, build, or substantially improve a taxpayer’s home. Refinanced mortgage debt will be treated as having been incurred on the date of the original mortgage for purposes of determining which mortgage limit applies (\$750,000 or \$1 million). After 2025, the mortgage interest deduction is scheduled to revert to the pre-2017 tax revision limits.

Assessment

Major justifications for the mortgage interest deduction have been the desire to encourage homeownership and to stimulate residential construction. Homeownership is alleged to encourage neighborhood stability, promote civic responsibility, and improve the maintenance of residential buildings.

Homeownership is also viewed as a mechanism to encourage families to save and invest in what for many will be their major financial asset.

A major criticism of the mortgage interest deduction has been its distribution of tax benefits in favor of higher-income taxpayers. As shown in the table above, it is estimated that 90.4 percent of the benefit accrued to taxpayers with incomes greater than \$100,000 in 2020.

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

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

Data show that the rate of homeownership in the United States is lower than the average for the Organisation for Economic Co-operation and Development countries, including those without a tax subsidy for mortgage interest (Keightley, 2020). The value of the U.S. deduction may be at least partly capitalized into higher prices at the middle and upper end of the housing market.

Additionally, two other changes included in the 2017 tax revision likely reduced the number of homeowners claiming the mortgage interest deduction and, therefore, the deduction's scope for the years 2018 to 2025. First, the 2017 tax revision limited the deduction for state and local property and income taxes (SALT) to \$10,000 until the end of 2025. The SALT deduction is a primary reason why taxpayers choose to itemize. As a result, limiting the deduction will reduce the number of homeowners who itemize their deductions and, therefore, the number claiming the mortgage interest deduction. Additionally, the 2017 tax revision increased the standard deduction to \$12,000 (single) and \$24,000 (married), both of which are adjusted for inflation. The increase in the standard deduction further reduced the rationale for itemizing one's tax deductions, which is required to claim the mortgage interest deduction.

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Commerce and Housing

**DEDUCTION FOR PREMIUMS FOR QUALIFIED
MORTGAGE INSURANCE**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This estimate does not reflect the extension of the provision through 2021. This provision was extended through 2021 by P.L. 116-260 and is estimated to cost \$207 million over FY2021-FY2025.

Authorization

Section 163.

Description

Qualified mortgage insurance premiums paid with respect to a qualified residence can be treated as residence interest and are therefore tax deductible. The deduction is phased out for married taxpayers with adjusted gross income from \$100,000 to \$110,000, and is phased out for single taxpayers with adjusted gross income from \$50,000 to \$55,000. For the purposes of this deduction, qualified mortgage insurance means mortgage insurance obtained from the Department of Veterans Affairs (VA), the Federal Housing Authority (FHA), the Rural Housing Administration (RHA), and private mortgage insurance as defined by the Homeowners Protection Act of 1988.

Impact

For a number of reasons, the mortgage insurance premium deduction primarily benefits young middle-income households. First, most lenders require mortgage insurance if a borrower's down payment is less than 20 percent of the home's assessed value. Young households are more likely to lack the wealth needed to meet this requirement and will therefore purchase mortgage insurance. Second, the deduction is only beneficial to households who itemize their deductions. Lower-income households generally do not itemize as they find the standard deduction to be more valuable. Third, while higher-income households are more likely to itemize, income eligibility limits for this provision exclude higher-income households from benefitting from this deduction.

As with any deduction, a dollar of mortgage insurance premium deduction is worth more the higher the taxpayer's marginal tax rate. Thus, within the group of middle-income households that are eligible for this deduction, higher-income earners will find it more beneficial.

Rationale

The deduction was added, for 2007, by the Tax Relief and Health Care Act of 2006 (P.L. 109-432) and initially extended through 2010 by the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142). The deduction was extended several more times: through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through 2016 by Division Q of P.L. 114-113, the Protecting Americans from Tax Hikes Act (or "PATH" Act); through 2017 by the Bipartisan Budget Act of 2018 (P.L. 115-123); through 2020 by the Further Consolidation Appropriations Act, 2020 (P.L. 116-94). Most recently, the deduction was extended through 2021 by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (P.L. 116-260).

Proponents argue that allowing for the deduction of mortgage insurance premiums fosters home ownership. Most lenders will demand that a household purchase mortgage insurance if a down payment of less than 20 percent is made. By reducing the cost associated with the purchase of such insurance, more households—particularly younger middle-income households unable to

meet the 20 percent down payment criterion—may be encouraged to own a home.

Assessment

A justification for the mortgage insurance premium deduction has been the desire to encourage homeownership. Homeownership is generally believed to encourage neighborhood stability, promote civic responsibility, and improve the maintenance of residential buildings. Homeownership is also viewed as a mechanism to encourage families to save and invest in what for many will be their major asset.

Some assert it is not clear that the deduction promotes homeownership to the degree proponents argue it does. Economists have identified the high transaction costs associated with a home purchase—mostly resulting from the down payment requirement, but also closing costs—as the primary barrier to homeownership. The ability to deduct insurance premiums does not lower this barrier—most lenders will require mortgage insurance if the borrower’s down payment is less than 20 percent regardless of whether the premiums are deductible. The deduction may allow a buyer to borrow more, however, because they can deduct the higher associated premiums and therefore afford a higher housing payment.

Economists have also noted that owner-occupied housing in the United States is already heavily subsidized. By increasing the subsidy, resources are likely further directed away from other uses in the economy, such as investment in productive physical capital.

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Commerce and Housing

**EXCLUSION OF CAPITAL GAINS ON SALES OF
PRINCIPAL RESIDENCES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	34.5	—	34.5
2021	37.6	—	37.6
2022	40.3	—	40.3
2023	42.7	—	42.7
2024	45.3	—	45.3

Authorization

Section 121.

Description

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

Impact

Excluding the capital gains on the sale of principal residences from gross income primarily benefits middle- and upper-income taxpayers. At the same time, however, this provision avoids putting an additional tax burden on taxpayers, regardless of their income levels, who have to sell their homes because of changes in family status, employment, or health. It also provides

tax benefits to elderly taxpayers who sell their homes and move to less expensive housing during their retirement years. This provision simplifies income tax administration and record keeping in comparison to prior law.

Rationale

Capital gains arising from the sale of a taxpayer's principal residence have long received preferential tax treatment. The Revenue Act of 1951 (P.L. 82-183) introduced the concept of deferring the tax on the capital gain from the sale of a principal residence if the proceeds of the sale were used to buy another residence of equal or greater value. This deferral principal was supplemented by the Revenue Act of 1964 (P.L. 88-272) and the introduction of the tax provision that allowed elderly taxpayers a one-time exclusion from tax for some of the capital gain derived from the sale of their principal residence. Over time, the one-time exclusion provision was modified such that all taxpayers aged 55 years and older were allowed a one-time exclusion for up to \$125,000 gain from the sale of their principal residence.

By 1997, Congress had concluded that these two provisions, tax-free rollovers and the one-time exclusion of \$125,000 in gain for taxpayers aged 55 years and older, had created significant complexities for the average taxpayer with regard to the sale of their principal residence. To comply with tax regulations, taxpayers had to keep detailed records of the financial expenditures associated with their homeownership. Taxpayers had to differentiate between those expenditures that affected the basis of the property and those that were for maintenance or repairs. In many instances these records had to be kept for decades.

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

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

As a result of these concerns, Congress repealed the rollover provisions and the one-time exclusion of \$125,000 of gain in the Taxpayer Relief Act of

1997 (P.L. 105-34). In their place, Congress enacted the current tax rules which allow a taxpayer to exclude from their gross income up to \$250,000 of capital gain (\$500,000 in the case of married taxpayers filing joint returns) from the sale or exchange of his or her principal residence.

Assessment

This exclusion gives homeownership a competitive advantage over other types of investments, since the capital gains from investments in other assets are generally taxed when the assets are sold. Moreover, when combined with other provisions in the tax code such as the deductibility of home mortgage interest, homeownership is generally considered an especially attractive investment from a tax perspective. As a result, savings are diverted out of other forms of investment and into housing.

Viewed from another perspective, many see the exclusion on the sale of a principal residence as justifiable because the tax law does not allow the deduction of personal capital losses, because much of the profit from the sale of a personal residence can represent inflationary gains, and because the purchase of a principal residence is less of a profit-motivated decision than other types of investments. Taxing the gain on the sale of a principal residence might also interfere with labor mobility.

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Commerce and Housing

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR OWNER-OCCUPIED HOUSING**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	0.2	0.9
2021	0.7	0.2	0.9
2022	0.7	0.2	0.9
2023	0.7	0.2	0.9
2024	0.7	0.2	0.9

Authorization

Sections 103, 141, 143, and 146.

Description

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

These mortgage revenue bonds (MRBs) are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and

private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Numerous limitations have been imposed on state and local MRB programs, among them restrictions on the purchase prices of houses that can be financed, on the income of homebuyers, and on the portion of bond proceeds that must be expended for mortgages in targeted (i.e., lower-income) areas.

A portion of capital gains on an MRB-financed home sold within 10 years must be rebated to the Treasury. Housing agencies may trade in bond authority for authority to issue equivalent amounts of mortgage credit certificates (MCCs). MCCs take the form of nonrefundable tax credits for interest paid on qualifying home mortgages.

MRBs are subject to the private-activity bond annual volume cap that is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003. Housing agencies must compete for cap allocations with bond proposals for all other private activities subject to the volume cap.

In response to the housing market crisis in 2008, Congress included two provisions in the Housing and Economic Recovery Act of 2008 (HERA, P.L. 110-289) that were intended to assist the housing sector. First, HERA provided that interest on qualified private-activity bonds issued for (1) qualified residential rental projects, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds, would not be subject to the alternative minimum tax (AMT). Second, HERA created an additional \$11 billion of volume cap space for bonds issued for qualified mortgage bonds and qualified bonds for residential rental projects. The cap space was designated for 2008 but unused capacity could be carried forward through 2010.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to offer mortgages on owner-occupied housing at reduced mortgage interest rates. In 2019, according to the Council of Development Finance Agencies, roughly \$9.5 billion of MRBs and \$7.3 billion of MCCs were issued.

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

Rationale

The first MRBs were issued without any federal restrictions during the high-interest-rate period of the late 1970s. State and local officials expected reduced mortgage interest rates arising from the tax exemption to increase the incidence of homeownership. The Mortgage Subsidy Bond Tax Act of 1980 (P.L. 96-499) imposed several targeting requirements, most importantly restricting the use of MRBs to lower-income first-time purchasers. The annual volume of bonds issued by governmental units within a state was capped, and the amount of arbitrage profits (the difference between the interest rate on the bonds and the higher mortgage rate charged to the home purchaser) was limited to one percentage point.

Depending upon the state of the housing market, targeting restrictions were relaxed and tightened during the 1980s. MRBs were included under the unified volume cap on private-activity bonds by the Tax Reform Act of 1986 (P.L. 99-514).

MRBs had long been an “expiring tax provision” with a sunset date. MRBs first were scheduled to sunset on December 31, 1983, by the Mortgage Subsidy Bond Tax Act of 1980 (P.L. 96-499). Additional sunset dates have been adopted five times when Congress has decided to extend MRB eligibility for a temporary period. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) made MRBs a permanent provision.

The Tax Increase Prevention and Reconciliation Act (P.L. 109-222) required that payers of state and municipal bond tax-exempt interest begin to report those payments to the Internal Revenue Service after December 31, 2005. The manner of reporting is similar to reporting requirements for interest paid on taxable obligations. Additionally in the 109th Congress, the program was expanded temporarily to assist in the rebuilding efforts after the Gulf Region hurricanes in 2005.

In the 110th Congress, the Housing and Economic Recovery Act of 2008 (P.L. 110-289) made several permanent and temporary changes to the bonds. First, the interest on MRBs became permanently exempt from the AMT.

Second, eligible use of MRBs was temporarily expanded to include the refinancing of qualified subprime mortgages. Third, states' volume caps were increased for 2008 (which could have been carried forward through 2010). Fourth, changes enacted in the 109th Congress to assist victims of the Gulf Region hurricanes were extended. Also in the 110th Congress, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) waived certain program requirements, enabling disaster victims to benefit from MRB financing.

Assessment

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

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

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Commerce and Housing

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR RENTAL HOUSING**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	0.2	0.9
2021	0.8	0.2	1.0
2022	0.8	0.2	1.0
2023	0.8	0.2	1.0
2024	0.8	0.2	1.0

Authorization

Sections 103, 141, 142, and 146.

Description

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

These residential rental housing bonds are subject to the state private-activity bond annual volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003. Several additional

requirements have been imposed on these projects, primarily on the share of the rental units that must be occupied by low-income families and the length of time over which the income restriction must be satisfied.

In response to the housing market crisis in 2008, Congress included two provisions in the Housing and Economic Recovery Act of 2008 (HERA; P.L. 110-289) that are intended to assist the housing sector. First, HERA provided that interest on qualified private activity bonds issued for (1) qualified residential rental projects, (2) qualified mortgage bonds, and (3) qualified veterans' mortgage bonds, would not be subject to the AMT. Second, HERA created an additional \$11 billion of volume cap space for bonds issued for qualified mortgage bonds and qualified bonds for residential rental projects. The cap space was designated for 2008, but issuers had the option to carry forward unused capacity through 2010.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to offer residential rental housing units at reduced rates. Some of the benefits of the tax exemption also flow to bondholders. In 2019, according to the Council of Development Finance Agencies, roughly \$16.4 billion of multifamily-housing qualified private activity bonds were issued.

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

Rationale

Before 1968, state and local governments were allowed to issue tax-exempt bonds to finance multifamily rental housing without restriction. The Revenue and Expenditure Control Act of 1968 (RECA; P.L. 90-364) imposed tests that restricted the issuance of these bonds. However, the act also provided a specific exception which allowed unrestricted issuance for multifamily rental housing.

Most states issue these bonds in conjunction with the Leased Housing Program under section 8 of the United States Housing Act of 1937 (P.L. 75-412). The Tax Reform Act of 1986 (TRA86; P.L. 99-514) restricted eligibility for tax-exempt financing to projects satisfying one of two income-targeting

requirements: 40 percent or more of the units must be occupied by tenants whose incomes are 60 percent or less of the area median gross income, or 20 percent or more of the units are occupied by tenants whose incomes are 50 percent or less of the area median gross income. TRA86 subjected these bonds to the state volume cap on private-activity bonds.

The Tax Increase Prevention and Reconciliation Act (P.L. 109-222) required that payors of state and municipal bond tax-exempt interest begin to report those payments to the Internal Revenue Service after December 31, 2005. The manner of reporting is similar to reporting requirements for interest paid on taxable obligations. Additionally, in the 109th Congress, the program was expanded temporarily to assist in the rebuilding efforts after the Gulf Region hurricanes of fall 2005.

Most recently, the Housing and Economic Recovery Act of 2008 (P.L. 110-289) coordinated certain rules pertaining to the low-income housing tax credit program and the tax-exempt rental program when a project received both sources of financing. In addition, a hold-harmless policy for computing area median income limits was enacted to ensure that the annual income limits in a given year do not fall below the limits in the previous year.

Assessment

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

Federal subsidy for multifamily rental housing to offset underinvestment at the state and local level comes with potential costs. As one of many categories of tax-exempt private-activity bonds, those issued for multifamily rental housing increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the assets available to individuals and corporations to shelter their income from taxation.

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Commerce and Housing

**DEPRECIATION OF RENTAL HOUSING IN EXCESS OF
ALTERNATIVE DEPRECIATION SYSTEM**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.2	0.9	6.1
2021	5.0	0.8	5.8
2022	4.7	0.8	5.5
2023	4.4	0.7	5.1
2024	4.1	0.7	4.8

Authorization

Sections 167 and 168.

Description

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

The tax expenditure measures the revenue loss from current depreciation deductions in excess of the deductions that would have been allowed under this longer 40-year period.

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

deducted in the early years. (Used buildings with a life of 20 years or more were restricted to 125-percent declining balance methods.) The period of time over which deductions were taken varied with the taxpayer's circumstances.

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

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

Impact

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

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

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

Rationale

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

A IRS ruling issued in 1946 authorized the use of the 150-percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in statute in 1954 (Internal Revenue Code of 1954, P.L. 83-591) when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the

value of machinery and equipment declined faster in their earlier years. When the accelerated methods were adopted, however, real property was included as well.

By the 1960s, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. The first restriction on depreciation was to curtail the benefits that arose from combining accelerated depreciation with lower capital gains taxes when the building was sold. That is, while taking large deductions reduced the basis of the asset for measuring capital gains, these gains were taxed at the lower capital gains rate rather than the ordinary tax rate.

In 1964 (Revenue Act of 1964, P.L. 88-272), 1969 (Tax Reform Act of 1969, P.L. 91-172), and 1976 (Tax Reform Act of 1976, P.L. 94-455), various provisions to “recapture” accelerated depreciation as ordinary income in varying amounts when a building was sold were enacted.

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

In the Economic Recovery Tax Act of 1981 (P.L. 94-34), residential buildings were assigned specific write-off periods that were roughly equivalent to 175-percent declining balance methods (200 percent for low-income housing) over a 15-year period under the Accelerated Cost Recovery System (ACRS).

These changes were intended as a general stimulus to investment. Taxpayers could elect to use the straight-line method over 15 years, 35 years, or 45 years. The Deficit Reduction Act of 1984 (P.L. 98-369) increased the 15-year life to 18 years; in 1985, it was increased to 19 years. The recapture provisions would not apply if straight-line methods were originally chosen. The acceleration of depreciation that results from using the shorter recovery period under ACRS was not subject to recapture as accelerated depreciation.

The current treatment was adopted as part of the Tax Reform Act of 1986 (P.L. 99-514), which lowered tax rates and broadened the base of the income tax.

Assessment

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

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

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

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Commerce and Housing

CREDIT FOR LOW-INCOME HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	9.9	10.3
2021	0.4	10.0	10.4
2022	0.4	10.5	10.9
2023	0.5	10.9	11.4
2024	0.5	11.1	11.6

Authorization

Section 42.

Description

The Low Income Housing Tax Credit (LIHTC) was created by the Tax Reform Act of 1986 (TRA86; P.L. 99-514) to provide an incentive for the development or rehabilitation of affordable rental housing. Developers may receive one of two types of LIHTCs, depending on the nature of the construction project. The so-called 9 percent credit is generally reserved for new construction, while the so-called 4 percent credit is typically used for rehabilitation projects and new construction that is financed with tax-exempt bonds. Each year, for 10 years after the building is placed in service, a tax credit equal to roughly 4 percent or 9 percent of a project's qualified basis (cost of construction) is claimed. The applicable credit rates have historically not actually been 4 percent and 9 percent. Instead, the credit rates have fluctuated in response to market interest movements so that the program has delivered a subsidy equal to 30 percent of the present value of a project's qualified basis in the case of the 4 percent credit, and 70 percent in the case of the 9 percent credit. Since 2008, however, there has been a floor under the 9

percent credit below which the new construction credit rate cannot fall. And since 2021, there has been a floor under the 4 percent credit.

The credit is allowed only for the fraction of units serving low-income tenants, which are subject to a maximum rent. The “income test” for a qualified low-income housing project requires project owners to irrevocably elect one of three income level tests; the 20-50 test; 40-60 test; or the income averaging test. To satisfy the first test, at least 20 percent of the units must be occupied by individuals with income of 50 percent or less of the area’s median gross income, adjusted for family size. To satisfy the second test, at least 40 percent of the units must be occupied by individuals with income of 60 percent or less of the area’s median gross income, adjusted for family size. The third income test option allows owners to average the income of tenants. Specifically, under the income averaging option, the income test is satisfied if at least 40 percent of the units are occupied by tenants with an average income of no greater than 60 percent of AMI, and no individual tenant has an income exceeding 80 percent of AMI. Thus, for example, renting to someone with an income equal to 80 percent of AMI would also require renting to someone with an income no greater than 40 percent of AMI, so the tenants would have an average income equal to 60 percent of AMI.

In addition to the income test, a qualified low-income housing project must meet the “gross rents test” by ensuring rents do not exceed 30 percent of the elected income test level of income. An owner’s required time commitment to keep units available for low-income use was originally 15 years, but the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) extended this period to 30 years for projects begun after 1989. States may make longer commitments.

The credits are allocated in a competitive process by state housing agencies to developers, most of whom then sell their 10-year stream of tax credits to investors to raise capital for projects. The original law established an annual per-resident limit of \$1.25 for the state’s total credit authority. Under the Community Renewal Tax Relief Act of 2000 (P.L. 106-554), this limit was increased to \$1.50 in 2001, \$1.75 in 2002, and adjusted for inflation thereafter. The Consolidated Appropriations Act, 2018 (P.L. 115-141) temporarily increased state’s credit authority by 12.5 percent (on top of the annual inflation adjustment) from 2018 through 2021. In 2022, states received an LIHTC allocation of \$2.60 per person, with a minimum small population state allocation of \$2,975,000. The state allocation limits do not apply to the 4

percent credits that are automatically packaged with tax-exempt bond-financed projects.

The tax credits are subject to passive loss restrictions. The amount of the credit that can be offset against unrelated active income is limited to the equivalent of \$25,000 in deductions. This limitation stems from TRA86, which in part attempted to curb the use of tax shelters.

Impact

This provision substantially reduces the cost of investing in qualified units. Proponents of the credit argue that competitive sale of tax credits by developers to investors and the oversight requirements by housing agencies should prevent excess profits from occurring, and direct much of the benefit to qualified tenants of the housing units. Some critics have argued that the syndication process (the forming of a partnership between a developer and investors) results in a nontrivial portion of LIHTC funding being diverted away from subsidizing construction costs.

Rationale

The tax credit for low-income housing was enacted by the Tax Reform Act of 1986 to provide a subsidy directly linked to the addition of rental housing with limited rents for low-income households. It replaced less targeted subsidies in the law, including accelerated depreciation, five-year amortization of rehabilitation expenditures, expensing of construction-period interest and taxes, and general availability of tax-exempt bond financing. The credit was scheduled to expire at the end of 1989, but was temporarily extended a number of times until made permanent by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

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

The tax credit has also been used to assist victims of natural disasters. For example, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) allowed states harmed by Hurricane Ike and severe weather and flooding in the Midwest to allocate additional credits to affected areas for the years 2009, 2010, and 2011. Similar changes were enacted as part of the Gulf Opportunity Zone Act of 2005 to assist victims of Hurricanes Katrina, Rita, and Wilma. The Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260), increased, for calendar years 2021 and 2022, the credit allocation authority for buildings located in any qualified disaster zone, defined as that portion of any qualified disaster area which was determined by the President during the period beginning on January 1, 2020, and ending on the date which was 60 days from enactment of P.L. 116-260 (February 25, 2021) to warrant assistance. For 2021, the increase was equal to the lesser of \$3.50 multiplied by the population residing in a qualified disaster zone, and 65 percent of the state's overall credit allocation authority for calendar year 2020. For 2022, the increase is equal to any unused increased credit allocation authority from 2021 (i.e., 2021 increased credit allocation authority may be carried over to 2022).

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) temporarily changed the credit rate formula used for new construction. The act effectively placed a floor equal to 9 percent on the new construction tax credit rate. The 9 percent credit rate floor originally only applied to new construction *placed in service* before December 31, 2013. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the 9 percent floor for *credit allocations* made to housing developers before January 1, 2014. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the 9 percent credit floor for one year. The 9 percent floor was permanently extended by Division Q of P.L. 114-113, the Protecting Americans from Tax Hikes Act (or "PATH" Act). The 4 percent tax credit rate typically applied to rehabilitation construction has remained unaltered through the various iterations of the 9 percent floor. The Consolidated Appropriations Act, 2018 (P.L. 115-141) increased the amount of credits states receive by 12.5 percent through 2021. Most recently, the Consolidated Appropriations Act, 2021 (P.L. 116-260) set a permanent minimum credit (or "floor") of 4% for the housing tax credit typically used for the rehabilitation of affordable housing.

Assessment

The low-income housing credit is more targeted to lower-income individuals than the general tax provisions it replaced. By allowing state

authorities to direct its use, the credit can be used as part of a general neighborhood revitalization program. To this end, the LIHTC program today gives states about \$11 billion in annual budget authority for federal tax credits.

The most comprehensive database of tax credit units, compiled by the Department of Housing and Urban Development (HUD), revised as of April 2022, shows that 50,567 properties and 3.44 million housing units were placed in service between 1987 and 2020. More complete HUD data shows that between 2000 and 2020 more than 1,338 properties and nearly 107,236 units are placed in service each year. Since 2000, approximately 61 percent of LIHTC construction was new construction, 27 percent of the projects had a nonprofit sponsor, 24 percent of projects also used tax-exempt bonds as a financing source, and nearly 96 percent of all units in a LIHTC development are occupied by low-income residents.

Much less is known about the financial aspects of tax credit projects and how much it actually costs to provide an affordable rental unit under this program when all things are considered. Many tax credit projects receive other federal subsidies (aside from tax-exempt bonds), and some tax credit renters receive additional federal rental assistance (e.g., Housing Choice vouchers).

There are a number of criticisms that have been made of the credit. The credit is unlikely to have a substantial effect on the total supply of low-income housing, based on both microeconomic analysis and some empirical evidence. There are likely overhead and administrative costs which divert some of the subsidy away from affordable housing construction. And, in general, many economists would argue that housing vouchers, or direct-income supplements to low-income individuals, are more direct and fairer methods of providing assistance to lower-income individuals. Others argue that because of landlord discrimination against low-income people, minorities, and those with young children (and sometimes an unwillingness to get involved in a government program, particularly in tight rental markets), a mix of vouchers and project-based assistance like the tax credit might be necessary.

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Commerce and Housing

**CREDIT FOR REHABILITATION OF
HISTORIC STRUCTURES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.9	1.1
2021	0.2	0.9	1.1
2022	0.2	0.8	1.0
2023	0.2	0.8	1.0
2024	0.2	0.9	1.1

Authorization

Section 47.

Description

Certified expenditures used to substantially rehabilitate certified historic structures qualify for a 20-percent tax credit. The building must be depreciable. That is, it must be used in a trade or business, or held for the production of income. It may be used for offices, for commercial, industrial or agricultural enterprises, or for rental housing. The building may not serve exclusively as the owner's private residence.

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

The basis (the cost for purposes of depreciation) of the building is reduced by the amount of the rehabilitation credit.

The rehabilitation must be substantial. During a 24-month period selected by the taxpayer, rehabilitation expenditures must exceed the greater of \$5,000 or the adjusted basis of the building and its structural components. For phased rehabilitations, completed in two or more distinct stages, the measuring period is 60 months. Before 2018, the rehabilitation tax credit was generally allowed in the taxable year that the rehabilitated property is placed in service. Beginning in tax year 2018, the credit is taken ratably over five years (i.e., 20 percent per year) commencing in the taxable year that the property is placed into service.

There is no upper limit on the amount of rehabilitation expenditures that can be claimed. However, under the passive-loss rules, there is a limit on the amount of deductions and credits from rental real estate investment that can be used to offset tax on unrelated income in a single tax year. The limit is the equivalent of \$25,000 in deductions. This special deduction is phased out above specified income thresholds. The ordering rules for the phaseout are provided in Section 469 of the Internal Revenue Code.

Certified historic structures are either individually registered in the National Register of Historic Places, or they are structures certified by the Secretary of the Interior as having historic significance that are located in a registered historic district. State Historic Preservation Officers, who are designated by the governor of their respective state or territory, review applications and forward recommendations for historic designation to the U.S. Department of the Interior.

To qualify for the credit, the rehabilitation must be a “certified rehabilitation.” This means that the rehabilitation must be certified by the National Park Service to the IRS as being consistent with the historic character of the building or the historic district it is located in. The National Park Service or the State Historic Preservation Office may inspect a rehabilitated property at any time during the five-year period. The National Park Service may revoke certification if the building alterations do not conform to the plans specified in the application.

The credit has a recapture provision. Before legislative changes to the credit were enacted in 2017, the owner must have held the building for five full years after completing the rehabilitation, or pay back the credit. If the

owner disposed of the building within a year after it is placed in service, 100 percent of the credit is recaptured. For properties held between one and five years, the tax credit recapture amount was reduced by 20 percent per year.

Section 47 also provided a 10-percent tax credit for the rehabilitation of commercial structures that were built before 1936 but are not historically certified. (See the entry on “Credit for Rehabilitation of Structures, Other Than Historic Structures.”) This 10-percent credit was repealed, effective with the 2018 tax year.

Impact

The credit reduces the taxpayer’s cost of restoring historic buildings. The availability of the credit may raise the prices offered for certified historic structures in need of rehabilitation. Before 1986, historic preservation projects had become a popular, rapidly growing tax shelter. To help restrain this, the Tax Reform Act of 1986 (P.L. 99-514) imposed at-risk rules and passive-loss limits on deductions and credits from investments in rental real estate.

Both historic and non-historic rehabilitation projects proliferated after the introduction of the tax credits in 1981. Following the introduction of the passive-loss rules on individual investors in 1986, however, there was a steep decline in rehabilitation projects sponsored by limited partnerships and other syndication structures that linked individual investors to developers. Rehabilitation activity continued to decline through 1993. During the second half of the 1990s, historic rehabilitation rebounded, but in a new form. Corporations that had become regular investors under the Low-Income Housing Tax Credit (LIHTC) program began “twinning” or combining the historic tax credit (HTC) with the LIHTC by rehabilitating historic properties for affordable housing, sometimes also including retail or office space in the building. Subsequently, developers began twinning the HTC with the federal New Markets Tax Credit (NMTC), enacted in 2000. (See the entries on “Credit for Low-Income Housing” and “New Markets Tax Credit.”)

In addition to these federal tax credits, developers may receive tax credits on their state income taxes. As of 2022, the National Trust for Historic Preservation counts 39 states as having historic preservation tax credits. Some states also have their own programs similar to LIHTC and NMTC.

According to the National Park Service, in FY2021, over \$7.16 billion in private investments connected with the credit. The National Park Service issued 1,063 certifications of completed work, with median qualified

rehabilitation expenditures of \$1.20 million. The credit supported rehabilitation for 7,220 low- and moderate-income housing units.

Rationale

Congress identified the preservation of historic structures and neighborhoods as an important national goal. But achieving that goal depended on enlisting private funds in the preservation movement. It was argued that prior law encouraged the demolition and replacement of old buildings instead of their rehabilitation and re-use.

The Tax Reform Act of 1976 (P.L. 94-455) introduced rapid depreciation (amortization over a 60-month period) for capital expenditures incurred in the rehabilitation of certified historic structures. In addition, the 1976 act provided that in the case of a substantially altered or demolished certified historic structure, the amount expended for demolition, or any loss sustained on account of the demolition, is to be charged to the capital account with respect to the land; it is not to be included in the depreciable basis of a replacement structure. Further, the act prohibited accelerated depreciation for a replacement structure.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) provided a 25-percent tax credit for income-producing certified historic rehabilitation, a 15-percent credit for the rehabilitation of non-historic buildings at least 30 years old, and a 20-percent credit for renovation of existing commercial properties at least 40 years old.

The Tax Reform Act of 1986 (P.L. 99-514) simplified the structure from three to two tiers and lowered the credit rates, in keeping with the lowered tax rates on income under the act. The credit for certified historic rehabilitation was reduced from 25 percent to 20 percent. The 15-percent and 20-percent credits for the rehabilitation of non-historic buildings were combined into one credit of 10 percent for rehabilitating older qualified buildings first placed in service before 1936. The 1986 act also imposed limits on the use of credits and deductions from rental real estate investments, in the form of at-risk rules and passive-loss limitations.

In 2002, tax simplification proposals noted the numerous limitations and qualifications under the passive-loss rules. In response, the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) clarified the ordering rules in the Internal Revenue Code (section 469(i)(3)(E)).

The Gulf Opportunity Zone Act of 2005 (GO Zone Act; P.L. 109-135) temporarily increased the rate of the 20-percent tax credit to 23 percent, and the 10-percent credit to 13 percent. The 23-percent credit applied to the rehabilitation of certified historic structures located in specific areas of the Gulf Region that had been adversely affected by Hurricanes Katrina, Rita, and Wilma in the fall of 2005. It was effective for expenditures made from August 28, 2005, through December 31, 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended this temporary rate increase for one year, through December 31, 2009.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) retained the 20-percent credit for historic structures, but requires that the credit be taken over five years, rather than when the properties were placed in service, among other modifications. In contrast, P.L. 115-97 repealed the 10-percent credit for non-historic structures. These changes are effective with the 2018 tax year.

Assessment

The 20-percent tax credit is available for substantial rehabilitation expenditures approved by the National Park Service. The credit encourages the renovation of historic buildings. Opponents argue that the credit leads to economic inefficiency by encouraging investment in historic renovation projects that would not be profitable without the credit, and that the tax credit is duplicative of other federal grant programs that can be used for the promotion of historic preservation (e.g., Community Development Block Grants).

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Commerce and Housing

**CREDIT FOR REHABILITATION OF STRUCTURES, OTHER
THAN HISTORIC STRUCTURES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 47.

Description

Before 2018, qualified expenditures made to substantially rehabilitate a non-historic, non-residential building were eligible for a 10-percent tax credit. Only expenditures on buildings placed in service before 1936 were eligible. A building that was moved after 1935 was ineligible. Expenditures made during any 24-month period must have exceeded the greater of \$5,000 or the adjusted basis (cost less depreciation taken) of the building. There was no upper limit on the rehabilitation expenditures that could be claimed. The property must have been depreciable. The basis must have been reduced by the full amount of the credit. The tax credit was allowed to be claimed for the tax year in which the rehabilitated building was placed in service.

Beginning in 2018, the 10-percent credit was repealed. A transition rule provides relief to owners of either a certified historic structure or a pre-1936 building by allowing owners to use the prior law if the project meets these

conditions: (1) the taxpayer owned or leased the building on January 1, 2018, and at all times thereafter; and (2) the 24- or 60-month period selected for the substantial rehabilitation test began by June 19, 2018. (Sixty months after June 19, 2018, is June 19, 2023.)

For a building to have been eligible, at least 50 percent of the external walls must have been retained as external walls, at least 75 percent of the exterior walls must have been retained as internal or external walls, and at least 75 percent of the internal structural framework of the building must have been retained. While rental housing does not qualify for the credit, hotels do, because hotels are considered to be for commercial rather than residential use.

Section 47 of the Internal Revenue Code provides a 20-percent tax credit for the substantial rehabilitation of certified historic structures. (See entry on “Tax Credit for Rehabilitation of Historic Structures.”) The two credits are mutually exclusive. Unlike historic rehabilitation, there was no formal administrative review process for the rehabilitation of non-historic buildings.

Impact

The tax credit encouraged businesses to renovate property rather than relocate by reducing the cost of building rehabilitation. The availability of the tax credit could have turned an unprofitable rehabilitation project on the margins into a profitable one, and might have made rehabilitating a building more profitable than new construction.

Rationale

In 1978, there was concern about the declining usefulness of older buildings, especially in older neighborhoods and central cities. In response, the Revenue Act of 1978 (P.L. 95-600) introduced an investment tax credit for rehabilitation expenditures for non-residential buildings in use for at least 20 years. The purpose was to promote stability in and restore economic vitality to deteriorating areas.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) provided a 25-percent tax credit for income-producing certified historic rehabilitation, a 15-percent credit for the rehabilitation of non-historic buildings at least 30 years old, and a 20-percent credit for renovation of existing commercial properties at least 40 years old. The purpose was to counteract the tendency of significantly shortened depreciation recovery periods to encourage firms to relocate and build new plants. Concerns were expressed that investment in

new structures in new locations does not promote economic recovery if it displaces older structures, and that relocating a business can cause hardship for workers and their families.

The Tax Reform Act of 1986 (P.L. 99-514) simplified the structure of the rehabilitation credits from three to two tiers and lowered the credit rates, in keeping with the lowered tax rates on income under the act. The credit for certified historic rehabilitation was reduced from 25 percent to 20 percent. The 15-percent and 20-percent credits for the rehabilitation of non-historic buildings were combined into one 10-percent credit for rehabilitating older qualified buildings first placed in service before 1936.

The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) temporarily increased the rate of the non-historic rehabilitation credit from 10 percent to 13 percent. The 13-percent credit applied to the rehabilitation of non-residential structures located in specific areas of the Gulf Region that had been adversely affected by Hurricanes Katrina, Rita, and Wilma in the fall of 2005. It was effective for expenditures made from August 28, 2005, through December 31, 2008. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended this temporary rate increase for one year, through December 31, 2009.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) repealed the 10-percent credit for non-historic structures. In contrast, the 20-percent credit for historic structures was retained, with modifications. These changes are effective with the 2018 tax year.

Assessment

The main criticism of the tax credit was that it caused economic inefficiency by encouraging investment projects—restoring older buildings—that would not be profitable without the credit. A defense of the tax subsidy was that there may be external benefits to society that investors would not take into account, such as preserving the social and cultural attributes of affected neighborhoods, or stabilizing neighborhoods by promoting the re-use of existing buildings rather than having the buildings abandoned. In 2001, the Joint Committee on Taxation recommended eliminating the 10-percent credit based on simplification arguments.

Proponents of retaining and modifying the credit point out that when the fixed cutoff date of 1936 was set in 1976, the credit was available for buildings 40 or more years old. They argue that if buildings at least 40 years old are

considered worth saving, then the law should provide for a rolling qualification period, rather than the fixed date, which disqualifies buildings built after 1936 that may now be well over 40 years old.

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Commerce and Housing

**EXCLUSION OF INCOME ATTRIBUTABLE TO THE
DISCHARGE OF PRINCIPAL RESIDENCE
ACQUISITION INDEBTEDNESS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.5	—	0.5
2021	0.1	—	0.1
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This estimate does not reflect the extension of this provision through 2025. This provision was extended through 2025 by P.L. 116-260 and is estimated to cost \$2.3 billion over FY2021-FY2025.

Authorization

Section 108.

Description

Mortgage debt cancellation can occur when lenders either (1) restructure loans, reducing principal balances; or (2) sell properties, either in advance, or as a result, of foreclosure proceedings. Historically, if a lender forgives or cancels such debt, tax law has treated it as cancellation of debt (COD) income subject to taxation. Exceptions, however, have been available for certain taxpayers who are insolvent or in bankruptcy — these taxpayers may exclude canceled mortgage debt income under existing law.

An additional exception allows for the exclusion of discharged qualified residential debt from gross income. Qualified residential debt is defined as debt, limited to \$2 million (\$1 million if married filing separately), incurred in acquiring, constructing, or substantially improving the taxpayer's principal residence that is secured by such residence. It also includes refinancing of this debt, to the extent that the refinancing does not exceed the amount of refinanced indebtedness. The taxpayer is required to reduce the basis in the principal residence by the amount of the excluded income.

The provision does not apply if the discharge was on account of services performed for the lender or any other factor not directly related to a decline in the residence's value or to the taxpayer's financial condition. The exclusion of discharged qualified residential debt applies to discharges that are made on or after January 1, 2007, and before January 1, 2026.

Impact

The benefits stemming from the exclusion of discharged qualified residential debt from gross income is expected to be concentrated among middle- and higher-income taxpayers, as these households have likely incurred the largest residential debt and are subject to higher marginal tax rates. To a lesser extent, the benefits also extend to lower-income new homeowners who are in financial distress. The residential debt of lower-income households, however, is relatively small, thus limiting the overall benefit accruing to these taxpayers.

According to economic theory, discharged debt qualifies as income. As a result, the impact of the exclusion differs across taxpayers with identical income. Specifically, a household who has no forgiven debt can be expected to pay more taxes, all else equal, than a household who has the same amount of income, a part of which constitutes canceled debt.

Rationale

A rationale for excluding canceled mortgage debt income has focused on minimizing hardship for households in distress. Policymakers have expressed concern that households experiencing hardship and in danger of losing their homes, presumably as a result of financial distress, should not incur an additional hardship by being taxed on canceled debt income. Some analysts have also drawn a connection between minimizing hardship for individuals and consumer spending; reductions in consumer spending, if significant, can restrain overall economic activity.

This provision, as originally included in the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142), was set to expire on January 1, 2011. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) initially extended the exclusion through December 31, 2012. The exclusion was extended several more times: through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through 2016 by the Protecting Americans from Tax Hikes Act (Division Q of P.L. 114-113); through 2017 by the Bipartisan Budget Act of 2018 (P.L. 115-123); and through 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). Most recently, the exclusion was extended through 2025 by the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Assessment

By reducing the amount of taxes a homeowner would otherwise be required to pay, this provision provides relief to those who have qualified residential debt canceled by their lender. The exclusion also likely helps to support consumer spending among distressed borrowers by providing them with an income tax cut. Allowing canceled debt to be excluded from taxable income, however, does not guarantee that a distressed homeowner will retain their home — such outcome is determined in the loss mitigation process.

Opponents argue that an exclusion for canceled mortgage debt income increases the attractiveness of debt forgiveness for homeowners, and could encourage homeowners to be less responsible about fulfilling debt obligations. Some also question why the exclusion is not permanent. If the objective of the exclusion is to provide relief for distressed borrowers, then allowing the exclusion for all borrowers regardless of the overall default rate would be consistent with this objective.

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Commerce and Housing

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

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	148.5	—	148.5
2021	139.8	—	139.8
2022	145.0	—	145.0
2023	149.1	—	149.1
2024	153.7	—	153.7

Authorization

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

Description

Dividends on corporate stock and gains on the sale of capital assets held for more than a year are subject to lower tax rates under the individual income tax. These reduced rates vary based on the taxpayer's taxable income and filing status. For married couples in 2022, the 0 percent rate applies for taxable income less than or equal to \$83,350; the 15 percent rate applies for taxable income greater than \$83,350 to \$517,200; and the 20 percent rate applies for taxable income greater than \$517,200. Gain arising from prior depreciation deductions is taxed at ordinary rates, but gain arising from straight line depreciation on real estate is taxed at a maximum rate of 25 percent. Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than a year, but not inventory.

The tax expenditure is the difference between taxing gains and dividends at the lower rates and taxing them at the rates that apply to ordinary income. To be eligible for the lower dividend rate, stock must be held for 60 out of 120 days that begin 60 days before the ex-dividend day. Only stock paid by domestic corporations and qualified foreign corporations is eligible. For passthrough entities, RICs (regulated investment companies, commonly known as mutual funds), and real estate investment trusts (REITs), payments to shareholders are eligible only to the extent they were qualified dividends to the passthrough entities.

Impact

Since higher-income individuals receive most capital gains, benefits accrue to high-income taxpayers. Dividends are also concentrated among higher-income individuals, although not to as great a degree as capital gains. Estimates of the benefit for 2021 provided in the table below are based on data provided by the Urban-Brookings Tax Policy Center.

Estimated Distribution by Income Group of the Tax Expenditure for Preferential (Reduced) Rates for Capital Gains and Dividends, 2021

Income Group	Percentage Distribution
Lowest Quintile (Bottom 20%)	0.2
Second Quintile	0.8
Middle Quintile	2.6
Fourth Quintile	5.1
Highest Quintile (Top 20%)	89.3
<i>Addendum: Top 20%</i>	
80 st - 90 th Percentile	4.7
90 st - 95 th Percentile	4.9
95 st - 99 th Percentile	11.3
Top 1%	68.4
Top 0.1%	52.8

The primary assets that typically yield capital gains are corporate stock and business and rental real estate. Corporate stock accounts for 20 percent to 50 percent of total realized gains, depending on the state of the economy and

the stock market. There are also gains from assets such as bonds, partnership interests, owner-occupied housing, timber, and collectibles, but all of these are relatively small as a share of total capital gains.

Rationale

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

From 1913 to 1935 a portion of dividends were generally exempted from the income tax. The Revenue Act of 1936 (P.L. 74-740) modified the system by subjecting dividends to both the ordinary income tax and the surtax on high-income taxpayers. These modifications expired at the end of 1939 and through 1954 there was no special tax on dividends.

In 1934, a sliding-scale treatment was adopted for capital gains (where lower rates applied the longer the asset was held). This system was revised in 1938.

In 1942, the sliding-scale approach was replaced by a 50-percent exclusion for all but short-term gains (held for less than six months), with an elective alternative tax rate of 25 percent. The alternative tax affected only individuals in tax brackets above 50 percent. The Revenue Act of 1942 (P.L. 77-753) also extended special capital gains treatment to property used in the taxpayer's trade or business, and introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate then in effect for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime, and that resulting gains should not be taxed at the greatly escalated wartime rates.

The 1954 Act (P.L. 83-591) recodifying the income tax provided for the taxation of dividends at ordinary tax rates after excluding the first \$50 in dividends for each spouse or individual. The Revenue Act of 1964 (P.L. 88-272) increased the exclusion to \$100 and the Crude Oil Windfall Profit Tax Act (P.L. 96-223) again doubled the exclusion, but for only 1981.

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

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

The Tax Reform Act of 1986 (P.L. 99-514), which lowered overall tax rates and provided for only two rate brackets (15 percent and 28 percent), provided that capital gains and dividends would be taxed at the same rates as ordinary income. This rate structure included a “bubble” due to phase-out provisions that caused effective marginal tax rates to go from 28 percent to 33 percent and back to 28 percent.

In 1990 (P.L. 101-508), this bubble was eliminated, and a 31-percent rate was added to the rate structure. There had, however, been considerable debate over proposals to reduce capital gains taxes. Since the new rate structure would have increased capital gains tax rates for many taxpayers from 28 percent to 31 percent, the separate capital gains rate cap was introduced. The 28-percent rate cap was retained when the 1993 Omnibus Budget Reconciliation Act (P.L. 103-66) added a top rate of 36 percent and a 10-percent surcharge on very high incomes, producing a maximum rate of 39.6 percent.

The Taxpayer Relief Act of 1997 (P.L. 105-34) provided lower rates; its objective was to increase saving and risk-taking, and to reduce lock-in. Individuals subject to the 15-percent ordinary income tax rate paid a 10-percent rate, and individuals in the 28-, 31-, 36-, and 39.6-percent rate brackets paid a 20-percent rate. Gain arising from prior depreciation deductions was taxed at ordinary rates but with a maximum of 28 percent. Eventually, property held for five years or more would be taxed at 8 percent and 18 percent, rather than 10 percent and 20 percent. The 8-percent rate applied to sales after 2000; the 18-percent rate applied to property *acquired* after 2000 (and, thus, to such property sold after 2005). The holding period was increased to 18 months, but cut back to one year in 1998.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) provided for lower tax rates on capital gains and qualified dividends, with a sunset after 2008 (extended to 2010 by the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) and then to 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312)). The current rate structure (with a new higher rate) was made permanent under the American Taxpayer Relief Act of 2012 (P.L. 112-240).

Assessment

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

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

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

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

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

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

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

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Commerce and Housing

SURTAX ON NET INVESTMENT INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	-29.2	—	-29.2
2021	-27.5	—	-27.5
2022	-28.7	—	-28.7
2023	-29.9	—	-29.9
2024	-31.3	—	-31.3

Authorization

Section 1411.

Description

Single taxpayers with a modified adjusted gross income (MAGI) in excess of \$200,000 and married taxpayers with a MAGI in excess of \$250,000 may be subject to a 3.8 percent surtax on net investment income. MAGI includes wages, salaries, tips, and other compensation, dividend and interest income, business and farm income, realized capital gains, and income from a variety of other passive activities and certain foreign earned income. For those who must pay the tax, the amount of tax owed is equal to 3.8 percent multiplied by the lesser of (1) net investment income, or (2) the amount by which their MAGI exceeds the \$200,000/\$250,000 thresholds.

Net investment income includes interest, dividends, annuities, royalties, certain rents, and certain other passive business income. Net investment income also includes the amount of capital gain on a home sale that exceeds the amount that can be excluded from taxation. Currently, when taxpayers sell their principal residences, they may exclude from taxation up to \$250,000 in capital gain if single, and \$500,000 in capital gain if married. If taxpayers sell

a second home (vacation home, rental property, etc.), they must pay taxes on the entire capital gain.

Impact

The primary impact of the tax is to increase the tax burden on upper-income taxpayers. This is due to the relatively high income thresholds, below which the tax is not levied, and the fact that the majority of investment income is earned by those toward the upper end of the income distribution. The tax may also negatively impact certain investment choices, although since the tax rate is relatively small compared to current dividend and capital gain tax rates, it is not likely to be the primary factor affecting investment choices.

Rationale

The Patient Protection and Affordable Care Act (P.L. 111-148), as amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), was intended to expand health care coverage through a variety of provisions and mandates, such as the requirement (since amended) that most U.S. residents obtain health insurance. The 3.8 percent surtax on net investment income was enacted as a revenue raiser to help finance the expansion of health care coverage.

Assessment

The tax is estimated to raise a significant amount of revenue and thus it appears that it will likely be successful in achieving its objective of partly financing the health care reform enacted by P.L. 111-148. At the same time, the surtax will increase the tax burden on upper-income taxpayers, and could potentially negatively impact saving and thus investment.

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Commerce and Housing

EXCLUSION OF CAPITAL GAINS AT DEATH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	41.6	—	41.6
2021	41.9	—	41.9
2022	42.9	—	42.9
2023	44.5	—	44.5
2024	47.0	—	47.0

Authorization

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

Description

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

In the case of assets transferred at death, the heir's cost basis in the asset (the amount that he subtracts from sales price to determine gain if the asset is sold in the future) is generally the fair market value as of the date of the decedent's death. Thus no income tax is imposed on appreciation occurring before the decedent's death, since the cost basis is increased by the amount of appreciation that has already occurred.

Assets transferred at death or by *inter vivos* gifts (gifts between living persons) may be subject to the federal estate and gift taxes, respectively, based upon their value at the time of transfer. Gain on the asset is taxed if the donees sell during their lifetime and the benefit is deferral of tax rather than exclusion.

Impact

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

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

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

Some insight into the distributional effects of this tax expenditure may be found by considering the distribution of the tax expenditure for reduced rates on capital gains, based on data provided by the Urban-Brookings Tax Policy Center (2020). The benefits of these tax expenditures are heavily concentrated among high-income individuals. Of course, the distribution of capital gain and dividend tax expenditures could be different from the distribution of taxes not paid because they are passed on at death, but the benefits of the provision would always accrue largely to higher-income individuals who tend to hold most wealth.

Estimated Distribution by Income Group of the Tax Expenditure for Preferential (Reduced) Rates for Capital Gains and Dividends, 2019

Income Group	Percentage Distribution
Lowest Quintile (Bottom 20%)	0.0%
Second Quintile	0.3%
Middle Quintile	1.6%
Fourth Quintile	3.3%
Top Quintile (Top 20%)	94.5%

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

A 2022 Congressional Research Service report indicated that unrealized capital gains were distributed in a similar way to realized gains, with around 90% of the gain attributable to the top 10% of the income classes. This report also indicated that, considering gains outside of owner-occupied housing, about 70% of realized gains came from corporate stock, while slightly over half of unrealized gains came from corporate stock. Owner-occupied housing is allowed exclusions which largely leave these gains not subject to tax when realized. Unrealized gains were found to be larger than realized gains for this category of assets: unrealized gains were estimated to be 59% of total accrued gains.

Rationale

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

The Tax Reform Act of 1976 (P.L. 94-455) provided that the heir's basis in property transferred at death would be determined by reference to the decedent's basis. This carryover basis provision was not permitted to take effect and was repealed in 1980. The primary stated rationale for repeal was the concern that carryover basis created substantial administrative burdens for estates, heirs, and the Treasury Department.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) gradually reduced the estate tax before repealing it for 2010 and substituted carryover basis with a \$1.3 million exemption. On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) retroactively reinstated the tax for 2010 and provided an option for estates of decedents who died in that year to pay an estate tax or apply carryover basis. Gordon, Joulfaian, and Poterba estimated that 60 percent of estates over \$5 million in value elected carryover basis. This share rose with estate size, with 86 percent of estates over \$20 million in value electing carryover basis.

Assessment

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

The lower capital gains taxes that occur because of failure to tax capital gains at death can also affect efficiency through other means, primarily through the reallocation of resources between types of investments. Lower capital gains taxes may disproportionately benefit real estate investments and may cause corporations to retain more earnings than would otherwise be the case, thus resulting in efficiency losses. At the same time, lower capital gains taxes reduce the distortion that favors corporate debt over equity, which produces an efficiency gain.

Several challenges have been associated with taxing capital gains at death. Among these are administrative challenges, particularly for assets held for a very long time when heirs do not know the basis. In addition, taxation of capital gains at death could cause liquidity issues for some taxpayers, such as owners of small farms and businesses. Therefore, most proposals for taxing capital gains at death combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of gain to be taxed. An alternative to taxing capital gains at death is to tax gains on an accrual basis.

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Commerce and Housing

**DEFERRAL OF GAIN ON NON-DEALER
INSTALLMENT SALES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.2	4.0	5.2
2021	1.2	4.1	5.3
2022	1.3	4.2	5.5
2023	1.3	4.4	5.7
2024	1.4	4.7	6.1

Authorization

Sections 453 and 453A(b).

Description

An installment sale is a sale of property in which at least one payment will be received in a tax year later than the year in which the sale took place. Some taxpayers are allowed to report some sales of this kind for tax purposes under a special method of accounting, called the installment method, in which the gross profit from the sale is prorated over the years during which the payments are received.

This treatment conveys a tax advantage compared to being taxed in full in the year of the sale, because the taxes that are deferred to future years have a time value (the amount of interest they could earn).

Use of the installment method was once widespread, but it has been severely curtailed in recent years. Under current law, it can be used only by persons who do not regularly deal in the property being sold (except for the sellers of farm property, timeshares, and residential building lots who may use

the installment method but must pay interest on the deferred taxes). In 2004, a provision of the American Jobs Creation Act of 2004 (P.L. 108-357) denied the installment sale treatment to readily tradeable debt.

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

Impact

Installment sale treatment constitutes a departure from the normal rule that gain is recognized when the sale of property occurs. The deferral of taxation permitted under the installment sale rules essentially furnishes the taxpayer an interest-free loan equal to the amount of tax on the gain that is deferred.

The benefits of deferral are currently restricted to those transactions by non-dealers in which the sales price is no more than \$150,000 and to the first \$5,000,000 of installment sales arising during the year, to sales of personal-use property by individuals, and to sales of farm property. (There are other restrictions on many types of transactions, such as in corporate reorganizations and sales of depreciable assets.)

Thus the primary benefit probably flows to sellers of farms, small businesses, and small real estate investments.

Rationale

The rationale for permitting installment sale treatment of income from disposition of property is to match the time of payment of tax liability with the cash flow generated by the disposition. It has usually been considered unfair, or at least impractical, to attempt to collect the tax when the cash flow is not available, and some form of installment sale reporting has been permitted since at least the Revenue Act of 1921 (P.L. 67-98). It has frequently been a source of complexity and controversy, however, and has sometimes been used in tax shelter and tax avoidance schemes.

Installment sale accounting was greatly liberalized and simplified in the Installment Sales Revision Act of 1980 (P.L. 96-471). It was significantly restricted by a complex method of removing some of its tax advantages in the Tax Reform Act of 1986 (P.L. 99-514), and it was repealed except for the limited uses in the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203). Further restrictions applicable to accrual method taxpayers were enacted in the Work Incentives Improvement Act of 1999 (P.L. 106-170). The 1999 Act prohibited most accrual basis taxpayers from using the installment method of accounting. Concern, however, in the small business community over these changes led to the passage, in December 2000, of the Installment Tax Correction Act of 2000 (P.L. 106-573). The 2000 Act repealed the restrictions on the installment method of accounting imposed by the 1999 Act. The repeal was made retroactive to the date of enactment of the 1999 change. The American Jobs Creation Act of 2004 (P.L. 108-357) denied installment sale treatment to readily tradeable debt.

Assessment

The installment sales rules have always been pulled between two opposing goals: taxes should not be avoidable by the way a deal is structured, but they should not be imposed when the money to pay them is not available. Allowing people to postpone taxes by taking a note instead of cash in a sale leaves obvious room for tax avoidance.

Trying to collect taxes from taxpayers who do not have the cash to pay is administratively difficult and strikes many as unfair. After having tried many different ways of balancing these goals, lawmakers have settled on a compromise that denies the advantage of the method to taxpayers who would seldom have trouble raising the cash to pay their taxes (retailers, dealers in property, investors with large amounts of sales) and permits its use to small, non-dealer transactions (with “small” rather generously defined).

Present law results in modest revenue losses and probably has little effect on economic incentives.

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Commerce and Housing

DEFERRAL OF GAIN ON LIKE-KIND EXCHANGES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.6	2.2	7.8
2021	5.7	2.3	8.0
2022	5.9	2.5	8.4
2023	6.0	2.5	8.5
2024	6.2	2.5	8.7

Authorization

Section 1031.

Description

When business or investment real property is exchanged for real property of a “like-kind,” no gain or loss is recognized on the exchange and therefore no tax is paid at the time of the exchange on any appreciation. This treatment is in contrast to the general rule that any sale or exchange for money or property is a taxable event.

It is also an exception to the rules allowing tax-free exchanges when the real property is “similar or related in service or use,” the much stricter standard applied in other areas, such as replacing condemned property (section 1033). The latter is not considered a tax expenditure, but the postponed tax on appreciated property exchanged for “like-kind” property is.

Impact

The like-kind exchange rules have been liberally interpreted by the courts to allow tax-free exchanges of real property of the same general type but of

very different quality and use. All real estate, in particular, is considered “like-kind,” allowing a retiring farmer from the Midwest to swap farm land for a Florida apartment building or a right to pump water tax free when held for investment or productive use in a trade or business. The provision is very popular with real estate interests, some of whom specialize in arranging property exchanges. It is useful primarily to persons who wish to alter their real estate holdings without paying tax on their appreciated gain. Vehicle rental companies also used this provision, before it was restricted to real estate.

Stocks and financial instruments are generally not eligible for this provision, so it is not useful for rearranging financial portfolios. However, shares in a qualified mutual ditch, reservoir, or irrigation company are eligible under Section 1031.

Rationale

The general rationale for allowing tax-free exchanges is that the investment in the new property is merely a continuation of the investment in the old. A tax-policy rationale for going beyond this, to allowing tax-free adjustments of investment holdings to more advantageous positions, does not seem to have been offered. It may be that this was an accidental outgrowth of the original rule.

A provision allowing tax-free exchanges of like-kind property was included in the first statutory tax rules for capital gains in the Revenue Act of 1921 (P.L. 67-98) and has continued in some form until today. Various restrictions over the years took many kinds of property and exchanges out of its scope, but the rules for real estate, in particular, were broadened over the years by court decisions. In moves to reduce some of the more egregious uses of the rules, the Deficit Reduction Act of 1984 (P.L. 98-369) set time limits on completing exchanges, and the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) outlawed tax-free exchanges between related parties.

Among more recent legislative changes was a provision in the American Jobs Creation Act of 2004 (P.L. 108-357), as amended by the Gulf Opportunity Zone Act of 2005 (P.L. 109-135), affecting the recognition of a gain on a principal residence acquired in a like-kind exchange. The exclusion for gain on the sale of a principal residence no longer applies if the principal residence was acquired in a like-kind exchange within the past five years. In effect, this requires the taxpayer to hold the exchanged property for a full five years before it would qualify as a principal residence.

The Food, Conservation, and Energy Act of 2008 (P.L. 110-246) provides that the general exclusion from Section 1031 treatment for stocks shall not apply to shares in a qualified mutual ditch, reservoir, or irrigation company.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) restricted the use of like-kind exchanges to real property.

Assessment

From an economic perspective, the failure to tax appreciation in property values as it occurs defers tax liability and thus offers a tax benefit. (Likewise, the failure to deduct *declines* in value is a tax penalty.) Continuing the “nonrecognition” of gain, and thus the tax deferral, for a longer period by an exchange of properties adds to the tax benefit.

This treatment does, however, both simplify transactions and make it less costly for businesses and investors to replace property. Taxpayers gain further benefit from the loose definition of “like-kind,” because they can also switch their property holdings to types they prefer without tax consequences. This might be justified as reducing the inevitable bias a tax on capital gains causes against selling property, but it may be difficult to argue for restricting the relief primarily to those taxpayers engaged in sophisticated real estate transactions.

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Commerce and Housing

**7-YEAR RECOVERY PERIOD FOR MOTORSPORTS
ENTERTAINMENT COMPLEXES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 167 and 168(e)(3)(C) and (i)(15).

Description

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

Motorsports complexes (tracks and other land improvements and support facilities) are depreciated over seven years using a double declining balance method (where a rate twice as large as straight line is applied to the undepreciated balance, with a switch to straight line midway through the period). The alternative treatment for motorsports complexes is set to expire at the end of 2025.

Impact

Accelerated depreciation provides a tax incentive to the extent it is faster than economic (i.e., actual) depreciation. Data indicate that the economic decline rate for motorsports complexes is slower than that reflected in tax depreciation methods.

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

Rationale

The seven-year life for the motorsports complex had been in the regulations for some time, assigning these assets to the category of amusement park assets. When the Treasury reconsidered the appropriateness of this classification, Congress in 2004 made the seven-year treatment mandatory through 2007. The provision was then extended through 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-143), which also included retail improvement property in the 15-year life. Both provisions were extended through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240), and through 2016 by the PATH Act (P.L. 114-113). The 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act, eliminated the modified treatment of retail improvement property, while the Bipartisan Budget Act of 2018 (P.L. 115-123) retroactively extended the seven-year treatment for motorsports complexes through 2017. The Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), extended the seven-year treatment through 2020 and the Consolidated Appropriations Act, 2021 (P.L. 116-260) further extended the treatment through the end of 2025.

Assessment

The tax authorities presumably estimated motorsports racing facilities to have slower depreciation rates than the seven-year life that applies to amusement park facilities. If so, this temporary provision constitutes a subsidy to the auto-racing industry that does not appear to have a clear economic

justification. The treatment may, however, make racing more competitive with sports facilities that are often subsidized by state and local governments.

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Commerce and Housing

LIMIT NOL DEDUCTION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	-0.1	-0.8	-0.9
2022	-0.1	-0.8	-0.9
2023	-0.1	-0.9	-1.0
2024	-0.1	-0.9	-1.0

Authorization

Section 172.

Description

A business incurs a net operating loss (NOL) when its deductions exceed its gross income. The year in which the NOL is realized is referred to as a “loss year.” A business has no tax liability in a loss year. Under permanent law, a business is allowed to carry forward losses indefinitely and use the losses to offset future taxable income. Businesses, however, are prohibited from carrying losses back and receiving a refund for previously paid taxes. Losses may also not be used to offset more than 80 percent of taxable income. The limitation to 80 percent of taxable income is a departure from normal tax law as specified by the JCT, and results in a negative tax expenditure. In response to the economic effects of the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily suspended the 80 percent limit for taxable years beginning before January 1, 2021.

Slightly different restrictions apply to insurance companies (see, *Insurance Companies' Two-Year NOL Carryback*) and farming (see, *Two-year Carryback Period for Net Operating Losses Attributable to Farming*).

Impact

The NOL limitation primarily impacts businesses that are most likely to experience losses, such as younger businesses, businesses with financial problems, and businesses that undertake risky investments. The number of businesses impacted can be naturally expected to increase during economic downturns.

Rationale

The ability to use losses to offset income earned in other years can be traced back to the Revenue Act of 1918, which first allowed for a one-year carryback and one-year carryforward. The carryback and carryforward periods have varied since then, with the longest carryback period, outside of temporary changes or special exceptions previously mentioned, being three years and the longest carryforward period being indefinite. Until 2017, the general NOL regime instituted by the Taxpayer Relief Act of 1997 (P.L. 105-34) allowed for a two-year carryback and 20-year carryforward. Most recently, the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) disallowed carrybacks, extended the carryforward period indefinitely, and limited the NOL deduction to 80 percent of taxable income.

The NOL rules have also been modified in the past to temporarily assist during economic downturns or in response to natural disasters. For example, in response to the Great Recession, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) provided business taxpayers with \$15 million or less in gross receipts an opportunity to extend the NOL carryback period for up to five years. Later that same year, the Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92) extended the provision to all business taxpayers except those who had received certain federal assistance relating to the financial crisis. The NOL carryback period was also temporarily extended to five years for losses incurred in 2001 and 2002 as part of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). The extension was intended to assist businesses through the 2001 recession.

In response to the destruction caused by Hurricanes Katrina, Rita, and Wilma, the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) extended the carryback period from two to five years for qualified losses occurring in the

Gulf Opportunity Zone (or GO Zone) and suspended the 90-percent AMT offset limitation. In addition, the act expanded the list of acceptable deductions used for determining NOLs in the GO Zone, effectively increasing the amount of losses a taxpayer could recover.

In response to the economic effects of the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily suspended the rules limiting the NOL deduction to 80 percent of taxable income for taxable years beginning before January 1, 2021. The act also allows for NOLs generated in taxable years beginning after December 31, 2017, and before January 1, 2021, to be carried back for up to five years.

Assessment

Businesses prefer to fully offset taxable income earned in non-loss years. Limiting the allowable offset amount diminishes the ability of businesses to smooth out fluctuations in income and taxes, and address cash-flow problems over the business cycle, which could negatively impact some firms during periods of economic weakness. Full-loss offset also helps to minimize the distorting effects taxation has on risky investment decisions. As a result, limiting the NOL offset amount may deter certain investments.

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Commerce and Housing

INSURANCE COMPANIES TWO-YEAR NOL CARRYBACK

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	0.2	2.0	2.2
2022	0.3	3.1	3.4
2023	0.3	3.1	3.4
2024	0.3	3.1	3.4

Authorization

Section 172(b)(1)(C).

Description

A business incurs a net operating loss (NOL) when its deductions exceed its gross income. Under permanent law, insurance companies, other than life insurance companies, may carry back losses for up to two years and carry forward losses for up to 20 years and deduct them from income. Most other businesses are, under permanent law, prohibited from carrying back losses but may carry losses forward indefinitely and offset 80 percent of taxable income. Insurance companies are exempt from the 80 percent limitation. The two-year carryback for insurance companies results in a tax expenditure.

In response to the economic effects of the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily extended the carryback period to five years for most businesses, including non-life insurance companies. The extension applies to losses incurred after December 31, 2017, and before January 1, 2021. Non-life insurance companies are still subject to a 20-year carryforward limit.

Losses attributed to the trade or business of farming are also allowed a two-year carryback under permanent law. For more on the tax treatment of losses incurred while farming, see the section titled “*Two-year Carryback Period for Net Operating Losses Attributable to Farming*” in this compendium. For more information on changes to the net operating loss deduction provision more generally, see the section titled “*Limit NOL Deduction.*”

Impact

This provision impacts non-life insurance companies experiencing losses that have had a positive tax liability within the last two years. The ability of these firms to carry back their losses allows them to receive an immediate tax refund rather than waiting to reduce future taxes.

Rationale

A provision for deducting net operating losses from income in other years has been an integral part of the income tax system from its inception. The general two-year carryback and 20-year carryforward rules that existed until the enactment of the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) date from the Taxpayer Relief Act of 1997 (P.L. 105-34), which shortened the carryback period from three to two years (except for farmers and small businesses in federally declared disaster areas, which remained at three years).

P.L. 115-97 eliminated the two-year carryback period for most businesses, and changed the 20-year carryforward to an indefinite carryforward period with a limitation that losses may not offset more than 80 percent of taxable income. However, the Act left in place the two-year carryback and 20-year carryforward rules for non-life insurance companies. Presumably, non-life insurers are still allowed to carry back losses because of the volatility of their income.

In response to the economic effects of the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily extended the carryback period to five years for most businesses, including non-life insurance companies. The extension applies to losses incurred after December 31, 2017, and before January 1, 2021. Non-life insurance companies are still subject to a 20-year carryforward limit.

Assessment

Allowing non-life insurance companies a two-year carryback period improves their ability to smooth out fluctuations in income and taxes, as well as address cash-flow problems over the business cycle. However, because non-insurance businesses also experience fluctuations in income and taxes, and can experience cash-flow problems over the business cycle, it is not clear why these businesses are also not provided a two-year carryback period.

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Commerce and Housing

**LIMITATION IN NET INTEREST DEDUCTION TO 30
PERCENT OF ADJUSTED TAXABLE INCOME**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	-0.6	-2.0	-2.6
2021	-0.5	-4.8	-5.3
2022	-0.9	-11.4	-12.3
2023	-1.3	-15.9	-17.2
2024	-1.5	-18.1	-19.6

Note: This provision was modified by P.L. 116-136 and was estimated to reduce revenue by \$13.4 billion over FY2019-FY2030.

Authorization

Section 163(j).

Description

The deduction of business interest is limited for tax years beginning after December 31, 2017, to the sum of the taxpayer's business interest income, certain floor plan financing, and 30 percent (50 percent for tax years 2019 and 2020) of adjusted taxable income.

Business interest income is the amount of interest includible in the taxpayer's gross income for the tax year that is properly allocable to a trade or business. It does not include any investment income. Investment interest and investment income in this context has the same meaning as for the limitation on the deduction of interest by taxpayers other than corporations.

Floor plan financing interest is interest paid or accrued on debt used to finance the acquisition of motor vehicles held for sale or lease to retail

customers and secured by the inventory. A motor vehicle for this purpose includes any self-propelled vehicle designed for transporting people or property on a public street, highway, or road, as well as a boat, and farm machinery or equipment.

The adjusted taxable income of a taxpayer for purposes of the limitation is the taxpayer's regular taxable income computed without regard to: any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; any business interest or business interest income; the amount of any net operating loss (NOL) deduction; the 20-percent deduction for qualified business income of a passthrough entity under Code Sec. 199A; and allowable deductions for interest, taxes, depreciation, amortization, or depletion (commonly referred to as EBITDA) in tax years beginning before January 1, 2022. For tax years starting after that date, the definition of adjusted taxable income is the same, except that it does not allow for a deduction for depreciation, amortization, or depletion (commonly referred to as EBIT).

The limitation on the deduction of business interest does not apply to certain small businesses. For 2022, a taxpayer meets the small business test for the tax year if its average annual gross receipts for the three tax years ending with the prior tax year do not exceed \$27 million (\$25 million in 2018 as adjusted for inflation).

Taxpayers in select industries may elect to be excluded from the limitation. In particular, real estate trade or business and farm businesses may elect to be excluded from the limitation. The election is made at a time and manner as provided by the IRS. Businesses that elect to be excluded from the limitation must depreciate property using the alternative depreciation system and are not eligible for bonus depreciation. Once made, the election is irrevocable.

Any disallowed interest generally may be carried forward indefinitely. In the case of a partnership or S corporation, the deduction limitation applies at the entity level, except that disallowed interest of the entity is allocated to each partner or shareholder as excess business interest.

Impact

The limitation on net interest deductions is a negative tax expenditure that increases tax liability of affected businesses. Because the provision is targeted at large businesses with interest expenses that exceed a ceiling and exempts some industries, it will not apply to all businesses with interest

expenses. According to a 2018 study, a limited number of public companies—averaging less than 5 percent of companies per year—may face the limitation initially. The percentage of firms subject to the limitation is expected to increase for tax years beginning in 2022—averaging under 8 percent of companies per year. According to a 2019 study, the limitation was expected to be binding more on small companies pre-2022 and companies in the energy sector post-2022.

Rationale

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) limited the deductibility of certain cross-border related-party interest expenses. The deduction for net interest was limited to 50 percent of adjusted taxable income using an EBITDA income concept for firms with a debt-to-equity ratio above 1.5. Interest paid above the limitation was allowed to be carried forward indefinitely. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) modified the provision to exempt transactions entered into prior to the enactment of P.L. 101-239. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) limited the applicability of the provision to corporations. The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) exempted real estate investment trusts (REITs) from the provision.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) replaced the prior provision with the current limitation on the deductibility of net interest expense.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily increased the percent limitation to 50 percent for tax years 2019 and 2020.

Assessment

The limitation on net interest expense deductions replaces prior rules limiting related party interest expenses designed to limit earnings-stripping. While the prior rules focused on cross-border related-party transactions, the current provision does not distinguish between cross-border related-party transactions and other transactions. (For a discussion of restrictions on cross-border transactions, see the entry on the Base Erosion and Anti-Abuse Tax.) Further, the prior rules were less restrictive because they permanently used an

EBITDA income concept; allowed a higher ceiling of 50 percent; and had a safe harbor debt-to-equity ratio of 1.5.

Some concern has been raised that the 30 percent ceiling may be too high. Citing a 2015 study, Doug Poms, then-Treasury acting deputy international tax counsel, stated that a ratio of 10 percent would be supported by the data. At that ratio, roughly one-third of large companies would face the limitation. The ratio of firms facing the limitation would also be expected to increase with the shift to an EBIT concept of income for tax years beginning after 2021.

Some commentators have expressed concern that the floor stock exception is written too narrowly and, as a result, fails to allow non-motorized RV dealers access to the exception, potentially raising their after-tax cost of doing business. In addition, it has been noted that the limitation may become more restrictive, if interest rates rise from their current historically low levels.

Others have suggested that the current formulation of the interest limitation may be easily avoidable. For example, substituting variable rate debt (with a hedge built in against interest rate increases) for fixed rate debt could be used to work around the interest limitation. Similarly, interest (potentially subject to limit) could be converted to fees, or to other deductible payments.

Interactions between the interest limitation and other provisions, such as expensing, Global Intangible Low-Taxed Income (GILTI), and the Base Erosion and Anti-Abuse Tax (BEAT) may introduce excessive complexity to the tax system. For example, the interest limitation may disallow interest prior to the application of BEAT. As BEAT applies only to related-party cross-border transactions, determining which interest to disallow under the interest limitation, so BEAT can work as intended, will require regulatory, business, and enforcement resources. Similar concerns apply to the interaction of the interest limitation and GILTI.

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Commerce and Housing

**DEPRECIATION ON EQUIPMENT IN EXCESS OF
ALTERNATIVE DEPRECIATION SYSTEM**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	15.4	43.2	58.6
2021	12.6	35.6	48.2
2022	10.6	29.6	40.2
2023	8.2	22.4	30.6
2024	2.0	3.5	5.5

Authorization

Sections 167 and 168.

Description

Taxpayers are allowed to deduct the cost of acquiring depreciable assets (assets that wear out or become obsolete over a period of years) as depreciation deductions. How quickly the deductions are taken depends on the method and length of the recovery period. Straight-line methods allow equal deductions in each year; accelerated methods, such as declining balance methods, allow larger deductions in the earlier years. For tax years 2018 through 2022, the full cost may be deducted immediately. The percentage of costs available for expensing declines by 20 percent per year for tax years 2023 through 2026, and subsequently property is subject to the standard depreciation rates. Full expensing is available for longer-lived equipment and certain transportation equipment an additional year, through tax year 2023, before phasing out in tax years 2024 through 2027

Equipment is currently divided into six categories to be depreciated over 3, 5, 7, 10, 15, and 20 years. Double declining balance depreciation is allowed

for all but the last two classes, which are restricted to 150 percent declining balance. A double declining balance method allows twice the straight-line rate to be applied in each year to the remaining undepreciated balance; a 150-percent declining balance rate allows 1.5 times the straight-line rate to be applied in each year to the remaining undepreciated balance. At some point, the taxpayer can switch to straight-line and write off the remaining undepreciated cost in equal amounts over the remaining life.

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

This tax expenditure measures the difference between regular (straight-line) tax depreciation and the alternative depreciation system.

For example, consider a \$10,000 piece of equipment that falls in the five-year class (with double declining balance depreciation) with an eight-year midpoint life. In the first year, depreciation deductions would be $\frac{2}{5}$ times \$10,000, or \$4,000. In the second year, the basis of depreciation is reduced by the previous year's deduction to \$6,000, and depreciation would be \$2,400 ($\frac{2}{5}$ times \$6,000).

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

The tax expenditures estimates reflect bonus depreciation, which was modified by the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act). P.L. 115-97 allowed 100 percent of the cost of equipment placed into service from 2018 through either 2022 (for property with shorter production periods) or 2023 (for property with longer production periods and certain transportation equipment), and gradually phased out bonus depreciation through 2026 (for property with shorter production periods) and 2027 (for property with longer production periods and certain transportation equipment).

Impact

Accelerated depreciation methods are faster than straight-line methods, allowing for larger deductions in early years and smaller deductions in later years. This reduction in the useful tax life of the asset leads to quicker recovery, so that accelerated depreciation results in a deferral of tax liability. This represents a tax expenditure because the depreciation methods are faster than economic (i.e., actual) depreciation. Existing evidence indicates that the economic decline rate for equipment is much slower than that reflected in tax depreciation methods.

Expensing (immediate deduction) results in a zero effective tax rate for the marginal investment, as the value of the deduction offsets the present value of taxes on the income. The direct benefits of accelerated depreciation accrue to owners of assets and particularly to corporations. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation under the alternative minimum tax. Benefits to capital income tend to concentrate in the higher-income classes (see discussion in the Introduction).

Rationale

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

A ruling issued in 1946 authorized the use of the 150-percent declining balance method. Statutory authorization for accelerated depreciation methods first appeared in legislation in 1954 with the enactment of double-declining balance and other methods. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in its earlier years.

In 1962, new tax lives for equipment assets were prescribed that were shorter than the lives existing at that time. In 1971, the Asset Depreciation Range System was introduced by regulation and confirmed through legislation. This system allowed taxpayers to use lives up to 20 percent shorter or longer than those prescribed by regulation.

In the Economic Recovery Act of 1981 (P.L. 97-34), equipment assets were assigned fixed write-off periods which corresponded to 150-percent

declining balance over five years (certain assets were assigned three-year lives). These changes were intended to stimulate general investment and to simplify the tax law by providing for a single write-off period. The method was initially scheduled to be phased into a 200-percent declining balance method, but the 150-percent method was made permanent by the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248). The current treatment was adopted as part of the Tax Reform Act of 1986 (P.L. 99-514), which lowered tax rates and broadened the base of the income tax.

A temporary provision allowed a write-off of 30 percent of the cost in the first year (for 36 months beginning September 10, 2001), adopted in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) as an economic stimulus. The percentage was increased to 50 percent in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) and expired in 2004. This provision, referred to as bonus depreciation, was also adopted as part of the Economic Stimulus Act of 2008 (P.L. 110-185) in February 2008, and was effective for 2008. Bonus depreciation was extended through 2009 by the American Recovery and Reinvestment Act (P.L. 111-5), through 2010 by the Small Business Jobs Act of 2010 (P.L. 111-240), and through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The 2010 Act increased the rate of bonus depreciation to 100 percent from September 8, 2010, through the end of 2011. It reverted to 50 percent in 2012. Bonus depreciation was extended through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240). The Consolidated Appropriations Act, 2016 (P.L. 114-113) further extended the 50 percent equipment cost deduction through 2017, and allowed for a 40 percent deduction in 2018 and a 30 percent deduction in 2019.

The 2017 tax revision (P.L. 115-97) allowed 100 percent of the cost of equipment in the 3-, 5-, and 7-year categories to be deducted when incurred (expensed) for property; 80 percent of equipment costs are eligible for immediate deduction in 2023; 60 percent of costs are eligible in 2024; 40 percent of costs are eligible in 2025; and 20 percent of costs are eligible in 2026. For property in the 10-, 15-, and 20-year categories and certain transportation equipment, P.L. 115-97 allowed 100 percent of expensing to be deducted in tax years 2018 through 2023; 80 percent in 2024; 60 percent in 2025; 40 percent in 2026; and 20 percent in tax year 2027. P.L. 115-97 also repealed the corporate alternative minimum tax.

Assessment

Evidence suggests that the rate of economic decline of equipment is much slower than the rates allowed under current law, and this provision causes a lower effective tax rate on such investments than would otherwise be the case. The effect of these benefits on investment in equipment is uncertain, although more studies find that equipment tends to be somewhat more responsive to tax changes than do structures. Kitchen and Knittel (2016) found that take-up of the accelerated depreciation option ranged from 40 to 60 percent of eligible firms in 2002-2004 and 2008-2014, and varied by firm type, profit status, lifespan of the equipment, and industry. Equipment did not, however, appear to be very responsive to the temporary expensing provisions adopted and expanded in 2003.

If inflation is at a rate of roughly two percent for most assets, the accelerated depreciation more than offsets the understatement of depreciation due to the use of historical cost basis depreciation. Under these circumstances the effective tax rate on equipment is below the statutory tax rate, and the tax rates of most assets are relatively close to the statutory rate. Thus, equipment tends to be favored relative to other assets and the tax system causes a misallocation of capital.

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

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Commerce and Housing

**EXPENSING UNDER SECTION 179 OF DEPRECIABLE
BUSINESS PROPERTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	6.7	1.1	7.8
2021	6.1	1.0	7.1
2022	5.4	0.9	6.3
2023	8.1	1.3	9.4
2024	8.6	1.4	10.0

Authorization

Section 179.

Description

Under Section 179, firms have the option, within certain limits, of expensing part or all of the cost of new and used qualified property (or assets) they acquire in the year when the assets are placed in service, rather than over time according to other depreciation schedules. Under permanent law, business taxpayers that cannot or choose not to claim the allowance may recover capital costs over longer periods by claiming the appropriate depreciation deductions under the Modified Accelerated Cost Recovery System (MACRS) or Alternative Depreciation System (ADS). Under current law, though, business taxpayers that do not expense under Section 179 may still be able to fully expense qualified property or accelerate the cost recovery of their capital investments through 2026.

For the most part, qualifying property is new and used machinery and equipment, and off-the-shelf computer software for business use. Aside from

some exceptions for qualified improvement property, real property such as buildings and their structural components do not qualify for the allowance.

The maximum expensing allowance under Section 179 is set at \$1,000,000 and the phaseout threshold at \$2.5 million. These statutory amounts are indexed for inflation beginning in 2019. For 2022, firms cannot claim a Section 179 deduction for more than \$1,080,000 of the cost of assets placed in service that year. Once a firm's investment reached at least \$2,700,000 the amount eligible is reduced one dollar for each dollar of investment in excess of \$2,700,000.

Section 179 also is subject to an income limitation, in which the expensing allowance cannot exceed a taxpayer's taxable income from the active conduct of the trade or business in which the qualifying property is used. Any expensing allowance in excess of the investment limitation may not be carried forward. However, any expensing allowance in excess of the taxpayer's taxable income may be carried forward under ordinary loss carryover rules (up to 20 years).

Taxpayers unable to expense the costs of qualified property under Section 179 due to income limitations may still be able to fully expense qualified property through 2022 under current law. After 2022, full expensing is then replaced by a "bonus depreciation" treatment, which is phased out by 20 percent over four years: 80 percent for 2023, 60 percent for 2024, 40 percent for 2025, 20 percent for 2026 and terminated beginning with the 2027 tax year. See "Depreciation of Equipment in Excess of the Alternative Depreciation System."

Impact

In the absence of Section 179 (and temporary expensing), the cost of qualified assets would have to be recovered over longer periods. Thus, the provision accelerates the depreciation of relatively small purchases of those assets. This effect has significant implications for business investment. All other things being equal, expensing boosts the cash flow of firms able to take advantage of it, as the present value of the taxes owed on the stream of income earned by a depreciable asset is smaller under expensing than other depreciation schedules. Expensing also is equivalent to taxing the income earned from affected assets at a marginal effective tax rate of zero.

The allowance offers the additional benefit of simplifying tax accounting by reducing the record keeping for qualified investments.

Because the allowance has a phase-out threshold, its benefits are confined to firms that are relatively small in asset, employment, or revenue size. Businesses in excess of the phase-out threshold, though, may still be able to fully expense or claim bonus depreciation through 2026 under current law.

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

Rationale

The expensing allowance originated as a special first-year depreciation deduction established by the Small Business Tax Revision Act of 1958 (P.L. 85-866). The deduction was equal to 20 percent of the first \$10,000 of spending (\$20,000 in the case of a joint return) on new and used business equipment and machinery with a tax life of six or more years. It was intended to reduce the tax burden on small firms, give them an incentive to invest more, and simplify their tax accounting.

The deduction remained unchanged until the Economic Recovery Tax Act of 1981 (ERTA; P.L. 97-34) replaced it with a maximum expensing allowance of \$5,000. ERTA also established an investment tax credit and a timetable for increasing the allowance in incremental amounts to \$10,000 by 1986. Business taxpayers were not permitted to claim the allowance and the credit for acquisitions of the same assets. As a result, relatively few firms took advantage of the allowance until the credit was repealed by the Tax Reform Act of 1986 (P.L. 99-514).

The Deficit Reduction Act of 1984 (P.L. 98-369) postponed the scheduled rise in the maximum allowance to \$10,000 from 1986 to 1990. The allowance did reach that amount in 1990.

It remained at \$10,000 until 1993, when President Clinton proposed a temporary investment credit for equipment for large firms and a permanent one for small firms. The credits were not adopted, but the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) raised the expensing allowance to \$17,500, starting January 1, 1993.

With the enactment of the Small Business Job Protection Act of 1996 (P.L. 104-188), the size of the allowance embarked on an accelerated upward path: it rose to \$18,000 in 1997, \$18,500 in 1998, \$19,000 in 1999, \$20,000 in 2000, \$24,000 in 2001 and 2002, and \$25,000 in 2003.

Seeking to give a boost to the economy and lower the tax burden on small business owners at the same time, Congress made several notable changes in the expensing allowance by passing the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27). First, the act raised the maximum allowance to \$100,000 and the phase-out threshold to \$400,000 for qualifying assets placed in service from 2003 through 2005. Second, JGTRRA indexed both amounts for inflation in 2004 and 2005, the first time such a step had been taken. Finally, it added purchases of off-the-shelf computer software for business use to the list of qualified assets from 2003 through 2005.

Under the American Jobs Creation Act of 2004 (P.L. 108-357), all the changes in the allowance made by JGTRRA were extended through 2007.

The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) extended the changes through 2009.

In passing the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28), Congress raised the maximum allowance to \$125,000 and the phaseout threshold to \$500,000 for assets placed in service from 2007 through 2010. The act also indexed both amounts for inflation for 2008 through 2010.

The Economic Stimulus Act of 2008 (P.L. 110-185) increased the allowance to \$250,000 and the phaseout threshold to \$800,000 in 2008 only. These amounts were extended through 2009 by the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5), and through 2010 by the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147).

Under the Small Business Jobs Act of 2010 (P.L. 111-240), the maximum allowance rose to \$500,000 and the phaseout threshold to \$2,000,000 for qualifying property placed in service in 2010 and 2011. The act also created a maximum allowance of \$250,000 for qualified leasehold and restaurant and retail property improvements made in the same period and extended through 2011 the eligibility of purchases of off-the-shelf software for the Section 179 allowance.

In the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), Congress set the maximum allowance at \$125,000 and the phaseout threshold at \$500,000 for 2012, and indexed those amounts for inflation. The eligibility of off-the-shelf computer software for the allowance was also extended for 2012.

The American Taxpayer Relief Act of 2012 (P.L. 112-240) increased the maximum expensing allowance to \$500,000 and the phaseout threshold to \$2,000,000 for the 2012 (retroactively) and 2013 tax years. It also made purchases of off-the-shelf software eligible for the allowance in 2013 and extended through 2013 the \$250,000 expensing allowance for leasehold property improvements that first became available in 2010.

The Consolidated Appropriations Act, 2016 (P.L. 114-113) made permanent the \$500,000 expensing allowance and \$2,000,000 phaseout threshold for the 2014 and 2015 tax years, and indexed both of these amounts for inflation after 2015. Off-the-shelf computer software for business purposes and qualified leasehold property were both permanently classified as property eligible for Section 179 treatment.

The 2017 tax revision, commonly referred to as the Tax Cuts and Jobs Act (P.L. 115-97), permanently set the Section 179 expensing allowance to \$1,000,000; set the phaseout threshold at \$2.5 million; and indexed both amounts for inflation beginning in 2019. It also expanded the definition of qualified property to include “qualified improvement property,” which includes improvements to the interior of any non-residential real property, as well as roofs; heating, ventilation, and air conditioning (HVAC) systems; fire protection and alarm systems; and security systems installed on such property. P.L. 115-97 also eliminated the exclusion for tangible personal property used in connection with lodging facilities and indexed for inflation the \$25,000 expensing limit for sport utility vehicles starting in 2019. These changes apply to property placed into service in 2018 or later.

Assessment

The expensing allowance under Section 179 has implications for tax administration and economic efficiency. With regard to the former, it simplifies tax accounting by permitting some taxpayers to write off the entire cost of qualified assets in the year in which they are placed in service. With regard to the latter, the provision encourages greater investment in certain capital assets than otherwise would be likely to occur by smaller firms in a way that could divert financial capital away from more productive uses. Nonetheless, its overall influence on tax administration and the allocation of investment is probably modest. Large firms normally are unable to use the allowance, for the most part, and Section 179 property is a small share of overall gross domestic investment.

Even among smaller firms, though, the take-up rate for Section 179 has not been universal. For example, a study by the Department of the Treasury found that corporations, pass-through entities, and individuals elected to use Section 179 expensing in the 60 percent to 80 percent range, both in terms of the numbers of firms and relative to total allowed investment amounts annually over the 2002 to 2014 period.

Some argue that investment by smaller firms should be supported by government subsidies because they create more jobs and develop and commercialize more new technologies than larger firms. The evidence on this issue is inconclusive. In addition, economic analysis offers no clear justification for targeting investment tax subsidies at such firms. In theory, taxing the returns to investments made by all firms at the same effective rate does less harm to social welfare than granting preferential tax treatment to the returns earned by many small firms.

Some question the efficacy of expensing as a policy tool for encouraging higher levels of business investment. A more fruitful approach, in the view of these skeptics, would be to enact permanent reductions in tax rates and purge the tax code of most business tax preferences for simplicity purposes.

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Commerce and Housing

AMORTIZATION OF BUSINESS STARTUP COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.1	0.3
2021	0.2	0.1	0.3
2022	0.2	0.1	0.3
2023	0.2	0.1	0.3
2024	0.2	0.1	0.3

Authorization

Section 195.

Description

In general, business taxpayers are allowed to deduct for tax purposes all “ordinary and necessary” expenses they incur or pay in conducting their trade or business. This rule implies that costs incurred before a business begins to operate cannot be deducted as a current expense. Such treatment would be inappropriate because those costs are not incurred in connection with the actual conduct of a trade or business. If anything, the rule implies that start-up costs should be capitalized and added to a taxpayer’s basis in the business, to be recovered only when the business is sold.

Under Internal Revenue Code (IRC) section 195, however, a taxpayer may deduct up to \$5,000 in qualified start-up expenditures as a current expense. This amount is reduced dollar-for-dollar when those expenses exceed \$50,000. As a result, no start-up expenses may be deducted as a current expense once a taxpayer’s total start-up expenses reach or exceed \$55,000. Remaining start-up expenses may be amortized over a period of 15 or more years, beginning with the month in which the business begins to operate. If a

business owner disposes of a trade or business before the end of this period, deferred start-up expenses can be deducted as a loss under IRC section 165.

An expenditure must satisfy two requirements to qualify for the deduction. First, it must be paid or incurred with respect to one or more of the following activities: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; or (3) engaging in what the Internal Revenue Service (IRS) deems “a profit-seeking or income-producing activity” before a trade or business commences. An example of these expenses is an analysis or survey of potential markets, products, workers, and transportation facilities.

Second, the expenditures must be similar to costs that would be deductible if they were paid or incurred in connection with an operating trade or business. These expenses include advertising, wages and salaries, travel expenses, and consultant fees. Qualifying start-up expenditures exclude interest payments on debt, tax payments, and spending on research and development.

Impact

The option to deduct and amortize business start-up costs reduces a common barrier to the formation of a new business: cash flow. By permitting the immediate deduction and recovery over 15 years of expenses that otherwise would be capitalized, section 195 boosts the cash reserves of start-up firms.

Tax preferences for capital income (like IRC section 195) tend to benefit higher-income individuals (see the discussion in the Introduction).

Rationale

Before the creation of section 195 in 1980, the question of whether a business start-up expense could be deducted as a current expense, or capitalized and recovered over time through allowable depreciation deductions or upon the sale of a business, had been a source of controversy and litigation between many taxpayers and the IRS. Taxpayers did have the option of treating certain organizational expenditures for the formation of a corporation or partnership as deferred expenses and amortizing them over 60 or more months (IRC sections 248 and 709).

IRC section 195 entered the federal tax code through the Miscellaneous Revenue Act of 1980 (P.L. 96-605). The original provision allowed business taxpayers to amortize start-up expenditures over at least 60 months. It defined start-up expenditures as any expense “paid or incurred in connection with investigating the creation or acquisition of an active trade or business, or creating an active trade or business.” In addition, the expense had to be one that would have been immediately deductible if it were paid or incurred in connection with the expansion of an existing trade or business. Congress added IRC section 195 to facilitate the creation of new businesses and reduce the frequency of protracted litigation over the tax treatment of start-up expenditures.

Disputes between the IRS and numerous businesses continued over whether certain start-up costs should be expensed under IRC section 162, capitalized under IRC section 263, or amortized under IRC section 195. In an attempt to curtail litigation over the application of IRC section 195, Congress added a provision to the Deficit Reduction Act of 1984 (P.L. 98-369) to clarify the definition of start-up expenditures. It required taxpayers to treat start-up expenditures as deferred expenses, which meant that they were to be capitalized unless a taxpayer elected to amortize them over 60 or more months. It also broadened the definition of start-up expenditures to include expenses incurred in anticipation of entering a trade or business.

IRC section 195 remained unchanged until Congress passed the American Jobs Creation Act of 2004 (P.L. 108-357). The act permitted businesses to deduct up to \$5,000 in eligible start-up costs in the year when their trade or business began to operate. This amount had to be reduced (but not below zero) if start-up expenses exceeded \$50,000. Non-deductible amounts could be amortized over 15 or more years, beginning with the month when the trade or business commenced. The definition of start-up costs was left unchanged. Congress made these changes for two reasons. One was to encourage the formation of new firms with low start-up costs by allowing a large share of those costs to be deducted in the year the business started. The second purpose was to equalize the amortization period for business start-up costs and for intangible assets under section 197, which was 15 or more years.

To accelerate rates of new business formation during the U.S. economy’s slow recovery from the severe recession of 2007 to 2009, the Small Business Jobs and Credit Act of 2010 (P.L. 111-240) temporarily increased the maximum deductible amount of business start-up expenditures from \$5,000 to \$10,000 and increased to \$60,000 the threshold amount for phasing out the

deduction. These changes applied to qualified start-up costs incurred in 2010 only.

Since 2011, the maximum deductible amount has been set at \$5,000, and the phaseout threshold at \$50,000.

Assessment

Under the foundational principles of the federal income tax, business start-up costs should be written off over the life of a business because they are a capital expense. Such a view, however, raises the challenge of estimating the useful life of a business at its outset.

IRC section 195 has three advantages as a means of addressing this challenge. First, it lowers the likelihood of costly and drawn-out legal disputes involving businesses and the IRS over the tax treatment of start-up costs. Second, IRC section 195 does so at a small revenue cost. Third, it simplifies tax accounting and temporarily increases cash flow for small business owners at an early stage of their firms' existence.

It is unclear from the literature on new business formation to what extent the IRC section 195 deduction has affected the rate of new business formation. Nor is it always clear when a new business can begin to deduct eligible start-up costs.

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Commerce and Housing

EXEMPTIONS FROM IMPUTED INTEREST RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.8	(¹)	0.8
2021	0.8	(¹)	0.8
2022	0.9	(¹)	0.9
2023	0.9	(¹)	0.9
2024	0.9	(¹)	0.9

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 163(e), 483, 1274, and 1274A.

Description

The tax code generally requires that debt instruments bear a market rate of interest at least equal to the average rate on outstanding Treasury securities of comparable maturity. If an instrument does not, the Internal Revenue Service imputes a market rate for the instrument. The imputed interest must be included as income to the recipient and is deducted by the payer. The failure to report interest as it accrues can allow the deferral of taxes. The tax expenditure is the revenue loss in the current year from the deferral of taxes caused by certain exceptions allowed by law.

There are several exceptions to the general rules for imputing interest on debt instruments, including debt associated with the sale of property when the total sales price is no more than \$250,000, the sale of farms or small businesses by individuals when the sales price is no more than \$1 million, or the sale of a personal residence. Debt instruments for amounts not exceeding an inflation-adjusted maximum (about \$4.6 million or \$3.3 million, depending on the kind

of the debt instrument), given in exchange for real property, may not have imputed to them an interest rate greater than 9 percent. A temporary suspension was also given to high-yield discount obligations issued between August 30, 2008, and December 31, 2009.

Impact

The exceptions to the imputed interest rules are generally directed at “seller take-back” financing, in which the seller of the property receives a debt instrument (e.g., note, mortgage) in return for the property. This is a financing technique often used in selling personal residences, small businesses, and farms, especially in periods of tight credit conditions and high interest rates, both to facilitate the sales and to provide the sellers with continuing income.

This financing mechanism can also be used, however, to shift taxable income between tax years and thus delay the payment of taxes. When interest is fully taxable but the gain on the sale of the property is taxed at reduced capital gains rates, as in current law, taxes can be eliminated, not just deferred, by characterizing more of a transaction as gain and less as interest (that is, the sales price could be increased and the interest rate decreased).

With only restricted exceptions to the imputation rules, and other recent tax reforms, the provisions now cause only modest revenue losses and have limited economic impact.

Rationale

Restrictions were placed on the debt instruments arising from seller-financed transactions beginning with the Revenue Act of 1964 (P.L. 88-272), to assure that taxes were not reduced by manipulating the purchase price and stated interest charges. These restrictions still allowed considerable creativity on the part of taxpayers, however, resulting in more comprehensive rules included in the Deficit Reduction Act of 1984 (P.L. 98-369).

The 1984 rules were regarded as detrimental to real estate sales and they were modified almost immediately; temporarily in 1985 by P.L. 98-612 and permanently in 1986 by P.L. 99-121. The exceptions to the imputed interest rules described above were introduced in 1984 (P.L. 98-369) and 1986 (P.L. 99-121) to allow more flexibility in structuring sales of personal residences, small businesses, and farms by the owners, and to avoid the administrative problems that might arise in applying the rules to other smaller sales. Since

that time, several other pieces of legislation have clarified rules or issued limited additional exemptions.

Assessment

The imputed interest and related rules dealing with property-for-debt exchanges were important in restricting unwarranted tax benefits before the Tax Reform Act of 1986 (P.L. 99-514) eliminated the capital gains exclusion and lengthened the depreciable lives of buildings.

Under pre-1986 law, the seller of commercial property would prefer a higher sales price with a lower interest rate on the associated debt, because the gain on the sale was taxed at lower capital gains tax rates. The buyer would at least not object to, and might prefer, the same allocation because it increased the cost of property and the amount of depreciation deductions (i.e., the purchaser could deduct the principal, through depreciation deductions, as well as the interest). It was possible to structure a sale so that both seller and purchaser had more income at the expense of lower government revenue.

Under current depreciation rules and low interest rates, this allocation is much less important. In addition, the 9 percent cap on imputed interest for some real estate sales has no effect when market interest rates are well below that level.

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Commerce and Housing

**EXPENSING OF MAGAZINE
CIRCULATION EXPENDITURES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 173.

Description

In general, current federal tax law allows publishers of newspapers, magazines, and other periodicals to deduct their expenditures to establish, maintain, or increase circulation of their periodicals in the year when the expenditures are made.

Deductions of these expenditures as current expenses are permitted, even when the expenditures would otherwise be treated as capital expenditures under Section 263. The expenditures eligible for this preferential treatment do not include purchases of land, depreciable property, or the acquisition of circulation through the purchase of any part of the business of another publisher.

The tax expenditure in Section 173 arises from the difference between the deduction of costs as current expenses and the present value of the depreciation deductions that would be taken if the costs were capitalized.

Impact

Deducting circulation costs as a current expense speeds up the recovery of those costs. This acceleration in turn increases cash flow and reduces the effective cost of capital for publishers. Investment in maintaining and expanding circulation is a key element of the competitive strategies for publishers of newspapers and magazines. Readers are an important source of revenue, and the advertising rates publishers charge typically are based on the volume of sales and readership.

Rationale

Section 173 was added to the federal tax code through the Revenue Act of 1950 (P.L. 81-814). In taking this step, Congress wanted to eliminate some of the difficulties associated with distinguishing between expenditures to maintain circulation, which had been treated as currently deductible, and those to establish or develop new circulation, which had to be capitalized. Numerous legal disputes between publishers and the Internal Revenue Service (IRS) over the application and interpretation of this distinction had arisen as far back as the late 1920s.

The treatment of circulation expenses under Section 173 remained unchanged until the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248). Among other things, P.L. 97-248 made the expensing of circulation expenditures a preference item under the alternative minimum tax (AMT) for individuals and required individuals paying the AMT to amortize any such expenditures over 10 years. Congress lowered the recovery period to three years in the Deficit Reduction Act of 1984 (P.L. 98-369), where it now stands. The Tax Reform Act of 1986 (P.L. 99-841) further clarified the treatment of circulation expenditures under the AMT: it allowed taxpayers who recorded a loss on the disposition of property related to such expenditures (e.g., a newspaper) to claim as a deduction against the AMT all circulation expenditures that had not already been deducted against the tax.

Assessment

Section 173 allows publishers to expense the acquisition of certain assets (i.e., costs associated with maintaining or developing lists of subscribers) that

yield returns in more years than one. At the same time, it simplifies tax compliance and accounting for them and tax administration for the IRS. Without such treatment, it would be necessary for the IRS or Congress to clarify how to distinguish between expenditures for establishing or expanding circulation and expenditures for maintaining circulation.

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Commerce and Housing

**SPECIAL RULES FOR MAGAZINE, PAPERBACK BOOK,
AND RECORD RETURNS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 458.

Description

In general, if a buyer returns goods to the seller, the seller's income is reduced in the year in which the items are returned. If the goods are returned after the tax year in which the goods were sold, the seller's income for the previous year is not affected.

There is an exception to this general rule for publishers and distributors of magazines, paperbacks, and records or similar items with pre-recorded sounds (i.e., not blank records), who may elect to exclude from gross income for a tax year the income from the sale of goods that are returned after the close of the tax year. The exclusion applies to magazines and other periodicals that are returned within two months and fifteen days after the close of the tax year, and to paperbacks and records that are returned within four months and fifteen days after the close of the tax year.

To be eligible for the special election, a publisher or distributor must be under a legal obligation, at the time of initial sale, to provide a refund or credit for unsold copies.

Impact

Publishers and distributors of magazines, paperbacks, and records who make the special election are not taxed on income from goods that are returned after the close of the tax year. The special election mainly benefits large publishers and distributors.

Rationale

The purpose of the special election for publishers and distributors of magazines, paperbacks, and records is to avoid imposing a tax on accrued income when goods that are sold in one tax year are returned after the close of the year. In effect, the special election creates more equivalent treatment between similar transactions: a good was returned, and a tax year may or may not have ended between the sale and return dates.

The special rule for publishers and distributors of magazines, paperbacks, and records was enacted by the Revenue Act of 1978 (P.L. 95-600).

Assessment

For goods returned after the close of a tax year in which they were sold, the special exception allows publishers and distributors to reduce income for the previous year. Therefore, the special election is inconsistent with the general principles of accrual accounting.

The special tax treatment granted to publishers and distributors of magazines, paperbacks, and records is not available to producers and distributors of other goods. On the other hand, publishers and distributors of magazines, paperbacks, and records often sell more copies to wholesalers and retailers than they expect will be sold to consumers.

One reason for the overstocking of inventory is that it is difficult to predict consumer demand for particular titles. Overstocking is also used as a marketing strategy that relies on the conspicuous display of selected titles. Knowing that unsold copies can be returned, wholesalers and retailers are more likely to stock a larger number of titles and to carry more copies of individual titles.

For business purposes, publishers generally set up a reserve account in the amount of estimated returns. Additions to the account reduce business income for the year in which the goods are sold.

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Commerce and Housing

COMPLETED CONTRACT RULES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.3	0.7	1.0
2021	0.1	0.7	0.8
2022	0.1	0.7	0.8
2023	0.1	0.8	0.9
2024	0.1	0.8	0.9

Authorization

Section 460.

Description

Some taxpayers with construction or manufacturing contracts extending for more than one tax year are allowed to report some or all of the profit on the contracts under special accounting rules rather than the normal rules of tax accounting. Many such taxpayers use the “completed contract” accounting method.

A taxpayer using the completed contract method of accounting reports income on a long-term contract only when the contract has been completed. All costs properly allocable to the contract are also deducted when the contract is completed and the income reported, but many indirect costs may be deducted in the year paid or incurred. This mismatching of income and expenses allows a deferral of tax payments that creates a tax advantage in this type of reporting.

Most taxpayers with long-term contracts are not allowed to use the completed contract method and must capitalize indirect costs and deduct them

only when the income from the contract is reported. There are exceptions, however. Home construction contracts may be reported according to the taxpayer's "normal" method of accounting and allow current deductions for costs that others are required to capitalize.

Other real estate construction contracts may also be subject to these more relaxed rules if they are of less than two years' duration and the contractor's gross receipts are \$25 million or less the year the contract is signed.

Impact

Use of the completed contract rules allows the deferral of taxes through mismatching income and deductions because they allow some costs to be deducted from other income in the year paid or incurred. This is true, even though the costs actually relate to the income that will not be reported until the contract's completion, and because economic income accrues to the contractor each year he works on the contract but is not taxed until the year the contract is completed. Tax deferral is the equivalent of an interest-free loan from the government of the amount of the deferred taxes. Because of the restrictions now placed on the use of the completed contract rules, most of the current tax expenditure relates to real estate construction, especially housing.

Rationale

The completed contract method of accounting for long-term construction contracts has been permitted by Internal Revenue regulations since 1918, on the grounds that such contracts involved so many uncertainties that profit or loss was undeterminable until the contract was completed.

In regulations first proposed in 1972 and adopted in 1976, the Internal Revenue Service extended the method to certain manufacturing contracts (mostly defense contracts), at the same time tightening the rules as to which costs must be capitalized. Perceived abuses, particularly by defense contractors, led Congress to question the original rationale for the provision and eventually led to a series of ever more restrictive rules. The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) further tightened the rules for cost capitalization.

The Tax Reform Act of 1986 (P.L. 99-514) for the first time codified the rules for long-term contracts and also placed restrictions on the use of the completed contract method. Under this act, the completed contract method could be used for reporting 60 percent of the gross income and capitalized

costs of a contract, with the other 40 percent reported on the “percentage of completion” method, except that the completed contract method could continue to be used by contractors with average gross receipts of \$10 million or less to account for real estate construction contracts of no more than two years’ duration. It also required more costs to be capitalized, including interest.

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) reduced the share of a taxpayer’s long-term contracts that could be reported on a completed contract basis from 60 percent to 30 percent. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) further reduced the percentage from 30 to 10 (except for residential construction contracts, which could continue to use the 30 percent rule) and also provided the exception for home construction contracts.

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) repealed the provision allowing 10 percent to be reported by other than the percentage of completion method, thus repealing the completed contract method, except as noted above.

More recently the American Jobs Creation Act of 2004 (P.L. 108-357), later amended in the Gulf Opportunity Zone Act of 2005 (109-135), extended the use of the completed contract method to naval shipbuilders.

The Small Business Jobs Act of 2012 (P.L. 111-240) allowed for the allocation of bonus depreciation to the costs allocated to the contract for property placed in service after December 31, 2009, and before January 1, 2011, for most property (2012 for certain longer-lived and transportation property). This provision was extended through the end of 2014 (for most property) by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through the end of 2015 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through the end of 2016 by the Protecting Americans from Tax Hikes Act of 2015 (Division Q of P.L. 114-113); and through the end of 2019 by a subsequent amendment in P.L. 114-113. The 2017 tax revision (P.L. 115-97) allowed the completed contract method for construction contracts that are expected to be completed within two years if the company has gross receipts of \$25 million or less in the year the contract is signed and extends the provision through the end of 2027.

Assessment

Use of the completed contract method of accounting for long-term contracts was once the standard for the construction industry. Extension of the

method to defense contractors, however, created a perception of wide-spread abuse of a tax advantage. The Secretary of the Treasury testified before the Senate Finance Committee in 1982 that “virtually all” defense and aerospace contractors used the method to “substantially reduce” the taxes they would otherwise owe.

The principal justification for the method had always been the uncertainty of the outcome of long-term contracts, an argument that lost a lot of its force when applied to contracts in which the government bore most of the risk. It was also noted that even large construction companies, who used the method for tax reporting, were seldom so uncertain of the outcome of their contracts that they used it for their own books; their financial statements were almost always presented on a strict accrual accounting basis comparable to other businesses.

Since the use of the completed contract rules is now restricted to a small segment of the construction industry, it produces relatively small revenue losses for the government and probably has little economic impact in most areas. One area where it is still permitted, however, is in the construction of single-family homes, where it adds some tax advantage to an already heavily tax-favored sector.

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Commerce and Housing Credit

**LIMITATION ON ACTIVE PASS-THROUGH LOSSES
IN EXCESS OF \$500,000/\$250,000**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	-18.9	—	-18.9
2022	-27.8	—	-27.8
2023	-28.4	—	-28.4
2024	-28.3	—	-28.3

Authorization

Section 461(l)

Description

Internal Revenue Code (IRC) section 461(l) prohibits active owners of partnerships, S corporations, sole proprietorships, limited liability companies, trusts, and estates from deducting what the provision calls an “excess business loss” (EBL) from their taxable income from other sources in the year when the loss occurs. An EBL occurs when a pass-through business’s total deductions exceed the sum of (1) its “gross income or gain” for the year, and (2) \$500,000 in the case of joint filers or \$250,000 in the case of all other filers. Both amounts are adjusted for inflation, starting in 2019; in 2022, the limits are \$270,000 for single filers and \$540,000 for joint filers.

An EBL is treated the same way as a net operating loss (NOL) under section 172. Under P.L. 115-97, NOLs incurred in 2018 and later years may be carried forward indefinitely but not carried back to a previous tax year. The losses may offset no more than 80 percent of a company’s taxable income.

Pass-through business owners are required to apply the passive activity loss (PAL) rules under section 469 before they apply the EBL rules. The PAL rules prevent a passive pass-through business owner from using a NOL to offset taxable income from other sources, an activity known as tax sheltering. Section 469 requires that net income from passive business ownership be added to an owner's taxable income from all sources, whereas a net loss from the same activity may be carried forward to offset future net income from that activity. Unused PALs may be carried forward indefinitely but not carried back, like NOLs.

For partnerships and S corporations, the EBL limit is applied at the partner or shareholder level. This means that each partner or S corporation shareholder takes into account his or her share of a business's income, gain, deduction, or loss in applying the EBL rules to determine their personal income tax liability.

Impact

The EBL provision could increase the tax liability of some active pass-through business owners from 2021 to 2028, when the provision is currently scheduled to expire. Married couples filing jointly will be allowed to use no more than an inflation-adjusted \$500,000 of a NOL to offset other sources of income in the same year, and all other filers are limited to an inflation-adjusted \$250,000 in losses. Pass-through business net losses below these caps that exceed a taxpayer's taxable income from other sources are added to that individual's NOL.

Rationale

P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act) created the loss limitation for active pass-through businesses. Initially, the limitation was to apply to tax years beginning after December 31, 2017, and before January 1, 2026.

The Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136, CARES Act) temporarily modified the tax treatment of NOLs and EBLs. Under the act, companies were allowed to carryback up to five years NOLs they incurred in 2018 to 2020, and a NOL could offset up to 100 percent of a company's taxable income in a previous tax year. The act also suspended the limit on the use of EBLs to offset non-business income under section 461(l) in the same period.

The section 461(l) loss limitation was restored in 2021. The American Rescue Plan Act of 2021 (P.L. 117-2) extended the limitation by one year, through the end of 2026. This expiration date was extended through the end of 2028 by P.L. 117-169, commonly referred to as the Inflation Reduction Act of 2022.

There was no stated rationale for the creation of the section 461(l) EBL limitation in the conference agreement for P.L. 115-97, beyond raising revenue. There was no indication that the limitation was intended to remedy a market failure involving pass-through businesses, most of which are relatively small in employment or revenue size. A possible rationale was to restrict the ability of high-income individuals to use current-year business losses to shelter income from other sources from taxation.

Assessment

The provision limits the ability of active pass-through businesses owners to use a NOL to lower non-business taxable income from the same year between 2021 and 2028. These individuals may use up to an inflation-adjusted \$250,000 (for a single filer) or an inflation-adjusted \$500,000 (for joint filers) of a NOL for this purpose. Net losses that exceed those amounts are treated as a NOL under section 172. As a result, the earliest an active pass-through business owner could use an EBL to offset other taxable income is the following tax year. This timing change may constrict a pass-through firm's short-term cash flow.

Federal tax law treats pass-through business profits and losses differently. Profits are taxed in the year when they are earned, but NOLs can be deducted against taxable income in a future tax year only. Symmetrical treatment of NOLs would require that the tax value of a NOL be refunded to a business owner in the year it occurs.

The section 461(l) limitation could affect the survival or growth of some firms by restricting the owners' ability to use NOLs to reduce their tax liability. This may be a particular concern for owners of start-up firms, which typically have a critical need for cash reserves during their first few years of operation. The limitation means that affected taxpayers have to wait until next year at the earliest to get a tax refund for a current-year net loss. Such a rule is likely to increase the present value of an owner's expected tax liabilities from an investment, since he or she can use a NOL only to offset taxable income in a future year. Net losses that shelter other income from tax have the potential to

sustain a firm's cash flow during periods of financial loss, perhaps allowing it to continue to operate. But such losses can also serve as a shelter for the non-business income of pass-through business owners, who generally have relatively high incomes.

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Commerce and Housing

CASH ACCOUNTING, OTHER THAN AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	2.9	0.9	3.8
2021	2.5	0.7	3.2
2022	2.4	0.6	3.0
2023	2.5	0.5	3.0
2024	2.5	0.6	3.1

Authorization

Sections 446 and 448.

Description

In general, companies are allowed to compute their taxable income with the same method of accounting that they use to compute net income in keeping their financial accounts. This treatment is available only if the method clearly reflects income for tax purposes and is consistently applied. The accounting method must clearly determine when a business should report income and deductible expenses on its tax return.

Section 446 of the Internal Revenue Code (IRC) states that several methods of accounting may be used to compute taxable income. They are the (1) “cash receipts and disbursements” (or cash) method, (2) accrual method, or (3) any other method permitted by tax rules, such as a long-term contract method or a hybrid method drawing on two or more permissible methods.

The two most widely used methods for tax accounting are the cash-basis and the accrual-basis methods. Under the former, a business recognizes income when it receives cash payments for goods or services it provides, and

it recognizes expenses when it makes payments for inputs. This recognition is done regardless of when the revenues were actually earned and the expenses actually incurred. Financial statements created with cash-basis accounting typically postpone or accelerate the recognition of revenues and expenses, depending on a firm's financial condition and its tax liability. Such statements do not reflect all of a company's assets and liabilities as of a particular date.

By contrast, the accrual method of accounting requires a business to recognize income and expenses when the transaction creating them occurs. The transaction does not necessarily coincide with the receipt of cash payments or the payment of expenses. Rather, the accrual method requires a business to recognize income when it is earned and expenses when they are incurred. This means that a company using the accrual method has to recognize expenses in the same period when it earns income from the delivery of goods or services.

In general, the cash method is simpler and less costly to use and gives business owners greater flexibility in recognizing income or expenses for tax purposes. By contrast, the accrual method generally presents a more accurate picture of a taxpayer's income, assets, and liabilities at a specific moment. It matches income and expenses with greater precision and rigor than the cash method does.

Not all businesses are allowed to use the cash method for tax purposes. Companies that maintain inventories as an essential component of their trade or business generally must use the accrual method. These largely are companies that produce, buy, or sell merchandise in earning income. In addition, IRC section 448 requires that C corporations, partnerships with a C corporation as a partner, trusts subject to tax on their unrelated trade or business income, and tax shelters must use the accrual method, regardless of whether they maintain inventories.

But there are a few exceptions to these rules. IRC section 448 allows the following businesses to use the cash method for tax purposes, regardless of whether they maintain inventories: (1) non-corporate companies engaged in farming or tree-raising, (2) qualified personal service corporations (PSCs), and (3) C and S corporations and partnerships with average annual gross receipts in the three previous tax years of \$25 million or less. PSCs are businesses owned by a partnership or an S corporation that provide services in the fields of health care, law, engineering, architecture, accounting, actuarial science, the performing arts, or consulting. The \$25 million limit applies to tax years

beginning in 2018 and thereafter. Eligible businesses are not required to maintain inventories, apply the uniform capitalization rules under section 263A, or use the percentage-of-completion method of accounting for small construction contracts.

(The use of cash accounting in computing taxable income in agriculture is discussed in a separate chapter of the compendium.)

Impact

Most self-employed individuals and many other smaller businesses use the cash method of accounting for tax purposes because recordkeeping is less burdensome and the method can yield temporary tax savings, relative to the accrual method. The tax expenditure from the cash method stems from the opportunities it creates to defer the recognition of income and expenses for tax purposes, yielding temporary tax savings. Owners of eligible small businesses and PSCs of all sizes capture most of the benefit from the expenditure.

Rationale

The Revenue Act of 1916 allowed businesses to calculate their taxable income using the same accounting method that they used to compute their income for financial reporting.

The revision of the Internal Revenue Code in 1954 (P.L. 83-591) broadened this rule to allow taxpayers to use a combination of accounting methods in calculating their tax liabilities.

Additional changes in use of the cash method for tax purposes were made by the Tax Reform Act of 1986 (P.L. 99-514). The act prohibited tax shelters, C corporations, partnerships with C corporations as partners, and certain trusts from using the method. But the act did allow most firms with average annual gross receipts of \$5 million or less in the previous three tax years to use the cash method, regardless of whether they maintained inventories.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) permanently raised the limit for the gross-receipts test to \$25 million.

Assessment

Accounting methods can affect the timing of a business's income tax payments from one year to the next. Relative to the cash method, the accrual

method matches income with the expenses incurred in producing it during a certain period with greater precision and rigor. As a result, the accrual method is preferred for financial reporting because it provides investors with a more accurate picture of a firm's financial condition at a particular moment.

The cash method gives businesses greater control over when receipts and expenses are recognized for tax purposes. By shifting income or expenses from one year to the next, a business can defer the payment of taxes on income that would be recognized sooner under the accrual method, or it can take advantage of credits or net operating losses that otherwise may expire. As noted earlier, the cash-basis method of accounting entails lower tax compliance costs for small business owners. Therefore, some professional organizations (like the American Institute of Certified Public Accountants) have opposed imposing stricter limits on the use of the cash method for tax accounting.

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Commerce and Housing

**CARRYOVER BASIS OF APPRECIATED PROPERTY
TRANSFERRED BY GIFTS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.0	—	3.0
2021	3.0	—	3.0
2022	2.1	—	2.1
2023	4.8	—	4.8
2024	6.3	—	6.3

Authorization

Sections 1015, 1023, 1040, 1221, and 1222.

Description

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

In the case of assets transferred as a gift, the donee's basis (the amount that he subtracts from the sales price to determine gain if the asset is sold in the future) is generally the same as the donor's (usually the original cost of the asset). Thus, if the donee disposes of the property in a sale or exchange, the capital gains tax will apply to the pre-transfer appreciation. Tax on the gain is deferred, however, and may be forgiven entirely if the donee in turn passes on the property at death.

One caveat to this general rule occurs if the donor paid federal gift taxes related to the gift of the asset. In this case, the donee's basis is increased by the share of the gift tax paid on the asset's appreciation prior to transfer.

Impact

The use of carryover basis on gifts provides a deferral of taxation on the appreciation of *inter vivos* gifts (i.e., a gift made by one living person to another).

Rationale

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

The Technical Amendments Act of 1958 (P.L. 85-866) provided for an adjustment of basis for a portion of the gift taxes paid. The Tax Reform Act of 1976 (P.L. 94-455) modified this calculation for gifts made after December 31, 1976, and limited the adjusted basis to the asset's fair market value. The Deficit Reduction Act of 1984 (P.L. 98-369) specified that the basis of assets transferred between spouses is not adjusted for gift taxes paid.

Assessment

Carryover basis for *inter vivos* gifts prevents the avoidance of tax when mutual or sequential gifts are made between relatives. This may result in additional compliance costs to the donee.

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Commerce and Housing

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT SMALL-ISSUE QUALIFIED
PRIVATE ACTIVITY BONDS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 103, 141, 144, and 146.

Description

Interest income on state and local bonds used to finance business loans of \$1 million or less for construction of private manufacturing facilities is tax exempt. These small-issue industrial development bonds (IDBs) are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Government Bonds*.

The \$1 million loan limit may be raised to \$10 million if the aggregate amount of related capital expenditures (including those financed with tax-exempt bond proceeds) made over a six-year period is not expected to exceed

\$10 million. Aggregate borrowing is limited to \$40 million for any one borrower. The bonds are subject to the state private-activity bond annual volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003.

The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) temporarily expanded the definition of manufacturing facilities to include facilities that manufacture, create, or produce tangible property or intangible property. Intangible property means any patent, copyright, formula, process, design, knowhow, format, or other similar item. This expanded definition applied to bonds issued after February 17, 2009, and before January 1, 2011.

Impact

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

Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the share of benefits going to bondholders and business borrowers, and estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Government Bonds*.

Rationale

The first bonds for economic development were issued without any federal restrictions. State and local officials expected that reduced interest rates on business loans would increase investment and jobs in their communities. The Revenue and Expenditure Control Act of 1968 (P.L. 90-364) imposed several targeting requirements, limiting the tax exempt bond issue to \$1 million and the amount of capital spending on the project to \$5 million over a six-year period. The Revenue Act of 1978 (P.L. 95-600) increased the \$5 million limit on capital expenditures to \$10 million, and to \$20 million for projects in certain economically distressed areas. The American Jobs Creation Act of 2004 (P.L. 108-357) effectively increased the related expenditures limit to \$20 million for bonds issued after September 30, 2009, but the \$10 million limit would still apply to the amount of the bond

issuance. The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-122) moved the eligible date for the bonds up to December 31, 2006.

The Deficit Reduction Act of 1984 (P.L. 98-369) restricted use of the bonds to manufacturing facilities, and limited any one beneficiary's use to \$40 million of outstanding bonds. The annual volume of bonds issued by governmental units within a state first was capped in 1984, and then included by the Tax Reform Act of 1986 (P.L. 99-514) under the unified volume cap on private-activity bonds.

Small-issue IDBs were once an "expiring tax provision" with a sunset date. IDBs first were scheduled to sunset on December 31, 1986, by the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248). Revised sunset dates were adopted three separate times when Congress extended small-issue IDB eligibility for a temporary period. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), however, made small-issue IDBs permanent.

Since then, small-issue IDB capacity has gradually expanded reflecting congressional desire to encourage investment in manufacturing. As noted above, the American Jobs Creation Act of 2004 (P.L. 108-357) increased the total capital expenditure limitation from \$10 million to \$20 million, but the \$10 million limit would still apply to the amount of the bond issuance. Congress, at the time, thought it was appropriate because the \$10 million limit had not been changed for many years. More recently, as noted earlier, the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) temporarily expanded the definition of manufacturing facilities to include facilities that manufacture, create, or produce tangible property or intangible property. The ARRA provision expired January 1, 2011.

Assessment

It is not clear that the nation benefits, in aggregate, from IDB issuances. Any increase in investment, jobs, and tax base obtained by communities from their use of these bonds likely is offset by the loss of jobs and tax base elsewhere in the economy. National benefit could arise from relocating jobs and tax base to achieve social or distributional objectives. The use of the bonds, however, is not targeted to specific geographic areas that satisfy explicit federal criteria such as median income or unemployment; all jurisdictions are eligible to benefit from the bonds.

As one of many categories of tax-exempt private-activity bonds, small-issue IDBs have increased the financing costs of bonds issued for public

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

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Commerce and Housing Credit

LIMITATION ON DEDUCTION FOR FDIC PREMIUMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	-1.5	-1.5
2021	—	-1.5	-1.5
2022	—	-1.5	-1.5
2023	—	-1.5	-1.5
2024	—	-1.5	-1.5

Authorization

Section 162(r)

Description

In general, taxpayers are allowed to deduct ordinary and necessary expenses they incur or pay in the conduct of a for-profit trade or business, under section 162(a). These expenses include most insurance premiums paid by companies as part of their trade or business.

In the case of banks and credit unions of all asset sizes, those premiums have included the semi-annual payments they make into the Deposit Insurance Fund (DIF), which is managed by the Federal Deposit Insurance Corporation (FDIC). These payments are authorized under section 7(b) of the Federal Deposit Insurance Act (P.L. 81-797) and are intended to maintain the institutions' status as insured depository institutions. The FDIC was created as an independent government corporation through the Banking Act of 1933 (P.L. 73-66) to insure bank deposits. It is funded through insurance premiums collected from member depository institutions and held in the DIF. Proceeds from the DIF are used to reimburse depositors up to the depository insurance

limit of \$250,000 per checking account, savings account, and individual retirement account when a member institution fails.

Before 2018, member institutions were allowed to deduct the full amount of their DIF payments if the payments passed a test known as the “all events test.”

Starting in 2018, banks over a certain size no longer are allowed to deduct the full amount of their FDIC premium payments, under section 162(r). Specifically, no deduction is allowed for the “applicable percentage” of any FDIC premium paid or incurred by a member institution. For banks with consolidated assets of \$50 billion or more, the percentage is 100 percent, which means that they cannot deduct any of their FDIC premiums under current law. Otherwise, the applicable percentage is determined by subtracting \$10 billion from an institution’s consolidated assets and dividing the remainder by \$40 billion. For example, in the case of a bank with \$26 billion in consolidated assets, no deduction may be claimed for 40 percent of its FDIC premium: $(\$26 \text{ billion} - \$10 \text{ billion}) / \$40 \text{ billion} = 40 \text{ percent}$. Member institutions with less than \$10 billion in consolidated assets may still deduct the full amount of FDIC premiums.

The term “consolidated assets” has the same meaning in the tax treatment of FDIC premium payments as it does in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). In determining a taxpayer’s consolidated assets, members of an affiliated group are treated as a single taxpayer.

Impact

The limitation on the deduction for FDIC premiums has the potential to increase the tax burden of large banks that are members of the federal deposit insurance system.

Rationale

The section 162(r) limitation was enacted by P.L. 115-97 (commonly referred to as the Tax Cuts and Jobs Act). There is no stated rationale for the section 162(r) limitation in the conference agreement for H.R. 1, the bill that became P.L. 115-97, apart from raising revenue to offset part of the law’s revenue cost.

Assessment

The limitation on the deduction for FDIC premium payments by banks with \$10 billion or more in consolidated assets may be inconsistent with the general principle in taxing business income of allowing a deduction for any ordinary and necessary expense incurred or paid in the conduct of a for-profit trade or business. This principle is embedded in section 162 of the federal tax code.

At the same time, the loss of the full deduction for large banks is mitigated by the reduction in the top corporate tax rate from 35 percent to 21 percent under P.L. 115-97. Banks organized under the laws of any of the 50 states and the District of Columbia are taxed as C corporations. Because the corporate tax rate is 40 percent lower under current law, the loss of the FDIC premium deduction is unlikely to prevent a large bank from earning a greater after-tax profit than it did before 2018 for the same taxable income.

For example, suppose a bank with \$70 billion in consolidated assets in 2022 has a gross income of \$1 billion and its only expense is a \$100 million FDIC premium. Under current law, the bank would owe a federal income tax of \$210 million: \$1 billion x 0.21. Under pre-2018 law, however, the bank's tax liability would total \$315 million: $[(\$1 \text{ billion} - \$100 \text{ million}) \times (0.35)]$. As this example suggests, the revenue gain from the loss of the full deduction might be more than offset by the revenue loss from the reduction in the corporate tax rate for large banks.

To the extent that large banks realize greater profits under current law, they could increase their lending, pay down debt, increase dividend payments to shareholders, or buy back their stock, among other things.

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Commerce and Housing

CREDIT FOR EMPLOYER-PAID FICA TAXES ON TIPS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.1	0.5	1.6
2021	0.8	0.4	1.2
2022	0.9	0.4	1.3
2023	1.1	0.4	1.5
2024	1.1	0.5	1.6

Authorization

Section 45B.

Description

Tips received by employees providing, serving, or delivering food and beverages are treated as wages under the Federal Unemployment Tax Act (FUTA) and the Federal Insurance Contributions Act (FICA). Employers are required to report tips received to the Internal Revenue Service (IRS), and tip income is subject to both the employer and employee portions of Social Security and Medicare taxes. In the case of tipped employees, the Fair Labor Standards Act (FLSA) allows employers to lower the minimum wage to \$2.13 per hour, provided the combination of tips and cash wages equals the applicable federal minimum wage, \$7.25 per hour in 2022.

Employers of tipped employees may claim a non-refundable tax credit for a portion of the employer-paid FICA taxes. Specifically, the credit is equal to the employer's FICA tax obligation on employee tip income in excess of tips treated as wages for the purpose of meeting the minimum wage requirements of the FLSA. The credit is available regardless of whether an employee reports tips received. Under the Small Business and Work

Opportunity Tax Act of 2007 (enacted as part of P.L. 110-28), the minimum wage for determining the credit was fixed at the minimum wage in effect on January 1, 2007, or \$5.15 per hour. As a result, the credit is available for FICA taxes paid on tip income received by an employee in excess of \$5.15 per hour.

The credit is one of the components of the general business credit (GBC) under section 38. Thus, the credit is subject to general business credit carryback and carryforward rules. Unused FICA credits may be carried back one year or carried forward up to 20 years. The credit is not refundable. An employer may also elect not to use the credit in any given tax year. To avoid a double benefit, employers cannot deduct wages for any amount taken into account when computing the credit.

In 2002, the U.S. Supreme Court ruled that the IRS may use an aggregate estimation method to calculate a restaurant's FICA tax liability for unreported tip income. The decision rested on whether tax law authorized the IRS to base the FICA assessment upon an aggregate estimate of all tips paid to a restaurant's employees, or whether the law required the IRS to determine total tip income by estimating each individual employee's tip income separately and summing the individual amounts. The Supreme Court held that the IRS could use an aggregate estimate, provided it was based on a reasonable method.

Impact

Section 45B reduces labor costs for firms with tipped employees. It also boosts tax compliance in the industry by encouraging employers to provide complete and accurate reports of employee tip income to the IRS. Some believe that before the enactment of section 45B, FICA and FUTA created an incentive for employers to reduce their FICA taxes by encouraging or requiring their employees not to report all of their tip income. Current tax law imposes no additional burdens on food and beverage employers for complete reporting of tip income. To the extent that all tips are reported and all FICA taxes paid, employees may be eligible for larger payments from the Social Security system when they retire.

A 2016 Treasury study provides data showing that in the 2012 tax year, 66,400 firms claimed a total of \$1.3 billion in FICA tip credits. Most of the firms claiming the credit were S corporations (55%). Another 26% of firms claiming the credit were structured as partnerships, 12% were C corporations, and 7% were sole proprietorships. On average, the dollar value of credits

claimed is larger for C corporations than for other types of firms. About 40% of credits claimed were claimed by C corporations, while that figure was 30% for partnerships, 28% for S corporations, and 2% for sole proprietorships. Fifty C corporations with total income in excess of \$1 billion claimed 18% of the total FICA tip credits.

Rationale

The credit for employer-paid FICA taxes on tips originated with the Omnibus Budget Reconciliation Act of 1993 (P.L. 101-508). Although it was not included in either the House-passed version of the bill or the amended version passed by the Senate, the credit was inserted in the conference committee report without an explanation. Some news reports indicated that it was added at the last minute to mitigate the impact on restaurant industry sales and revenue of another provision that reduced the deductible portion of the cost of business meals from 80 percent to 50 percent.

The Small Business Job Protection Act of 1996 (P.L. 104-188) clarified two aspects of the credit. First, it specified that the credit was available regardless of whether employees reported the tips on which an employer paid the FICA tax, and that the credit applied to all FICA taxes paid on tips after December 31, 1993, even if some of the tip income was received before that date. The act also stated that tips received by employees delivering food or beverages were eligible for the credit (prior law provided the credit only for tips received on the premises of a food or beverage establishment). According to the legislative history of the credit, Congress intended that the effective date be set at January 1, 1994, but it deemed the Treasury Department's interpretation of that date to be inconsistent with the provision as enacted. The Ways and Means committee report on the bill noted there was no good reason not "to apply the credit to all persons who provide food and beverages, whether for consumption on or off the premises."

As a result of the Small Business and Work Opportunity Act of 2007 (enacted as part of P.L. 110-28), employers may calculate their credit for FICA taxes paid on tip income by using a fixed federal minimum wage of \$5.15 per hour, instead of the current minimum wage, which stands at \$7.25 per hour. As a result of this change, any future increases in the minimum wage would not affect the amount of the tip credit for employers.

Assessment

Many would agree that tips are income that should be treated for tax purposes the same way as other forms of compensation. Waiters, waitresses, and delivery persons are not self-employed individuals, hence their tip income should be considered part of their total compensation. When seen from this perspective, tips can be thought of as a surrogate wage that employers might have to pay in their absence. In addition, many would argue that all employers should share equally the costs of providing future benefits for retirees under the Social Security program.

Because Social Security taxes are determined on the basis of an employee's total compensation (including tip income), current law provides a benefit only to food and beverage employers whose employees receive part of their compensation in the form of tips. Other businesses whose employees receive a portion of their compensation in the form of tips (such as cab drivers, hairdressers, etc.) are barred from using the tax credit. Thus, section 45B may violate the principle of horizontal equity by treating businesses that employ tipped employees differently. Further, since all other employers pay Social Security taxes on the entire earnings of their employees, the provision may result in different tax treatment for taxpayers in different industries. For example, a carry-out food establishment where tipping is not customary pays the full amount of applicable Social Security taxes, while a sit-down restaurant does not.

The restaurant industry has some objections to the current design of the credit. First, it maintains that tip income is not a cash wage, but a gift to employees from the customers they serve. Second, industry representatives contend that if the tip income is treated as compensation, employers should be able to count all tip income in determining the minimum wage (current law allows only a portion of the federal minimum wage to consist of tip income). In addition, the industry argues that the mandatory reporting of tip income forces employers to bear large and unreasonable administrative costs. The credit does, however, help defray some of these costs.

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Commerce and Housing

**20-PERCENT DEDUCTION FOR QUALIFIED BUSINESS
INCOME**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	45.7	—	45.7
2021	46.0	—	46.0
2022	48.5	—	48.5
2023	51.9	—	51.9
2024	55.4	—	55.4

Authorization

Section 199A.

Description

The taxation of business income depends, in part, on how a business is organized for legal purposes. Basically, a firm has two choices: it can be organized as a C corporation or as a pass-through entity (i.e., partnership, limited liability corporation (LLC), S corporation, or sole proprietorship).

C corporation profits are taxed twice: first at the entity level, and then at the individual level of shareholders when profits are distributed to them as dividends and long-term capital gains. All items of gain, loss, income, deduction, and credit are attributed to a C corporation in determining its tax liability.

By contrast, pass-through business profits are taxed once: at the individual level of owners. The federal tax code treats profits as having been passed through to the owners in the year they are earned, even if they are retained in the business. A partner or an S corporation shareholder takes into

account an entity's items of income, gain, loss, deduction, and credit in calculating the taxable income reported on their individual returns. A sole proprietorship is treated for tax purposes as inseparable from the owner, which means the owner is taxed directly on any profits as part of her or his individual income from all sources.

Under current law, the tax rate for corporate income is permanently set at a single rate of 21 percent for tax years beginning in 2018 and beyond. By contrast, the tax rates for individual income in 2018 through 2025 range from 10 percent to 37 percent and are scheduled to return to their pre-2018 levels beginning in 2026.

Internal Revenue Code (IRC) section 199A allows individuals, some trusts, and estates with pass-through business profits to deduct up to 20 percent of those profits in determining their individual income tax liability. The deduction does not affect a taxpayer's adjusted gross income (AGI) and cannot be claimed as an itemized deduction. But individuals may claim the section 199A deduction, regardless of whether they claim the standard deduction or itemize their deductions.

The deduction for a pass-through business income depends largely on three considerations: (1) the taxable income of taxpayers with qualified pass-through business income (QBI); (2) the nature of the business activity; and (3) an owner's share of a business's total W-2 wages and total unadjusted basis of tangible, depreciable assets. Taxable income in this case refers to a pass-through business owner's AGI less other allowable deductions, excluding the section 199A deduction. W-2 wages are a pass-through business's total wages subject to withholding, elective deferrals, and deferred compensation paid to employees during a year. The unadjusted basis of a business's tangible, depreciable assets refers to the cost of such property when a pass-through business acquired it.

An owner's QBI is the net amount of qualified items of income, gain, loss, and deduction for a qualified trade or business conducted in the United States. If a taxpayer owns more than one qualified trade or business, then QBI must be determined separately for each of them and then combined to determine his or her total QBI.

QBI does not include wage income, long-term capital gains or losses, dividends, interest income unrelated to a qualified trade or business, amounts received from an annuity (unless related to a trade or business), reasonable

compensation paid to an S corporation shareholder for services rendered to the business, and guaranteed payments (described in section 707(c)) paid to a partner for services rendered to the partnership. The exclusion for S corporation compensation and partnership guaranteed payments is intended to prevent S corporation shareholders and partners from receiving the section 199A deduction for what might be considered labor income.

The deduction is subject to three limits, one of which applies to every claim for it. The other two limits may or may not apply, depending on the nature of a pass-through business and the owner's taxable income.

The first limit sets the maximum amount an individual taxpayer may deduct under section 199A. In this case, the deduction is the lesser of 20% of a taxpayer's total QBI or 20% of her or his taxable income in excess of any long-term capital gains (or ordinary income). This limit establishes what could be described as the baseline for the other two limits, when they come into play.

The second limit pertains to QBI from a "specified service and trade business" (SSTB). An SSTB is any trade or business primarily engaged in a variety of personal professional services. These include accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, the performing arts, investing and investment management, and trading or dealing in securities, partnership interests, and commodities. An SSTB also includes any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners. Excluded from the list of SSTBs are services provided by engineers and architects, even though their services often are regarded as personal and professional.

The second limit comes into play when an SSTB owner's taxable income exceeds what can be called the deduction's lower-income threshold for the owner's filing status. The threshold is indexed for inflation: in 2022, that threshold is \$340,100 for joint filers and \$170,050 for all other filers. For taxable income below those thresholds, all of an SSTB's QBI is eligible for the deduction, making it the same amount as the maximum deduction under the first limit. The SSTB limit phases in for taxable incomes between the lower-income threshold and the upper-income threshold (\$440,100 for joint filers and \$220,050 for all other filers in 2022, also indexed for inflation). No SSTB income is eligible for the deduction if the owner's taxable income exceeds the upper-income threshold. For taxable incomes within the phase-in range, the maximum deduction for an SSTB's QBI under the first limit is

reduced by a factor linked to the amount by which an owner's taxable income exceeds the lower-income threshold.

Lower and Upper Income Threshold Amounts, 2018-2022

	2018	2019	2020	2021	2022
<i>Lower Income Thresholds</i>					
Joint Filers	\$315,000	\$321,400	\$326,600	\$329,800	\$340,100
All Other	\$157,500	\$160,700	\$163,300	\$164,900	\$170,050
<i>Upper Income Thresholds</i>					
Joint Filers	\$415,000	\$421,400	\$426,600	\$429,800	\$440,100
All Other	\$207,500	\$210,700	\$213,300	\$214,900	\$220,050

The third limit is based on a qualified business's W-2 wages and its total original cost of the depreciable, tangible assets used in the business. It specifies that the deduction cannot exceed the greater of 50 percent of a taxpayer's share of a business's W-2 wages, or the sum of 25 percent of those wages and 2.5 percent of the taxpayer's share of the firm's total unadjusted basis of eligible assets (or property) used in the business. This limit may be referred to as the wage-and-qualified-property (WQP) limit. Like the SSTB limit, it does not come into play if an owner's taxable income is less than the lower-income threshold. But if an owner's taxable income falls in the phase-in range for the second and third limits, the maximum deduction for SSTB and non-SSTB income is reduced by a factor also based on the extent to which taxable income exceeds the lower-income threshold. And if taxable income is greater than the upper-income threshold, the full limit applies to non-SSTB QBI only.

The three limits on the deduction apply at the same time only when the taxable income of an SSTB owner is within the phase-in range for the second and third limits.

Impact

The section 199A deduction is intended to reduce the tax burden of qualified pass-through business owners. If a taxpayer can take the maximum deduction of 20 percent of QBI, the provision lowers marginal individual income tax rates for that income as follows:

***Federal Marginal Individual Income Tax Rates
With and Without the 199A Deduction, 2022***

Marginal Rates Without 199A	Marginal Rates With 199A
10.0%	8.0%
12.0%	9.6%
22.0%	17.6%
24.0%	19.2%
32.0%	25.6%
35.0%	28.0%
37.0%	29.6%

Source: Tax Foundation

According to tax filing statistics compiled by the IRS, 18.7 million taxpayers claimed the section 199A deduction in 2018, the first year it was available. Those claims totaled \$149.9 billion. Both the number of claims (22.2 million) and the total amount claimed (\$155.3 billion) rose in 2019. But the average amount of the deduction per claim declined from 2018 to 2019: \$8,034 in 2018 and \$6,979 in 2019. The reason for the decline is unclear.

A 2021 study by Lucas Goodman et al. found no evidence of “large responses” in 2018 to the section 199A deduction among pass-through businesses and individuals. Specifically, the study found no change in the share of pass-through business owners’ income eligible for the deduction in the first year it was available. It also found no evidence that the deduction led to an increase in the number of workers switching to independent contractors who might be eligible for the deduction. Finally, the authors found no evidence that the deduction induced “large increases” in capital investment or employment growth in 2018.

Rationale

Section 199A was added to the federal tax code by the tax revision enacted in December 2017 (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act). The provision seemed to have been intended to provide tax relief to pass-through businesses somewhat similar to the 40% reduction in the top income tax rate (from 35 percent to a single rate of 21 percent) for C corporations. The 20-percent deduction for qualified pass-through business profits was also intended to encourage small business owners to increase their investment and employment by reducing their tax burden.

Assessment

It is too soon to evaluate the impact of the deduction on pass-through business investment and employment since it became available. But the deduction's implications for tax administration and the equity and efficiency effects of the federal income tax can be examined.

The equity effects of a tax system concern the distribution of its burden among households ranked by income. There are two aspects to section 199A deduction's equity effects. The first is how its benefits are distributed among income groups. The second deals with how it affects horizontal equity, which is the principle that individuals with similar abilities to consume should have similar tax burdens, everything else being equal.

There is evidence that the deduction benefits upper-income households more than lower-income households. An analysis by the Tax Policy Center (TPC) showed that upper-income households gained much more from the deduction than lower- and middle-income households combined. According to the findings, taxpayers with incomes above \$1 million likely received 49.1 percent of the total benefit in 2018, while households with incomes of \$100,000 or less got only 4.5 percent of the benefit.

The deduction seems not to promote horizontal equity within the federal income tax system. As the deduction applies only to QBI, two people with the same taxable income would have different tax burdens if one person has only wage income and the other person has only pass-through business income eligible for the maximum deduction. If neither taxpayer is eligible for other tax benefits, the effective tax rate for the latter will be 20 percent lower than the effective tax rate for the former.

Taxes affect economic efficiency through their impact on the allocation of economic resources. An efficient tax code would have minimal or no effect on the decisions consumers and businesses make on a range of economic activities, such as saving, consumption, and investment. An efficient tax code would be neutral with regard to the tax burden on the returns to any investment a firm could make.

The section 199A deduction has the potential to stimulate added investment but in a manner that does not necessarily encourage an efficient allocation of resources, particularly among pass-through businesses. The deduction could increase pass-through business investment by increasing short-term cash flow for affected firms and reducing their cost of capital for new investments. But the deduction cannot be regarded as an efficient policy tool for investment stimulus because it allows affected firms to earn windfall profits from investments made before the deduction was available.

The deduction further distorts the allocation of resources through its treatment of SSTBs owned by high-income individuals. As noted earlier, upper-income pass-through business owners are likely to capture a disproportionately large portion of the overall tax savings from the deduction. As a result, it is likely that these owners will undertake much of any new investment attributable to the deduction. Yet high-income SSTB owners receive no benefit from the deduction, and high-income owners of non-SSTBs face a significant limit on the deduction they can claim. At least two outcomes are possible under these circumstances. First, the investment stimulus from the deduction is modest, on the whole. Second, the section 199A deduction encourages the flow of economic resources away from SSTBs to businesses with potentially greater after-tax returns on investment.

The deduction gives people earning wage income an incentive to become independent contractors. It does this by lowering the tax burden on each additional dollar of pass-through business income by up to 20 percent, relative to each additional dollar of wage income. Of course, taxes are only one consideration in deciding whether to work as an independent contractor. Self-employed persons must pay the full 15.30% federal payroll tax and typically receive no benefits like health insurance, sick and vacation leave, and pensions. Under Treasury regulations, people who worked as employees before the 2017 tax revision and elected to become an independent contractor doing essentially the same work for their former employers after the law went into effect are ineligible for the deduction.

Tax administration encompasses the cost to a government of administering a tax system and the cost to taxpayers of complying with it. One of Congress's aims in the 2017 tax revision was to simplify the taxation of small firms, thereby lowering their tax compliance costs and perhaps increasing their compliance. Nonetheless, the deduction adds another layer of complexity to the taxation of small pass-through firms, although the deduction is not exclusively targeted at small firms. The requirements for claiming the deduction are likely to increase the recordkeeping burden for eligible business owners. Pass-through business owners with 2022 taxable incomes up to the lower-income threshold of \$170,050 for single filers and \$340,100 for joint filers may generally find it easier to claim the deduction without professional assistance than higher-income taxpayers subject to the SSTB and WQP limits.

The deduction applies at the partner and S corporation shareholder level. As a result, partnership and S corporation tax filings have become more complex. The filings must include information for each qualified business owned by the pass-through entity on a business's W-2 wages and its total unadjusted basis of all depreciable, tangible assets used in the business from the beginning.

Among the deduction's effects is the opportunities it creates for gaming. This refers to the adjustments and transfers a business might undertake to take full advantage of a tax benefit. Tax gaming can arise from a variety of factors, including unequal tax treatment of income, complexity, and ambiguous or haphazard rules that invite creative interpretation by taxpayers and their tax advisers. The section 199A deduction has the potential to open up several avenues for gaming.

One such avenue relates to the allocation of labor income among upper-income S corporation shareholders. S corporation income is not subject to the payroll tax. As a result, there has been a longstanding tendency among high-income S corporation owners to understate their labor income and overstate their income from profits, allowing them to avoid paying the additional 3.8 percent Medicare tax imposed on high-earners. Curiously, the deduction offers S corporation owner-employees an incentive to stop this practice. By allocating more income to wages, an S corporation would increase its W-2 wage/qualified property limit, potentially increasing the deduction each shareholder could claim.

A strategy known as "cracking" offers another way to game the section 199A deduction. This strategy might help a pass-through business operating

as an unqualified SSTB that has elements or activities that qualify for the deduction. By cracking (or splitting) the business into two separate pass-through businesses, the owners could benefit from the deduction through the qualifying business. For example, assume that a large law firm, which does not qualify for the deduction, splits off ownership of the office building it owns and related furniture and amenities like a gym. The firm's partners own both businesses. While income from legal services would not qualify for the deduction, income earned by the business that owns the building would qualify. To increase the income of the real estate business, the law firm could pay relatively high fees to lease the office space and rent its furnishings.

Another option for gaming the deduction is known as "packing." A qualifying business is packed (or combined with) a non-qualifying business so that the combined entity is engaged in a business that qualifies for the pass-through income deduction. For example, a well-known person like a sports superstar cannot claim the deduction for income she or he receives from licensing her or his name to others for selling products or services, such as using the person's name on athletic shoes. But the sports star could pack (or merge) a commercial real estate venture she or he owns and manages into the branding business and claim the deduction on the grounds that the primary business of the combined entity is qualifying real estate.

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Commerce and Housing

**CREDIT FOR THE COST OF CARRYING TAX-PAID
DISTILLED SPIRITS IN WHOLESALE INVENTORIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 5011.

Description

This credit applies to domestically bottled distilled spirits purchased directly from the bottler. Distilled spirits that are imported in bulk and then bottled domestically also qualify for the credit. The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of the taxable year. A case is 12 750-milliliter bottles of 80-proof alcohol. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period, on an assumed tax rate of \$25.68 per case set in statute.

Impact

The excise tax on distilled spirits is imposed when distilled spirits are removed from the plant where they are produced. In the case of imported

distilled spirits that are bottled, the excise tax is imposed when they are removed from a U.S. customs bonded warehouse. For distilled spirits imported in bulk containers for bottling in the United States, the excise tax is imposed in the same way as for domestically produced distilled spirits – when the bottled distilled spirits are removed from the bottling plant.

In 2017, the federal excise tax rate on distilled spirits was \$13.50 per proof gallon (ppg). This rate is in permanent law. For 2018 through 2020, the excise tax rate schedule is temporarily modified into a three-tier system: \$2.70 ppg on the first 100,000 proof gallons, \$13.34 ppg for proof gallons in excess of that amount but less than 22,130,000 proof gallons, and \$13.50 ppg for amounts thereafter.

Since the credit depends on the interest rate, the benefit to wholesalers from claiming the credit depends, in part, on prevailing market interest rates. Assuming an annual interest rate of six percent, the tax credit would save wholesalers approximately \$0.25 a case or \$0.02 per bottle of distilled spirits. That calculation per case is based on $\$25.68 * [(1.06)^{(2/12)} - 1]$. At an interest rate of two percent, it would save approximately \$0.08 per case or less than \$0.007 per bottle. That calculation per case is based on $\$25.68 * [(1.02)^{(2/12)} - 1]$.

Rationale

The tax credit, created in 2005 by the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (P.L. 109-59), is intended to help equalize the differential costs associated with wholesaling domestically produced distilled spirits compared with imported distilled spirits. Under current law, wholesalers are not required to pay the federal excise tax on bottled imported spirits until the spirits are removed from a bonded warehouse and sold to a retailer. It is assumed that the federal excise tax on domestically produced distilled spirits is passed forward as part of the purchase price when the distiller transfers the product to the wholesaler. If so, this raises the cost to wholesalers of domestically distilled spirits relative to bottled imported spirits. The credit is designed to compensate the wholesaler for the foregone interest that could have been earned on the funds that were used to pay the excise taxes on the domestically produced distilled spirits being held in inventory (the opportunity cost of the excise tax payment).

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) enacted several temporary changes to federal excise taxes on distilled spirits and alcoholic beverages, more generally, for 2018 and 2019.

The three-tier excise tax rate schedule under Section 5001 was one of these changes. Additionally, P.L. 115-97 temporarily allows the transfer of spirits in approved containers other than bulk containers without payment of excise tax under Section 5212. The three-tier excise tax rate schedule was extended through 2020 by Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94).

Assessment

Under current law, tax credits are not allowed for the costs of carrying products in inventory on which an excise tax has been levied. Normally, the excise tax that is included in the purchase price of an item is deductible as a cost when the item is sold.

Allowing wholesalers a tax credit for the interest costs (or float) of holding excise-tax-paid distilled spirits in inventory confers a tax benefit on the wholesalers of distilled spirits that is not available to other businesses that also carry tax-paid products in inventory. For instance, wholesalers of beer and wine also hold excise-tax-paid products in their inventories and are engaged in similar income-producing activities similar to wholesalers of distilled spirits. But beer and wine wholesalers are not eligible for this tax credit.

Given its relatively small size, the credit is unlikely to have much effect on price differentials between domestically produced distilled spirits and imported bottled distilled spirits. The credit is also unlikely to produce much tax savings for small wholesalers. Most of the tax benefits from this credit likely accrue to large-volume wholesalers of distilled spirits.

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Commerce and Housing

**EXPENSING OF COSTS TO REMOVE ARCHITECTURAL
AND TRANSPORTATION BARRIERS TO THE
HANDICAPPED AND ELDERLY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 190.

Description

Generally, an improvement to a depreciable asset such as a building or motor vehicle is treated for tax purposes as a capital expense. In most cases, taxpayers recover the amount spent on these improvements through depreciation. Depreciation allows a taxpayer to deduct part of the cost of a capital expense each year.

Under section 190, however, a business taxpayer may deduct in a single tax year (or expense) up to \$15,000 of the expenses incurred for *removing existing physical barriers* to handicapped or elderly individuals in qualified facilities or public transportation vehicles. (None of the costs associated with constructing a *new* facility or vehicle, or undertaking a *complete renovation* of an existing facility to make it more accessible to those individuals, qualifies

for the deduction.) Qualified expenses in excess of \$15,000 must be capitalized. In other words, excess expenses above \$15,000 can be depreciated according to the appropriate schedule. Also, in the case of partnerships, the \$15,000 limit applies separately to a partnership and its individual partners.

A qualified facility is broadly defined to include any or all portions of a building, structure, equipment, road, walkway, parking lot, or similar real or personal property. A vehicle qualifies for the \$15,000 expensing allowance if it offers transportation services to the public; it may be a bus, train, or other mode of public transportation. For example, the modification of a vehicle used to transport a business taxpayer's customers to make it more accessible to or usable by the elderly and handicapped could qualify for the expensing allowance. In addition, the taxpayer claiming this deduction must own or lease the qualified facility or public transportation vehicle.

To qualify for the expensing allowance, barrier removal projects have to meet design standards approved by the Architectural and Transportation Barriers Compliance Board. These standards apply to projects involving buses, rail cars, grading, walkways, parking lots, ramps, entrances, doors and doorways, stairs, floors, toilet facilities, water fountains, public telephones, elevators, light switches and similar electrical controls, the identification of rooms and offices, warning signals, and the removal of hanging lights, signs, and similar fixtures.

Besides the expensing allowance, eligible small firms may claim a non-refundable disabled access tax credit under Section 44 for expenses they incur to make their facilities more accessible to disabled individuals. The credit applies to a wider range of expenses than the expensing allowance: all amounts paid for the cost of enabling the taxpayer to comply with applicable requirements under the Americans with Disabilities Act of 1990 (ADA, P.L. 101-336) can be used to compute the credit. A firm claiming the credit may also use the Section 190 expensing allowance, but the expenses eligible for the allowance must be reduced by the amount of the credit. (See the entry on "Tax Credit for Disabled Access Expenditures.")

Impact

Expensing allows a taxpayer to fully deduct a business expense in the first year of investment, in comparison to depreciation whereby the taxpayer deducts the expense over many years according to a depreciation schedule. Expensing will generally provide additional tax savings (in comparison to

depreciation) to taxpayers, since the full cost of the property (or improvements to the property) is recovered in the first year, rather than in future years when the value of any associated tax savings will fall. This latter concept—that money today is worth more the sooner it is received—is known as the “time value of money.”

Under temporary provisions enacted in the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act), equipment investments are expensed in general through 2022 (with expensing then phased out), so the benefit currently accrues to real property improvements. Nonresidential buildings are depreciated in equal amounts over 39 years and residential buildings over 27.5 years. Thus a \$10,000 improvement to a nonresidential building will result in a deduction of \$256 per year for the next 39 years, rather than the \$10,000 deduction under expensing. When expensing phases out, the benefit is smaller for equipment because it is typically depreciated over short periods and smaller investments are still eligible for expensing.

Rationale

The expensing allowance under Section 190 originated with the Tax Reform Act of 1976 (P.L. 94-455). The act set the maximum allowance at \$25,000 for a single tax year and specified that it would expire at the end of 1979. P.L. 96-167 extended the allowance through 1982, without modifying it. Congress permitted the allowance to expire at the end of 1982. The Deficit Reduction Act of 1984 (P.L. 98-369) reinstated the allowance from January 1, 1984, through December 31, 1985, and raised the maximum deduction to \$35,000. The Tax Reform Act of 1986 (P.L. 99-514) permanently extended the allowance for tax years after 1985. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) lowered the maximum allowance to its present amount of \$15,000.

Assessment

By establishing the expensing allowance under Section 190, Congress was using the tax code to promote certain social and economic goals. In this case, the likely goal was to engage the private sector in expanding employment opportunities and improving access to goods and services for the elderly and disabled. Supporters of the provision have long contended that without it, firms would be less likely to remove physical barriers to the elderly and disabled from their facilities and transport systems.

The effectiveness of the provision as an incentive is limited because the Americans with Disabilities Act (P.L. 101-336, enacted in 1990) requires accessibility for new buildings and reasonable retrofitting for older ones.

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Commerce and Housing

EXCLUSION OF GAIN FROM CERTAIN SMALL BUSINESS STOCK

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.6	—	1.6
2021	1.8	—	1.8
2022	1.9	—	1.9
2023	1.5	—	1.5
2024	1.1	—	1.1

Authorization

Sections 1202 and 1045.

Description

Under the federal income tax, a capital gain occurs when a taxpayer sells an asset (e.g., stock, bond, home, or work of art) for more than his or her adjusted basis in the asset. Generally, an asset's basis is the amount someone pays to own it. Capital gains (or losses) can be short-term or long-term. A short-term capital gain happens when a taxpayer sells for a gain an asset that he or she held for no longer than one year. Short-term gains are taxed as ordinary income. By contrast, long-term gains on the sale of capital assets generally are taxed at rates below ordinary income tax rates.

In 2022, long-term capital gains are taxed at three rates: 0 percent, 15 percent, and 20 percent. Income brackets for these rates vary by filing status. For single filers (joint filers) in 2022, the rate is 0 percent for adjusted gross incomes (AGIs) up to \$41,675 (\$83,350); 15 percent for AGIs between

\$41,676 (\$83,351) and \$459,750 (\$517,200); and 20 percent for AGIs above \$459,750 (\$517,200).

Internal Revenue Code (IRC) Section 1202 allows an exception to this general rule for non-corporate taxpayers (including pass-through entities like partnerships and subchapter S corporations) to exclude from their gross income 100 percent of any gain from the sale or exchange of qualified small business stock (QSBS) acquired after September 27, 2010. For QSBS acquired between August 11, 1993, and February 17, 2009, 50 percent of any gain was excludable. The gain exclusion rose to 75 percent for QSBS acquired between February 18, 2009, and September 27, 2010. The taxable portion of a QSBS capital gain realized between August 11, 1993, and September 27, 2010, was taxed at a maximum rate of 28 percent, the top long-term capital gains rate when the IRC Section 1202 exclusion was enacted in 1993.

Several conditions must be met before an eligible taxpayer can benefit from the QSBS gain exclusion. First, the taxpayer must acquire the stock at its original issue (in exchange for money, property, or as compensation for services performed for the issuing firm) and hold on to the stock for a minimum of five years. Purchases of stock issued by eligible firms through an initial public offering generally qualify for the exclusion. Second, the stock must be issued by a C corporation with no more than \$50 million in gross assets up to the date the stock is issued. Third, the issuing corporation must use at least 80 percent of its assets in a qualified trade or business during “substantially all” of the minimum five-year holding period for the exclusion. A business qualifies if it is a specialized small business investment company (SSBICs) licensed under the Small Business Investment Act of 1958, or if it is primarily engaged in any activity except health care, law, engineering, architecture, food service, lodging, farming, insurance, finance, or mining. Fourth, the QSBS must be issued after August 10, 1993.

A taxpayer’s total gains exclusion for a single corporation is limited to the greater of ten times the taxpayer’s basis in the QSBS or \$10 million.

Taxpayers have the option of rolling over a capital gain from the sale of QSBS they have held more than six months under IRC Section 1045. To exercise this option, a taxpayer must use the proceeds from a QSBS sale to purchase a different company’s QSBS within 60 days of the date of the sale. A capital gain is recognized only to the extent that the proceeds exceed the cost of the replacement stock. Any unrecognized gain from the sale lowers the taxpayer’s basis in the new QSBS.

For QSBS acquired on and after September 28, 2010, the excluded amount is not considered a preference item for the individual alternative minimum tax (AMT), which meant that none of the exclusion was added to a taxpayer's AMT taxable income. This was not always the case. IRC Section 57(a)(7) required that seven percent of an excluded gain from a QSBS sale was added to a taxpayer's AMT taxable income for QSBS acquired between May 6, 2003, and September 27, 2010.

Impact

The QSBS gains exclusion seems largely intended to increase the flow of equity capital to new or young small firms and SSBICs in a range of industries. These firms may have difficulty raising capital from more traditional sources such as banks, angel investors, or private equity firms. The exclusion encourages a greater flow of equity capital by increasing the risk-adjusted, after-tax rate of return a taxpayer could earn by buying, holding for five years, and then selling QSBS, relative to alternative investments.

The exclusion constitutes a tax expenditure because the provision taxes capital gains for sales or exchanges of QSBS acquired after September 27, 2010, at a rate of 0 percent.

Most of the benefits from the exclusion are captured by high-income individuals (including pass-through business owners) who have relatively high risk tolerances.

Rationale

The exclusion for capital gains on the sale or exchange of QSBS originated with the Omnibus Budget Reconciliation Act of 1993 (OBRA93, P.L. 103-66) as a 50-percent exclusion. This meant that starting in 1998, when QSBS acquired in 1993 could first be sold, 50 percent of the gain on QSBS sales or exchanges was not taxed, and the other 50 percent was taxed at long-term capital gains rates, whose top rate was 20 percent at the time. OBRA93 specified that half of the excluded gain was to be treated as an AMT preference item.

Under the Taxpayer Relief Act of 1997 (TRA, P.L. 105-34), individuals holding QSBS for more than six months gained the option of deferring the recognition of any gain from the sale or exchange of the stock by reinvesting (or rolling over) the proceeds in another QSBS within 60 days of the transaction. The act also reduced the portion of the excluded gain treated as an

AMT preference item from 50 percent to 42 percent for stock sold or exchanged between May 8, 1997, and December 31, 2000.

The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) extended the rollover option to pass-through entities such as partnerships and S corporations. It also reduced the portion of the excluded gain regarded as an AMT preference item from 42 percent to 28 percent for QSBS sold or exchanged after December 31, 2000.

Under the Community Renewal Tax Relief Act of 2000 (P.L. 106-554), 60 percent of the gain from the sale or exchange of QSBS issued after December 31, 2000, by qualified C corporations with a substantial economic presence in an empowerment zone (EZ) could be excluded from a taxpayer's gross income.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) further lowered the share of the excluded gain considered an AMT preference item to seven percent for QSBS sold or exchanged between May 7 and December 31, 2010. Beginning in 2011, the share returned to 42 percent.

To encourage increased equity investment in new small firms, the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) raised the gains exclusion to 75 percent for QSBS purchased after February 17, 2009, and before January 1, 2011. This increase applied to QSBS issued by qualified EZ corporations, as well.

Congress raised the exclusion to 100 percent for QSBS acquired after September 27, 2010, and before January 1, 2011, in the Small Business Jobs Act of 2010 (P.L. 111-240). The Tax Relief, Employment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the 100-percent exclusion through 2011. The American Taxpayer Relief Act of 2012 (P.L. 112-240) further extended it to QSBS acquired in 2012 and 2013.

In the Protecting Americans from Tax Hikes Act of 2015 (PATH Act, P.L. 114-113), Congress made the 100-percent gains exclusion permanent for all QSBS acquired after September 27, 2010. The act also extended the 60-percent gain exclusion for QSBS issued by EZ businesses through December 31, 2018, and permanently ended the gain exclusion's designation as an AMT preference item.

Assessment

Section 1202 encourages the formation and growth of small C corporations in certain businesses by subsidizing equity investment in such companies. Angel investors and venture capital funds organized as partnerships are among the taxpayers likely to benefit the most from the exclusion.

The exclusion raises a number of policy questions. Two of them concern the economic rationale for the exclusion and its effectiveness.

Proponents of Section 1202 argue that it is needed to address financing gaps that interfere with the formation and growth of young small firms seeking to develop and sell innovative technologies. In their view, these gaps result from the failure of investors, banks, and other financiers to adequately grasp the risk of financing new business ventures pursuing untested but potentially profitable new products and services. Proponents argue that established firms generally are likely to have less difficulty accessing financial capital for new technology investments.

Such a disparity, say proponents, constitutes a market failure based on information asymmetries. The asymmetries reflect systemic differences between entrepreneurs and possible financiers in their expectations of commercial success for new products and processes.

Small start-up firms developing new technologies are especially vulnerable to such a capital market imperfection. Their growth potential may be difficult to evaluate for several reasons. First, the potential rests largely on new intangible assets. Second, new businesses typically lack tangible assets to use as collateral for loans to finance their early years. Third, any innovative technologies small start-up firms develop may be untested in markets and prone to relatively rapid rates of obsolescence. Thus, say proponents of Section 1202, the QSBS gains exclusion is a needed option for overcoming capital-market imperfections that deny sufficient early-stage funding for many small start-up firms.

Not everyone agrees that the Section 1202 gains exclusion is an appropriate remedy for such a capital market imperfection. Some argue there is no evidence that too few small start-up firms are being formed, that too many of these firms fail to grow into successful enterprises, or that financial markets systematically prevent the growth of many small start-up firms. As a result, say these critics, a policy initiative like the exclusion might do more

harm than good. They are concerned that the exclusion does more to distort the domestic allocation of financial capital than it does to facilitate the creation and growth of innovative small start-up firms. More specifically, critics contend that the exclusion might be steering equity capital toward politically favored businesses and away from those with a greater potential for growth. Others argue that there appears to be no evidence to support this concern.

While a case can be made on economic grounds for a tax subsidy such as the Section 1202 gains exclusion, it is more difficult to build a case for the subsidy on the basis of its efficacy. There are no apparent indications that the provision has greatly increased the flow of equity capital to eligible small firms. In the 24 or so years since QSBS owners were first able to take advantage of the exclusion (August 12, 1998), little research has been done on Section 1202's impact on the cash flow, capital structure, employment, and investment of companies issuing the stock.

Still, policymakers could evaluate what can be done to enhance the value of the gains exclusion as a means of injecting equity capital into risky small start-up companies. Critics maintain that the gains exclusion entails considerable paperwork for issuers and investors in QSBS, and that the asset size limit for C corporations fosters economically inefficient outcomes by excluding certain businesses from the benefits of the QSBS gains exclusion.

The reduction in the top corporate income tax rate from 35 percent to 21 percent in 2018 seems to have stirred more interest among investors in QSBS. Some note that private equity firms in particular may be able to realize significant tax savings by acquiring such an asset, holding it for five years to qualify for the 100-percent gains exclusion, and benefiting from the 21 percent tax rate on corporate profits during the holding period. But a lack of data on investment in QSBS makes it difficult to assess the impact of the 2017 tax law on purchases and sales of QSBS and financing outcomes for issuing C corporations.

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Commerce and Housing

**DISTRIBUTIONS IN REDEMPTION OF STOCK TO PAY
VARIOUS TAXES IMPOSED AT DEATH**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	—	0.1
2021	0.1	—	0.1
2022	0.1	—	0.1
2023	0.1	—	0.1
2024	0.1	—	0.1

Authorization

Section 303.

Description

When a shareholder in a closely held business dies, a partial redemption of stock (selling stock back to the corporation) is treated as a sale or exchange of an asset eligible for long-term capital gain treatment. With step-up in basis there will be no gain or loss on the redemption—this treatment essentially means that no federal income tax will be due on the redemption. At least 35 percent of the decedent’s estate must consist of the stock of the corporation. The benefits of this provision are limited in amount to estate taxes and expenses (funeral and administrative) incurred by the estate.

Impact

Most of the benefits of this provision accrue to estates with small business interests that are subject to estate and inheritance taxes. For 2020, the estate tax exemption was \$12.06 million.

Rationale

This provision was added to the tax code by the Revenue Act of 1950 (P.L. 81–814). The primary motivation behind it was congressional concern that estate taxes would force some estates to liquidate their holdings in a family business. There was further concern that outsiders could join the business, and the proceeds from any stock sales used to pay taxes would be taxable income under the income tax.

Assessment

The idea of the provision is to keep a family business in the family after the death of a shareholder. There are no special provisions in the tax code, however, for favorable tax treatment of other needy redemptions, such as to pay for medical expenses. To take advantage of this provision, the decedent's estate does not need to show that the estate lacks sufficient liquid assets to pay taxes and expenses. Furthermore, the proceeds of the redemption do not have to be used to pay taxes or expenses.

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Commerce and Housing

**INVENTORY METHODS AND VALUATION: LIFO, LCM,
AND SPECIFIC IDENTIFICATION**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.0	0.7	1.7
2021	1.0	0.8	1.8
2022	1.1	0.8	1.9
2023	1.1	0.8	1.9
2024	1.1	0.8	1.9

Authorization

Sections 475, 491, and 492.

Description

A taxpayer who sells goods must generally maintain inventory records to determine the cost of goods sold. Individuals can account for inventory on an item-by-item basis, but may also use conventions, which include FIFO (first-in, first-out, assuming the most recent good sold is the earliest one purchased) and LIFO (last-in, first-out, assuming the most recent good sold is the last one purchased). LIFO can only be used if it is also used for financial reporting, although it is not available to securities dealers. In connection with FIFO, a taxpayer may choose the LCM method, or lower of cost or market. This method allows the taxpayer a tax deduction for losses on goods whose value has fallen below cost while in inventory.

The provisions included in the tax expenditure are the allowance of LIFO, which accounts for over 90 percent of the revenue cost for 2019-2023, the LCM method, which accounts for the remainder, and the specific

identification method for homogeneous commodities, which has a negligible effect.

The tax expenditure is based on the notion that basic FIFO is the appropriate method of accounting for costs (unless heterogeneous goods are specifically identified). This view is consistent with the expectation that firms would sell their oldest items first. It is also based on the notion that costs should be allowed only when goods are sold. LIFO allows the appreciation in value to be excluded from income when prices are rising. LCM allows recognition of losses when inventory declines in value (but there is no recognition of gain for rise in value). Allowing specific identification of homogeneous goods permits firms to select higher-cost items and minimize taxable income.

Impact

The LIFO, LCM and specific identification methods of inventory accounting allow taxpayers to reduce the tax burden on the difference between the sales price and cost of inventories. Thus, it encourages taxpayers to carry more inventories than would otherwise be the case, although the magnitude of this effect is unclear. Use of LIFO for accounting purposes also results in a valuation of the existing stock of inventory that is smaller than market value, while use of FIFO leads to a valuation more consistent with market value. Use of FIFO also increases reported profits.

According to Plesko (2006), the use of LIFO increased in the 1970s (a period of high inflation) and peaked in the early 1980s when 70 percent of large firms used LIFO for some part of their inventory. That figure declined to 40 percent by 2004. Use of FIFO also increases reported profits. LIFO was most heavily used by the chemicals, furniture, general merchandisers, and metal industries. Most firms are small, however, and most firms use FIFO. Neubig and Dauchy (2007) found that over 90 percent of the increased corporate sector tax from the repeal of LIFO and LCM would come from manufacturing and over half would fall on petroleum and coal products. (These projections depend, however, on forecasts of prices.) Knittel (2009) found that 10 percent of firms used LIFO to value some portion of their inventories in 2006 and LIFO inventories accounted for 31 percent of inventories. The method was most prevalent in the petroleum industry and in motor vehicle, food and beverage, and general merchandise retailers. Kostolansky and Polnaszek (2013) found that only 6.5 percent of publicly traded firms used LIFO and that LIFO was associated with larger firms.

Harrison et al. (2017) indicate that one third of LIFO inventories are in energy companies (oil and gas). Tinkelman (2017) reports that use of LIFO is predominantly in large companies, has been declining in usage, and that LIFO reserves, especially among oil companies, have declined. He explains this decline may be traced to several factors, including a decline in inflation, lower tax rates, and economizing on inventory levels. The recent reduction in the corporation tax rate from 35 percent to 21 percent as enacted in the 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act, may further reduce use of LIFO. Tinkelman and Tan (2018) estimate a significantly smaller share of inventories (14%) covered currently by LIFO when considering all businesses.

LIFO allows tax-planning opportunities to firms that do not exist with FIFO. For example, for firms expecting a high tax liability, purchasing inventory at year end under LIFO can increase costs and reduce taxable income, while firms expecting losses can reduce taxable income by shrinking inventory.

Since the 1980s, management has stressed keeping smaller inventories to hold down costs. The COVID-19 pandemic and resulting supply chain disruptions showed the value of inventories in meeting supply. In addition, disruptions in supply causing the drawdown of inventories can increase profits under LIFO, since these sales involve lower costs (Sullivan 2022). This issue has been particularly important in the case of automobile dealers. At the same time, the recent increase in inflation, if it persists, makes LIFO more attractive as an inventory method.

Rationale

As early as 1918, the Treasury Department regulations allowed FIFO and LCM, which were used in financial accounts. LCM was considered a conservative accounting practice which reflected the loss in value of inventories. LIFO, however, was not allowed. The Revenue Act of 1938 (P.L. 75-554) allowed LIFO for a small number of narrowly defined industries, and the scope was liberalized by the Revenue Act of 1939 (P.L. 76-1). The reason for adopting it was to allow a standard accounting practice. A financial conformity requirement was imposed. Since this period was not one with rising prices, the effects on revenue were minimal. Treasury regulations restricted the application to industries where commodities could be measured in specific units (e.g., barrels), and thus use was limited. In 1942, a dollar value method that could be applied to pools of inventory was introduced for limited

cases, and a court case (Hutzler Brothers, 8th Tax Court 14) in 1947, and 1949 Treasury regulations (T.D. 5756, 1949-2 C.B. 21), extended it to all taxpayers.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) simplified LIFO by allowing a simplified dollar value method that could be applied to all inventory by small businesses and allowed the use of external indexes. The reason was to make the method that most effectively mitigates the effects of inflation more accessible to all businesses.

Assessment

The principal argument currently made for LIFO is that it more closely conforms to true economic income by deferring, and for firms that operate indefinitely, effectively excluding, income that arises from inflation. There are two criticisms of this argument. The first is that the method also allows the deferral and exclusion of real gains. For example, when oil prices increased during the first half of 2008, firms using LIFO that had gains from oil in inventory would not recognize these gains. The second is that other parts of the tax code are not indexed. In particular, firms are allowed to deduct the inflation portion of the interest rate. As a result, debt financed investments in LIFO inventory are subject to a negative effective tax rate. Another criticism of LIFO is that it facilitates tax planning to minimize tax liability over time.

It is more difficult to find an argument for using LCM for tax purposes (although it may be desirable for financial purposes). For small firms, using the same inventory system for financial purposes as for tax purposes may simplify tax compliance.

The International Financial Reporting Standards (IFRS) accounting method that is used by most other countries and is being considered for adoption in the United States does not permit LIFO accounting; if this system is adopted, and no other changes are made, LIFO would not be available because of the financial conformity requirement. The LIFO issue may, however, present a barrier to adoption. On July 22, 2015, the Financial Accounting Standards Board (FASB), in a move to simplify inventory accounting, ultimately exempted LIFO from guidance. The guidance made some changes in the calculation of LCM, restricting the measurement of market value to net realizable value (excluding consideration of market replacement cost and net realizable value less a profit margin).

There is little discussion about the specific identification for homogeneous products, but the revenue associated with that effect is small.

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Commerce and Housing

**EXCLUSION OF GAIN OR LOSS ON SALE OR EXCHANGE
OF BROWNFIELD PROPERTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	(¹)	(¹)
2021	—	(¹)	(¹)
2022	—	(¹)	(¹)
2023	—	(¹)	(¹)
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 512, 514.

Description

Tax-exempt organizations are subject to tax under the unrelated business income tax (UBIT) for activities that are not part of their tax-exempt purpose. Gains on the sale of property are generally not taxed, unless the property is inventory or stock in trade. Gains from the sale of assets that were debt-financed in part are, however, subject to the UBIT in proportion to the debt. Qualifying brownfield property that is acquired from an unrelated party, subject to remediation, and sold to another unrelated party, is exempt from this tax.

The exclusion for brownfield property applies to property certified as a brownfield site. Documentation is also required to illustrate the presence of a hazardous substance, pollutant, or contaminant on the property that is complicating the property's use and development.

This provision applies to gain or loss on property acquired after December 31, 2004, and before January 1, 2010. Property acquired during this period does not need to be disposed of by the termination date (December 31, 2009) to qualify for the exclusion.

Impact

The exclusion from the UBIT reduces the cost of remediating and reselling brownfields by tax-exempt organizations using debt finance. Most tax-exempt organizations are taxed as corporations for the purposes of the UBIT, and thus the saving would typically be 21 percent of the gain in value. When the gain in value is large relative to the acquisition cost, the cost is reduced by 21 percent due to the tax exclusion. Thus, this provision reduces the cost of remediating environmentally damaged property.

Rationale

This provision was initially added by the American Jobs Creation Act of 2004 (P.L. 108-357). In 2003, when Senator Baucus, ranking member of the Senate Finance Committee, introduced this provision as a separate bill, he indicated that the UBIT had unintentionally interfered with the use of a tax-exempt entity's ability to invest and redevelop environmentally contaminated real estate because of the possibility of becoming subject to the UBIT.

Assessment

The purpose of the UBIT is to prevent tax-exempt entities from competing unfairly with taxable firms. Since taxable firms were previously allowed to expense their investment in brownfield remediation, their effective tax rate could be lowered substantially, particularly in the case where the remediation costs were large relative to the acquisition cost of the property. Thus, to some extent, restoring tax-exempt status for gains from debt-financed purchases may have led to a more equitable treatment. Both the provision allowing taxable firms to expense their investment in brownfield remediation (IRC Section 198), and the exclusion of gain or loss on the sale of brownfield areas, have now expired.

The effectiveness of this subsidy has been questioned by those who view the main disincentive to development of brownfield sites as the potential liability under current environmental regulation, not the accounting cost. Barring such regulatory disincentives, the market system ordinarily creates its own incentives to develop depressed areas, as part of the normal economic

cycle of growth, decay, and redevelopment. However, if the benefits of cleanup are not captured by those bearing the cost of cleanup, there may be an economic justification for government intervention to encourage cleanup efforts that would otherwise be underprovided by the market.

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Commerce and Housing

**INCOME RECOGNITION RULE FOR GAIN OR LOSS FROM
SECTION 1256 CONTRACTS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.1	(¹)	1.1
2021	1.1	(¹)	1.1
2022	1.2	(¹)	1.2
2023	1.2	0.1	1.3
2024	1.3	0.1	1.4

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 1256.

Description

A Section 1256 contract is any regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or dealer securities futures contract that is traded on a qualified board of exchange with a mark-to-market accounting system. Under this mark-to-market rule, the gains and losses must be reported on an annual basis for tax purposes. Section 1256 does not apply to certain derivatives contracts (e.g., credit default swaps).

The capital gain or loss of applicable contracts is treated as consisting of 40 percent short-term and 60 percent long-term gain or loss. This is true regardless of how long the contract is held. This favorable tax treatment generates a tax expenditure. The 60-40 rule does not apply to hedging transactions or limited partnerships. A hedging transaction is a transaction conducted by a business in its normal operation with the primary purpose of reducing certain risks.

Impact

The application of mark-to-market accounting to Section 1256 contracts eliminates deferral that would result under traditional realization principles and taxes accrued gain, which may mean paying income tax on income that was not received. The 60-40 rule, however, simplifies tax calculations and removes the one-year holding period requirement for long-term capital gains tax treatment.

Rationale

The Economic Recovery Tax Act of 1981 (P.L. 97-34) established that all regulated futures contracts must be valued on an annual basis using a mark-to-market method. Using mark-to-market overcomes the tax sheltering impact of certain commodity futures trading strategies and harmonizes the tax treatment of commodities futures contracts with the realities of the marketplace.

The Deficit Reduction Act of 1984 (P.L. 98-369) and the Tax Reform Act of 1986 (P.L. 99-514) extended the mark-to-market rule to non-equity listed options and dealers' equity options, and increased the information required for banks to qualify for the exemption for hedging. Rules were provided to prevent limited partners (or entrepreneurs) of an options dealer from recognizing gain or loss from equity options as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. These changes have been motivated by Congress's desire for consistent tax treatment for economically similar contracts—or horizontal equity concerns, at least when pricing was readily available.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) clarified that Section 1256 does not apply to certain derivatives contracts (e.g., credit default swaps).

Assessment

The taxation of accrued gains moves the tax system toward taxing economic income (i.e., the Haig-Simons definition of income—consumption plus additions to wealth). It eliminates the benefits of taxing realized gains—taxes cannot be deferred until the taxpayer decides to realize the gains by selling the asset. But, by taxing 60 percent of the accrued gains at the lower long-term capital gains rate, assets held for less than one year receive favorable tax treatment, which often results in lower taxes for traders.

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Commerce and Housing

ADVANCED MANUFACTURING INVESTMENT CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-167 and is estimated to cost \$24.3 billion over FY2022 – FY2031.

Authorization

Sections 48D, 6417, 6418.

Description

Starting in 2023, taxpayers may be able to claim a 25 percent tax credit for investments in qualified advanced manufacturing facilities. For the purposes of this credit, advanced manufacturing facilities are those where the primary purpose of the facility is manufacturing semiconductors or semiconductor manufacturing equipment.

The tax credit can be claimed for qualifying property that is placed in service after December 31, 2022, and for which construction begins before January 1, 2027. For property placed in service after December 31, 2022, for which construction began before January 1, 2023, the credit can only be claimed for property that was constructed, reconstructed, or erected after August 2, 2022.

Qualified property includes property that is depreciable or amortizable and is integral to the operation of an advanced manufacturing facility. Qualified property may include buildings and their structural components, but credits cannot be claimed for a building or portion of a building used for offices, administrative services, or other functions unrelated to manufacturing.

The tax credit cannot be claimed by any entity identified as a foreign entity of concern. Foreign entities of concern include entities designated as foreign terrorist by the Secretary of State; those included on the list of specially designated national and blocked persons maintained by the Treasury Department's Office of Foreign Assets Control; entities owned or controlled by, or subject to the jurisdiction or direction of the government of North Korea, China, Russia, or Iran; taxpayers convicted of espionage or under laws governing unregistered agents of foreign governments; or determined by the Secretary of State, in consultation with the Secretary of Defense and the Director of National Intelligence, to be engaged in unauthorized conduct that is detrimental to U.S. national security or foreign policy.

Similar to other investment tax credits, the credit can be recaptured during a five-year recapture period if the property for which the credit was claimed ceases to be qualifying property. Additionally, the advanced manufacturing investment credit can be recaptured if taxpayers claiming the credit subsequently, for a 10-year period, have any significant transaction expanding semiconductor manufacturing in China or another foreign country of concern. This restriction does not apply to expansions of manufacturing capacity for legacy semiconductors. Legacy semiconductors include a semiconductor technology that is of the 28 nanometer or older generation for logic; with respect to memory, analog, packaging and other relevant technologies, a legacy generation of semiconductor technology relative to the 28 nanometer or older generations for logic; and other technology the Secretary of State identifies in a public notice. Legacy semiconductors do not include any that are determined by the Secretary of State, in consultation with the Secretary of Defense and the Director of National Intelligence, as critical to national security.

Taxpayers can elect to treat the advanced manufacturing investment tax credit as a payment of tax, allowing the credit to be received as a refundable tax credit or direct pay.

Impact

Tax credits awarded to businesses tend to benefit the upper end of the income distribution. It is expected that this credit will be claimed by large manufacturers. Additional investment in domestic semiconductor manufacturing could contribute to economic and national security policy objectives. Tax incentives for semiconductor manufacturing might be viewed as being part of a broader industrial policy supporting a critical or strategic industry.

Rationale

The advanced manufacturing investment credit was enacted in the CHIPS Act of 2022 (Division A of P.L. 117-167), which included various policies (i.e., tax, loan, and grant programs) to support investment in domestic semiconductor manufacturing.

Assessment

Federal financial support to the domestic semiconductor industry may be provided in pursuit of economic or national security policy objectives. In recent decades, many semiconductor manufacturers have chosen to locate manufacturing activities abroad in regions with lower production and labor costs. Supply chains and concerns regarding ongoing and potential future disruptions are a factor motivating the development of domestic semiconductor manufacturing capacity.

Tax credits reduce the cost of qualifying activities, relative to other types of investment. Generally, subsidies that reallocate capital are economically inefficient, as such policies direct capital away from what would otherwise be its most productive use. If, however, the tax subsidy supports economic activities that generate positive external benefits, such as research and development (R&D), or prevents supply chain disruptions, then the tax subsidy might lead to more efficient resource allocation. Investment in R&D and the associated technological development supports long-term economic growth. One option would be to support investment in research activities across industries, or for a broad group of high-tech industries.

Higher effective tax rates for buildings and structures, due to longer cost-recovery periods, might discourage investment in certain types of manufacturing capacity. If manufacturing facilities face higher effective tax rates than other economic sectors, policies that promote neutral tax treatment

across industries could, over time, result in more investment flowing to manufacturing facilities. Neutrality could be pursued by accelerating cost recovery for buildings and structures, equalizing effective tax rates across industries. Alternatively, cost recovery for other economic sectors could be set to better match economic depreciation (a change which would increase the effective tax rates on investments in those sectors).

One way to look at the efficacy of an ITC is to consider how much additional investment occurs because of the tax credit, relative to investment that would have taken place with or without the credit. Companies may choose to invest in domestic semiconductor manufacturing capacity in response to opportunities provided by market conditions or other government initiatives. If projects that claim the tax benefit would likely have gone forward absent the tax incentive, then the amount of induced investment relative to the foregone federal tax revenue may be limited.

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Commerce and Housing

DEFERRAL OF CERTAIN ADVANCE PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	0.4	0.8
2021	1.3	0.4	1.7
2022	1.4	0.4	1.8
2023	1.4	0.4	1.8
2024	1.4	0.4	1.8

Authorization

Section 451(c).

Description

Most taxpayers account for income using an accrual method where income and deductions are recognized when the transaction is made rather than the cash method, where income and deductions are recognized when payments are made and received. For tax purposes, accrual basis taxpayers include amounts received in income when that income is fixed under an all events test: when income is earned, when payment is made, or when payment is due, whichever comes first. However, income is also included even if it does not meet these tests if it is reflected on the taxpayer's financial statement.

A special provision allows taxpayers to defer the recognition of advance payments (payments received before the goods or services are provided) if the taxpayer's financial accounting statement defers recognition but only for one year. Advance payments eligible for this treatment include payments for goods and services, although it excludes certain items such as rent and insurance payments. In addition to goods and services that are prepaid, examples include items such as subscriptions and gift cards

Impact

The provision allows taxpayers to defer taxes for a year, which is beneficial because of the time value of money (the interest that can be earned on tax savings). Revenue estimates indicate that it is used more extensively by unincorporated businesses.

Rationale

The provision allowing taxpayers to defer recognition of advance payments was originally allowed by administrative guidance, including Revenue Procedure 2004-34. The 2017 tax revision, commonly known as the Tax Cuts and Jobs Act (P.L. 115-97), codified this treatment.

Assessment

While this provision benefits taxpayers by delaying taxation, it also conforms the recognition of income more closely to financial accounting and is consistent with matching income and costs.

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Transportation

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR HIGHWAY PROJECTS AND RAIL-TRUCK TRANSFER
FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	(¹)	0.1
2021	0.1	(¹)	0.1
2022	0.1	(¹)	0.1
2023	0.1	(¹)	0.1
2024	0.1	(¹)	0.1

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 103, 141, 142(m), and 146.

Description

The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU; P.L. 109-59), enacted on August 10, 2005, created a new class of tax-exempt, qualified private-activity bonds for the financing of qualified highway or surface freight transfer facilities. Qualified facilities include: (1) any surface transportation project which receives federal assistance under U.S.C. Title 23; (2) any project for an international bridge or tunnel for which an international entity authorized under federal or state law is responsible and which receives federal assistance under U.S.C. Title 23; and (3) any facility for the transfer of freight from truck to rail or rail to truck

(including any temporary storage facilities directly related to such transfers) which receives federal assistance under U.S.C. Title 23 or Title 49.

The bonds used to finance these facilities are classified as private-activity bonds rather than governmental bonds because a substantial portion of the benefits generated by the project(s) accrue to individuals or businesses rather than to the government. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Bonds issued for qualified highway or surface freight transfer facilities are not subject to the federally imposed annual state volume cap on private-activity bonds. The bonds are capped, however, by a national limitation to be allocated at the discretion of the Secretary of Transportation. The national limitation was increased from \$15 billion to \$30 billion in 2021 through the Infrastructure Investment and Jobs Act (P.L. 117-58).

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low-interest rates allow issuers to construct highway or surface freight transfer facilities at lower cost. Some of the benefits of the tax exemption and federal subsidy also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the highway or surface freight transfer facilities, and estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Before 1968, state and local governments were allowed to act as conduits for the issuance of tax-exempt bonds to finance privately owned and operated facilities. The Revenue and Expenditure Control Act of 1968 (RECA, P.L. 90-364), however, imposed tests that restricted the issuance of these bonds. The act provided a specific exception which allowed issuance for specific projects such as nongovernment-owned docks and wharves. Intermodal facilities are similar in function to docks and wharves, yet were not included in the original list of qualified facilities. The addition of truck-to-rail and rail-to-truck intermodal projects to the list of qualified private activities in 2005 (P.L. 109-59) is intended to enhance the efficiency of the nation’s long-distance freight transport infrastructure. With more efficient intermodal facilities, proponents

suggest that long-distance truck traffic will shift from government financed interstate highways to privately-owned long-distance rail transport.

Assessment

Generally, there are two reasons cited for federal subsidy of these facilities. First, state and local governments tend to view these projects as potential economic development tools. The value of the projects in encouraging new economic development depends on the economic conditions in each location. Second, the federal subsidy may correct a potential market failure, leading to additional investment in qualifying transportation facilities where markets would tend to underinvest. However, there may be cases where public (or even private) investment would have occurred even without the federal subsidy, which reduces the target efficiency of the subsidy.

The value of allowing these bonds to be eligible for tax-exempt status hinges on whether only the users of such facilities should pay the full cost, or whether sufficient social benefits exist to justify federal taxpayer subsidy. Economic theory suggests that to the extent these facilities provide social benefits that extend beyond the boundaries of the state or local government, then federal support is merited. The facilities might be underprovided because state and local taxpayers may be unwilling to finance benefits for nonresidents.

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

According to the Federal Highway Administration, as of July 2022, \$15.20 billion of bonds have been issued under this provision for 38 projects. Thus, just over half (51 percent) of the bond allowance has been subscribed with the recent increase in the national limitation to \$30 billion.

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Transportation

PROVIDE A 50-PERCENT TAX CREDIT FOR CERTAIN EXPENDITURES FOR MAINTAINING RAILROAD TRACKS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.2	0.2
2021	—	0.2	0.2
2022	—	0.2	0.2
2023	—	0.1	0.1
2024	—	—	—

Note: These estimates do not reflect the costs of the legislation in the Consolidated Appropriations Act of 2021. Those revisions resulted in an additional revenue loss of \$0.1 billion in FY2023 and \$0.2 billion in FY 2024.

Authorization

Section 45G.

Description

Qualified railroad track maintenance expenditures paid or incurred in a taxable year by eligible taxpayers are eligible for a 50 percent business tax credit. The credit rate is reduced to 40% after 2022. The credit is limited to \$3,500 times the number of miles of railroad track owned or leased by an eligible taxpayer. Railroad track maintenance expenditures are amounts, which may be either repairs or capitalized costs, spent to maintain railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad. Eligible taxpayers are smaller (Class II or Class III) railroads and any person who

transports property using these rail facilities or furnishes property or services to such a person.

The taxpayer's basis in railroad track is reduced by the amount of the credit allowed (so that any deduction of cost or depreciation is only on the cost net of the credit). The credit cannot be carried back to years before 2005. The credit can be taken against the individual alternative minimum tax.

The amount eligible is the gross expenditures not taking into account reductions such as discounts or loan forgiveness.

Impact

This provision substantially lowers the cost of track maintenance up to the per mile limit for the qualifying short-line (regional) railroads, with tax credits covering half the costs for those firms and individuals with sufficient tax liability. According to the Association of American Railroads, these railroads account for approximately 30 percent of the nation's rail miles. These regional railroads are particularly significant in providing transportation of agricultural products.

Rationale

This provision was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357), effective through 2007. While no official rationale was provided in the bill, sponsors of earlier free-standing legislation and industry advocates indicated that the purpose was to encourage the rehabilitation, rather than the abandonment, of short-line railroads, which were spun off in the deregulation of railroads in the early 1980s. Advocates also indicated that this service is threatened by heavier 286,000-pound cars that must travel on these lines because of inter-connectivity. They also suggested that preserving these local lines will reduce local truck traffic. There is also some indication that a tax credit was thought to be more likely to be approved by Congress than grants.

The provision relating to discounts was added by the Tax Relief and Health Care Act (P.L. 109-432), enacted December 2006. The provision was extended through 2009, and the credit was allowed against the alternative minimum tax by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), enacted in October 2008. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the credit through 2011, the American Taxpayer Relief Act (P.L. 112-240)

extended it through 2013, and the Tax Increase Prevention Act (P.L. 113-295) extended it through 2014. The Consolidated Appropriations Act, 2016 (P.L. 114-113) extended the provision through 2016. The Bipartisan Budget Act of 2018 (P.L. 115-123) extended the provision through 2017. The Tax Certainty and Disaster Relief Act of 2019, Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), retroactively extended the provision through 2022. The Consolidated Appropriations Act, 2021 (P.L. 116-260) made the credit permanent and reduced the rate to 40% after 2022.

Assessment

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

In general, special subsidies to industries and activities tend to lead to inefficient investment allocation since, in a competitive economy, businesses should earn enough to maintain their capital. Nevertheless, it may be desirable to subsidize rural or low-density railroads to support a more complete railroad network. It may also be desirable to subsidize rail transportation in order to reduce the congestion and pollution of highway traffic. At the same time, a tax credit may be less suited to remedy these problems than a direct grant since firms without sufficient tax liability cannot use the credit.

The dollar cap on per mile expenditures would also limit the marginal incentive for additional expenditures although it would provide cash flow effects. A revenue estimate prepared for a similar credit for the state of California indicated that 80% of the credit would go to taxpayers with enough tax liability to use the credit, and of that amount 70% of the credit would be claimed in the year generated with the remainder carried over for the next five years. These data suggest that most credits would go to firms that reach the dollar cap.

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Transportation

**DEFERRAL OF TAX ON CAPITAL CONSTRUCTION
FUNDS OF SHIPPING COMPANIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.1	0.1
2021	—	0.1	0.1
2022	—	0.1	0.1
2023	—	0.1	0.1
2024	—	0.1	0.1

Authorization

Section 7518.

Description

U.S. operators of vessels in foreign, Great Lakes, or noncontiguous domestic trade, or in U.S. fisheries, may establish a capital construction fund (CCF) into which they may make certain deposits. CCF accounts are jointly administered by the Internal Revenue Service (IRS) covering tax matters, and on the program side by the National Oceanic and Atmospheric Administration (NOAA) Fisheries for fishery-related uses and the U.S. Department of Transportation Maritime Administration for commercial vessel-related uses. Such deposits are deductible from taxable income, and income tax on the earnings of the deposits in the CCF is deferred.

When tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct, acquire, lease, or pay off the indebtedness on a qualifying vessel. A qualifying vessel must be constructed or reconstructed in the United States, and any lease period must be at least five years.

The tax basis of the vessel, with respect to which the operator's depreciation deductions are computed, is reduced by the amount of such withdrawal. Thus, over the life of the vessel, tax depreciation will be reduced, and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation of the replacement vessel may be deposited into the CCF, the tax deferral may be extended.

CCF withdrawals for non-qualified purposes are taxed at the top marginal income tax rate. This rule prevents firms from withdrawing funds in loss years and escaping tax entirely.

Monies may remain in a fund without being withdrawn for qualified purposes for up to 25 years. Deposits not withdrawn after a 25-year period are treated as non-qualified withdrawals, in which the owner is treated as having withdrawn 20 percent of the remaining deposits annually over five years.

Impact

According to the U.S. Department of Transportation Maritime Administration, there were 113 CCF fund holders as of April 19, 2021. This was a decrease from 120 on June 16, 2019.

The allowance of tax deductions for deposits can, if funds are continually rolled over, amount to a complete forgiveness of tax. When funds are eventually withdrawn and taxed, there is a deferral of tax that leads to a low effective tax rate. This provision makes investment in U.S.-constructed ships and registry under the U.S. flag more attractive than it would be otherwise. Despite these benefits, however, there is little U.S. participation in the worldwide large commercial vessels shipbuilding market.

For commercial vessels, the incentive for domestic construction may be less than it would be otherwise, because firms engaged in international shipping have the benefits of deferral of tax through other provisions of the tax law, regardless of where the ship is constructed. Therefore, this provision may be more attractive to operators of fishing vessels, which tend to be smaller and are more likely to be constructed in the United States.

Rationale

The special tax treatment originated in 1936 to ensure an adequate supply of shipping in the event of war. Although tax subsidies of various types have

been in existence since 1936, the coverage of the subsidies was expanded substantially by the Merchant Marine Act of 1970 (P.L. 91-469).

Before the Tax Reform Act of 1976 (P.L. 94-455) it was unclear whether any investment tax credit was available for eligible vessels financed in whole or in part out of funds withdrawn from a CCF. The 1976 Act specifically provided (as part of the Internal Revenue Code) that a minimum investment credit equal to 50 percent of an amount withdrawn to purchase, construct, or reconstruct qualified vessels was available in 1976 and subsequent years.

The Tax Reform Act of 1986 (P.L. 99-514) incorporated the deferral provisions directly into the Internal Revenue Code. It also extended benefits to leasing, provided for the 25-year limit for withdrawals for qualified purposes, and required payment of the tax at the top rate.

Assessment

One argument in support of this provision is the national defense argument—that it is important to maintain a shipping and shipbuilding capability in time of war. This justification may be in doubt today, since U.S. firms control many vessels registered under a foreign flag and many U.S. allies control a substantial shipping fleet and have substantial ship-building capability that might be available to the United States.

There is also an argument that subsidizing domestic ship-building and flagging offsets some other subsidies—both shipbuilding subsidies that are granted by other countries, and the deferral provisions of the U.S. tax code that encourage foreign flagging of U.S.-owned vessels.

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Transportation

**TREATMENT OF EMPLOYER-PAID TRANSPORTATION
BENEFITS (PARKING, VAN POOLS, AND TRANSIT PASSES,
BLACK CAR SERVICES)**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.0	-2.7	2.3
2021	4.9	-2.6	2.3
2022	5.0	-2.7	2.3
2023	5.2	-2.8	2.4
2024	5.4	-2.9	2.5

Authorization

Section 132(f).

Description

Some employer-sponsored transportation benefits are tax exempt within certain limits. Qualified transportation benefits may include transit passes, vanpool transportation, and parking. The value of transit passes or parking costs provided directly by the employer can be excluded from employees' income, subject to a monthly limit. The value of employer-provided parking facilities can be excluded from employee's income, subject to a monthly limit. Transportation provided by employers (as opposed to transportation benefits paid for by employers) is also subject to qualified tax exclusion. A limit applies to the total of vanpool costs, transit passes, and parking. Tax legislation (P.L. 115-97) enacted in 2017 disallows the employer deduction for costs of providing qualified transportation fringe benefits to employees, except as necessary for ensuring the safety of an employee. That legislation also

suspended the exclusion of bicycle commuting benefits for tax years starting after December 31, 2017, and before January 1, 2026.

In 2022, the limit for the parking benefit is set at \$280 per month. Initially, the parking benefit limit was set at \$175 per month in 1998 and was adjusted for inflation in later years. Bicycle commuters had been able to receive up to \$20 per month, an amount not subject to inflation adjustment, before that exclusion was suspended.

An employee taking the parking tax benefit can also receive a vanpool or transit benefit. Thus, an employee could receive up to \$280 in qualified transportation benefits and \$280 in parking benefits, for a total of up to \$560 per month. Employees can use pretax dollars, if their employer allows, to pay for transit passes, vanpool fares and parking. De minimis transportation benefits for an employee are excluded so long as they remain under \$21 per month.

Employers may provide benefits as a credit on a transit pass or “smartcard” used on some transit systems. Employers may provide these benefits in cash, subject to a compensation reduction arrangement, only if the benefits cannot be provided readily through a transit pass or a voucher. These measures were imposed in part to prevent employees from reselling transportation vouchers for cash. Employer payments of cash or cash-equivalents, such as debit cards, are generally treated as taxable income to employees.

Impact

Exclusion from taxation of transportation fringe benefits provides a subsidy to employees of those businesses and industries in which such fringe benefits are common and feasible. The subsidy benefits employees by effectively raising their after-tax compensation. This exemption arguably induces employees to use mass transportation, which reduces traffic congestion and lowers commuting costs to all urban workers. About 8 percent of the civilian workforce receives subsidized commuting benefits.

Higher-income individuals are more likely to benefit from the parking exclusion than the mass transit and vanpool subsidies as the propensity to drive to work is correlated with income. The effective value of the transit benefits rises with the marginal tax rate of a recipient. The value of the benefit also depends on the location of the employer: the provision is targeted towards

taxpayers working in the highly urbanized areas or other places where transit is available or parking space is limited.

Rationale

An exclusion for the value of parking was enacted in 1984 (P.L. 98-369), along with exclusions for several other fringe benefits. Some employers had provided one or more of these fringe benefits for many years, and employers, employees, and the Internal Revenue Service had not considered those benefits to be taxable income.

Many employers used fringe benefits during World War II to attract workers because wage and price controls limited their ability to compete for labor. A generation later, Congress sought to limit the use of tax-free fringe benefits such as employer-provided transportation benefits. After the U.S. Treasury proposed and then withdrew regulations regarding the tax treatment of certain fringe benefits, Congress in 1978 (P.L. 95-600) imposed a moratorium on such regulations, which was extended in 1981. In the Deficit Reduction Act of 1984 (P.L. 98-369), Congress introduced new rules governing the tax treatment of fringe benefits. At that time, Congress expressed concern that without clear boundaries on the use of these fringe benefits, new approaches could emerge that would further erode the tax base and increase inequities among employees in different businesses and industries.

The Comprehensive Energy Policy Act of 1992 (P.L. 102-486) placed a dollar ceiling on the exclusion of parking facilities and introduced the exclusions for mass transit facilities and van pools in order to encourage mass commuting, which would in turn reduce traffic congestion and pollution. In 1998, the Transportation Equity Act for the 21st Century (P.L. 105-178) raised the benefit limits and modified their phase-in periods and inflation adjustment rules. Employees at that time could also choose to receive cash instead of transit benefits.

The Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343) added a bicycle commuting reimbursement. Until that exclusion was suspended at the end of 2017, an employee who regularly biked to work could receive a tax-free \$20 per month reimbursement from the employer to cover documented costs of a bicycle, repair, maintenance, or storage.

For 2022, the transportation benefit limit is \$280 per month for vanpool transportation and transit passes. The limit had been set at \$100 per month for

2001 and had been adjusted each year for inflation, with the adjustment being rounded to the nearest \$5. Starting in March 2009, however, following passage of the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5), the limit was raised to \$230 per month, to match the level of the parking benefit limit from March 2009 until January 1, 2011. That limit was extended through the end of 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) extended the parity between transit and parking benefits until January 1, 2014. That limit was again extended by the Tax Increase Prevention Act of 2014 (P.L. 113-295) for an additional year. The Consolidated Appropriations Act, 2016 (P.L. 114-113) made technical changes that also resulted in a transportation benefit limit at the same level as the parking benefit limit.

Employer costs of providing qualified transportation fringe benefits in general had been deductible as a cost of business until changes enacted in 2017 (P.L. 115-97) limited the deduction to costs needed to ensure employee safety. The 2017 act also required nonprofit organizations to include the value of transportation and parking benefits to employees in their unrelated business income tax calculations (26 U.S.C. §512(a)(7)). The Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), repealed this provision for nonprofits. In December 2018, the IRS provided guidelines for the calculation of the value of parking benefits that are nondeductible.

Assessment

The exclusion subsidizes employment in those businesses and industries located where transportation fringe benefits are feasible and commonly used. Businesses and workers located where mass transportation alternatives are lacking gain little benefit from this provision. Workers in more highly paid occupations and employed at larger firms are more likely to benefit from commuting benefits. Among workers in the top 10 percent of occupations ranked by average wages, 18 percent received commuting benefits, while three percent in the lowest decile did. Fourteen percent of workers in firms with more than 500 employees received commuting benefits, while in firms with fewer than 50 employees, six percent did.

Subsidies for mass transit and vanpools encourage use of mass transportation and may reduce congestion and pollution. Some studies have found that transportation benefit programs can spur non-users of public

transportation to become occasional users, and occasional users to become more regular users. Motivating commuters in highly urbanized areas to use mass transportation can reduce commuting costs generally. All commuters in an area may enjoy spillover benefits from reduced traffic congestion such as lower transportation costs, shorter waiting times in traffic, and improved air quality.

Subsidies or favorable tax treatment of parking may encourage more employees to drive to work, which may increase traffic congestion and air pollution. One study found that when employees in California firms were allowed to opt for a cash benefit instead of employer-provided parking benefits, the proportion of employees driving to work fell significantly. Another study found that employer provision of free parking increased driving, while benefits related to mass transit or cycling decreased driving. Subsidized employee parking may also make finding parking spaces harder, which can affect quality of life in residential neighborhoods near work areas and the flow of customers for retail businesses.

Determining fair market values for fringe benefits such as free or reduced-price parking may be difficult in some places. Commercial parking lots are common in most highly urbanized areas, however, so that calculating the comparable value of parking benefits in those areas is straightforward in principle. IRS guidelines issued in 2018 sought to clarify those calculations. In 2020, the IRS issued regulations to conform tax treatment transportation fringe benefits with tax legislation enacted in 2017.

Fringe benefits are part of the compensation package that employees receive and that employers provide to compete in labor markets. If some fringe benefits, such as transportation benefits, are not considered taxable income, then both employers and firms may wish to reduce taxable wages and salaries in order to increase untaxed fringe benefits. The tax exclusion of such fringe benefits may motivate employees and employers to design compensation packages that increase consumption of goods and services linked to tax-favored fringe benefits relative to goods and services bought with taxable ordinary income. Removing the deductibility of transportation fringe benefits may induce some employers to redesign benefits packages.

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Transportation

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR PRIVATE AIRPORTS, DOCKS, AND MASS-
COMMUTING FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.6	0.1	0.7
2021	0.6	0.1	0.7
2022	0.6	0.1	0.7
2023	0.6	0.1	0.7
2024	0.6	0.1	0.7

Authorization

Sections 103, 141, 142, and 146.

Description

Interest income on state and local bonds used to finance the construction of publicly accessible airports, docks, wharves, and mass-commuting facilities, such as bus depots and subway stations, is tax exempt. These airport, dock, and wharf bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Because private-activity *mass-commuting facility* bonds are subject to the private-activity bond annual volume cap, they must compete for cap

allocations with bond proposals for all other private activities subject to the volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003. Bonds issued for *airports, docks, and wharves* are not, however, subject to the annual federally imposed state volume cap on private-activity bonds. The cap is forgone because government ownership requirements restrict the ability of the state or local government to transfer the benefits of the tax exemption to a private operator of the facilities.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low-interest rates enable issuers to provide the services of airport, dock, and wharf facilities at lower cost. Some of the benefits of the tax exemption also flow to bondholders. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the airport, dock, and wharf facilities, and estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

Before 1968, state and local governments were allowed to issue tax-exempt bonds to finance privately owned airports, docks, and wharves without restriction. The Revenue and Expenditure Control Act of 1968 (RECA, P.L. 90-364) imposed tests that restricted the issuance of bonds for private purposes. However, the Act also provided a specific exception which allowed unrestricted issuance for airports, docks, and wharves.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) extended the tax exemption to mass-commuting vehicles (bus, subway car, rail car, or similar equipment) that private owners leased to government-owned mass transit systems. This provision allowed both the vehicle owner and the government transit system to benefit from the tax advantages of tax-exempt interest and accelerated depreciation allowances. This vehicle exemption expired on December 31, 1984.

The Deficit Reduction Act of 1984 (P.L. 98-369) allowed bonds for private airports, docks, wharves, and mass-commuting facilities to be tax-exempt, but required the bonds to be subject to the volume cap that applies to

several private activities. The volume cap, however, did not apply if the facilities were governmentally owned.

The Tax Reform Act of 1986 (TRA86, P.L. 99-514) restricted issuance further, allowing tax exemption only if the facilities were government owned, but excluded the bonds for airports, wharves, and docks from the private-activity bond volume cap. This act also denied tax exemption for bonds used to finance related facilities such as hotels, retail facilities in excess of the size necessary to serve passengers and employees, and office facilities for nongovernment employees.

Assessment

State and local governments tend to view airports, docks, wharves, and mass-commuting facilities as economic development tools. The desirability of allowing these bonds to be eligible for tax-exempt status hinges on one's view of whether the users of such facilities should pay the full cost, or whether sufficient social benefits exist to justify federal taxpayer subsidy. Economic theory suggests that to the extent these facilities provide social benefits that extend beyond the boundaries of the state or local government, the facilities might be underprovided due to the reluctance of state and local taxpayers to finance benefits for nonresidents.

Even if a case can be made for a federal subsidy due to underinvestment at the state and local level, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, those issued for airports, docks, wharves, and mass commuting facilities increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to attract investors. In addition, expanding the availability of tax-exempt bonds increases the assets available to individuals and corporations to shelter their income from taxation.

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Community and Regional Development

EMPOWERMENT ZONE TAX INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.1	0.3
2021	0.1	0.1	0.2
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: The Consolidated Appropriations Act, 2021 (P.L. 116-260) modified and extended this provision at the cost of \$1.4 billion over 10 years.

Authorization

Sections 38(b), 39(d), 280C(a), 1391-1397D.

Description

Tax incentives are offered to residents and businesses located within Empowerment Zones (EZ). There are currently authorized 40 EZs (30 urban and 10 rural) through the end of 2025.

Communities designated as EZs are eligible for two tax incentives to encourage economic development. One tax incentive is a 20 percent employer wage credit for the first \$15,000 of wages for zone residents who work in the zone. The second is expanded tax-exempt financing for certain zone facilities, primarily qualified zone businesses. In addition, for activity prior to the end of

2022 there were empowerment zone benefits allowing additional expensing for qualified zone property and deferral of gain on certain empowerment zone property.

Impact

Both businesses and employees within the designated areas may benefit from these provisions. Wage credits given to employers can increase the wages of individuals if not constrained by the minimum wage, and these individuals tend to be lower-income individuals. If the minimum wage is binding (so that the wage does not change), the effects may show up in increased employment and/or in increased profits to businesses.

Benefits for capital investments may be largely received by business owners initially, although the eventual effects may spread to other parts of the economy. Eligible businesses are likely to be smaller businesses because they must operate within the designated area.

Rationale

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) authorized the creation of nine EZs, subsequently expanded to 11 by executive order 13005 (May 21, 1996), and the Taxpayer Relief Act of 1997 (P.L. 105-34) authorized the creation of an additional 20 EZs. These designations were originally set to expire after 10 years.

EZ designations have subsequently been extended through the end of 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); the end of 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); the end of 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); the end of 2016 by the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113); the end of 2017 by the Bipartisan Budget Act of 2018 (P.L. 115-123); and the end of 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). The Consolidated Appropriations Act, 2021 (P.L. 116-260) extended the designations through the end of 2025 and terminated the empowerment zone benefits related to deferral of capital gains and section 179 expensing.

Assessment

The geographically targeted tax provisions may encourage increased employment and income of individuals living and working in the zones and increased incentives to businesses operating in the zones.

A number of studies have evaluated the effectiveness of the geographically targeted programs. Government-sponsored studies by the Government Accountability Office (GAO) and the Department of Housing and Urban Development (HUD) have not linked EZ and similar Enterprise Community (EC) designations with improvement in community outcomes. These studies examined the Round I EZs and ECs, which received significant grant funding for community organizations. If designation is an important catalyst for economic development, then these studies may represent an upper bound for the effectiveness of the programs.

In addition, economic literature has evaluated the effectiveness of empowerment zone incentives. Overall, these studies have found modest, if any, effects and may call into question the cost-effectiveness of these programs.

If the main target of these provisions is an improvement in the economic status of individuals currently living in these geographic areas, it is not clear to what extent these tax subsidies will succeed in that objective. None of the subsidies are given directly to workers; rather they are received by businesses. Capital subsidies may not ultimately benefit workers; it is possible that they may encourage more capital-intensive businesses and make workers worse off. Wage subsidies are more likely than capital subsidies to be effective in benefitting low-income zone or community residents.

Another reservation about the economic development zone approach is that it may make surrounding communities, which may also be poor, worse off by attracting businesses away from them. Questions have also been raised, more generally, about the efficiency of provisions that target all beneficiaries in a low-income area rather than specifically the low-income residents.

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Community and Regional Development

CREDIT FOR INDIAN RESERVATION EMPLOYMENT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.6	—	1.6
2021	1.8	—	1.8
2022	1.9	—	1.9
2023	1.5	—	1.5
2024	1.1	—	1.1

(1) Positive tax expenditure of less than \$50 million.

Authorization

Sections 38(b), 39(d), 45A, and 280C(a).

Description

Businesses on Indian reservations are eligible for a credit for 20 percent of the cost of the first \$20,000 of wages and health benefits paid by the employer to tribal members and their spouses earning \$30,000 or less, in excess of eligible qualified wages and health insurance cost payments made in 1993. Employers can't claim the Work Opportunity Tax Credit for the same employee.

Impact

Wage credits given to employers can increase the wages of individuals, who tend to be lower-income individuals, if not constrained by the minimum wage. If the minimum wage is binding (so that the wage does not change) the

effects may show up in increased employment and/or in increased profits to businesses.

Rationale

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) created this provision, along with one that allows accelerated depreciation for businesses on Indian reservations (discussed in a separate chapter), to encourage businesses to invest in Indian reservations and to hire certain individuals who live on or near an Indian reservation. The two provisions were originally set to expire at the end of 2003.

The provisions were subsequently extended through the end of 2004 by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147); through the end of 2005 by the Working Families Tax Relief Act of 2004 (P.L. 108-311); through the end of 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432); through the end of 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343); through the end of 2011 by the Tax Relief, Employment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); through the end of 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through the end of 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through the end of 2016 by the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113); through the end of 2017 by the Bipartisan Budget Act of 2018 (P.L. 115-123); through the end of 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94); and through the end of 2021 by the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Assessment

These subsidies may encourage increased employment and income of tribal members, although the effect on wages may be constrained by the minimum wage.

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Community and Regional Development

**ACCELERATED DEPRECIATION FOR BUSINESS
PROPERTY ON AN INDIAN RESERVATION**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(²)	(²)	(²)
2024	(²)	(²)	(²)

(¹) Positive tax expenditure of less than \$50 million.

(²) Negative tax expenditure of less than \$50 million.

Authorization

Section 168(j).

Description

Businesses on Indian reservations were eligible for accelerated depreciation which allows shorter lives for equipment and nonresidential structures through the end of 2021. Because equipment is generally allowed to be expensed on a temporary basis (through 2025), the shorter lives for equipment were not generally beneficial. The main benefit was a shorter depreciation period of 22 years for nonresidential structures, which are depreciated over 39 years under the general rules.

Impact

Benefits for capital investments may be largely received by businesses initially, although the eventual effects may spread to other parts of the economy. Businesses affected tend to be small because of the geographic limitation.

Rationale

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) created this provision, along with a wage credit (discussed in a separate chapter), to encourage businesses to invest on Indian reservations and to hire certain individuals who live on or near an Indian reservation. The two provisions were originally set to expire at the end of 2003.

The provisions were subsequently extended through the end of 2004 by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147); through the end of 2005 by the Working Families Tax Relief Act of 2004 (P.L. 108-311); through the end of 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432); through the end of 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343); through the end of 2011 by the Tax Relief, Employment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); through the end of 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through the end of 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through the end of 2016 by the Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113); through the end of 2017 by the Bipartisan Budget Act of 2018 (P.L. 115-123); through the end of 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94); and through the end of 2021 by the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Assessment

These subsidies may encourage investment in structures, which may have effects on other investment and employment.

Selected Bibliography

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Community and Regional Development

NEW MARKETS TAX CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	1.2	1.2
2021	(¹)	1.1	1.1
2022	(¹)	1.1	1.1
2023	(¹)	1.1	1.1
2024	(¹)	1.0	1.0

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 45D.

Description

The New Markets Tax Credit (NMTC) is designed to stimulate investment in low- and moderate-income rural and urban communities nationwide. NMTCs are allocated by the Community Development Financial Institutions (CDFI) Fund, a bureau within the United States Department of the Treasury, under a competitive application process. Investors who make qualified equity investments reduce their federal income tax liability by claiming a credit equal to 39 percent of their investment, over a seven-year period. The NMTC program, enacted in 2000, is currently authorized to allocate \$91 billion in credits through the end of 2025.

Impact

The NMTC is an investment credit. Thus investors, who are likely in higher-income brackets, are the direct beneficiaries. Nevertheless, the tax incentives may encourage investment spending in economically distressed communities. The additional investment could indirectly benefit the workers and residents of these communities. A more direct means of providing assistance to individuals in distressed communities would be direct aid to individuals.

Rationale

The NMTC was enacted by the Community Renewal Tax Relief Act of 2000 (P.L. 106-554). The NMTC is designed to provide tax relief to investors in economically distressed communities through providing a more certain rate of return with fixed credit rates. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) targeted an additional \$1 billion in NMTCs towards investment in areas affected by Hurricane Katrina. The Tax Relief and Health Care Act of 2006 (P.L. 109-432) extended the NMTC through 2008, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended the NMTC through 2009, both with \$3.5 billion in allocation authority, and the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) increased the allocation authority in both 2008 and 2009 to \$5.0 billion. The NMTC was further extended through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240); through 2014 by the Tax Increase Prevention Act of 2014 (P.L. 113-295); through 2019 by the Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114-113); through 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94); and through 2025 by the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Assessment

Evaluations of the NMTC program's effectiveness are difficult. The CDFI Fund, which operates the NMTC program, reports that as of September 2022, New Markets Tax Credit allocatees had raised nearly \$63.4 billion in private equity to invest in low-income communities. The potential new investment must be assessed against the fact that the potential target area includes approximately 35 percent of the U.S. population and 40 percent of the land area. In addition, the fixed credit rate, 5 percent for the first three years

and 6 percent for the four final years, may not be enough to compensate investors for the underlying risk of the principal investment.

The most comprehensive evaluation of the NMTC, to date, was conducted by the Urban Institute under contract from the CDFI Fund. While the Evaluations Final Report found project-level activity consistent with the NMTC achieving program goals, it was unable to generalize its findings to the broader universe of NMTC activity or census tract-level outcomes due to evaluation design limitations. The report noted it was an initial effort to a more robust research plan that has not yet been implemented.

The NMTC is primarily intended to encourage private capital investment in eligible low-income communities. However, the source of the investment funds has implications for the effectiveness of the program in achieving its objective. From an economic perspective, the impact of the NMTC would be greatest in the case where the investment represents new investment in the U.S. economy that would not have occurred in the absence of the program. Gurley-Calvez et al. (2009) empirically assessed whether NMTC investment is funded through shifted investment or whether it represents new investment, finding mixed results. Freeman (2012) found small effects on poverty and unemployment in areas that received NMTC investment. Abravanel et al. (2013) estimated that early NMTC investments generated one job per \$53,162 of investment (on average).

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Community and Regional Development

QUALIFIED OPPORTUNITY ZONES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	1.2	1.6
2021	0.4	1.1	1.5
2022	0.4	1.2	1.6
2023	0.4	1.3	1.7
2024	0.4	1.3	1.7

Authorization

Sections 1400Z-1, 1400Z-2.

Description

Three tax incentives are associated with qualified Opportunity Zones. First, tax due on capital gains may be temporarily deferred if the gains are reinvested in a qualified opportunity fund (QOF) within 180 days after the sale or disposition of the related asset. Second, if the investment in the QOF is held for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the asset or investment is held for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. Third, QOF investments held for at least 10 years and until at least December 31, 2026, are to be eligible for permanent exclusion of capital gains tax on any gains from the qualified portion of their investment earned within the Opportunity Zone when the QOF investment is sold or disposed. For more information on the tax treatment of capital gains, see “Reduced Rates of Tax on Dividends and Long-Term Capital Gains.”

A QOF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property that holds at least 90 percent of its assets in qualified opportunity zone property or another QOF. Qualified opportunity zone property includes any qualified opportunity zone stock, qualified opportunity zone partnership interest, and qualified opportunity zone business property. QOFs may self-identify on their income tax returns, and do not require federal certification in advance of claiming Opportunity Zone-related tax benefits.

Certain low-income community population census tracts were eligible to be designated as qualified opportunity zones by the chief executive officer of each state (i.e., the governor) and the District of Columbia. The economic criteria and caps on the number of potentially eligible low-income census tracts that could have been designated by the chief executive officer are defined in statute. State nominations for Opportunity Zone designation were due by March 21, 2018. The official list of all census tracts designated and certified as Opportunity Zones was published in IRS Notice 2018-48, Internal Revenue Bulletin 2018-28 (July 9, 2018).

Opportunity Zone tax incentives are in effect from December 22, 2017, through December 31, 2026. There is no gain or deferral available with respect to any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified Opportunity Zones made after December 31, 2026.

Impact

Opportunity Zone tax incentives are designed to be broad incentives to retain investment in or shift investment toward specific geographic areas. Thus, investors, who are likely in higher-income and long-term capital gains tax brackets, are the direct beneficiaries. The benefits accrued from investments in QOFs are staggered over time, which could encourage long-term, “patient” capital for development projects in areas that could be classified as higher risk by lenders and financiers.

The tax incentives may encourage investment spending in economically distressed communities. The additional investment could indirectly benefit the workers and residents of these communities. A more direct means of providing assistance to individuals in distressed communities would be direct aid to individuals.

Rationale

Opportunity Zone tax incentives were first enacted by the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act). Under current law, the tax incentives are in effect from December 22, 2017, through December 31, 2026.

Assessment

The Internal Revenue Code occasionally has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing federal tax benefits to businesses and investment located within designated boundaries.

A number of studies have evaluated the effectiveness of geographically targeted programs. Overall, these studies have found modest, if any, effects and call into question the cost-effectiveness of these programs. For example, see the bibliographies under “Empowerment Zone Tax Incentives” and “New Markets Tax Credit.”

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Community and Regional Development

NATIONAL DISASTER RELIEF

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: The JCT score does not break out the full cost of this provision. Estimates for this provision are contained in other provisions.

Authorization

Sections 24, 32, 38, 42, 72, 123, 139, 165, 170, and 1033.

Description

A number of tax provisions provide relief to taxpayers following natural disasters. Several of the provisions are permanent, while other temporary disaster tax relief provisions have been made available in response to certain disaster events or for specified periods. The tax expenditure associated with disaster tax relief is generally included in the tax expenditure estimate for the underlying provision. Cases where these provisions are discussed elsewhere in this compendium are noted below.

Disaster relief provisions that are currently permanent in the Internal Revenue Code (IRC) include:

- A casualty loss itemized deduction for personal (non-business) losses attributable to federally declared disasters. Each casualty is subject to a \$100 floor, meaning that only losses in excess of \$100 are deductible for each casualty. Additionally, the casualty losses are deductible only to the extent that aggregate losses exceed 10% of the taxpayer's adjusted gross income (AGI). Only casualty losses not compensated for by insurance or otherwise can be deducted. See the entry *Deduction for Casualty and Theft Losses* elsewhere in this compendium.
- The replacement period for an involuntary conversion stemming from a federally declared disaster of a taxpayer's principal residence and its contents is four years, as opposed to two or three years for other types of property. Additional special rules also apply. First, gain realized from the receipt of insurance proceeds for unscheduled personal property (property in the home that is not listed as being covered under the insurance policy) is not recognized. Second, any other insurance proceeds received for the residence or its contents are treated as a common fund. If the fund is used to purchase property that is similar or related in service or use to the converted residence or its contents, then the owner may elect to recognize gain only to the extent that the common fund exceeds the cost of the replacement property. If a taxpayer's business property is involuntarily converted as a result of a federally declared disaster, then the taxpayer is not required to replace it with property that is similar or related in service to the original property in order to avoid having to recognize gain on the conversion, as long as the replacement property is still held for a type of business purpose.
- Taxpayers can exclude from income qualified disaster relief and disaster mitigation payments. See the entry *Exclusion of Disaster Mitigation Payments* elsewhere in this compendium.
- Owners of low-income housing tax credit (LIHTC) properties are eligible for relief from certain requirements of the program if the property is located in a major disaster area. Specifically, property owners are provided relief from credit recapture, carryover allocation rules, and income certifications for displaced households temporarily housed in an LIHTC unit. Property owners may also qualify for additional credits for rehabilitation expenditures, and, for severely damaged buildings in the first year of the credit period, the allocation

of credits may either be treated as having been returned, or the first year of the credit period can be extended. State LIHTC allocating agencies are eligible for relief from compliance monitoring under the same IRS guidance. Additionally, households are eligible to occupy an LIHTC unit without being subject to the program's income limits if their principal residence was located in a major disaster area. See the entry *Credit for Low-Income Housing* elsewhere in this compendium.

- Taxpayers whose principal residence is damaged in a disaster (including a fire, storm, or other casualty) can exclude from income insurance reimbursements for living expenses while temporarily occupying another residence. This exclusion also applies to taxpayers who are denied access to their home by government authorities due to the threat of casualty or disaster.

Since 2001, temporary and event-specific disaster tax policy has been enacted following many, but not all, major disaster events. The Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Division Q of the Further Consolidated Appropriations Act, 2020; P.L. 116-94) provided relief for major disasters that generally occurred in 2018 or 2019. Relief provided in this legislation included (1) an enhanced casualty loss deduction (see the entry *Deduction for Casualty and Theft Losses*); (2) expanded access to retirement plan funds; (3) increased limits on charitable deductions; (4) employee retention tax credits; and (5) earned income tax credit (EITC) and child tax credit (CTC) credit computation look-back rules (see the entry *Credit for Children and Other Dependents*). Certain areas of California that were affected by natural disasters in 2017 and 2018 received additional LIHTC allocations in 2020.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021; P.L. 116-260) provided relief for major disasters that generally occurred in 2020. Relief provided in P.L. 116-260 included the establishment of special rules for certain retirement fund use for eligible individuals affected by a qualified disaster and the establishment of an employee retention credit for employers affected by a qualified disaster.

Impact

Generally, these tax benefits will reduce the tax burden on individuals and businesses in areas affected by disasters. For individuals, casualty loss deductions special rules for disaster-related involuntary conversions can reduce tax burdens for those suffering disaster-related property losses. Certain disaster provisions, such as the EITC and CTC credit computation look-back rules, tend to benefit taxpayers in the lower part of the income distribution. The benefit of the exclusion for disaster mitigation payments depends on the taxpayer's marginal tax rate, and thus provides a larger benefit to taxpayers in higher tax brackets. The expanded access to retirement plan funds and the increased limits on the charitable deduction tend to benefit taxpayers in the upper part of the income distribution, as those taxpayers are more likely to have retirement savings or to make large charitable contributions.

Employee retention tax credits reduce the cost of retaining employees when a disaster renders a business inoperable. In response to past disasters, expensing and bonus depreciation provisions have provided additional tax relief. However, since 2018, expanded expensing and 100 percent bonus depreciation have reduced the scope for providing this type of relief following disaster events.

Rationale

Disaster relief provisions increase revenue loss to the government at a time when investment in disaster stricken regions and relief for affected individuals is desired. The rationale for such aid is that the short- and long-term benefits of this investment and individual support outweighs the short-term revenue loss, which may have long-term implications on economic recovery and growth.

Several provisions were enacted following recent disasters to facilitate the economic recovery of the affected regions, including the "Liberty Zone" in lower Manhattan; the Gulf Opportunity (GO) Zone throughout the area affected by Hurricanes Katrina, Rita, and Wilma; the Midwestern disaster area, which included Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin; and the area affected by Hurricane Ike. The provisions for the Midwestern disaster area were applicable to the floods, severe storms, and tornadoes declared from May 20, 2008, through August 1, 2008.

The Liberty Zone was created by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) after the September 11, 2001 terrorist attacks. Congress designated a portion of lower Manhattan in New York as the Liberty Zone. The tax incentives included increased private-purpose tax-exempt bond capacity for New York (Liberty Bonds and special one-time advance refunding) and a special depreciation allowance for certain real property. In 2004, P.L. 108-311 extended the Liberty Bond program through January 1, 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) further extended the incentives through 2011.

Following Hurricane Katrina, the Katrina Emergency Tax Relief Act of 2005 (KETRA; P.L. 109-73) provided tax relief to individuals and businesses affected by the disaster. This was followed by the Gulf Opportunity Zone Act of 2005 (GOZA; P.L. 109-135), which established the Gulf Opportunity Zone to provide relief to those affected by Hurricanes Rita and Wilma and assist in economic recovery. KETRA and GOZA included provisions allowing individuals to deduct housing- and insurance-related recovery expenditures from gross income and offered tax credits to employers to encourage them to resume operations and retain employees. KETRA and GOZA also included other business-related provisions allowing for bonus depreciation, expensing of certain property, and a 5-year carryback of net operating losses. Other provisions increased the rehabilitation credit for historic property and expanded the number of tax-exempt bonds.

Subsequent legislation has contained temporary disaster tax relief. The Food, Conservation, and Energy Act of 2008 (2008 Farm Bill; P.L. 110-234) provided tax relief intended to assist those affected by severe storms and tornadoes in Kansas in 2007. The Heartland Disaster Tax Relief Act of 2008 and other provisions in P.L. 110-343 responded to severe Midwest storms in summer 2008 and Hurricane Ike, and provided general disaster relief for events occurring between December 31, 2007, and January 1, 2010.

Natural disaster relief from Hurricanes Harvey, Irma, and Maria was included in the Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63). The 2017 tax revision (P.L. 115-97) contained limited disaster relief for 2016 and 2017 disasters. The Bipartisan Budget Act of 2018 (P.L. 115-123) provided disaster tax benefits to areas affected by the 2017 California wildfires. The Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Division Q of the Further Consolidated Appropriations Act, 2020; P.L. 116-94) provided relief for major disasters that generally occurred in 2018 or

2019. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021; P.L. 116-260) provided relief for major disasters that generally occurred in 2020.

Assessment

Tax policy for disaster relief may be motivated by multiple objectives. One objective could be distributional or relief-oriented. Tax policy could be designed to provide additional resources to businesses or individuals who experienced an uncompensated disaster loss. This relief could be targeted toward low-income individuals and households, although there are limitations when using tax policy to address low-income individuals and businesses with little or no tax liability.

Tax policy can also be used to encourage investment in disaster-affected areas. Absent government intervention, some level of private rebuilding will occur. A policy question, however, is whether this private building is sufficient, or if there are other barriers to investment in the disaster-affected region that call for government intervention. When investment subsidies are provided, there is the question of how much new investment is supported relative to how much investment is subsidized that would have occurred absent the subsidy. In general, tax provisions aiding specific activities or types of investment lead to a misallocation of resources. However, one perspective is that all taxpayers should assist in recovery of an area affected by such a large-scale disaster, as a part of national risk-spreading where a degree of economic inefficiency may be warranted.

There are also challenges associated with identifying the disaster area for the purposes of providing tax relief. In some cases, relief has been provided to a certain geographic area. In other cases, relief has been tied to a federal disaster declaration or provided only when individual assistance or individual and public assistance is provided. Narrowly defined geographic areas can limit tax benefits to those most likely to be harmed by the disaster, but can exclude some disaster victims.

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Community and Regional Development

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR SEWAGE, WATER, AND HAZARDOUS WASTE
FACILITIES**

Estimated Revenue Loss
[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.1	0.3
2021	0.2	0.1	0.3
2022	0.2	0.1	0.3
2023	0.2	0.1	0.3
2024	0.3	0.1	0.4

Authorization

Sections 103, 141, 142, and 146.

Description

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

Some of these bonds are classified as private-activity bonds rather than as governmental bonds because a substantial portion of their benefits accrues to individuals or business rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity

bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Bonds*.

The bonds classified as private activity for these facilities are subject to the state private-activity bond annual volume cap. The private-activity bond annual volume cap is equal to the greater of \$105 per state resident or \$321.78 million in 2020. The cap has been adjusted for inflation since 2003.

Impact

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

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

Rationale

Before 1968, no restriction was placed on the ability of state and local governments to issue tax-exempt bonds to finance sewage, water, and hazardous waste facilities. The Revenue and Expenditure Control Act of 1968 (RECA, P.L. 90-364) imposed tests that would have restricted issuance of these bonds. However, it provided a specific exception for sewage and water (allowing continued unrestricted issuance).

To qualify for tax-exempt bond financing, a water-furnishing facility must be made available to the general public (including electric utility and other businesses) and must be either operated by a governmental unit or have its rates approved or established by a governmental unit. A hazardous waste exception was adopted by the Tax Reform Act of 1986 (TRA86, P.L. 99-514). The portion of a hazardous waste facility that can be financed with tax-exempt bonds cannot exceed the portion of the facility to be used by entities other than the owner or operator of the facility. In other words, a hazardous waste producer cannot use tax-exempt bonds to finance a facility to treat its own waste.

Assessment

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

Alternatively, subsidizing hazardous waste treatment facilities reduces the cost of producing waste if the subsidy is passed through to waste producers. When the cost of producing waste declines, then waste emitters may in turn increase their waste output. Thus, subsidizing waste treatment facilities may actually increase waste production. Recognizing the potential effect of subsidizing private investment in waste treatment, Congress eliminated a general subsidy for private investment in waste and pollution control equipment in TRA86.

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

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Community and Regional Development

RECOVERY ZONE ECONOMIC DEVELOPMENT BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	(¹)	0.2
2021	0.2	(¹)	0.2
2022	0.2	(¹)	0.2
2023	0.2	(¹)	0.2
2024	0.2	(¹)	0.2

Note: Estimates include outlay effects associated with the refundable portion of RZEDBs. These outlay effects are estimated to be a combined \$0.7 billion from FY2020-FY2024. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 54A, 54AA, 1400U, and 6431.

Description

In the 111th Congress, the American Recovery and Reinvestment Act (ARRA, P.L. 111-5) created a new type of tax credit bond, the Build America Bond (BAB). These bonds allow issuers the option of (1) receiving a direct payment from the U.S. Treasury, or (2) tax credits for bond investors instead of the traditional tax-exempt interest payments (see the entry *Build America Bonds*). The legislation also provided for a version of BABs with a larger subsidy called Recovery Zone Economic Development Bonds (RZEDBs) for economically distressed areas. This tax expenditure chapter discusses Recovery Zone Economic Development Bonds.

RZEDBs proceeds were targeted to economically distressed areas. Specifically, these bonds were for any area (“recovery zone”) designated by the state government (1) as having significant poverty, high unemployment, a high rate of home foreclosures, or general distress; (2) as economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990 (P.L. 101-510, Title XXIX); or (3) as an empowerment zone or renewal community. The purpose of the bonds was, as the name implies, economic development. The bonds were used for: capital expenditures paid or incurred with respect to property located in such recovery zone; expenditures for public infrastructure and construction of public facilities; and expenditures for job training and educational programs.

The RZEDB offers a tax credit equal to 45 percent of the interest rate established between the buyer and issuer of the bond. The issuer and investor agreed on terms either as a result of a competitive bid process or through a negotiated sale. For example, if the negotiated taxable interest rate was 8 percent, on \$100,000 of bond principal, then the federal tax credit amount was \$3,600 (8 percent times \$100,000 times 45 percent). The issuer had the option of receiving a direct payment from the Treasury equal to the tax credit amount or allowing the investor to claim the tax credit. The issuers chose the direct payment option for all RZEDBs issued because the net interest cost was less than traditional tax-exempt debt of like terms. In this example, the interest cost to the issuer choosing the direct payment was \$4,400 (\$8,000 less the \$3,600 credit amount). If the tax-exempt rate was greater than 4.40 percent (requiring an interest payment of greater than \$4,400) then the direct payment RZEDB would have been a better option for the issuer. Note that the direct payment option means the bond proceeds must have been used for capital expenditures.

The statutory volume limit for RZEDBs was set at \$10 billion. The bond authority was allocated to states (including the District of Columbia and the U.S. territories) based on the state’s employment decline in 2008. Every state that experienced an employment decline in 2008 received an allocation that bore the same ratio as the state’s share of the total employment decline in those states. All states and U.S. territories, regardless of employment changes, were guaranteed a minimum of 0.90 percent of the \$10 billion.

Large municipalities and counties were also guaranteed a share of the state allocations based on a jurisdiction’s share of the aggregate employment decline in its state for 2008. A large jurisdiction is defined as one with a population greater than 100,000. For counties with large municipalities

receiving an allocation, the county population was reduced by the municipal population for purposes of the 100,000 threshold. The authority to issue RZEDBs expired on December 31, 2010, thus the tax expenditure represents the tax credits generated by the outstanding bonds. The 2017 tax revision (P.L. 115-97) repealed issuing authority for all tax credit bonds beginning on January 1, 2018.

Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rates for direct payment RZEDBs and all other direct payment tax credit bonds (TCBs) were subject to sequestration from FY2013 through FY2020. For FY2021 through FY2030, current law imposes a sequestration reducing the direct payment RZEDB credit rate by 5.7 percent.

Impact

The impact of RZEDBs is unclear because the potential issuance was capped and limited to specific, state-defined economically distressed areas. The authority to issue RZEDBs expired after December 31, 2010, which may further diminish the impact of the program because some authority may have gone unused. For 2009, the IRS reported that \$471 million of RZEDBs had been issued. For 2010, the IRS reported \$6,131 million of RZEDBs had been issued.

Rationale

The American Recovery and Reinvestment Act (ARRA, P.L. 111-5) created BABs and RZEDBs. These bonds offer a federal subsidy larger than that provided by tax-exempt bonds and were intended to spur more infrastructure spending and to aid state and local governments. Proponents also cited the possible stimulative effect of additional public infrastructure spending arising from this program during the economic downturn in 2009 and 2010.

Assessment

There are three principal stakeholders in the tax-preferred bond market: (1) state and local government issuers; (2) investors; and (3) the federal government. For issuers, RZEDBs are best assessed against the most common alternative mechanism for financing public infrastructure: tax-exempt bonds. With direct-payment RZEDBs, the federal government subsidizes the issuer directly, unlike with tax-exempt bonds which provide an indirect subsidy through lower interest rates. Either way, issuers receive an interest rate

subsidy. In theory, if the demand for RZEDBs exceeded that for traditional tax-exempt bonds issued for the same purpose, then interest costs for the issuer would have been further reduced. Also, if the credit rate were set such that the bonds were more attractive relative to other taxable instruments, issuers might have realized an additional interest cost savings.

When RZEDBs are evaluated against tax-exempt bonds, the market clearing credit rate should equal the ratio of the investor's forgone market interest rate on tax-exempt bonds divided by one minus the investor's tax rate. Investors in higher-tax marginal income tax brackets would need a higher rate to equate the return on RZEDBs to that of tax-exempt bonds. Thus, high-income investors may prefer tax-exempt bonds to RZEDBs. In contrast, non-taxable investors, international investors, and lower marginal tax rate investors would find RZEDBs more attractive than tax-exempt bonds.

For the federal government, the tax credit mechanism is a more economically efficient subsidy than the mechanism for tax-exempt bonds, particularly in cases where the issuer claims the direct payment. The direct payment to the issuer mechanism, which is modeled after the "taxable bond option," was first considered in the late 1960s. Later, in 1976, the following was posited by the then-President of the Federal Reserve Bank in Boston, Frank E. Morris:

The taxable bond option is a tool to improve the efficiency of our financial markets and, at the same time, to reduce substantially the element of inequity in our income tax system which stems from tax exemption [on municipal bonds]. It will reduce the interest costs on municipal borrowings, but the benefits will accrue proportionally as much to cities with strong credit ratings as to those with serious financial problems.

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Community and Regional Development

EMPLOYER CREDIT FOR QUALIFIED WAGES PAID BY CERTAIN EMPLOYERS TO CERTAIN EMPLOYEES IN CONNECTION WITH NATURAL DISASTERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	0.3	0.3
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Note: This provision was extended by P.L. 116-260 and estimated to cost \$0.1 billion in FY2021 and FY2022, with a total of \$0.3 billion for FY2021-FY2023.

Authorization

Section 303 of P.L. 116-260; Section 38

Description

A temporary employee retention tax credit can be claimed by disaster-affected businesses that continued to pay wages to employees unable to work after a disaster rendered the business inoperable. Eligible employers can claim an employee retention credit for 2020 qualified disasters (the incident period of the federally declared disaster must have begun on or before December 27, 2020, to be a qualified disaster). The credit is 40 percent of up to \$6,000 in qualified wages paid to each eligible employee, making the maximum credit amount \$2,400 per employee. Qualified wages are the employee's first \$6,000 in wages paid between the date the business became inoperable and the date it

resumed significant operations at that location (or the date which is 150 days after the last day of the incident period of the disaster). Wages can be those paid even if the employee provides no services for the employer, or for wages paid for services performed at a different location or before significant operations resume. Eligible employees are those whose principal place of employment was in the applicable disaster area.

For employers claiming the employee retention credit, the employer's deduction otherwise allowed for wages paid is reduced by the amount of the credit claimed. This employee retention credit cannot be claimed for an employee during any period that the employer claims a work opportunity credit (WOTC) for the employee.

The credit is a component of the general business credit, and thus can be carried back one year and has a 20-year carryforward period. However, the temporary credit may not be carried back to a tax year prior to the tax year in which the credits became available.

Impact

The employee retention tax credit subsidizes the wages of employees paid when a disaster forces a business to close. Business owners benefit from reduced after-tax labor costs. Employees that are retained may benefit from continued wage payments, which could help blunt the short-run economic declines associated with major disaster events. Both employers and employees may benefit from continuity in their employment relationship.

Rationale

The employee retention credit for disaster-affected employers was first enacted in the Katrina Emergency Tax Relief Act of 2005 (KETRA; P.L. 109-73). When initially enacted, the credit could only be claimed by employers impacted by Hurricane Katrina with no more than 200 employees. The Gulf Opportunity Zone Act of 2005 (P.L. 109-135) expanded the credit to include Hurricanes Rita and Wilma, removed the 200-employee limit, and codified the employee retention tax credit in Section 1400R of the Internal Revenue Code. The employee retention credit was allowed for the Kansas disaster area (in the Food, Conservation, and Energy Act of 2008; P.L. 110-246) and the Midwestern disaster area (in the Emergency Economic Stabilization Act of 2008; P.L. 110-343).

The Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63) included an employee retention tax credit for the Hurricane Harvey, Hurricane Irma, and Hurricane Maria disaster areas. The credit was codified differently, and Section 1400R was repealed as deadwood by the Tax Technical Corrections Act of 2018 (P.L. 115-141; Division U).

The Bipartisan Budget Act of 2018 (P.L. 115-123) included an employee retention credit for the California wildfire disaster zone, while the employee retention credit for 2018 and 2019 disasters was enacted in the Further Consolidated Appropriations Act, 2020 (P.L. 116-94; Division Q). The employee retention credit for disasters in 2020 was enacted in the Consolidated Appropriations Act, 2021 (P.L. 116-260; Division EE).

Assessment

Employee retention credits encourage employers to continue paying employees when disasters affect business operations. The tax credit can provide resources to businesses in areas where general business infrastructure has been damaged or destroyed. The tax credit, through supporting continued employment, may reduce income loss for individuals whose workplaces are damaged by the disaster.

One question is whether tax credits, particularly nonrefundable tax credits, are the most effective form of support for businesses struggling post-disaster. The employee retention tax credit offsets positive tax liability when income tax returns are filed. If businesses have little or no tax liability in the disaster year, and if the business cannot carry back the unused credit, the tax credit is of limited immediate value.

Another question is the issue of timing. Employee retention tax credits that reduce income tax liability are claimed when tax returns are filed. Tax returns for a disaster year may be filed the following year, meaning there is a delay in the timing of the relief.

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Community and Regional Development

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR QUALIFIED BROADBAND PROJECTS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	—	—
2021	—	—	—
2022	—	—	—
2023	—	—	—
2024	—	—	—

Note: This provision was added by P.L. 117-58, the Infrastructure Investment and Jobs Act, and was estimated to cost \$0.6 billion over the FY2022–FY2031 period.

Authorization

Sections 103, 141, 142(n), and 146.

Description

The Infrastructure Investment and Jobs Act (IIJA; P.L. 117-58), enacted in November 2021, created a new category of tax-exempt qualified private activity bonds for the financing of qualified broadband projects. Qualified broadband projects are defined as projects that provide high-speed, comprehensive broadband service to communities where a significant portion of recipients lacked comparable access before the project. These bonds are classified as private-activity bonds, rather than as governmental bonds, because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the

entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

The interaction of qualified broadband projects with the state private activity bond annual volume cap depends on the ownership structure of the qualified broadband project. Qualified broadband projects that are government-owned are not subject to the cap. For privately owned qualified broadband projects, 25% of the total bond issuance is subject to the state private-activity bond annual volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003.

Impact

Since interest on the bonds is tax exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to provide the services of qualified broadband projects at lower cost, benefitting end users. Some, perhaps most, of the benefits of the tax exemption, however, flow to bondholders. For a discussion of the factors that determine the shares of benefits going to users and bondholders as well as estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The creation of a new category of qualified private activity bonds in the IIJA for broadband projects was intended to increase general access to high-speed internet. In order to receive the federal subsidy, projects must: (1) provide broadband service solely to one or more census block groups where more than 50 percent of households do not have fixed, terrestrial, high-speed broadband service; and (2) provides sufficiently high-speed and comprehensive service to those locations. By exempting the interest income earned on these bonds from federal taxation, these qualified private activity bonds can be issued with interest rates lower than a comparable taxable bond. The reduction in the interest rates thereby reduces borrowing costs for the project and encourages general investment in broadband projects.

Assessment

Legislative discussions about the exemption for qualified broadband project bonds may include analysis both of their public benefits generally and

relative to other projects. As one of many categories of tax-exempt private-activity bonds, those issued for broadband projects increase the financing cost of bonds issued for other public capital. With a greater supply of public bonds, the interest rate on the bonds necessarily increases to lure investors. In addition, expanding the availability of tax-exempt bonds increases the range of assets available to individuals and corporations to shelter their income from taxation.

Existing evidence suggests that increasing access to high-speed broadband services may lead to increased economic activity and innovation. Studies of broadband coverage suggest high-speed broadband is less prevalent in rural and low-income areas. Additionally, the increased reliance on high-speed internet for commerce and educational services during and after the COVID-19 pandemic may have increased the potential benefits of comprehensive high-speed broadband access.

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Education, Training, Employment and Social Services

DEDUCTION FOR TEACHER CLASSROOM EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal	Individual	Corporate	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	0.2	—	0.2
2023	0.2	—	0.2
2024	0.2	—	0.2

Note: This provision was expanded by P.L. 116-260. These changes are estimated to reduce revenues by \$16 million from FY2021 through FY2025 according to JCT (JCX-24-20).

Authorization

Section 62(a)(2)(D).

Description

In 2022, an eligible educator working at a public (including charter) or private elementary or secondary school may claim up to \$300 as an above-the-line deduction for eligible unreimbursed expenses (up to \$600 if married filing jointly and both spouses are eligible educators, but not more than \$300 each). Since the “educator deduction” is an “above-the-line” deduction, taxpayers do not need to itemize their deductions to claim this tax benefit.

Eligible expenses for the purposes of this deduction are expenses paid by an eligible educator for books, supplies (other than nonathletic supplies for health or physical education courses), computer equipment, software, and services and other equipment; and supplementary materials used by the

educator in the classroom. Expenses for the educator's professional development shall also be considered eligible expenses for purposes of the deduction. Additionally, under direction from Congress, the IRS clarified that educators can also claim the deduction for expenses paid or incurred after March 12, 2020, to purchase supplies to prevent the spread of COVID-19. These include but are not limited to face masks; disinfectant for use against COVID-19; hand soap; hand sanitizer; disposable gloves; air purifiers; and other items recommended by the Centers for Disease Control and Prevention (CDC) to be used for the prevention of the spread of COVID-19. The statute sets the maximum deduction at \$250, which is annually adjusted for inflation beginning in 2016 in \$50 increments. (The measure of inflation generally used to adjust inflation-indexed provisions in the Internal Revenue Code (IRC) was permanently changed from the CPI-U to the chained CPI-U by P.L. 115-97.) In 2022, the maximum amount increased from \$250 to \$300. An eligible educator is defined to be an individual who, with respect to any tax year, is an elementary or secondary school teacher, instructor, counselor, principal, or aide in a school for a minimum of 900 hours in a school year. A school means any school that provides elementary education or secondary education (kindergarten through grade 12), as determined under state law.

Taxpayers must reduce the total amount they deduct by any interest from an Education Savings Bond or distribution from a Qualified Tuition (Section 529) Program or Coverdell Education Savings (Section 530) account that was excluded from income. In other words, if educators or members of their tax filing units use earnings from these savings vehicles to pay tuition and other qualified educational expenses, only those classroom expenses that exceed the value of these income exclusions are deductible.

Impact

Educators, as an occupation, are actively involved in improving the human capital of the nation. One study (Garcia, 2019) found, for example, that public school teachers spent an average of \$480 on classroom supplies in the 2015-2016 school year, with higher levels (\$523) among teachers in high-poverty schools compared to low-poverty schools (\$434).

As noted in the table below, more than three-quarters of the dollars deducted are taken by taxpayers with adjusted gross incomes over \$50,000, with more than one-third claimed by those with income between \$100,000 and \$200,000.

***Distribution by Income Class of Amounts Deducted
for the Educator Expense Deduction, 2019***

Income Class (in thousands of \$)	Percentage
Below \$10	1.0
\$10 to \$20	2.5
\$20 to \$30	4.1
\$30 to \$40	5.3
\$40 to \$50	8.9
\$50 to \$75	17.4
\$75 to \$100	16.0
\$100 to \$200	36.6
\$200 and over	8.2

Source: IRS *Statistics of Income Table 1.4*. This is not a distribution of the tax expenditure, but of the amount deducted, classified by adjusted gross income.

Rationale

The educator deduction was enacted on a temporary basis as part of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). It was reauthorized through December 31, 2009, as part of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the deduction for 2010 and 2011. The American Taxpayer Relief Act of 2012 (P.L. 112-240) extended the deduction through the end of 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the deduction through the end of 2014.

The Protecting Americans from Tax Hikes Act, or “PATH” Act (Division Q of P.L. 114-113), made the deduction permanent beginning in 2015. In addition to extending the provision permanently, the PATH Act made two changes to the deduction that went into effect in 2016. First, the maximum amount of the deduction—\$250—was indexed annually for inflation. Second, the definition of eligible expenses was expanded to include expenses for the educator’s professional development.

The COVID-related Tax Relief Act of 2020 (Subtitle B of Division N of P.L. 116-260) included a provision directing the Treasury Secretary to clarify

by regulation or other guidance that expenses paid or incurred after March 12, 2020, for “personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19” are qualifying expenses for the deduction. IRS Revenue Procedure 2021-15, issued on February 4, 2021, made this clarification by creating a safe harbor for these expenses under which educators can clearly claim the deduction for expenditures they make for supplies to prevent the spread of COVID-19 after March 12, 2020.

Before the educator deduction’s enactment, the only tax benefit available to educators for trade/business expenses was the permanent deduction under IRC Section 162. That deduction was available to educators, but to take it, the total of their miscellaneous itemized deductions had to have exceeded two percent of adjusted gross income. However, section 11046 of P.L. 115-97 temporarily repealed the itemized deduction for miscellaneous expenses from 2018 through the end of 2025. An above-the-line deduction targeted at educators may be considered desirable because teachers voluntarily augment school funds by purchasing items thought to enhance the quality of children’s education.

Assessment

Theoretically, the educator deduction may encourage educators already purchasing supplies to increase the amount spent and may encourage other educators to purchase supplies. However, a deduction that is capped below the amounts teachers spend may not encourage additional spending, since those who spend more than the cap have no marginal incentive to increase their spending. As previously noted, on average, teachers are spending \$480 per year (Garcia, 2019) compared to the \$300 cap.

If the purpose of the deduction is to reimburse some portion of educators’ classroom spending, a deduction may not be a particularly equitable way to provide this type of refund. Deductions are worth more to taxpayers in higher tax brackets than those in lower tax brackets. A teacher in a higher tax bracket (perhaps due to his or her spouse’s income) spending \$100 on supplies might see a reduction in tax liability of \$35. A teacher in a lower tax bracket, also spending \$100 on supplies, might realize tax savings of \$12. Thus, even when each teacher spends the same amount on classroom supplies, one teacher’s tax savings is more than twice that of the other. The increasing marginal tax rates of the federal income tax in conjunction with the greater amount deducted by higher-income taxpayers (see the distribution table) means that the largest share of this benefit will generally be received by higher-income taxpayers.

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Education, Training, Employment, and Social Services

**TAX CREDITS FOR TUITION FOR POST-
SECONDARY EDUCATION**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	14.5	—	14.5
2021	15.3	—	15.3
2022	15.5	—	15.5
2023	15.6	—	15.6
2024	15.7	—	15.7

Note: Estimates include outlay effects associated with the refundable portion of the American Opportunity Tax Credit (AOTC). These outlay effects are \$6.8 billion (2020), \$5.6 billion (2021), \$4.9 billion (2022), \$4.9 billion (2023), and \$4.9 billion (2024).

Authorization

Section 25A.

Description

There are two education tax credits available to taxpayers—the American Opportunity Tax Credit and the Lifetime Learning Credit.

The American Opportunity Tax Credit

The American Opportunity Tax Credit (AOTC) is a refundable tax credit that provides financial assistance to taxpayers pursuing a post-secondary education (college, university, or vocational school) or whose children are pursuing a post-secondary education. The credit, worth up to \$2,500 per eligible student, can be claimed for a student's qualifying expenses incurred during the first four years of postsecondary education at an eligible

postsecondary institution. In addition, 40 percent of the credit (up to \$1,000) can be received as the refundable portion of the credit by taxpayers with little or no income tax liability, typically low-income households.

The AOTC is calculated as 100 percent of the first \$2,000 of qualified tuition, academic fees and required course materials (e.g., textbooks), and 25 percent of the next \$2,000. Hence, the maximum value of the credit per student is \$2,500.

The AOTC is refundable, meaning taxpayers with little to no tax liability may still be able to benefit from this tax provision. By definition, a refundable tax credit is not limited by a taxpayer's income tax liability. The amount of the AOTC that can be received as a refundable credit (the "refundable portion") equals 40 percent of the credit the taxpayer is eligible for based on qualifying education expenses. Therefore, if the taxpayer was eligible for a \$2,500 AOTC, but had no income tax liability, they could receive \$1,000 (40 percent of \$2,500) as the refundable portion of the AOTC.

The credit phases out for taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married couples filing jointly) and is unavailable to taxpayers with modified adjusted gross income above \$90,000 (\$180,000 for married couples filing jointly). These phaseout levels are *not* indexed for inflation.

An eligible student is one enrolled on at least a half-time basis for at least one academic period during the tax year in a program leading to a degree, certificate, or credential at an institution eligible to participate in U.S. Department of Education student aid programs (these include most accredited public, private, and proprietary postsecondary institutions). The student must be in their first four years of post-secondary education, which for most students is the first four years of undergraduate education. The student must not have been convicted of any state or federal felony offense for possessing or distributing a controlled substance when they claim the credit.

Qualifying education expenses are tuition and certain expenses required for enrollment at a higher education institution, including the cost of books, supplies, and equipment needed for a student's studies. Qualifying expenses for the AOTC must be reduced by any tuition and fees financed with tax-free scholarships, including Pell Grants, veterans' education assistance, and other tax-free educational assistance. (To the extent that the taxpayer chooses to report an otherwise tax-free grant, scholarship, or fellowship on their tax

return—and hence it is subject to taxation—they may not need to reduce their education expenses by the amount of the award included in income.) The credit cannot be claimed for the same student for whom a Lifetime Learning Credit is claimed in the same tax year. They also cannot claim a credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell Education Savings Account or a Qualified Tuition (Section 529) Plan. Through 2020, taxpayers could also not claim the AOTC and the deduction for qualified higher education expenses (the “tuition and fees deduction”) for the same student in the same year. The tuition and fees deduction was repealed by P.L. 116-260, effective beginning in 2021.

In cases where the student is claimed as a dependent by the taxpayer, any qualifying expenses paid by the dependent are treated as if they were paid by the taxpayer. If a taxpayer does not claim the student as a dependent and the dependent is a qualifying student, then the qualifying student can claim the credit based on the expenses the student paid.

Lifetime Learning Credit

The Lifetime Learning Credit provides a 20 percent credit per return for the first \$10,000 of qualified tuition and fees that taxpayers pay for themselves, their spouses, or their dependents. For the purposes of this credit, qualified tuition and fees include expenses for any course of instruction to acquire or improve job skills. The credit is available for those enrolled in one or more courses of instruction at an eligible institution. There is no limit on the number of years for which the credit may be claimed.

The nonrefundable credit phases out for single taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married couples filing jointly) and is unavailable to taxpayers with modified adjusted gross income above \$90,000 (\$180,000 for married couples filing jointly). These phaseout levels are *not* indexed for inflation.

As with the AOTC, tuition and fees financed with scholarships, Pell Grants, veterans’ education assistance, and other tax-free educational assistance are not qualified expenses. (To the extent that the taxpayer chooses to report an otherwise tax-free grant, scholarship, or fellowship on their tax return—and hence it is subject to taxation—they may not need to reduce their education expenses by the amount of the award included in income.) The Lifetime Learning Credit cannot be claimed for the same student for whom the AOTC is claimed in the same tax year. Through 2020, taxpayers could also

not claim the AOTC and the deduction for qualified higher education expenses (the “tuition and fees deduction”) for the same student in the same year. The tuition and fees deduction was repealed by P.L. 116-260, effective beginning in 2021. Finally, the definitions of qualifying student and qualifying educational institutions for the Lifetime Learning credit are the same as those for the AOTC.

Impact

Tuition tax credits, like other forms of traditional student aid and other forms of tax-based financial aid, reduce the cost of higher education.

Research indicates that students from lower-income households are more sensitive to the price of college when deciding whether to attend college, in comparison to their higher-income counterparts. Policies that reduce the price of college, like tuition tax credits, would then be expected to have the largest effect on enrollment if they were targeted towards lower-income students. The AOTC is refundable, so taxpayers with little to no tax liability including low-income taxpayers, may be able to claim the AOTC. Data suggest, however, that the majority of the AOTC is claimed by middle- and higher-income taxpayers, and hence this credit is not specifically targeted to lower-income students. The Lifetime Learning Credit is non-refundable and hence taxpayers with little to no tax liability—including low-income taxpayers—cannot claim this credit.

As shown in the following table, which reflects the refundability of the AOTC, tuition tax credits primarily benefit middle-income taxpayers. More than 60 percent of the total dollar amount of the credits are received by tax filing units with adjusted gross incomes of between \$50,000 and \$200,000.

Distribution by Income Class of the Tax Expenditure for Education Tax Credits, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	3.3
\$10 to \$20	7.0
\$20 to \$30	8.2
\$30 to \$40	7.5
\$40 to \$50	7.9
\$50 to \$75	16.9

Income Class (in thousands of \$)	Percentage Distribution
\$75 to \$100	12.9
\$100 to \$200	34.2
\$200 and over	2.1

Rationale

The Hope Scholarship and Lifetime Learning Credits were enacted as permanent tax provisions as part of the Taxpayer Relief Act of 1997 (P.L. 105-34). The intent of these benefits was to make postsecondary education more affordable for middle-income families and students who might not qualify for need-based federal student aid.

The American Opportunity Tax Credit was enacted as part of the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), temporarily replacing the Hope Scholarship Credit for 2009 and 2010. The AOTC was extended for 2011 and 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). Subsequently, the AOTC was extended for five more years, through the end of 2017, by the American Taxpayer Relief Act of 2012 (P.L. 112-240; ATRA).

The Protecting Americans from Tax Hikes (PATH) Act (Division Q of P.L. 114-113) made the AOTC permanent, effectively eliminating the Hope Credit. (The Tax Technical Corrections Act of 2018, included as part of P.L. 115-141, made numerous technical corrections to the Internal Revenue Code (IRC), including modifying the text of IRC section 25A to eliminate text that referenced the Hope credit.) The PATH Act also included a number of provisions intended to reduce improper payments of the AOTC. These provisions included the disallowance of the credit due to fraud or a reckless disregard of the credit's rules and the ID requirements for the taxpayer, student, and educational institution.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021; P.L. 116-260) permanently modified the Lifetime Learning Credit phaseout. Specifically, the law increased the statutory income level and the range over which the credit phased out from \$40,000-\$50,000 (\$80,000-\$100,000 for married joint filers) to \$80,000-\$90,000 (\$160,000-\$180,000 for married joint filers). Of note, the prior-law income range (i.e., \$40,000-\$50,000; \$80,000-\$100,000 for married joint filers) was annually adjusted for inflation. Hence, in 2020, the income range

over which the credit phased out was \$59,000-\$69,000 (\$118,000-\$138,000 for married joint filers). The new income range is not annually adjusted for inflation. With this change, the phaseout ranges for the Lifetime Learning Credit and the AOTC are the same. This change was effective beginning in 2021.

Assessment

One rationale for tuition tax credits may be to increase college attendance by reducing the after-tax price of college. Increased college attendance may not only lead to benefits for individuals in terms of higher wages, but also may provide societal benefits including increased productivity and innovation. This economic rationale is often referred to as the “positive externality” rationale for government interventions in higher education. Broadly, an externality is a cost or benefit associated with a transaction that is not reflected in market prices. In the case of a positive externality associated with education, the positive benefit to society in terms of increased productivity and innovation is greater than the benefit to the individual, which may result in under-investment in education from a social perspective.

There are a variety of factors that may determine whether a student attends college, including family socioeconomic level, student educational aspirations, peer support, academic performance, and the cost of college. Education tax credits, like other forms of traditional student aid and other forms of tax-based financial aid, subsidize some of the costs associated with higher education. The effect that a cost reduction has on college attendance will depend on how sensitive a student’s (and her family’s) decision to attend college is to price. Some students will be very sensitive to price, and insofar as tax credits reduce college costs, these tax benefits may induce them to attend college. On the other hand, certain students will attend college irrespective of price. In this case, education tax credits reward students and their families for an action—attending college—that they would have made regardless of the credit’s availability, and the credits are a windfall gain to certain taxpayers.

Recent studies analyzing the effect of education tax incentives on college attendance indicate a minimal impact of tax credits on college attendance. Research by Turner (2011) has found that tax-based aid did have an impact on college attendance, but also that a significant proportion of recipients—93 percent—would have attended college in the absence of these benefits. Other research by Bulman and Hoxby (2014) finds a “meager” effect of the higher education tax credits on students’ decisions to attend college.

Another rationale for government interventions in higher education more broadly may be because private capital markets may be unwilling to lend to students to finance their higher education expenses. Many students do not have sufficient savings to finance their education. And since students often lack property to pledge as collateral for student loans, private lenders must charge high interest rates to reflect the losses they would incur (and could not recover) if the student defaults. To rectify this problem, the federal government guarantees student loans which effectively absorbs private lenders default risk. Tuition tax credits, often received many months after tuition payments are required to be paid and which in many cases may be substantially less than student's tuition costs, may do little to help credit-constrained students and families finance their college education.

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Education, Training, Employment, and Social Services

DEDUCTION FOR INTEREST ON STUDENT LOANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.4	—	1.4
2021	1.9	—	1.9
2022	2.3	—	2.3
2023	2.3	—	2.3
2024	2.4	—	2.4

Authorization

Section 221.

Description

Taxpayers may deduct up to \$2,500 of interest paid on qualified education loans when determining their adjusted gross income. The deduction is not restricted to itemizers (i.e., it is an above-the-line deduction). The maximum amount that can be deducted (\$2,500) is the same irrespective of a taxpayer’s filing status.

The amount that can be deducted is reduced for taxpayers with income over specific thresholds. In 2022, the amount that can be deducted phases out for taxpayers with modified adjusted gross income between \$70,000 and \$85,000 (\$145,000 to \$175,000 for married taxpayers filing joint returns). Hence, taxpayers with income above \$85,000 (\$175,000 for taxpayers filing joint returns) cannot claim this deduction. Taxpayers are not eligible for the deduction if they can be claimed as a dependent by another taxpayer.

Qualified education loans are loans incurred solely to pay qualified higher education expenses of taxpayers, their spouse, or their dependents who

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

Impact

As with other tax benefits that reduce taxable income, the student loan interest deduction benefits for taxpayers are proportional to a taxpayer's marginal tax rate (see Appendix A). Most education debt is incurred by students, who generally have low tax rates immediately after they leave school and begin loan repayment. However, some debt is incurred by parents in higher tax brackets.

The cap on the amount of student loan interest that can be deducted annually limits the tax benefit's impact for those who have large loans (and hence a high level of interest paid). The income ceilings prevent the highest income taxpayers (with more than \$200,000 of income) from benefitting from this deduction as shown in the table below. Middle and upper-middle income taxpayers tend to receive the greatest share of the tax savings from this deduction. More than three-fourths of the tax reduction that results from this deduction benefits tax filing units with adjusted gross incomes between \$50,000 and \$200,000.

Distribution by Income Class of the Tax Expenditure for the Student Loan Interest Deduction, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	1.1
\$20 to \$30	3.1
\$30 to \$40	4.6

Income Class (in thousands of \$)	Percentage Distribution
\$40 to \$50	7.3
\$50 to \$75	28.5
\$75 to \$100	17.0
\$100 to \$200	38.0
\$200 and over	0.5

Rationale

Since 1954, interest generally—including student loan interest—was deductible by taxpayers. The Tax Reform Act of 1986, (TRA86, P.L. 99-514) disallowed all forms of personal interest deductions other than for mortgage interest.

The current student loan interest deduction for qualified education loans was authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34). The interest deduction was seen as a way to help taxpayers repay student loan debt, which has risen substantially in recent years.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) modified this deduction in two ways that were initially in effect from 2002 through the end of 2010, but were then made permanent. First, EGTRRA temporarily repealed a limitation of this deduction whereby only interest paid within the first 60 months was deductible. Second, EGTRRA increased the income levels at which the deduction began to phase out. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the EGTRRA modifications through the end of 2012, and they were made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

Assessment

The tax deduction can be justified both as a way of encouraging persons to undertake additional education and as a means of easing repayment burdens. On the other hand, the deduction, which subsidizes debt financing of education, may encourage students and their families to take on additional debt to pay for higher education (either more education or more costly education). At the very least, analysis by the Pew Trusts indicates that as student loan debt has increased, so has the aggregate costs of the deduction (in terms of reduced revenues). Whether the deduction affects enrollment decisions is unknown.

The deduction has also been criticized for providing a subsidy to all borrowers (aside from those with the highest incomes), even those with little debt, and for doing little to help borrowers who have large loans and high interest payments. It is unlikely to reduce loan defaults, which generally are related to low income and unemployment.

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Education, Training, Employment, and Social Services

EXCLUSION OF EARNINGS OF COVERDELL EDUCATION SAVINGS ACCOUNTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	—	0.1
2021	0.1	—	0.1
2022	0.1	—	0.1
2023	0.1	—	0.1
2024	0.1	—	0.1

Authorization

Section 530.

Description

A Coverdell education savings account (ESA)—often referred to simply as a Coverdell—is a tax-advantaged investment account that can be used to pay for both higher education expenses and elementary and secondary school expenses. Contributions to a Coverdell must be made in cash using after-tax dollars. The specific tax advantage of a Coverdell is that distributions (i.e., withdrawals) from this account are tax-free if they are used to pay for qualified education expenses. If the distribution is used to pay for nonqualified expenses, a portion of the distribution is taxable and may be subject to a 10 percent penalty.

Generally, a contributor, often a parent, makes a contribution to a Coverdell for a designated beneficiary, often their child. Contributors can open a Coverdell at many banks, brokerage firms, or mutual fund companies. Since Coverdells are established for minors, a “responsible individual” is named to the account, generally the beneficiary’s legal guardian. This responsible

individual may also be a contributor to the account. While a contributor selects the initial investments for a beneficiary when they open the account, the responsible individual (if they differ from the contributor) makes investment and withdrawal decisions after the account is established.

Contributions to a Coverdell are prohibited once a beneficiary reaches 18, and the balance of the account must be liquidated when the beneficiary turns 30. However, these age limitations do not apply to special-needs beneficiaries. Account owners can change the designated beneficiary of their account to another relative of the original beneficiary who is under the age of 30 or is a special-needs beneficiary.

The total amount that contributors can add to all Coverdells designated for a given beneficiary is limited to \$2,000 per year. The beneficiary is subject to a 6 percent excise tax each year on excess contributions that are in all Coverdell ESAs in his or her name at the end of the year.

Contributions to Coverdell accounts are means tested. Specifically, as the contributor's income exceeds \$95,000 (\$190,000 for married joint filers), the maximum amount the contributor can donate (\$2,000) is reduced. When the contributor's income exceeds \$110,000 (\$220,000 for married joint filers), a contributor is prohibited from funding a Coverdell. (These amounts are not adjusted for inflation.)

Qualified education expenses are referred to as adjusted qualified education expenses (AQEE), and include expenses related to enrollment or attendance at either a higher education institution or elementary and secondary school. Specifically, these expenses include the following for higher education:

- Tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution;
- Expenses for special needs services incurred in connection with enrollment or attendance of a special-needs beneficiary at an eligible educational institution; and
- Room and board expenses for students enrolled at least half-time at an eligible educational institution.

Qualified elementary and secondary school (i.e., K-12) education expenses include:

- Tuition, fees, books, supplies, equipment, academic tutoring, and special needs services for special needs beneficiaries;
- Room and board, uniforms, transportation, and supplementary items and services (including extended day programs) if these expenses are required or provided by an eligible K-12 institution in connection with attendance; and
- Computer technology, equipment, or Internet access and related services if used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary and secondary school.

To determine the amount of AQEE, qualified higher education expenses must be reduced by the amount of any tax-free educational assistance. Tax-free educational assistance includes the tax-free portion of scholarships and fellowships, veterans' educational assistance, Pell grants, and employer-provided educational assistance. They also must be reduced by the value of expenses used to claim education tax credits. (Eligible postsecondary institutions are those eligible to participate in U.S. Department of Education student aid programs; these include most accredited public, private, and proprietary postsecondary institutions. A qualifying elementary or secondary school is any public, private, or religious school that provides elementary or secondary education as determined under state law.)

Impact

The exclusion from gross income of account earnings withdrawn to pay for qualified expenses confers benefits to tax filing units according to their marginal tax rate (see Appendix A). These benefits are most likely to accrue to higher-income families that have the means to save on a regular basis.

Tax benefits from Coverdell ESAs might be offset by reductions in federal student aid, much of which is awarded to students based on their financial need. While the financial aid treatment of Coverdell assets depends on a student's particular circumstances (e.g., does the parent or student own the account, is the student a dependent of the parents), the financial aid formula generally treats savings for college in Coverdell plans more favorably than savings in other types of accounts. This preference will grow even stronger during the 2024-2025 aid year, when Coverdell plan distributions from nonparent relatives such as grandparents will no longer count against a student's eligibility for federal student aid.

Rationale

Tax-favored saving for higher education expenses was authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34) as one of a number of tax benefits for postsecondary education. These benefits reflected congressional concern that families faced difficulty paying for college. They also may reflect congressional intent to subsidize middle-income families that otherwise would not qualify for need-based federal student aid.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) made several temporary modifications to Coverdells. These modifications included:

- An increase in the maximum contribution amount per beneficiary from \$500 to \$2,000 per year;
- An expansion of qualified education expenses to include elementary and secondary school expenses in addition to higher education expenses (this was intended, in part, to encourage families to exercise school choice, i.e., attend alternatives to the traditional public school);
- An increase in the income range at which the contribution limit phases out for married taxpayers such that it is double the range for unmarried taxpayers;
- A waiver on the beneficiary age limitations with respect to contributions and withdrawal for special needs beneficiaries;
- Coordination of tax-free Coverdell distributions and education tax credits such that beneficiaries who use Coverdells can also claim education tax credits without penalty (expenses paid for with Coverdell funds cannot be used to claim credits);
- Coordination between contributions to Coverdells and 529 qualified tuition programs, such that contributions can be made to both a 529 and Coverdell for the same beneficiary without penalty.

The modifications were initially scheduled to expire at the end of 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the provisions enacted in 2001 for two additional years, through 2012. The American Taxpayer Relief Act of 2012 (P.L. 112-240) made the EGTRRA changes to Coverdells permanent.

The FAFSA Simplification Act (Title VII of Division FF of the Consolidated Appropriations Act, 2021, P.L. 116-260) excluded Coverdell distributions from an account owned by an eligible student’s nonparent family members from the calculation for federal student aid starting in the 2023-2024 aid year. Congress delayed this change until the 2024-2025 aid year in the FAFSA Simplification Act Technical Corrections Act (Division R of the Consolidated Appropriations Act, 2022, P.L. 117-103).

Assessment

The tax exclusion for earnings in Coverdell accounts could be justified both as a way of encouraging families to save for college expenses and as a means of easing financing burdens. However, there is not conclusive evidence that tax incentives for savings generally are effective at inducing more saving.

Among families who do use these accounts to save for college, higher-income families—who both have a greater ability to save and receive a larger tax benefit (due to their high tax bracket)—will tend to benefit the most from these accounts. In addition, tax benefits for Coverdell ESAs are not related to the student’s cost of attendance or family resources, as is most federal student aid for higher education, which limits target efficiency.

Higher-income families also are more likely than lower-income families to establish accounts for their children’s K-12 education expenses. The amount of the tax benefit, particularly if the maximum contribution to an account is not made each year, is probably too small to affect a family’s decision to send their children to public or private school. In addition, 529 accounts are generally less restrictive than Coverdells are. Congress neutralized one of the few advantages Coverdells had over 529s when they let families use 529s to pay for elementary and secondary education expenses.

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Education, Training, Employment, and Social Services

**EXCLUSION OF TAX ON EARNINGS OF QUALIFIED
TUITION PROGRAMS: PREPAID TUITION PROGRAMS
AND SAVINGS ACCOUNT PROGRAMS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations	Total
	Prepaid	Savings		
2020	0.1	1.2	—	1.3
2021	0.1	1.0	—	1.1
2022	0.1	1.2	—	1.3
2023	0.1	1.6	—	1.7
2024	0.1	2.0	—	2.1

Authorization

Section 529.

Description

Qualified Tuition Programs (QTPs), also known as “529 plans” for the tax code section governing their tax treatment, are tax-advantaged accounts that are generally used to pay for higher education expenses. They can also be used to pay for expenses related to registered apprenticeships, up to \$10,000 of elementary and secondary school tuition expenses, and up to \$10,000 of student loan payments.

States create 529 plans, but the federal government recognizes them for federal tax purposes provided they meet certain guidelines. There are two types of 529 plans recognized by the federal government: “prepaid” plans and “savings” plans. Under a prepaid plan, a contributor can make payments on behalf of the plan’s beneficiary for a specified number of academic periods or

course units at current prices at a specific institution or university system, usually within the same state as the 529 plan. Prepaid plans thus provide a hedge against tuition inflation. Few states offer these types of plans.

The majority of 529 plans are “savings” plans. Savings plans let contributors invest in a variety of investment vehicles offered by plan sponsors (e.g., age-based portfolios whose mix of stocks and bonds changes the closer the beneficiary’s matriculation date, or an option with a guaranteed rate of return). Individuals can contribute to 529 savings plans on behalf of a designated beneficiary using after-tax income. Assets in a 529 savings plan can typically grow tax-free, and distributions (i.e., withdrawals) are also tax-free if used to pay for qualified education expenses. If the distribution is not used for qualified expenses, the portion of the distribution attributable to earnings in the account is taxable, and may also be subject to a 10 percent penalty.

Qualified education expenses for 529 plans include (1) qualified higher education expenses (including those associated with apprenticeship programs); (2) qualified elementary and secondary school expenses; and (3) qualified student loan repayments.

Qualified higher education expenses are expenses related to enrollment or attendance at any eligible educational institution, typically including those outside of the state in which the 529 plan was created. Qualified expenses include tuition, fees, books, supplies, and equipment *required* for enrollment or attendance of the beneficiary at an eligible educational institution; expenses for special needs services incurred in connection with enrollment or attendance of a special-needs beneficiary at an eligible educational institution; and room and board expenses for students enrolled at least half-time at an eligible educational institution. Qualified higher education expenses also include fees, books, supplies and equipment required for an apprenticeship program registered and certified by the Department of Labor or a state apprenticeship agency recognized by the Department.

Qualified elementary and secondary school expenses include up to \$10,000 per beneficiary per year for tuition expenses at a public, private, or religious elementary school.

Qualified student loan repayments include payments of principal and interest on student loans eligible for the student loan interest deduction. The amount of a 529 distribution that can be applied to qualified student loan

repayments is \$10,000 per beneficiary (i.e., a lifetime limit). An additional \$10,000 limit applies to qualified student loan repayments of a sibling of the beneficiary.

Qualified higher education expenses and qualified elementary and secondary school expenses must be reduced by the amount of any tax-free educational assistance. Tax-free educational assistance includes the tax-free portion of scholarships and fellowships, veterans' educational assistance, Pell grants, and employer-provided educational assistance. They also, in the case of qualified higher education expenses, must be reduced by the value of expenses used to claim education tax credits.

For the purposes of the federal gift tax, payments to 529 plans are considered completed gifts of present interest from the contributor to the beneficiary. As a result, a contributor can give up to \$16,000 per beneficiary in 2022 without incurring any gift tax (this amount is adjusted for inflation). A special gifting provision allows a 529 plan contributor to make an excludable gift of up to \$80,000 in one year by treating the payment as if it were made over 5 years. Because 529 plan contributions are completed gifts, their value is generally removed from the contributor's taxable estate.

A 529 plan must receive cash contributions, maintain separate accounting for each beneficiary, and not allow investments to be directed by contributors and beneficiaries. A contributor may fund multiple accounts for the same beneficiary in different states, and an individual may be the designated beneficiary of multiple accounts.

The specifics of plans vary greatly across states. Plan sponsors may establish restrictions that are not mandated by federal law. There are no income caps on contributors, unlike the limits that generally apply to taxpayers who want to claim the other higher education benefits. There is also no federal annual dollar limit on contributions, unlike Coverdell Education Savings Accounts (ESAs). However, the statute does stipulate that a state program will not be treated as a 529 plan unless it provides adequate safeguards to prevent aggregate contributions on behalf of a beneficiary in excess of the *amount necessary* to provide for the education expenses of the beneficiary.

The IRS assesses a 10 percent tax penalty on the earnings portion of distributions that exceed (or are not used toward) adjusted qualified education expenses. This penalty is waived in the case of the beneficiary's death; disability; attendance at a military academy; or receipt of a scholarship,

veterans' educational assistance allowance, or other nontaxable payment for educational purposes (excluding a gift or inheritance). An account owner can also transfer an account to a new beneficiary who is a family member of the old beneficiary without paying any taxes or penalties.

To determine if any 529 plan distributions are taxable, a taxpayer must reduce the qualified higher education expenses by any amounts used to claim higher education tax credits. The qualified higher education expenses as defined for 529 plans are not identical to the qualified higher education expenses for education tax credits. The qualified higher education expenses common to both 529 plans and education tax credits are tuition and fees, and hence these are the expenses which taxpayers may (mistakenly) try to use to claim both an education tax credit and a tax-free 529 plan distribution. (Other expenses, like room and board which are a qualified expense for 529 plans, are not a qualified expense for education tax credits and hence would not be used to claim an education tax credit.)

Impact

The value of the tax benefit of excluding earnings from the individual income taxation is larger for tax-filing units with higher marginal tax rates. 529s are more likely to benefit higher-income families because those taxpayers are subject to higher tax rates.

In addition to the tax advantages of 529s, these plans are also treated more favorably than other types of college savings or investments when determining a student's eligibility for federal need-based student aid. While the financial aid treatment of 529 assets depends on a student's particular circumstances (e.g., does the parent or student own the account, is the student a dependent of the parents), the financial aid formula generally treats savings for college in a 529 plan more favorably than savings in other types of accounts. This preference will grow even stronger during the 2024-2025 aid year, when 529 plan distributions from nonparent relatives such as grandparents will no longer count against a student's eligibility for federal student aid.

Rationale

529 plans were established by states in response to concern about the rising cost of college. The tax status of the first program, the Michigan Education Trust, was the subject of several federal court rulings that left major

issues unresolved. Congress eventually clarified these issues by enacting section 529 as part of the Small Business Job Protection Act of 1996 (P.L. 104-188). Under this law, individuals could defer taxes on their investment until they withdrew money from these accounts.

The Taxpayer Relief Act of 1997 (P.L. 105-34) added room and board to the list of qualified higher education expenses.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA, P.L. 107-16) temporarily (through 2010) made qualified distributions from 529s tax free (as opposed to tax-deferred). In 2006, the Pension Protection Act of 2006 (P.L. 109-280) made this EGTRRA change to 529s permanent.

At the end of 2017, P.L. 115-97 (commonly referred to as the Tax Cuts and Jobs Act or TCJA), expanded the definition of qualified higher education expenses to include up to \$10,000 per beneficiary per year for tuition expenses at a public, private, or religious elementary and secondary school.

At the end of 2019, the Setting Every Community Up for Retirement Enhancement Act (SECURE; Division O of P.L. 116-94) expanded the definition of qualified education expenses to include certain expenses associated with apprenticeships as well as up to \$10,000 in student loan repayments (for the beneficiary and each sibling of the beneficiary).

In late 2020, the FAFSA Simplification Act (Title VII of Division FF of P.L. 116-260) excluded 529 plan distributions from an account owned by an eligible student's nonparent family members from the calculation for federal student aid starting in the 2023-2024 aid year. Congress delayed this change until the 2024-2025 aid year in the FAFSA Simplification Act Technical Corrections Act (Division R of P.L. 117-103).

Assessment

The College Savings Plan Network found that there were almost 16 million 529 savings accounts with an aggregate value of \$412.5 billion at the end of June 2022. Families that save in 529 accounts tend to be wealthier. According to a 2012 report by the Government Accountability Office, "less than 3 percent of families saved in a 529 plan [or Coverdells]. . . among those families who considered saving for education a priority, fewer than 1 in 10 had a 529 plan (or Coverdell). Families with these accounts had about 25 times the median financial assets of those without. They also had about 3 times the

median income and the percentage that had college degrees was about twice as high as for families without 529 plans (or Coverdells).”

529 plans were intended to encourage families to save for college. However, their disproportionate use by higher-income families, who are more likely to save without 529 plans, suggests these plans may not efficiently encourage college saving. Even with 529 plans, lower- and middle-income families may lack the income or have other financial priorities (like retirement savings) that make it difficult to save for college in the first place. In addition, lower- and middle-income families may be unaware of 529 plans, discouraged from investing with minimum initial contribution requirements or complex fee structures, or unfamiliar with the variety of investment options available.

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Education, Training, Employment, and Social Services

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR STUDENT LOANS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.1	0.3
2021	0.3	0.1	0.4
2022	0.3	0.1	0.4
2023	0.3	0.1	0.4
2024	0.3	0.1	0.4

Authorization

Sections 103, 141, 144(b), and 146.

Description

Student loan bonds are tax-exempt bonds issued by states to finance reduced-rate student loans. Since July 1, 2010, students have had the option of borrowing directly from the U.S. Department of Education, a process that can compete with student loans financed with tax-exempt bonds issued by states. These tax-exempt bonds are subject to the private-activity bond annual volume cap and must compete for cap allocations with bond proposals for all other private activities subject to the volume cap. The private-activity bond annual volume cap is equal to the greater of \$110 per state resident or \$335.115 million in 2022. The cap has been adjusted for inflation since 2003. This tax expenditure represents the revenue loss from these bonds.

Before July 1, 2010, the federal government maintained several loan programs that were made through private lenders and were financed in part by

tax-exempt debt. Part of this tax expenditure includes outstanding tax-exempt bonds issued for this purpose. These programs include Stafford Loans, PLUS Loans, and Consolidation Loans, which were made by private lenders under the Federal Family Education Loan (FFEL) Program. No further loans were made under the FFEL Program beginning July 1, 2010. All new Stafford, PLUS, and Consolidation Loans will come directly from the department under the Direct Loan Program.

Impact

Since interest on the student loan bonds is tax-exempt, purchasers are willing to accept lower pre-tax rates of interest than on taxable securities. The relatively low interest rate may increase the availability of student loans because states may be more willing to lend to more students. In 2021, \$2.97 billion in qualified student loan bonds were issued. However, the interest rate paid by the students is not any lower since the rate is set by federal law. Student loan bonds also create a secondary market for student loans that compares favorably with the private sector counterpart in the secondary market for student loans.

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

Rationale

Although the first student loan bonds were issued in the mid-1960s, few states used them in the next 10 years. The use of student loan bonds began growing rapidly in the late 1970s because of the combined effect of three pieces of legislation.

First, the Tax Reform Act of 1976 (P.L. 94-455) authorized nonprofit corporations established by state and local governments to issue tax-exempt bonds to acquire guaranteed student loans. It exempted the special allowance payment from tax-code provisions prohibiting arbitrage profits (borrowing at low interest rates and investing the proceeds in assets (e.g., student loans) paying higher interest rates). State authorities could use arbitrage earnings to make or purchase additional student loans or turn them over to the state government or a political subdivision. This rule provided incentives for state

and local governments to establish more student loan authorities. State authorities could also offer discounting and other features private lenders could not because of the lower cost of tax-exempt debt financing.

Second, the 1976 act raised the ceiling on Special Allowance Payments (SAPs) and tied them to quarterly changes in the 91-day Treasury bill rate. The Middle Income Student Assistance Act of 1978 (P.L. 95-566) made all students, regardless of family income, eligible for interest subsidies on their loans, expanding the demand for loans by students from higher-income families.

Third, the Higher Education Technical Amendments of 1979 (P.L. 96-49) removed the ceiling, making the program more attractive to commercial banks and other lenders, and increasing the supply of loans.

In 1980, when Congress became aware of the profitability of tax-exempt student loan bond programs, it passed remedial legislation, the Mortgage Subsidy Bond Tax Act of 1980 (P.L. 96-499), which reduced by one-half the special allowance rate paid on loans originating from the proceeds of tax-exempt bonds.

Subsequently, the Deficit Reduction Act of 1984 (P.L. 98-369) mandated a Congressional Budget Office study of the arbitrage treatment of student loan bonds, and required that Treasury enact regulations if Congress did not respond to the study's recommendations.

Regulations were issued in 1989, effective in 1990, which required SAPs to be included in the calculation of arbitrage profits, and that restricted arbitrage profits to 2 percentage points in excess of the yield on the student loan bonds. The Tax Reform Act of 1986 (P.L. 99-514) allowed student loans to earn 18 months of arbitrage profits on unspent (not loaned) bond proceeds. This special provision expired one-and-a-half years after adoption, and student loans are now subject to the same six-month restriction on arbitrage earnings as other private-activity bonds.

The Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) ended loans made available through the FFEL after June 30, 2010. These loans included Stafford Loans, Unsubsidized Stafford Loans, PLUS Loans, and Consolidation Loans. Tax-exempt private-activity bonds were often issued in conjunction with these state administered FFEL programs.

Assessment

The desirability of allowing these bonds to be eligible for tax-exempt status hinges on one's view of whether students should pay the full cost of their education, or whether sufficient social benefits exist to justify a federal subsidy. Students present high credit risk due to their uncertain earning prospects, their high mobility, and society's unwillingness to accept future earnings as loan collateral. This suggests there may be insufficient funds available for investment in education, which increases the value of human capital, as opposed to investment in physical capital.

Even if a case can be made for subsidy for underinvestment in human capital, it is not clear that tax-exempt financing is necessary or sufficient to correct the market failure. The presence of direct federal loans already addresses the problem and could be adjusted to address the underinvestment. In addition, it is important to recognize the potential costs. As one of many categories of tax-exempt private-activity bonds, bonds issued for student loans have increased the financing costs of bonds issued for public capital stock, and have increased the supply of assets available to individuals and corporations to shelter their income from taxation.

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Education, Training, Employment, and Social Services

**EXCLUSION OF EMPLOYER-PROVIDED
TUITION REDUCTION BENEFITS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.3	—	0.3
2021	0.3	—	0.3
2022	0.3	—	0.3
2023	0.3	—	0.3
2024	0.3	—	0.3

Authorization

Section 117(d).

Description

Individuals who work for educational institutions and receive tuition reductions from their employers do not have to include the amount of this reduction in their gross income if it is a “qualified tuition reduction.” Amounts that are excludible from gross income for income tax purposes are also excluded from wages for payroll tax purposes.

There are a variety of requirements that must be met for a tuition reduction to be considered “qualified” and hence tax-free. First, a qualified tuition reduction must be provided by and used at an eligible education institution. An eligible education institution is defined as an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. Hence, eligible educational institutions include both higher education institutions as well as elementary and secondary educational institutions.

Second, a qualified tuition reduction must be available to employees on a nondiscriminatory basis. In other words, the provision of this benefit cannot discriminate in favor of highly compensated employees.

Third, any tuition reduction that is received as payment for services is generally includable in income and hence may be subject to taxation. Exceptions to this rule exist for scholarship or fellowship income received through the National Health Service Corps Scholarship Program, the Armed Forces Health Professions Scholarship and Financial Assistance Program, and any comprehensive student work-learning-service program (as defined in section 448(e) of P.L. 89-329, the Higher Education Act of 1965) operated by a work college.

Other rules for determining if a tuition reduction is “qualified” (and hence tax-free) differ if the education is below the graduate level (K-12 and undergraduate), or graduate education. If the tuition reduction is for education below the graduate level, it is considered qualified (assuming other requirements are met) if the student has a specific relationship to the eligible educational institution providing the benefit—generally they are or were an employee of the eligible educational institution or an immediate family member of such employee. Specifically, the student must be (1) an employee of the eligible educational institution; (2) a former employee of the eligible educational institution, but retired or left on disability; (3) a widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability; or (4) a dependent child or spouse of any of the individuals described above. If the tuition reduction is for graduate education, it is considered qualified (assuming other requirements are met) if the student is a graduate student who performs teaching or research activities for the educational institution.

Impact

The exclusion of tuition reductions lowers the net cost of education for employees of educational institutions. When teachers and other school employees take reduced-tuition courses, the exclusion provides a tax benefit not available to other taxpayers unless their employers provide tuition assistance under an employer education-assistance plan (Section 127). When their spouse or children take reduced-tuition courses, the exclusion provides a unique employment benefit unavailable to other taxpayers.

Rationale

Language regarding tuition reductions was added by the Deficit Reduction Act of 1984 (P.L. 98-369) as part of legislation codifying and establishing boundaries for tax-free fringe benefits; similar provisions had existed in regulations since 1956.

Assessment

Educational institutions provide tuition reductions to employees as a fringe benefit, which may reduce costs of labor and job turnover. In addition, tuition reductions for graduate students providing research and teaching services for the educational institution also contribute to reducing the educational institution's labor costs. Both employees and graduate students may view the reduced tuition as a benefit of their employment that encourages education. The exclusion may, however, pass some of the educational institutions' labor costs onto other taxpayers.

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Education, Training, Employment, and Social Services

**EXCLUSION OF SCHOLARSHIP AND
FELLOWSHIP INCOME**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.8	—	3.8
2021	3.9	—	3.9
2022	4.0	—	4.0
2023	4.1	—	4.1
2024	4.2	—	4.2

Authorization

Section 117.

Description

Scholarships and fellowships are excludable from the recipient's gross income (and hence not taxable) provided that: (1) the recipient is a candidate for a degree at an eligible educational institution; and (2) the recipient uses the scholarship or fellowship amounts to pay for tuition and fees required for enrollment or for books, supplies, fees, and equipment required for courses at the eligible educational institution. Scholarships and fellowships include awards based upon financial need (e.g., Pell Grants) as well as those based upon scholastic achievement or promise (e.g., National Merit Scholarships).

Scholarships and fellowships that recipients use to pay for room, board, and incidental expenses are not excluded from gross income and are taxable.

Generally, payments for services—teaching, research, or other activities—are not excludable, regardless of when the service is performed or whether it is required of all degree candidates. An exception to this rule applies

to funds received from the National Health Service Corps Scholarship Program, the Armed Forces Health Professions Scholarship and Financial Assistance Program, or a comprehensive student work-learning-service program (as defined in section 448(e) of the Higher Education Act of 1965, P.L. 89-329) operated by a work college. These amounts are excludible from income and not subject to taxation even if they represent payment for services.

Eligible educational institutions are those that maintain a regular teaching staff and curriculum, and have a regularly enrolled student body attending classes where the school carries out its educational activities.

Impact

The exclusion reduces the net cost of education for students who receive financial aid in the form of scholarships or fellowships. The potential benefit is greatest for students at higher-tuition schools, as they can exclude a greater amount of scholarship or fellowship assistance.

In addition, as with all tax benefits that reduce taxable income, the tax benefit of this exclusion is proportional to the taxpayer's top marginal tax rate. If a taxpayer excludes \$10,000 of scholarship or fellowship income and is subject to a top marginal rate of 10%, the exclusion will result in a tax savings of \$1,000. If, on the other hand, the taxpayer is subject to a top marginal tax rate of 37%, the exclusion will result in a tax savings of \$3,700.

Some students with very low incomes may not benefit at all from this exclusion, as they could reduce their taxable income to zero by claiming the standard deduction regardless. However, the exclusion's benefit may be substantial for students with other income or married postsecondary students who file joint returns with their employed spouses.

Rationale

Section 117 was enacted as part of the Internal Revenue Code of 1954 to clarify the tax status of grants to students. Previously, students could only exclude grants that were gifts.

The statute has been amended a number of times. The Tax Reform Act of 1986 (P.L. 99-514) limited the exclusion in two ways. First, it barred individuals who were not candidates for a degree from claiming it. Previously, such taxpayers could exclude up to \$300 a month with a lifetime limit of 36 months. Additionally, it repealed a provision that permitted taxpayers to

exclude scholarships received for teaching and other service requirements provided all candidates had such obligations.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) temporarily enacted (through 2010) the exceptions for awards received under the National Health Service Corps Scholarship Program and the Armed Forces Health Professions Scholarship and Financial Assistance Program. Congress extended the exception until 2012 through the Tax Relief, Unemployment Insurance Reauthorization, and Tax Relief Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act of 2012 (P.L. 112-240) later made it permanent.

The exception for comprehensive student work-learning-service programs (as defined in section 448(e) of the Higher Education Act of 1965, P.L. 89-329) operated by a work college was added in the Protecting Americans from Tax Hikes Act of 2015 (PATH Act; Division Q of P.L. 114-113).

Assessment

Proponents initially justified the exclusion of scholarship and fellowship income on the grounds that the awards were analogous to gifts. With the development and proliferation of grant programs based on financial need, justification now rests on the hardship that taxation would impose.

If the exclusion were abolished, awards could arguably be increased to cover students' additional tax liability, but the likely effect would be that fewer students would get assistance. Additionally, scholarships and fellowships are not the only education benefits that receive favorable tax treatment (e.g., government support of public colleges, which has the effect of lowering tuition, is not considered income to the students), and it might be distortionary or inequitable to tax them without taxing the others.

The exclusion provides greater benefits to taxpayers with higher marginal tax rates. While students themselves generally pay tax at low (or even zero) marginal rates, many are members of families who are subject to higher rates. Determining the proper taxpaying unit for college students complicates assessment of the exclusion.

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Education, Training, Employment, and Social Services

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT BONDS FOR PRIVATE NONPROFIT AND
QUALIFIED PUBLIC EDUCATIONAL FACILITIES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	2.2	0.5	2.7
2021	2.2	0.5	2.7
2022	2.2	0.5	2.7
2023	2.2	0.5	2.7
2024	2.2	0.5	2.7

Authorization

Sections 103, 141, 142(k), 145, 146, and 501(c)(3).

Description

Interest income on state and local bonds used to finance the construction of private nonprofit educational facilities (usually university and college facilities such as classrooms and dormitories) and qualified public educational facilities (QPEFs) is tax-exempt. The private nonprofit organization bonds and bonds issued for QPEFs are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Bonds issued for nonprofit educational facilities are not subject to the state volume cap on qualified private-activity bonds (the state volume cap in

2022 is the greater of \$110 per state resident or \$335.115 million). This exclusion from the volume cap probably reflects the belief that the nonprofit bonds have a greater benefit to the general public than do many of the other private activities eligible for tax-exemption. The bonds are subject to a \$150 million cap on the amount of bonds any nonprofit institution (other than hospitals) can have outstanding.

Separate from the volume cap imposed on many qualified private activity bonds described above, bonds issued for QPEFs are also subject to a state-by-state annual cap: the greater of \$10 per capita or \$5 million.

Impact

Since interest on the bonds is tax-exempt, purchasers are willing to accept lower before-tax rates of interest than on taxable securities. These low interest rates enable issuers to finance both types of educational facilities at reduced interest rates. Some of the benefits of the tax-exemption also flow to bondholders. For a discussion of the factors that determine the share of benefits going to bondholders and users of the nonprofit educational facilities, and estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Purpose Public Assistance: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The income tax adopted in 1913, in conformance with long-standing principles regarding government support of charitable organizations that provide public benefit, exempted from taxation virtually the same organizations now included under Section 501(c)(3). In addition to their tax-exempt status, these institutions were permitted to receive the benefits of tax-exempt bonds under the Revenue and Expenditure Control Act of 1968 (RECA, P.L. 90-364). Almost all states have established public authorities to issue tax-exempt bonds for nonprofit educational facilities.

The interest exclusion for QPEFs was provided in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) and is intended to extend tax preferences to public school facilities which are owned by private, for-profit corporations. The school must have, however, a public-private agreement with the local educational authority. The private-activity status of these bonds subjects them to more severe restrictions in some areas, such as arbitrage rebate and advance refunding, than would apply if they were classified as traditional governmental school bonds. These provisions were

extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act of 2012 (P.L. 112-240) made the interest exclusion for QPEFs permanent.

Assessment

Efforts have been made to reclassify nonprofit bonds as governmental bonds. Central to this issue is the extent to which nonprofit organizations are fulfilling their public purpose. Some argue that these entities are using their tax-exempt status to subsidize goods and services for groups that might receive more critical scrutiny if they were subsidized by direct federal expenditure.

As one of many categories of tax-exempt private-activity bonds, nonprofit educational facilities and QPEFs have increased the financing costs of bonds issued for more traditional public capital stock. The higher cost arises because the QPEFs compete for a relatively fixed amount of available investment capital. In addition, this class of tax-exempt bonds has increased the supply of assets that individuals and corporations can use to shelter income from taxation.

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Education, Training, Employment, and Social Services

**CREDIT FOR HOLDERS OF QUALIFIED ZONE ACADEMY
BONDS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	0.1	0.3
2021	0.2	0.1	0.3
2022	0.2	0.1	0.3
2023	0.2	0.1	0.3
2024	0.2	0.1	0.3

Note: Estimates include outlay effects associated with the refundable portion of QZABs. These outlay effects are estimated to increase outlays by a combined \$0.8 billion from FY2020-FY2024. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

Authorization

Sections 54E and 1397E.

Description

Qualified zone academy bonds (QZABs) are debt instruments issued by municipal governments for projects related to certain primary and secondary schools. Holders of QZABs can claim a credit equal to the dollar value of the bonds held multiplied by a credit rate determined by the Secretary of the Treasury. The credit rate is equal to the percentage that will permit the bonds to be issued without discount and without interest cost to the issuer. The bonds must be purchased by a bank, an insurance company, or a corporation in the business of lending money.

More recent QZAB issuances were offered another financing option. In the 111th Congress, the American Recovery and Reinvestment Act (ARRA, P.L. 111-5) created a new type of tax credit bond, Build America Bonds (BABs, see the entry *Build America Bonds*), that allowed issuers the option of receiving a direct payment from the U.S. Treasury instead of tax-exempt interest payments or tax credits paid to the investors. Later in the 111th Congress, the Hiring Incentives to Restore Employment Act (HIRE, P.L. 111-147) provided for a direct payment option for new QZABs. Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rate for direct payment QZABs and all other direct payment tax credit bonds (TCBs) were subject to sequestration from FY2013 through FY2020. For FY2021, the sequestration reduced the direct payment QZAB credit rate by 5.7 percent. Current law extends the 5.7 percent reduction to direct payment QZABs for all fiscal years through FY2030.

A qualified zone academy must be a public school below the college level. It must be located in an Empowerment Zone or Enterprise Community, or have a student body with an eligibility rate for free or reduced-cost lunches of at least 35 percent. The maximum maturity of the bonds is that which will set the present value of the obligation to repay the principal equal to 50 percent of the face amount of the bond issue. The discount rate for the calculation is the average annual interest rate on tax-exempt bonds issued in the preceding month having a term of at least 10 years. Ninety-five percent of bond proceeds must be used within five years to renovate capital facilities, provide equipment, develop course materials, or train personnel. The academy must operate a special academic program in cooperation with businesses, and private entities must contribute equipment, technical assistance, employee services, or other property worth at least 10 percent of bond proceeds. The limit for QZAB debt was \$400 million annually from 1998 through 2008, \$1.4 billion for each of 2009 and 2010, and \$400 million for 2011 through 2016. Authority to issue QZABs has expired, and the 2017 tax revision (P.L. 115-97) repealed issuing authority for all tax credit bonds beginning on January 1, 2018.

Impact

The interest income on bonds issued by state and local governments usually is excluded from federal income tax (see the entry *Exclusion of Interest on Public Purpose State and Local Debt*). Such bonds result in the federal government paying a portion (approximately 25 percent) of the issuer's interest costs. QZABs are structured to have the entire interest cost of the state

or local government paid by the federal government in the form of a tax credit to the bond holders or in select instances direct payment to the issuer. QZABs are not tax-exempt bonds.

The cost has been capped at the value of federal tax credits generated by the cap on QZAB volume. If school districts in any state do not use their annual allotment, unused capacity can be carried forward for up to two years.

Rationale

The Taxpayer Relief Act of 1997 (P.L. 105-34) created QZABs. Some low-income school districts found it difficult to pass bond referenda to finance new schools or to rehabilitate existing schools. Increasing the size of the existing subsidy provided by tax-exempt bonds from partial to 100 percent federal payment of interest costs was expected to make school investments less expensive and therefore more attractive to taxpayers in these districts. The tax provision was also intended to encourage public/private partnerships, and eligibility depends in part on a school district's ability to attract private contributions that have a present value equal to at least 10 percent of the value of the bond proceeds. The Tax Relief and Health Care Act (P.L. 109-432) extended QZABs for two years (for 2006 and 2007), introduced the five-year spending horizon, and applied arbitrage rules. P.L. 110-343 extended the QZAB with \$400 million for each of 2008 and 2009. The \$1.4 billion limits for 2009 and 2010 were provided in ARRA. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (P.L. 111-312) extended QZAB through 2011 with a \$400 million limit. The authority to issue QZABs was extended through December 31, 2013, by the American Taxpayer Relief Act of 2012 (P.L. 112-240). Most recently, the Consolidated Appropriations Act, 2016 (P.L. 114-113) authorized an additional \$400 million dollars in QZABs for both 2015 and 2016. P.L. 115-97 repealed issuing authority for all tax credit bonds beginning in tax year 2018.

Assessment

Financial institutions can be induced to purchase these bonds if they receive the same after-tax return from the tax credit that they would from the purchase of tax-exempt bonds. The value of the credit is included in taxable income, but is used to reduce regular or alternative minimum tax liability. Assuming the taxpayer is subject to the regular corporate income tax, the credit rate should equal the ratio of the purchaser's forgone market interest rate on tax-exempt bonds divided by one minus the corporate tax rate. For example,

if the tax-exempt interest rate is 6 percent and the corporate tax rate is 21 percent, the credit rate would be equal to $.06/(1-.21)$, or about 7.6 percent. Thus, a financial institution purchasing a \$1,000 QZAB would receive a \$76 tax credit for each year it holds the bond.

With QZABs, the federal government pays 100 percent of interest costs; tax-exempt bonds used for financing other public facilities finance only a portion of interest costs. For example, if the taxable rate is 8 percent and the tax-exempt rate is 6 percent, the non-QZAB bond receives a subsidy equal to two percentage points of the total interest cost, the difference between 8 percent and 6 percent. The zone academy bond receives a subsidy equal to all eight percentage points of the interest cost. Thus, this provision reduces the price of investing in schools compared to investing in other public services provided by a governmental unit, and other things equal should cause some reallocation of the unit's budget toward schools. In addition, the entire subsidy (the cost to the federal taxpayer) is received by the issuing government if the direct payment option is chosen, unlike tax-exempt bonds.

The Budget Control Act (P.L. 112-25), as amended, reduced the credit rate for direct payment QZABs from FY2013 through FY2020, through sequestration. For FY2021 through FY2030, the sequestration will reduce the direct payment QZAB credit rate by 5.7 percent. With this modification, in the example above the direct payment subsidy received for the zone academy bond would be equal to 94.3 percent (i.e., $100-5.7$) of the eight percentage points of interest costs, or 7.544 percent.

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Education, Training, Employment, and Social Services

QUALIFIED SCHOOL CONSTRUCTION BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	—	0.7
2021	0.7	—	0.7
2022	0.7	—	0.7
2023	0.7	—	0.7
2024	0.7	—	0.7

Note: Estimates include outlay effects associated with the refundable portion of QSCBs. These outlay effects are estimated to increase outlays by a combined \$3.5 billion from FY2020 through FY2024. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

Authorization

Sections 54A and 54F.

Description

Qualified school construction bonds (QSCBs) are debt instruments issued by municipal governments for certain school construction projects. Holders of QSCBs can claim a credit equal to the dollar value of the bonds held multiplied by a credit rate determined by the Secretary of the Treasury. The credit rate is equal to the percentage that will permit the bonds to be issued without discount and without interest cost to the issuer and is roughly equivalent to the interest rate on a taxable 10-year bond. The maximum maturity of the bonds is that which will set the present value of the obligation to repay the principal equal to 50 percent of the face amount of the bond issue.

There was a second option for issuers of QSCBs. In the 111th Congress, the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) created a new type of tax credit bond, Build America Bonds (BABs, see the entry *Build America Bonds*), that allowed issuers the option of receiving a direct payment from the U.S. Treasury instead of tax-exempt interest payments or tax credits for investors. Later in the 111th Congress, the Hiring Incentives to Restore Employment Act (HIRE, P.L. 111-147) provided for a direct payment option, like that for BABs, for new QSCBs. Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rate for direct payment QSCBs and all other direct payment tax credit bonds (TCBs) was subject to sequestration from FY2013 through FY2020. For FY2021 through FY2030, the sequestration reduces the direct payment QSCB credit rate by 5.7 percent.

The bonds generally are allocated to states according to each state's share of Title I Basic Grants (Section 1124 of the Elementary and Secondary Education Act of 1965; 20 U.S.C. §6333). The District of Columbia and the possessions of the United States are considered states for QSCBs. The possessions other than Puerto Rico (i.e., American Samoa, Commonwealth of the Northern Mariana Islands, Guam, and U.S. Virgin Islands), however, are allocated an amount on the basis of the possession's population with income below the poverty line as a portion of the entire U.S. population with income below the poverty line. QSCBs had a national limit of \$11 billion in each of 2009 and 2010. An additional \$200 million in each of 2009 and 2010 was allocated to tribal schools. As of December 2012, QSCB issuance was over \$15.4 billion. Authority to issue QSCBs expired at the end of 2010, and the 2017 tax revision (P.L. 115-97) repealed issuing authority for all TCBs beginning on January 1, 2018.

Forty percent of the national QSCB volume (\$4.4 billion) was dedicated to large Local Education Agencies (LEAs). A "large" LEA is defined as one of the 100 largest based on the number of "children aged 5 through 17 from families living below the poverty level." Also, one of up to 25 additional LEAs can be chosen by the Secretary if the LEA is "in particular need of assistance, based on a low level of resources for school construction, high level of enrollment growth, or such other factors as the Secretary deems appropriate." Each large LEA would receive an allocation based on the LEA's share of the total Title I basic grants directed to large LEAs. The state allocation is reduced by the amount dedicated to any large LEAs in the state, and unused allocations can be carried forward.

Impact

The impact of QSCBs on new school construction has been significant given the relatively substantial interest rate subsidy. As of December 2012, QSCBs issuances exceeded \$15.4 billion. Generally, the interest income on traditional bonds issued by state and local governments for school construction is excluded from federal income tax (see the entry *Exclusion of Interest on Public Purpose State and Local Debt*). Such bonds result in the federal government paying a portion (approximately 25 percent) of the issuer's interest costs. In contrast, QSCBs are structured to have the federal government pay almost the entire interest cost of the state or local government in the form of a federal tax credit to the bond holders or the bond issuers.

Ultimately, however, the impact of QSCBs depends on how responsive school districts were to the reduced interest cost for school construction. Because QSCBs were relatively new, the impact of the tax expenditure for the bonds is somewhat uncertain. The \$15.4 billion of school construction with QSCBs may have occurred even without the QSCB program, though the size of the interest rate subsidy would seem to have had some stimulative effect on school construction.

Rationale

As noted earlier, the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) created QSCBs. These bonds offered a subsidy much larger than that provided by tax-exempt bonds. The federal payment of most interest costs was expected to make school investments less expensive and therefore more attractive to taxpayers in all school districts. Many observers noted that the underinvestment in public school infrastructure adversely affects education outcomes. Proponents also cited the possible stimulative effect of additional public infrastructure spending arising from this program during the Great Recession.

Assessment

For issuers, QSCBs were assessed against the most common alternative mechanism for financing school construction: tax-exempt bonds. With QSCBs, the federal government pays almost all of the interest costs. In contrast, tax-exempt bonds that finance the construction of schools as well as other public facilities provide a subsidy for only a portion of interest costs. For example, if the taxable rate is 7 percent and the tax-exempt rate is 5 percent, the tax-exempt bond issuer receives a subsidy equal to two percentage points

of the total interest cost, the difference between 7 percent and 5 percent. The QSCB issuer receives a subsidy equal to all seven percentage points of the interest cost. Almost the entire subsidy (the cost to the federal taxpayer) is received by the QSCB-issuing government. There is a clear incentive for issuers to use QSCBs over tax-exempt bonds, and the QSCB subsidy should be roughly the same with either the investor credit or direct-payment option. The Budget Control Act (P.L. 112-25), as amended, reduced the credit rate for direct payment QSCBs from FY2013 through FY2020 through sequestration. For FY2021 through FY2030, the sequestration reduces the direct payment QSCB credit rate by 5.7 percent.

Investors, in contrast to issuers, do not share the same clear incentive to purchase QSCBs. Investors can be induced to purchase these bonds if they receive at least the same after-tax return from the credit as that from the tax-exempt bonds or other taxable instruments of similar risk. When QSCBs are evaluated against tax-exempt bonds, the credit rate should equal the ratio of the investor's forgone market interest rate on tax-exempt bonds divided by one minus the regular tax rate. Thus, investors in higher-tax marginal income tax brackets would need a higher credit rate to equate the return on QSCBs to that of tax-exempt bonds. The uniform credit rate across jurisdictions would seem to make QSCBs less attractive to high-income investors for higher-risk jurisdictions.

Compared to other taxable investments of similar risk, QSCBs may be at a disadvantage given the relatively unique structure and limited supply of the bonds. In particular, jurisdictions generally perceived as higher risk may need to increase the attractiveness of QSCBs to investors with financial enhancements such as bond insurance. These enhancements would reduce the benefit to the issuing jurisdictions.

In theory, if the demand for these bonds exceeds that of traditional tax-exempt bonds issued for the same purpose, then interest costs for the issuer could be further reduced. Also, if the credit rate is set such that the bonds are more attractive relative to other taxable instruments, issuers may realize an additional interest cost savings. The savings from issuing QSCBs, thus, may lead to more investment in school construction.

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Education, Training, Employment and Social Services

**EXCLUSION OF INCOME ATTRIBUTABLE TO THE
DISCHARGE OF CERTAIN STUDENT LOAN DEBT AND
CERTAIN FEDERAL AND STATE EDUCATION LOAN
REPAYMENT PROGRAMS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	0.2	—	0.2
2023	0.2	—	0.2
2024	0.2	—	0.2

Note: This provision was temporarily expanded by P.L. 117-2. These changes are estimated to reduce revenues by \$43 million from FY2021 through FY2026 according to JCT (JCX-14-21).

Authorization

Section 108(f) and 20 U.S.C. §§1087(c)(4), 1087e(a)(1), 1087dd(g)(4), and 1087ee(a)(5).

Description

In general, cancelled or forgiven debt, or debt that is repaid on the borrower's behalf or discharged, is included as gross income for individuals for purposes of taxation under Section 61(a)(11) of the Internal Revenue Code (IRC). However, IRC Section 108(f) and provisions in the Higher Education Act provide that in certain instances, student loan cancellation or discharge and student loan repayment assistance may be excluded from gross income.

Loan Repayment and Forgiveness Programs

Cancelled or forgiven student loan debt may be excluded from gross income under Section 108(f)(1) under two main conditions. First, the loan was made by specified types of lenders to assist the individual in attending a qualified educational organization described in Section 170(b)(1)(A)(ii). Second, the loan contains terms providing that some or all of the loan will be cancelled for work for a specified period of time, in certain professions or occupations, and for any broad class of employers.

Specified lenders are the government (the United States, or an instrumentality or agency thereof; or a state, territory, possession, or the District of Columbia, or any, subdivision thereof); tax-exempt public benefit corporations that have assumed control of a state, county, or municipal hospital and whose employees are considered public employees under state law; and educational organizations if the loan is made under an agreement with an entity described above, or under a program of the organization designed to encourage students to serve in occupations or areas with unmet needs and under the direction of a governmental entity or a tax-exempt Section 501(c)(3) organization.

Student loans may be broadly categorized either as federal student loans, or as private education loans as defined under section 140(a)(8) of the Truth in Lending Act (P.L. 90-321, as amended). The primary program through which federal student loans are currently being made is the William D. Ford Federal Direct Loan (Direct Loan) program. Previously, federal student loans were also made available under the Federal Family Education Loan (FFEL) program and the Federal Perkins Loan (Perkins Loan) program. Although loans are no longer being made under the FFEL program or the Perkins Loan program, borrowers remain obligated to repay those loans. All three of these programs make or made loans available to students, and the Direct Loan and FFEL programs have made loans available to parents who may borrow on behalf of their dependent undergraduate student. Loans made under each of these programs contain terms that provide that if borrowers work for specified periods of time in certain professions, for certain broad classes of employers, all or a portion of their debt will be cancelled or forgiven. Examples include teacher loan forgiveness under the FFEL and Direct Loan programs, loan forgiveness for public service employees under the Direct Loan program, and loan cancellation for public service under the Perkins Loan program. Some private education loans may be made with terms that meet the requirements of Section 108(f). Thus, if they are repaid or forgiven upon the individual's

completion of specified service, some private education loans may be excluded from gross income.

Federal student loans are made by different types of lenders. Direct Loan program loans are made directly by the federal government and thus, when forgiven for work in certain professions or occupations, the forgiven debt may be excluded from gross income. FFEL program loans are guaranteed by the federal government, but were made by a variety of lenders, including commercial banks, nonprofit entities, and state entities. While many FFEL program lenders were not among the types specified in Section 108(f), the Department of the Treasury has determined that because of the government's role in guaranteeing FFEL program loans and in discharging borrowers' debt, as a matter of subrogation, these loans can reasonably be viewed as being made by the government (INFO 2011-0053). Thus, when FFEL program loans are forgiven for work in certain professions or occupations, the forgiven debt may be excluded from taxation. While Perkins Loans are made by the postsecondary institutions that borrowers attend, the statute authorizing the Perkins Loan program specifies that any part of a Perkins Loan cancelled for certain types of public service shall not be considered income for purposes of the IRC (20 U.S.C. §1087ee(a)(5)).

Individuals may refinance existing student loans borrowed from any lender by obtaining a new loan made by an educational or other tax-exempt organization for purposes of participating in a public service program of that organization. The public service program must be designed to encourage borrowers to serve in occupations or areas with unmet needs and in which the services performed are under the direction of a governmental entity or a tax-exempt Section 501(c)(3) organization. If borrowers refinance their loans in this way and qualify for loan forgiveness or repayment, amounts forgiven or repaid are excluded from gross income.

An exclusion from gross income is also provided under Section 108(f)(4) for assistance provided under certain student loan repayment and loan forgiveness programs for health professionals. Such programs include the National Health Service Corps (NHSC) Loan Repayment Program and state programs eligible to receive funds under the Public Health Service Act, which provide payment on a borrower's behalf for principal, interest, and related expenses of educational loans in return for the borrower's service in a health professional shortage area. The Patient Protection and Affordable Care Act (ACA, P.L. 111-148) extended the exclusion from gross income to apply to state loan repayment and loan forgiveness programs designed to facilitate the

increased availability of health care services in underserved or health professional shortage areas beginning with tax year 2009.

Loans Discharged in 2021 through 2025

Discharged student loan debt may be excluded from gross income under IRC Section 108(f)(5) if the student loan was made expressly for postsecondary educational expenses by specified types of lenders, was made by a qualifying educational organization described in Section 170(b)(1)(A)(ii), was a private education loan, or was made by a qualifying educational organization described in Section 170(b)(1)(A)(ii) or by an organization exempt from tax under Section 501(a) to refinance a loan to an individual to assist the individual in attending such an educational organization. The discharge must have been made for almost any reason (excluding discharges of loans made by a qualifying educational organization described in Section 170(b)(1)(A)(ii) or by a private education lender, if the discharge was made for services performed for such organization or private lender) after December 31, 2020 and before January 1, 2026. For purposes of this provision, student loans include those federal student loans described above.

Impact

Section 108(f) permits individuals to exclude from their gross income some cancelled or forgiven student loan debt and payments made on their behalf under the NHSC and state loan repayment programs. The benefit provided to any individual taxpayer and the corresponding loss of revenue to the federal government is proportional to the taxpayer's marginal tax rate. The extent to which individuals choose to finance the costs of their education by initially borrowing from or refinancing through specified types of lenders, and subsequently choose to enter certain professions (e.g., public service, occupations with unmet need) because of available loan forgiveness or repayment programs and the favorable tax treatment of forgiven debt is unknown.

Section 108(f) also permits individuals to exclude some student loan debt discharged after December 31, 2020, and before January 1, 2026, for almost any reason, which could include, for example, administrative action to cancel student loan debt or forgiveness benefits associated with certain loan repayment plans available to some federal student loan borrowers. The benefit provided to any individual taxpayer and the corresponding loss of revenue to the federal government depends on the taxpayer's marginal tax rate and the

amount that is discharged. The extent to which individuals who have chosen to finance the costs of their education by initially borrowing from or refinancing through specified types of lenders and subsequently having their debt discharged is unknown.

Rationale

Congress first excluded certain loan repayment benefits from gross income in 1976 under the Tax Reform Act of 1976 (P.L. 94-455). Under the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, P.L. 98-369), a similar exclusion was included in IRC Section 108. Subsequently, in 2004, P.L. 108-357 extended the exclusion from gross income to apply to payments received under the NHSC loan repayment program, and, in 2010, PL 111-148 extended the exclusion to apply to state loan repayment and loan forgiveness programs. In 2017, P.L. 115-97 extended the exclusion from gross income to amounts of loans discharged due to death or total and permanent disability. Finally, in 2021, the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2) replaced the exclusion from gross income of amounts of loans discharged due to death or total and permanent disability with an exclusion from gross income of amounts of loans discharged in 2021 through 2025 for almost any reason.

Whether to include the forgiveness of student loan debt or the repayment of debt through loan repayment assistance programs as part of gross income for purposes of taxation has been a policy issue for the past half century. Following the Supreme Court's decision in *Bingler v. Johnson*, 394 U.S. 741 (1969), the primary issue in determining whether loan forgiveness and loan repayment programs are taxable has been whether there exists a quid pro quo between the recipient and the lender. Generally, if borrowers must perform service for the entity forgiving or repaying their loans, it is assumed that a quid pro quo exists and so the amount forgiven or repaid is treated as taxable income. The policy issue is whether the service borrowers provide in return for the discharge of their loan is for the benefit of the grantor of debt forgiveness and thus should be considered akin to income, or if the service is for the benefit of the broader society and thus should potentially be excluded from income. Following IRS rulings made subsequent to *Bingler v. Johnson* that had established the discharge of student loan indebtedness as taxable income, Congress has periodically amended the IRC to override these rulings and to specifically exclude the discharge of broader categories of certain student loan debt from taxation. As a result, the IRC currently provides tax treatment for qualified loan forgiveness and loan repayment programs similar

to the treatment of educational grants and scholarships, which, generally, are not taxable.

Whether to include the discharge of student loan debt for other reasons (such as discharge due to death or total and permanent disability) as part of gross income for purposes of taxation has been a policy issue for several years, and legislation to exclude such discharged debt has been introduced multiple times in recent years. Most recently, under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2), Congress excluded the discharge of certain student loan debt from taxation for almost any reason for loans discharged after December 31, 2020, and before January 1, 2026.

Assessment

The value to an individual of excluding the discharge of student loan indebtedness from gross income depends on that individual's marginal tax rate in the tax year in which the benefit is realized.

In some instances, beneficiaries are required to have served in certain types of professions or occupations, including occupations with unmet need, or that are in locations with unmet needs. Examples of programs include federal and other programs that provide loan cancellation or repayment for employment as teachers, in public service jobs, in areas of national need, and in health professional shortage areas. In many instances, borrowers employed in these types of professions may be in lower tax brackets than if they had taken higher paying jobs elsewhere. Section 108(f) was made applicable to payments received through the NHSC Loan Repayment Program under P.L. 108-357. Previously, the program provided loan repayment recipients with an additional payment for tax liability equal to 39 percent of the loan repayment amount (42 U.S.C. §2541-1(g)(3)). By excluding NHSC loan repayment from income, tax relief is now provided through forgone revenue as opposed to discretionary outlays.

In other instances, student loans may be discharged for a variety of other reasons, including, but not limited to, upon an individual's death or becoming totally and permanently disabled. Through the enactment of ARPA, Congress sought to address these and other loan discharge scenarios by making discharged loan amounts nontaxable.

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Education, Training, Employment, and Social Services

**DEDUCTION FOR CHARITABLE CONTRIBUTIONS TO
EDUCATIONAL INSTITUTIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	7.3	1.0	8.3
2021	7.3	1.1	8.4
2022	7.7	1.1	8.8
2023	6.6	1.0	7.6
2024	7.4	1.1	8.5

Note: This table does not reflect the effects of the Consolidated Appropriations Act, 2021, which caused an additional loss of \$1.3 billion in FY2021 and \$4.8 billion in FY2022 for all charitable contributions. It also caused a gain of \$1.6 billion in FY2023 and of \$0.5 billion in FY2024.

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations, including scientific, literary, or educational organizations. The estimated revenue loss in the table above is related to giving to educational institutions.

Individuals who itemize may deduct qualified contribution amounts of up to 50 percent of their adjusted gross income (AGI) and up to 30 percent for gifts of capital gain property. For 2018-2025, the limit is increased to 60 percent. For contributions to non-operating foundations and certain

organizations, deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over the amount of contributions that qualified for the 50-percent deduction ceiling (including carryovers from previous years). Gifts of capital gain property to these organizations are limited to 20 percent of AGI. Excess contributions can be carried forward for five years.

The limit was temporarily increased to 100% for 2020 for cash contributions to public charities (not to private foundations, supporting organizations, or donor advised funds). An above-the-line deduction for contributions of up to \$300 was also allowed for non-itemizers for 2020. These provisions were extended through 2021, and the \$300 amount was increased to \$600 for joint returns.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. This limit was temporarily increased to 25% for 2020 and 2021. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts have been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. However, an accrual-basis corporation is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

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

Taxpayers are required to obtain written substantiation from a donee organization for contributions that exceed \$250. This substantiation must be

received no later than the date the donor-taxpayer files the required income tax return. The written acknowledgment must contain sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the federal government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Individuals who use the standard deduction or who pay no taxes normally receive no benefit from the provision.

A limitation (temporarily suspended for 2018-2025) applies to the itemized deductions of high-income taxpayers, whereby itemized deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds an inflation adjusted dollar amount (\$320,000 for joint returns in 2018). The limit is capped at 80 percent of itemized deductions. However, because the limitation is triggered by income rather than deductions it is not effectively a limit on itemized deductions unless the cap is reached, which is unusual. The limit acts as an additional tax rate.

The following table provides the distribution of all charitable contributions, not just those to educational organizations. In general, contributions to education are more heavily concentrated among higher income taxpayers (and similar to contributions to the arts and health), as compared to contributions for religion, combined purpose charities, and charities to meet basic needs.

Distribution by Income Class of the Tax Expenditure for the Charitable Deduction, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.1
\$30 to \$40	0.2
\$40 to \$50	0.3
\$50 to \$75	0.4
\$75 to \$100	1.7
\$100 to \$200	2.4

Income Class (in thousands of \$)	Percentage Distribution
\$200 and over	94.9

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the sponsor, argued that high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were contributed to charitable organizations.

It was also argued that many colleges would lose students to the military, and that charitable gifts were needed by educational institutions to make up for lost tuition. Thus, the original rationale shows a concern for educational organizations. The deduction was originally limited to individuals. A deduction for trusts and estates was added in 1918, but a deduction for corporations was not allowed until 1935.

The deduction allowed in 1917 was limited to 15 percent of taxable income. Most of the revisions in the early tax law related to this limit. In 1924, it was changed to 15 percent of adjusted gross income. The corporate deduction was limited to 5 percent of income when introduced in 1935. In 1952, the individual limit was increased to 20 percent. The limit was increased to 30 percent in 1954, but the additional 10 percent had to go to a public charity (thus retaining a 20 percent limit for foundations). A carryover of unused deductions for two years was first allowed for corporations in 1954. In 1964, the carryover was increased to five years and extended to individuals.

The percentage limit on individual contributions to charities was increased to 50 percent by the Tax Reform Act of 1969 (P.L. 91-172) but was restricted to 30 percent for gifts of appreciated property. The percentage limit on corporate charitable contributions was increased to 10 percent of taxable income in the Economic Recovery Tax Act of 1981 (P.L. 97-34). The limit on contributions to private foundations was increased to 30 percent for cash contributions by the Deficit Reduction Act of 1984 (P.L. 98-369).

The Economic Recovery Tax Act of 1981 also allowed a temporary deduction for non-itemizers, but this provision was not extended.

Concerns about abuse led to provisions requiring greater substantiation of gifts. The Deficit Reduction Act of 1984 (P.L. 98-369) required written

substantiation of contributions in excess of \$2,000 and the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) lowered that amount to \$250. The American Jobs Creation Act of 2004 (P.L. 109-280) increased reporting requirements for donors of non-cash gifts.

The Pension Protection Act of 2006 (P.L. 109-280) provided for some temporary additional benefits (part of the “extenders”) that were effective through 2007 at that time. The 2006 act also added restrictions on donor advised funds (where sponsors receive contributions and then make donations advised by the original contributor) and certain supporting organizations (organizations that receive donations used to support other active charities). The 2006 law also tightened rules governing charitable giving in certain areas, including gifts of taxidermy, contributions of clothing and household items, contributions of fractional interests in tangible personal property, and record-keeping and substantiation requirements for certain charitable contributions.

Temporary charitable giving incentives were further extended through 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) enacted in October 2008, and through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). Some provisions were extended through 2013 by the American Taxpayer Relief Act (P.L. 112-240). These provisions were made permanent in the Consolidated Appropriations Act, 2016 (P.L. 114-113).

The 2017 tax change, P.L. 115-97, popularly known as the Tax Cuts and Jobs Act, increased the percentage of income limit for contributions of cash to public charities to 60 percent and eliminated the phaseout of itemized deductions on a temporary basis.

For 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) increased the limit for cash contributions by individuals to charities to 100% for 2020, allowed a \$300 above-the-line deduction for non-itemizers, and increased the limit to 25% for corporations. The Consolidated Appropriations Act, 2021 (P.L. 116-260) extended these provisions through 2021 and increased the above-the-line deduction for non-itemizers to \$600 for joint returns.

Assessment

Most economists agree that education produces substantial “spillover” effects benefitting society in general. Examples include a more efficient workforce, lower unemployment rates, lower welfare costs, and less crime. An

educated electorate fosters a more responsive and effective government. Since these benefits accrue to society at large, they argue in favor of the government actively promoting education.

Further, proponents argue that the federal government could be forced to assume some activities now provided by educational organizations if the deduction were eliminated. However, public spending might not be available to make up all the difference. In addition, many believe that the best method of allocating general welfare resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect that varies with the marginal tax rate of the giver. There are a number of studies that find significant behavioral responses, although a study by Randolph (1995) suggests that such measured responses may largely reflect transitory timing effects. Most recent estimates indicate that the induced giving is less than the revenue cost.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than are contributions to health organizations, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. The volume of donations to religious organizations, however, is greater than to all other organizations. In 2021, according to Giving USA and its research partner at Indiana University, charitable contributions from individuals, corporations, bequests, and foundations totaled \$485 billion, of which 28 percent (\$136 billion) was for religious institutions. Contributions to educational institutions amounted to 15 percent (\$71 billion) of total giving that year

More highly valued contributions, like intellectual property and patents, tend to be made by corporations to educational institutions.

Opponents say that helping educational organizations may not be the best way to spend government money. Opponents further claim that the present system allows wealthy taxpayers to indulge special interests (such as gifts to their alma maters). It is also generally argued that the charitable contributions deduction is difficult to administer and adds complexity to the tax code.

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Education, Training, Employment, and Social Services

EXCLUSION OF EMPLOYER-PROVIDED EDUCATION ASSISTANCE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.4	—	1.4
2021	1.4	—	1.4
2022	1.2	—	1.2
2023	1.3	—	1.3
2024	1.3	—	1.3

Authorization

Sections 127 and 3121(a)(18).

Description

Individuals can exclude from their gross income (and therefore not pay taxes on) the value of educational assistance for both graduate and undergraduate education provided by their employer. This exclusion is capped at \$5,250 annually.

There are three main requirements that must be satisfied in order for employer-provided educational assistance to be excludable from gross income and hence tax-free. First, the educational assistance must be provided pursuant to a written qualified educational assistance program. Second, the plan may not discriminate in favor of highly compensated employees. Third, no more than 5 percent of the total amount paid out during the year may be paid to or for employees who are shareholders or owners of at least 5 percent or more of the business. (The employer must maintain records and file a plan return.) The employer can either reimburse the employee's educational expenses or may

directly provide the education. (The exclusion only applies to the employee and not their spouse or dependents.)

Qualifying assistance payments include, but are not limited to, tuition, fees, and similar payments; books; supplies; and equipment. Through 2025, student loan payments are also eligible expenses.

Courses do not have to be job-related to qualify for the exclusion. Qualifying assistance payments do not include amounts for tools or supplies that can be kept by the employee; or for meals, lodging or transportation. Qualified education assistance does not include payment for any course or other education involving sports, games or hobbies.

Congress made some employer-provided student loan repayment benefits eligible for the exclusion through 2025. Only payments towards student loans eligible for the student loan interest deduction (IRC Section 221(d)(1)) qualify. Payments can cover both the principal and interest of a qualified student loan.

Generally, employer-provided educational assistance in excess of \$5,250 is includable in the employee's gross income and subject to both income and payroll taxes. However, employer-provided educational assistance might also be excludable as a working condition fringe benefit under Section 132.

Impact

The exclusion of these benefit payments may make continuing education more affordable for employees. It also encourages employers to compensate employees through educational assistance rather than additional taxable wages or benefits. The value of the exclusion is dependent upon the amount of educational expenses furnished and varies with the taxpayer's marginal tax rate.

Access to the benefit can vary, both between firms and among employees within an individual firm. In 2008, the U.S. Bureau of Labor Statistics stopped reporting the percent of employees in the private sector with access to employer-provided educational assistance. At that time, one-half of private sector employees had access to work-related educational assistance while 15 percent had access to nonwork-related educational assistance as part of their fringe benefit package. The workers most likely to have access to educational assistance benefits were those in management, professional, and related occupations; in full-time jobs; who belong to labor unions; with average wages

in the top half of the earnings distribution; and who work at large firms (100 or more employees).

Rationale

Section 127 was enacted on a temporary basis under the Revenue Act of 1978 (P.L. 95-600), effective through 1983. Before enactment, the Internal Revenue Service typically decided whether an employee could deduct the assistance as job-related education on a case-by-case basis.

Congress then regularly extended this temporary provision. It first was extended from the end of 1983 through 1985 by P.L. 98-611. The Tax Reform Act of 1986 (P.L. 99-514) next extended it through 1987, and raised the maximum excludable assistance from \$5,000 to \$5,250. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) reauthorized the exclusion retroactively to January 1, 1989, and extended it through September 30, 1990. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) then extended it through December 31, 1991, and the Tax Extension Act of 1991 (P.L. 102-227) further extended it through June 30, 1992. The Omnibus Reconciliation Act of 1993 (P.L. 103-66) reauthorized the provision retroactively for 1993 and through December 31, 1994; the Small Business Job Protection Act (P.L. 104-188) extended it to run from January 1, 1995, through May 31, 1997, but excluded graduate education courses beginning after June 30, 1996. The Taxpayer Relief Act of 1997 (P.L. 105-34) extended the exclusion—only for undergraduate education—for courses beginning before June 1, 2000. The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) extended the exclusion, also only for undergraduate education, through December 31, 2001.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) originally extended the exclusion through the end of 2010. It also expanded the exclusion to once again include graduate education. Congressional committee reports indicate this extension was designed to reduce the complexity of the tax law and was intended to result in fewer disputes between taxpayers and the Internal Revenue Service. The exclusion (and the EGTRRA expansion to include graduate education) was extended an additional two years—2011 and 2012—by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The exclusion (and the EGTRRA modification) was made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) temporarily expanded the definition of employer-sponsored educational assistance to include qualified student loan payments made to employees before January 1, 2021. The Consolidated Appropriations Act, 2021 (P.L. 116-260) extended that end date to January 1, 2026.

Assessment

The availability of employer educational assistance encourages employer investment in human capital, which may be inadequate in a market economy because of spillover effects (i.e., the benefits of the investment extend beyond the individuals undertaking additional education and the employers for whom they work).

However, since not all employers provide educational assistance, taxpayers with similar incomes are not treated equally. Given that more highly compensated employees are more likely to have access to educational assistance, and the value of this benefit will increase with income, these benefits may also disproportionately benefit higher-income taxpayers. In addition, a 2020 Brookings Institution report estimated that most of the benefits from the temporary expansion for student loan payments would benefit higher-income families.

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Education, Training, Employment, and Social Services

SPECIAL TAX PROVISIONS FOR EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	2.5	1.7	4.2
2021	2.7	1.8	4.5
2022	2.9	2.0	4.9
2023	3.1	2.1	5.2
2024	3.4	2.3	5.7

Authorization

Sections 401(a)(28), 404(a)(9), 404(k), 415(c)(6), 512(e), 1042, 4975(d)(3), 4978, and 4979A.

Description

An employee stock ownership plan (ESOP) is a defined-contribution plan that is required to invest primarily in the stock of the sponsoring employer. Either a C corporation or an S corporation can have an ESOP. ESOPs are unique among employee benefit plans in their ability to borrow money to buy stock. An ESOP that has borrowed money to buy stock is a leveraged ESOP. An ESOP that acquires stock through direct employer contributions of cash or stock is a nonleveraged ESOP.

ESOPs are provided with various tax advantages. Employer contributions to an ESOP may be deducted by the employer as a business expense. Contributions to a leveraged ESOP are subject to less restrictive limits than contributions to other qualified employee benefit plans.

An employer may deduct dividends paid on stock held by an ESOP if the dividends are paid to plan participants, if the dividends are used to repay a loan that was used to buy the stock, or if the dividends are paid on stock in a retirement plan. The deduction for dividends used to repay a loan is limited to dividends paid on stock acquired with that loan. Employees are not taxed on employer contributions to an ESOP or the earnings on invested funds until they are distributed.

A stockholder in a closely held company may defer recognition of the gain from the sale of stock to an ESOP if, after the sale, the ESOP owns at least 30 percent of the company's stock and the seller reinvests the proceeds from the sale of the stock in a U.S. company.

To qualify for these tax advantages, an ESOP must meet the minimum requirements established in the Internal Revenue Code. Many of these requirements are general requirements that apply to all qualified employee benefit plans. Other requirements apply specifically to ESOPs.

In particular, ESOP participants must be allowed voting rights on stock allocated to their accounts. In the case of publicly traded stock, full voting rights must be passed through to participants. For stock in closely held companies, voting rights must be passed through on all major corporate issues.

Closely held companies must give employees the right to sell distributions of stock to the employer (a put option), at a share price determined by an independent appraiser. An ESOP must allow participants who are approaching retirement to diversify the investment of funds in their accounts.

Impact

The various ESOP tax incentives encourage personal savings through employee ownership of stock in a qualified employee benefit plan. ESOPs also provide employers with a tax-favored means of financing. The deferral of recognition of the gain from the sale of stock to an ESOP encourages the owners of closely held companies to sell stock to the company's employees. The deduction for dividends paid to ESOP participants encourages the current distribution of dividends.

Various incentives encourage the creation of leveraged ESOPs. Compared to conventional debt financing, both the interest and principal on an ESOP loan are tax-deductible. The deduction for dividends used to make

payments on an ESOP loan and the unrestricted deduction for contributions to pay interest encourage employers to repay an ESOP loan more quickly.

According to the National Center for Employee Ownership, in 2019, 6,482 companies with roughly 14 million participants had an ESOP with combined assets in excess of \$1.6 trillion. Over half of these plans had fewer than 100 participants, and 90 percent of ESOPs are in private companies. Public company ESOPs, however, represent over 85 percent of ESOP participants and assets.

Rationale

The tax incentives for ESOPs are intended to broaden stock ownership, provide employees with a source of retirement income, and grant employers a tax-favored means of financing.

The Employee Retirement Income Security Act of 1974 (P.L. 93-406) allowed employers to form leveraged ESOPs. The Tax Reduction Act of 1975 established a tax-credit ESOP (called a TRASOP) that allowed employers an additional investment tax credit of one percentage point if they contributed an amount equal to the credit to an ESOP.

The Tax Reform Act of 1976 (P.L. 94-455) allowed employers an increased investment tax credit of one-half a percentage point if they contributed an equal amount to an ESOP and the additional contribution was matched by employee contributions.

The Revenue Act of 1978 (P.L. 95-600) required ESOPs in publicly traded corporations to provide participants with full voting rights, and required closely held companies to provide employees with voting rights on major corporate issues. The act required closely held companies to give workers a put option on distributions of stock.

The Economic Recovery Tax Act of 1981 (P.L. 97-34) replaced the investment-based tax credit ESOP with a tax credit based on payroll (called a PAYSOP). The 1981 act also allowed employers to deduct contributions of up to 25 percent of compensation to pay the principal on an ESOP loan. Contributions used to pay interest on an ESOP loan were excluded from the 25-percent limit.

The Deficit Reduction Act of 1984 (P.L. 98-369) allowed corporations a deduction for dividends on stock held by an ESOP if the dividends were paid

to participants. The act also allowed lenders to exclude from their income 50 percent of the interest they received on loans to an ESOP.

The act allowed a stockholder in a closely held company to defer recognition of the gain from the sale of stock to an ESOP if the ESOP held at least 30 percent of the company's stock and the owner reinvested the proceeds from the sale in a U.S. company. The act permitted an ESOP to assume a decedent's estate tax in return for employer stock of equal value.

The Tax Reform Act of 1986 (P.L. 99-514) repealed the payroll tax credit ESOP. The act also extended the deduction for dividends to include dividends used to repay an ESOP loan. The act permitted an estate to exclude from taxation up to 50 percent of the proceeds from the sale of stock to an ESOP. The act allowed persons approaching retirement to diversify the investment of assets in their accounts.

The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) limited the 50-percent interest exclusion to loans made to ESOPs that hold more than 50 percent of a company's stock. The deduction for dividends used to repay an ESOP loan was restricted to dividends paid on shares acquired with that loan. The act repealed both estate tax provisions: the exclusion allowing an estate to exclude proceeds from the sale of stock to an ESOP, and the provision allowing an ESOP to assume a decedent's estate tax. The Small Business Job Protection Act of 1996 (P.L. 104-188) eliminated the provision that allowed a 50 percent interest income exclusion for bank loans to ESOPs. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) allowed firms to deduct dividends on stock held in retirement plans through 2010. The Pension Protection Act of 2006 (P.L. 109-280) made this provision permanent and strengthened diversification requirements for ESOPs that hold publicly traded stocks.

Assessment

One of the major objectives of ESOPs is to expand employee stock ownership. These plans are believed to motivate employees by more closely aligning their financial interests with the financial interests of their employers. The distribution of stock ownership achieved through participation in ESOPs is broader than the distribution of stock ownership in the general population.

Some evidence suggests that among firms with ESOPs there is a greater increase in productivity if employees are involved in corporate decision-

making. But employee ownership of stock is not a prerequisite for employee participation in decision-making.

ESOPs do not provide participants with the traditional rights of stock ownership. Full vesting can depend on a participant's length of service, and distributions are generally deferred until a participant separates from service. To provide participants with the full rights of ownership would be consistent with the goal of broader stock ownership, but employees would be able to use employer contributions for reasons other than retirement.

The requirement that ESOPs invest primarily in the stock of the sponsoring employer is consistent with the goal of corporate financing, but it may not be consistent with the goal of providing employees with retirement income. The cost of such a lack of diversification was demonstrated with the failure of Enron and other firms whose employees' retirement plans were heavily invested in company stock. If a firm experiences financial difficulties, the value of its stock and its dividend payments will fall. Furthermore, employee-ownership firms do fail with not only the consequent loss of jobs but also the employees' ownership stakes. Because an ESOP is a defined-contribution plan, participants bear the burden of this risk. The partial diversification requirement for employees approaching retirement was enacted in response to this issue.

A leveraged ESOP allows an employer to raise capital to invest in new plant and equipment. But evidence suggests that the majority of leveraged ESOPs involve a change in ownership of a company's stock, and not a net increase in investment.

Although the deduction for dividends used to repay an ESOP loan may encourage an employer to repay a loan more quickly, it may also encourage an employer to substitute dividends for other loan payments.

Because a leveraged ESOP allows an employer to place a large block of stock in friendly hands, leveraged ESOPs have been used to prevent hostile takeovers. In these cases, the main objective is not to broaden employee stock ownership.

ESOPs have been used in combination with other employee benefit plans. A number of employers have adopted plans that combine an ESOP with a 401(k) salary reduction plan. Some employers have combined an ESOP with a 401(h) plan to fund retiree medical benefits.

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Education, Training, Employment and Social Services

CREDIT FOR FAMILY AND MEDICAL LEAVE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	0.2	0.3
2021	0.1	0.1	0.2
2022	(¹)	0.1	0.1
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

Note: This provision was extended by P.L. 116-260 with an estimated cost of \$3. (¹) Positive tax expenditure of less than \$50 million.

8 billion over FY2021 – FY2030.

Authorization

Section 45S.

Description

The employer credit for paid family and medical leave (FML) can be claimed by employers providing paid leave (wages) to employees under the Family and Medical Leave Act of 1993 (FMLA; P.L. 103-3). The credit can be claimed for wages paid during tax years that begin in 2018 through 2025.

The credit rate depends on how much employers provide for paid FML, relative to wages normally paid. If paid leave is 50% of wages normally paid to an employee, the tax credit is 12.5% of wages paid. If paid leave is 100% of wages normally paid to an employee, the tax credit is 25% of wages paid. The credit rate increases from 12.5% to 25% ratably as leave wages increase from 50% to 100% of wages normally paid. No credit can be claimed for paid FML that is less than 50% of wages normally paid. Further, no credit can be claimed for wages paid on leave that exceeds an employee's normal wage rate.

The credit can only be claimed for paid FML provided to certain lower-compensated employees. For wages paid to an employee to be credit eligible, compensation to the employee in the preceding year cannot exceed 60% of a “highly compensated employee” threshold. These amounts were \$78,000 for 2021 and \$81,000 for 2022. Further, for an employer to claim a credit for wages paid to an employee, the employee must have been employed by the employer for at least 12 months.

The amount of paid FML wages for which the credit is claimed cannot exceed 12 weeks per employee per year. Further, all qualifying employees must be provided at least two weeks of paid FML for an employer to be able to claim the credit (the two-week period is proportionally adjusted for part-time employees).

Tax credits cannot be claimed for leave paid by state or local governments, or for leave that is required by state or local law. Thus, this tax incentive does not reduce the cost of providing leave in jurisdictions where employers are required to do so by a state or local authority.

A tax credit can only be claimed for wages paid for family and medical leave. If an employer provides paid leave (e.g., vacation, personal, or sick leave) that is not specifically set aside for a FMLA-qualifying purpose, that leave is not considered FML leave. Family and medical leave is restricted to leave associated with (1) the birth of a child or placement of an adopted or foster child with the employee; (2) a serious health condition of the employee or the employee’s spouse, child, or parent; (3) an exigency arising out of the fact that a close relative is a member of the Armed Forces and on covered active duty; or (4) care for a covered service member who is a close relative of the employee.

For employers, there are other requirements associated with the credit. To claim the credit, an employer must have a written family and medical leave policy in effect. The policy cannot exclude certain classifications of employees (e.g., unionized employees). Additionally, a qualified employer is required to claim the credit, unless the employer opts out. For employers, the amount of wages and salaries deducted as a business expense is reduced by the amount of credit claimed. Further, the credit cannot be claimed if wages have been used to calculate another tax credit (to avoid a double tax benefit). The credit is part of the general business credit, meaning that unused credits from the current tax year can be carried back one year (offsetting the prior year’s tax

liability) or carried forward up to 20 years to offset future tax liability. The credit is allowed against the individual alternative minimum tax (AMT).

Impact

The section 45S credit encourages private-sector employers to offer paid family and medical leave to eligible employees, and to pay at least half of the regular wage of employees while they take qualified leave under the FMLA.

The employer credit for paid FML is targeted at a group that is less likely to have access to paid family leave: low- and moderate-income workers. The share of workers with access to paid family leave has increased in recent years (although it is not known to what extent the tax credit contributed to this change). The share of workers in lower-income groups with access to paid family leave has increased faster than the share in higher-income groups. Although access to paid family leave has increased across all income groups, there remains a gap in paid FML benefits between lower- and higher-wage workers.

Rationale

The credit was added by the 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) as a temporary provision, with the credit available for wages paid in 2018 and 2019. It builds on the Family and Medical Leave Act of 1993 (P.L. 103-3). The credit was extended through 2020 in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). The credit was extended through 2025 in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

Assessment

Providing a tax credit for employers that provide paid FML should, on the face of it, tend to increase access to this benefit. How effective the credit will be at achieving this goal remains an open question.

Will the credit, as currently structured, provide a large enough incentive to cause employers to change their behavior (e.g., provide a benefit they do not currently provide)? If the credit itself does not motivate employers to provide paid FML, then employers that provide paid FML for other reasons may receive a “windfall” in reduced tax liability. Currently, large employers and employers of management and professional employees are most likely to

provide paid family leave. Employers of management and professional employees, however, are less likely to have large shares of employees below the wage threshold.

Employers that provide paid FML to qualified employees for other reasons, such as to attract high-quality talent, will be able to claim the credit even though their benefit policies have not changed. If most of the credit's beneficiaries are employers that would have provided paid FML without the credit, then the credit is not a particularly efficient mechanism for increasing paid FML. Firms may also choose to offer paid family leave to attract workers when labor markets are tight, as was the case during the latter part of the COVID-19 pandemic.

There is also the possibility that employers choose to substitute credit-eligible paid FML for other forms of leave. An employer could reduce the amount of paid sick, personal, or vacation time off, knowing that employees use this time for paid family and medical leave purposes. By making this choice, when employees take leave for FMLA purposes, the employer would be allowed a tax credit. If other benefits are scaled back in favor of tax-preferred FMLA leave, employees may not be better off.

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Education, Training, Employment and Social Services

EXCLUSION OF EMPLOYEE AWARDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	—	0.4
2021	0.4	—	0.4
2022	0.4	—	0.4
2023	0.4	—	0.4
2024	0.4	—	0.4

Authorization

Sections 74(b), 74(c), and 274(j).

Description

Generally, bonuses and awards given to employees for outstanding performance that do not qualify as a *de minimis* fringe benefit under Internal Revenue Code (IRC) section 132(a)(4) are added to an employee’s taxable income. But IRC section 74 provides two exceptions to this rule.

IRC section 74(b) allows a taxpayer to exclude from gross income any designated prizes and awards that she or he transfers to a qualified charity. To qualify for the exclusion, a taxpayer must be selected for a prize or award without applying for it or entering a contest for it. In addition, the exclusion can be claimed only if the recipient is not obligated to provide “substantial future service” as a condition of receiving the prize or award.

IRC section 74(c) allows a taxpayer to exclude from gross income certain employee achievement awards. In this case, the exclusion applies to items of tangible personal property given to an employee in recognition of his or her length of service or safety record. To qualify, the property has to be awarded through a meaningful presentation and in circumstances that make it clear that

the award is not a form of “disguised” compensation. Tangible personal property in this case refers to items like a plaque, watch, ring or pen; it does not include cash and its equivalents, gift cards, coupons, certain gift certificates, tickets to theaters or sporting events, vacations, meals, lodging, stocks, bonds, securities, and similar items.

Certain limitations apply to the IRC section 74(c) exclusion. As specified in IRC section 274(j), a length-of-service award does not qualify for the exclusion if it is given within an employee’s first five years of service, or if the employee received a similar award earlier in the current year or in the preceding four years. A safety award does not qualify for the exclusion if more than 10 percent of an employer’s employees receive the same award in the current year, or if an employer gives safety awards to managers, administrators, clerical employees, or other professional employees.

The amount an employee may exclude from gross income under IRC section 74(c) takes into account the fair market value of the property but cannot exceed an employer’s deduction for the award. For awards not made under a qualified employee achievement plan, the maximum employer deduction per employee is \$400. For awards made under such a plan, the maximum employer deduction per employee is \$1,600. The exclusion for employee awards cannot exceed an employer’s deduction.

A qualified achievement plan is an established written plan or program available to all employees, regardless of their compensation. If the average cost per employee of all awards an employer provides under all its achievement plans exceeds \$400, no award qualifies for the exclusion.

An employee may exclude from gross income the entire value of a qualified award when an employer is allowed to deduct its full cost. But if the employer’s cost for the award is larger than the allowable deduction, then the employee must include in gross income the greater of: (1) the amount of the non-deductible portion of the award’s cost, up to the fair market value of the award; or (2) the excess (if any) of the award’s value over the allowable deduction.

For employees of non-profit entities, the exclusion is determined under the same rules that apply to for-profit employers. Thus, the maximum exclusion is \$400 per employee, unless a non-profit employer has a qualified employee achievement award plan, in which case the maximum exclusion rises to \$1,600.

The amount of an eligible employee award excluded from gross income is also excluded under the Federal Insurance Contributions Act (FICA) from the Social Security and Medicare payroll taxes.

Impact

IRC sections 74(c) and 274(j) exclude from gross income employee awards of tangible personal property for length-of-service and safety achievements that would otherwise be taxed.

Rationale

The exclusion for certain employee awards originated with the Tax Reform Act of 1986 (P.L. 99-514). Before this change in law, awards received by employees generally were taxable, although there were exceptions.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) defined “tangible personal property” under IRC section 74(c) to exclude cash, gift cards, and certain other non-tangible personal property.

Assessment

The exclusion promotes a traditional and widespread business practice. According to the findings of a 2018 employer survey by the Society for Resource Management, 63 percent of respondents offered length-of-service awards to employees.

Since the dollar limits on the exclusion are relatively small and have stayed the same since 1986, the exclusion has not become a vehicle for significant tax avoidance. Still, the lack of an increase in the exclusion may have led over time to reductions in the tax-free share of qualified awards, undercutting their incentive effect.

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Education, Training, Employment, and Social Services

TREATMENT OF MEALS AND LODGING (OTHER THAN MILITARY)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	7.6	-1.8	5.8
2021	6.9	-1.8	5.1
2022	6.9	-1.8	5.1
2023	7.1	-1.9	5.2
2024	7.4	-2.0	5.4

Authorization

Sections 119 and 132(e)(2).

Description

In general, employees' gross income includes the fair market value (FMV) of meals and lodging the employees, their spouses, and dependents receive from employers. But Internal Revenue Code (IRC) section 119 provides an exception to this rule. The provision allows employees to exclude the FMV of employer-provided meals and lodging under certain conditions. The exclusion from employee income for meals can be taken only if the meals are provided on the employer's business premises for the convenience of the employer. The exclusion for lodging can be taken only if it satisfies the condition for meals and an employee is required to accept the lodging as a condition of employment.

An employer's business premises generally refer to the place where an employee performs his or her job, or the place where an employer conducts a substantial share of its business activities. Business premises can occupy any place on the grounds of an employer's business, not just main buildings.

Regulations provide that an employer provides meals for its convenience if it does so for “a substantial non-compensatory business reason.” Determining whether such a reason is present generally depends on the facts and circumstances of specific cases. The Internal Revenue Service does not regard an employer’s statement that the meals it offers to employees are not compensation as sufficient proof. Of greater importance is whether employees accept the meals as a key to performing their jobs properly.

Lodging is considered a condition of employment if an employee is required to accept the lodging to properly perform his or her job. This condition is met if an employee has to be on the job at all times, or an employee could not perform the job without employer-provided lodging.

Section 132(e)(2) allows employees to exclude from gross income the value of any item or service they frequently receive from employers whose cost is so small that accounting for it would be impractical or burdensome. This benefit is known as a *de minimis* fringe benefit. Examples are small food or drink items frequently available to employees or occasional meals (or cash for meals) provided to employees to enable them to work overtime.

The exclusion for *de minimis* fringe benefits includes the FMV of meals provided to employees at an eating facility operated by an employer. Two conditions must be met to benefit from the exclusion. First, the facility has to be located on or near the employer’s place of business. Second, revenue from the facility must equal or exceed the facility’s operating costs. Highly compensated employees may claim the exclusion only if all employees, regardless of compensation level, have access to the facility on “substantially the same terms.”

Impact

Excluding from taxation the FMV of employer-provided meals and lodging subsidizes employment in occupations and industries where these workplace benefits are commonplace. Live-in housekeepers or apartment resident managers, for instance, frequently receive lodging or meals from their employers and thus benefit from the exclusion. The exclusion allows eligible employees to receive higher after-tax compensation and their employers to employ workers at lower wages and salaries.

Rationale

The exclusion for employee meals and lodging was the subject of numerous court cases in the first few decades after its inclusion in the original federal income tax. Section 119 was adopted as part of the revision of the Internal Revenue Code in 1954 (P.L. 83-591) to clarify the conditions under which the cost of employer-provided meals and lodging may be excluded from an employee's income.

Congress created the exclusion for certain employer-provided eating facilities as part of the Deficit Reduction Act of 1984 Act (P.L. 98-369). It recognized that the benefits provided to a particular employee who eats regularly at such a facility might constitute more than a *de minimis* fringe benefit. But the record-keeping burden of identifying employees who ate employer-provided meals on particular days and keeping track of the cost of those meals led Congress to establish the exclusion for employer-operated eating facilities under section 132(e)(2).

Assessment

The exclusion subsidizes employment in occupations and industries in which employer-provided meals and lodging are relatively frequent. In theory, the exclusion encourages more workers to seek such jobs than would happen without the exclusion, and it increases the after-tax compensation of eligible workers. Their employers would get their services at a lower cost if the employers reduce wages by the monetary value of the meals and lodging they offer.

Because the exclusion applies to practices that are available in relatively few occupations or industries, it introduces differences in the tax treatment of employees and employers among all industries.

Some tax benefits are intended to encourage or discourage taxpayers from engaging in certain activities. The section 119 exclusion is not one of them. Rather, it serves two purposes related to employers who provide meals and lodging to employees as a matter of business necessity. First, the exclusion simplifies tax accounting for employers to the extent that they avoid having to determine the FMV of the meals and lodging they provide to employees. Second, the exclusion compensates employees for any hardship they may endure because they are required to remain close to their places of employment to do their jobs properly.

Still, some maintain that the accounting benefits of the exclusion do not justify excluding from employee income the cost of employer-provided meals and lodging. Critics note that a value is placed on these services under some federal and many state income support programs, and that employers could use the same methods at little cost to estimate the FMV of meals and lodging they offer employees.

Another issue is the unlimited meals that certain technology companies provide their employees. Some argue that the FMV of those meals should not be excludable under section 119 because companies like Google and Facebook use them primarily as a means of attracting and retaining talented individuals; the lavishness of the meals should make them a form of taxable employee compensation under federal tax law. Others say that such an argument lacks validity because the employee meals offered by technology companies are intended to benefit employers by encouraging employees to spend more time at work and interact in social settings that could foster new innovations.

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Education, Training, Employment, and Social Services

**DEFERRAL OF TAXATION ON SPREAD ON ACQUISITION
OF STOCK UNDER INCENTIVE STOCK OPTION PLANS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	-1.5	-0.8
2021	0.7	-1.6	-0.9
2022	0.7	-1.5	-0.8
2023	0.7	-1.5	-0.8
2024	0.7	-1.5	-0.8

Authorization

Sections 421 and 422.

Description

Qualified (or “statutory”) options include “incentive stock options,” which are limited to \$100,000 a year for any one employee, and employee stock purchase plans (see entry on “Deferral of Taxation on Spread on Acquisition of Stock under Employee Stock Purchase Plans”). Incentive stock options may be confined to officers and highly paid employees. Qualified options are not taxed to the employee when granted or exercised (under the regular income tax); tax is imposed only when the stock is sold. If the stock is held at least one year from purchase and two years from the granting of the option, the gain is taxed as a long-term capital gain. The employer is not allowed a deduction for these options, which requires the employer to pay higher income taxes. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction. The value of incentive stock options is included in minimum

taxable income for the individual alternative minimum income tax in the year of exercise.

Impact

Incentive stock options provide employees with tax benefits under current law. The employee recognizes no income (for regular tax purposes) when the options are granted or when they are exercised. Taxes (under the regular tax) are not imposed until the stock purchased by the employee is sold. If the stock is sold after it has been held for at least two years from the date the option was granted *and* one year from the date it was exercised, the difference between the market price of the stock when the option was exercised and the price for which it was sold is taxed at long-term capital gains rates. If the option price was less than 100 percent of the fair market value of the stock when it was granted, the difference between the exercise price and the market price (the discount) is taxed as ordinary income (when the stock is sold).

Taxpayers with high incomes are the primary beneficiaries of incentive stock options. Because employers (usually corporations) cannot deduct the cost of stock options eligible for the lower tax rate on long-term capital gains, employers pay higher income taxes. The prevailing view of tax economists is that the corporate income tax falls primarily on owners of capital. Because most capital income is received by high-income households, these households bear the incidence of this aspect of stock options. These conflicting effects on incidence mean that the overall incidence of qualified stock options is uncertain. Because this tax expenditure raises corporate income tax revenue by more than it reduces individual income tax revenue, the net effect is to increase federal tax revenue.

Rationale

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

readily ascertainable fair market value at the time it was granted, the value of the option did not constitute ordinary income to the employee at that time. However, when the option was exercised, the spread between the option price and the value of the stock constituted ordinary income to the employee. The Economic Recovery Tax Act of 1981 (P.L. 97-34) reinstated special rules for qualified stock options with the justification that encouraging the management of a business to have a proprietary interest in its successful operation would provide an important incentive to expand and improve the profit position of the companies involved.

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) established Section 162(m), titled “Certain Excessive Employee Remuneration,” which applied to the Chief Executive Officer (CEO) and the four highest compensated officers (other than the CEO) of a publicly held corporation. For each of these “covered employees,” the publicly held corporation could only deduct, as an expense, the first \$1 million of applicable remuneration. The reason for this change was that “the committee [House Committee on the Budget] believes that excessive compensation will be reduced if the deduction for compensation ... paid to the top executives of publicly held corporations is limited to \$1 million per year.” Exceptions to this \$1 million in applicable remuneration included (1) “remuneration payable on commission basis” and (2) “other performance-based compensation.” Economic theory suggests that the \$1 million cap on deductible compensation increased the relative importance of performance-related compensation including stock options.

The Tax Cuts and Jobs Act, 2017 (P.L. 115-97) modified the definition of covered employees to include the principal executive officer (PEO), the principal financial officer (PFO), and the three highest compensated officers.

Assessment

Tax advantages for qualified stock options may encourage some companies to provide them to employees rather than other forms of compensation that are not tax favored. Paying for the services of employees, officers, and directors by the use of stock options has several advantages for the companies. Start-up companies often use the method because it does not involve the immediate cash outlays that paying salaries involves; in effect, a stock option is a promise of a future payment, contingent on increases in the value of the company’s stock. It also makes the employees’ pay dependent on the performance of the company’s stock, giving them extra incentive to try to

improve the company's (or at least the stock's) performance. Ownership of company stock is thought by many to assure that the company's employees, officers, and directors share the interests of the company's stockholders. Lastly, receiving pay in the form of stock options serves as a form of forced savings, since the money cannot be spent until the restrictions expire.

Critics of the stock options, however, argue that there is no real evidence that the use of stock options instead of cash compensation improves corporate performance. Furthermore, stock options are a risky form of pay, since the market value of the company's stock may decline rather than increase. Some employees may not want to make the outlays required to buy the stock, especially if the stock is subject to restrictions and cannot be sold immediately. And some simply may not want to invest their pay in their employer's stock. Critics also assert that the aggregate dollar amount of the benefits to employees is less than the aggregate dollar amount of the cost to employers (primarily corporations).

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Education, Training, Employment, and Social Services

**DEFERRAL OF TAXATION ON SPREAD ON EMPLOYEE
STOCK PURCHASE PLANS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	-0.2	-0.1
2021	0.1	-0.2	-0.1
2022	0.1	-0.2	-0.1
2023	0.1	-0.2	-0.1
2024	0.1	-0.2	-0.1

Authorization

Sections 421 and 423.

Description

Qualified (or “statutory”) options include “employee stock purchase plans,” which are limited to \$25,000 a year for any employee, and “incentive stock options” (see entry on Deferral of Taxation on Spread on Acquisition of Stock under Incentive Stock Option Plans). Employee stock purchase plans must be offered to all full-time employees with at least two years of service. Plans may allow a discount so that the option price is not less than the lesser of 85 percent of the fair market value when granted and 85 percent of the fair market value when acquired. A lag between grant and purchase can occur when payroll deductions are made to a fund that accumulates for a stock purchase, and the total discount may include a 15 percent discount plus a look-back to a lower price.

Qualified options are not taxed to the employee when granted or exercised (under the regular income tax); tax is imposed only when the stock is sold. If the stock is held at least one year from purchase and two years from

the granting of the option, the gain is taxed as a long-term capital gain but the discount is taxed as compensation. The employer is not allowed a deduction for these options, which requires the employer to pay higher income taxes. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction.

Impact

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

Taxpayers with above-average or high incomes are the primary beneficiaries of these tax advantages. Because employers (usually corporations) cannot deduct the cost of stock options eligible for the lower tax rate on long-term capital gains, employers pay higher income taxes. The prevailing view of tax economists is that the corporate income tax falls primarily on capital income. Because most capital income is owned by high-income households, these households bear the incidence of this aspect of stock options. These conflicting effects on incidence mean that the overall incidence of qualified stock options is uncertain. Because this tax expenditure raises corporate income tax revenue by more than it reduces individual income tax revenue, the net effect is to increase federal tax revenue.

A study by Fidelity found that participation in stock purchase plans was higher not only when the discount was higher, but also when employees could elect the price at either the beginning or ending of the offering period.

Rationale

The Revenue Act of 1964 (P.L. 88-272) enacted special rules for qualified stock options, which excluded these options from income when they were granted or exercised and instead included the gains as income at the time

of sale of the stock. The Tax Reform Act of 1976 (P.L. 94-455) repealed these special provisions and thus subjected qualified stock options to the same rules as applied to nonqualified options. Therefore, if an employee received an option, which had a readily ascertainable fair market value at the time it was granted, this value (less the option price paid for the option, if any) constituted ordinary income to the employee at that time. But, if the option did not have a readily ascertainable fair market value at the time it was granted, the value of the option did not constitute ordinary income to the employee at that time. However, when the option was exercised, the spread between the option price and the value of the stock constituted ordinary income to the employee. The Economic Recovery Tax Act of 1981 (P.L. 97-34) reinstated special rules for qualified stock options with the justification that encouraging the management of a business to have a proprietary interest in its successful operation would provide an important incentive to expand and improve the profit position of the companies involved.

Assessment

Tax advantages for qualified stock options may encourage some companies to provide them to employees rather than other forms of compensation that are not tax favored. Evidence from Babenko and Sen indicates that, although employee stock purchase plans are available to most employees, employees with lower income and education are less likely to participate in these plans even though the discounts provide a clear financial benefit. Younger and older employees are also less likely to participate, as are those with a lack of familiarity with the stock market.

To the extent that stock plans and their discounts substitute for wages, they make the employees' pay dependent on the performance of the company's stock, giving them extra incentive to try to improve the company's (or at least the stock's) performance. Ownership of company stock is thought by many to assure that the company's employees, officers, and directors share the interests of the company's stockholders. Lastly, receiving pay in the form of stock options serves as a form of forced savings, since the money cannot be spent until the restrictions expire.

Critics of stock options, however, argue that there is no real evidence that the use of stock options instead of cash compensation improves corporate performance. Furthermore, stock options are a risky form of pay, since the market value of the company's stock may decline rather than increase. Since

many employees tend to hold on to their stock, employee stock purchase plans may lead to less diversified retirement portfolios.

Since the aggregate dollar amount of the tax benefits to employees is less than the aggregate tax cost to employers (primarily corporations), stock purchase plans may be less likely to be used by employers.

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Education, Training, Employment, and Social Services

EXCLUSION OF HOUSING ALLOWANCES FOR MINISTERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.7	—	0.7
2021	0.8	—	0.8
2022	0.8	—	0.8
2023	0.9	—	0.9
2024	0.9	—	0.9

Authorization

Sections 107 and 265.

Description

In general, the gross income of employees includes the fair market value of lodging provided by an employer. An exception is made for housing allowances received by eligible clergy.

Internal Revenue Code (IRC) section 107 permits “ministers of the gospel” to exclude qualified housing allowances from their gross income. A minister of the gospel is “a duly ordained, commissioned, or licensed minister of a church.” This definition applies to clergy in all religions, and to non-ordained ministers if they perform substantially all of the duties of an ordained minister.

Members of the clergy are considered employees under the federal income tax, but they are regarded as self-employed under the federal payroll tax. This difference means that a minister may not exclude housing compensation from her or his income base for the self-employment tax. The

value of housing compensation for the payroll tax is based on the fair rental value of the housing.

Clergy members are allowed to exclude from gross income two kinds of housing-related compensation. One is known as the parsonage exemption (IRC section 107(1)). Clergy who have use of a house (or parsonage) as part of their compensation may exclude from gross income the fair rental value of the property.

The second housing-related exclusion is known as the minister's cash housing allowance (IRC section 107(2)). Clergy members who receive such an allowance instead of use of a parsonage may exclude from gross income the amount of the allowance that is used to pay expenses such as rent, mortgage payments, property taxes, utilities, and repairs. Like the parsonage exemption, the cash-housing exclusion is limited to the fair rental value of the property.

In addition, clergy receiving excludable housing allowances may also claim an itemized tax deduction for payments they make for mortgage interest and property taxes on their residences. They are allowed to deduct those payments even though they were not subject to income taxation. This is an example of a double tax benefit from the same expenditure, which is unusual under the federal tax code.

A clergy member can benefit from the exclusion only if his or her employer officially designates a specified amount of the member's compensation as a housing allowance before he or she receives it. The designation must be stated in writing, such as in the minutes of a church board or finance committee meeting concerning a clergy member's contract.

If a minister's housing allowance exceeds the actual amount he or she spends on qualified expenses, the excess has to be included in gross income.

Impact

As a result of the exclusion, ministers receiving qualified housing allowances pay less tax than other taxpayers with similar (or even smaller) incomes.

The size of the tax benefit from the exclusion depends on a minister's marginal income tax rate. For example, a \$1,000 housing allowance would

produce a \$370 tax savings for a minister taxed at 37 percent, but would produce only a \$120 tax savings if the minister were taxed at 12 percent.

Ministers who receive a cash housing allowance may be able to further decrease their tax liability by claiming an itemized deduction for the amount of their mortgage interest and property tax payments, even if the income used to make the payments has been excluded from the income tax. Once again, the amount of the tax savings varies by tax bracket. However, a minister may be better off claiming the standard deduction than itemizing.

Rationale

The exclusion for the clergy housing allowances was created by the Revenue Act of 1921 (RA, P.L. 67-98). There is no record of why Congress did so. The act addressed the value of employer-provided housing for ministers such as parsonages but did not address the tax treatment of cash housing allowances. Congress may have intended to provide tax relief to a segment of society that was widely seen as essential to the spiritual welfare of Americans, but that often experienced economic deprivation because of their relatively low salaries.

Several noteworthy disputes over the tax treatment of cash housing allowances involving the Internal Revenue Service (IRS) and ministers were settled on the basis of the RA. Congress responded to the uncertainties driving the disputes by exempting cash housing allowances for clergy from the income tax in the 1954 revision of the Internal Revenue Code (P.L. 83-591).

Several subsequent IRS and court rulings and congressional actions addressed the question of whether or not a minister's payments for mortgage interest and property tax from a housing allowance could be deducted from income as an itemized deduction.

In a 1962 ruling (Revenue Ruling 62-212), the IRS said that interest and taxes paid by a minister in connection with ownership of a personal residence could be claimed as an itemized deduction, in addition to the exclusion of a housing allowance from gross income. This ruling was revoked in 1983 (Revenue Ruling 83-3), but Congress blocked its implementation.

In the Tax Reform Act of 1986 (P.L. 99-514), Congress permanently reversed the 1983 IRS ruling, arguing that the double tax benefit should remain intact since it was long-standing. Additionally, some Members of Congress were concerned that if the 1983 ruling were allowed to stand, the IRS might

extend the elimination of the double tax benefit for clergy housing allowances to housing allowances for U.S. military personnel.

Following the Tax Reform Act of 1986, there was no change in the tax treatment of clergy housing allowances until 2002. At issue was the taxation of a housing allowance that exceeded the fair rental value of a clergy's residence. The issue had its origins in a 1971 IRS ruling (Revenue Ruling 71-280) that held that the excludable housing allowance for parsonages may not exceed the fair rental value of the home plus the cost of utilities. Galvanized by a pending lawsuit involving a claim that 100 percent of a minister's compensation was designated as a housing allowance (*Warren v. Commissioner*, 114 T.C. 343 (2000)), Congress clarified the tax treatment of the parsonage housing allowance in the Clergy Housing Allowance Clarification Act of 2002 (P.L. 107-181). Congress largely sided with the IRS ruling in the matter. Under the act, the exclusion for clergy housing allowances could not exceed the fair rental value of the parsonage, including furnishings and appurtenances such as a garage, plus the cost of utilities, beginning on January 1, 2002. Any housing allowance beyond this amount would be taxable income.

Assessment

It is not known to what extent the exclusion for clergy housing allowances boosts demand for housing by members of the clergy. The exclusion may convince some congregations to include higher housing allowances in ministerial compensation packages than they otherwise would.

The provision is inconsistent with the tax principles of horizontal and vertical equity. Horizontal equity requires that taxpayers with similar abilities to consume and save bear similar tax burdens. IRC section 107 gives members of the clergy a tax benefit that most other taxpayers with similar pre-tax incomes lack, reducing horizontal equity. For example, a clergyman teaching in an affiliated religious school may exclude most or all of the cost of his housing, but another teacher in the same school may not, even though they earn the same salary.

Vertical equity requires that tax burdens be based on a taxpayer's ability to consume and save. Ministers with higher incomes receive a greater tax subsidy than lower-income ministers because the subsidy amount hinges on marginal tax rates. The disproportionate benefit of the tax exclusion to high-

income individuals reduces vertical equity, which undergirds the progressivity of the federal income tax.

Ministers living in church-owned homes do not receive the same tax benefits as those who live in homes they own. IRC section 265 disallows deductions for interest and expenses related to tax-exempt income, except in the case of military housing allowances and the parsonage allowance. Thus, the exclusion for clergy housing allowances is inconsistent with the principle that no taxpayer should derive a double benefit from the same expenditure.

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Education, Training, Employment, and Social Services

**EXCLUSION OF INCOME EARNED BY VOLUNTARY
EMPLOYEES' BENEFICIARY ASSOCIATIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.0	—	1.0
2021	1.0	—	1.0
2022	1.1	—	1.1
2023	1.1	—	1.1
2024	1.1	—	1.1

Authorization

Sections 419, 419A, 501(a), 501(c)(9), 512(a)(3), 4976.

Description

Voluntary Employees' Beneficiary Associations (VEBAs) are generally used to fund fringe benefits for groups of active or retired employees and their families. More specifically, funds from the VEBAs cover some or all of the expenses of life insurance, medical, disability, accident, and other welfare benefits to associations of employees, their dependents, and their beneficiaries. Contributions to VEBAs can be made by either employers (which is relatively more common) or employees (which is relatively less common). Funds grow tax-deferred. Funds in VEBAs are legally separate from the employer, belong to employees, and may never revert to an employer. A substantial majority of VEBAs are formed as trusts, and that is the context in which they will be discussed in this chapter. Generally, income earned by VEBAs can be exempt from federal income taxes under Sections 501(a) and 501(c)(9). Some types of income, however, may be subject to the unrelated business income tax (UBIT).

Employer contributions to VEBAs are deductible within the limits described below. In contrast, employee contributions are made with after-tax dollars. Section 61 requires all income, from all sources, to be included in gross income unless there is a provision that excludes it from gross income. Distributions for accident and health benefits are excluded from taxable income to workers under Sections 104 and 105. Distributions for certain death benefits are excluded under Section 101. Those for certain educational assistance are excluded under Section 127. However, although a VEBA may make distributions for severance and vacation pay to protect against a contingency that would impair or interrupt a member's earning ability, such distributions would be considered wages. They would be reported on Form W-2 and subject to withholding for all payroll and income taxes.

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

These general requirements have been refined and limited by both IRS and court decisions. For example, employee members may have a common employer or affiliated employers, common coverage under a collective bargaining agreement or membership in a labor union, or a specified job classification. In addition, members may be employees of several employers engaged in the same line of business in the same geographic area. Not all members need be employees, but at least 90 percent of the membership on at least one day each calendar quarter must be employees. (Spouses and dependents that are eligible for benefits from the VEBA are not included in the calculation of the number of employees.) Membership may be required if contributions are not mandatory or if it is pursuant to a collective bargaining agreement or union membership. Permissible benefits generally include those

that safeguard or improve members' health or that protect against contingencies that interrupt or impair their earning power such as benefits for vacations, recreational activities, and child care. Prohibited benefits include pension and annuities payable at retirement and deferred compensation unless it is payable due to an unanticipated event such as unemployment.

As noted above, benefits funded through VEBAs generally may not discriminate in favor of the highly paid. In addition, VEBAs used for prefunding of retiree medical or life insurance benefits are required to establish *separate* accounts for members who are key employees, where key employees generally include certain owners and officers of an employer, highly paid employees, or both.

With certain exceptions discussed below, employer deductions for VEBA contributions are limited to the qualified cost reduced by the VEBA's after-tax income. The qualified cost is generally defined as the sum of qualified direct costs and additions to qualified asset accounts. These account limits are specified in Sections 419 and 419A.

- *Qualified direct costs* are the amounts employers could have deducted for employee benefits had they provided the benefits directly and used cash basis accounting (essentially, benefits and account expenses actually paid during the year).
- *Qualified asset accounts* include: (1) reserves set aside for claims incurred but unpaid at the end of the year for disability, medical, supplemental unemployment and severance pay, and life insurance benefits; (2) administrative costs for paying those claims; and (3) additional reserves for post-retirement medical and life insurance benefits and for non-retirement medical benefits of bona fide association plans. The reserve for post-retirement benefits must be funded over the working lives of covered individuals on a level basis, using actuarial assumptions incorporating current, not projected, medical costs.
- *After-tax net income* consists of net interest and investment earnings plus employee contributions, minus any UBIT liability.

The prefunding limits described in the above three points do not apply to VEBAs created by a collective bargaining arrangement, employee pay-all VEBAs (sometimes called 419A(f)(5) VEBAs), or to multiple employer welfare plans (MEWAs) of 10 or more employers in which no employer makes

more than 10 percent of the contributions (sometimes called 419A(f)(6) plans). MEWAs cannot have experience-rated contributions for single employers.

There are differences between collectively-bargained and non-collectively-bargained VEBAs in terms of their ability to include medical inflation. In particular, in calculating the amount needed to fund health benefits for current and perhaps future retirees over the lifetime of the VEBA, trusts conducted in the absence of collective bargaining must assume that future medical inflation is zero. On the other hand, trusts created as part of a collective bargaining agreement can allow for future medical inflation, which leads to higher trust fund balances holding all other factors constant.

Impact

Historically, VEBAs have been used by employers for a variety of reasons. These reasons include segregating assets, earning tax-free investment returns for qualified funds, reducing future contribution requirements by prefunding, creating an offsetting asset for an employer liability, and meeting requirements of rate-making bodies and regulatory agencies. Funding a welfare benefit through a VEBA often offers tax advantages to the employer as well as the employees. The magnitude of the tax advantage depends on the amount of benefits payable and the duration of the liability. Thus, the tax advantage is greater for a VEBA that funds the disabled claim reserve for a Long Term Disability plan than for a VEBA that funds the Incurred but Not Paid claim reserve for a medical plan. More recently, however, interest has focused on using VEBAs to fund health benefits for current and future retirees, especially retirees from firms in or contemplating bankruptcy proceedings.

Although employers are required to prefund qualified defined-benefit pension plans, they are not legally required to prefund retiree health plans. The use of VEBAs for prefunding retiree health benefits gathered momentum after the Financial Accounting Standards Board (FASB) required accrual accounting for non-pension post-retirement benefits under the Statement of Financial Accounting Standard 106 (FAS 106). This accounting standard, which was effective for employers' fiscal years beginning after December 15, 1992, required employers to accrue the cost of anticipated future retiree health benefits, and recognize the cost as an expense on their income statement. If an employer had segregated assets dedicated to the payment of retiree health care benefits, the return on these assets reduced the net periodic post-retirement health care cost. With the release of FAS 106, VEBAs that were the product of collective bargaining proved to be an attractive funding choice because the

investment income on the funds accumulated tax-free and there were no limits on contributions.

In the absence of a VEBA, retirees of a company in a bankruptcy proceeding might lose most or all of their health care coverage. Under certain circumstances, a provision of the Bankruptcy Code may allow an employer to discontinue health care coverage that was provided in already-ratified collective bargaining agreements. (The health coverage tax credit may be available to employees if a defined-benefit pension plan was turned over to the Pension Benefit Guaranty Corporation because of financial difficulties. This tax credit is currently in effect through 2021 although it may be extended.) Because the funds for qualifying benefits that are held in a VEBA may never revert to the employer, the presence of a VEBA guarantees that the retirees will receive at least some retiree health coverage. However, VEBAs do not guarantee that projected benefits will be fully funded (i.e., contain enough money to pay for all coverage expected over the life of the VEBA). The value of future benefits depends on the amount of the contributions and the growth in the assets in the VEBA relative to the increase in health care costs.

For example, negotiations in the late 2000s between the “Detroit Three” automakers (General Motors, Ford, and Chrysler, LLC) and the International Union, United Automobile, Aerospace, & Agricultural Implement Workers of America (UAW) established a VEBA for health benefits to current and some future retirees. The negotiations resulted in one VEBA, officially known as the UAW Retiree Medical Benefits Trust, which consists of three separate accounts: one each for the three automakers. Under the agreements, the automakers nearly eliminated their responsibility for retiree health benefits in exchange for making cash and other financial contributions that were worth significantly less than the present value of their obligations. The UAW received the security of knowing that the funds in the VEBA, and thus some retiree health benefits, would be protected if the automakers filed for bankruptcy. Despite bankruptcy reorganizations by both General Motors and Chrysler in 2009, the UAW VEBA is still available to provide retiree health benefits to eligible retirees from each company.

Rationale

VEBAs were originally granted tax-exempt status by the Revenue Act of 1928 (P.L. 70-562), which allowed associations to provide payment of life, sickness, accident, or other benefits to their members and dependents provided that: (1) no part of their net earnings accrued (other than through such

payments) to the benefit of any private shareholder or individual; and (2) 85 percent or more of their income consisted of collections from members for the sole purpose of making benefit payments and paying expenses. Perhaps VEBAs were seen as providing welfare benefits that served a public interest and should be exempt from taxation.

The Revenue Act of 1942 (P.L. 77-753) allowed employers to contribute to the association without violating the 85-percent-of-income requirement. In the Tax Reform Act of 1969 (P.L. 91-172), Congress eliminated the 85-percent requirement, allowing a tax exclusion for VEBAs that had more than 15 percent of their income from investments. However, the legislation imposed the UBIT on VEBA income (as well as the income of similar organizations) to the extent it was not used for exempt functions.

While VEBAs cannot be used for deferred compensation, sometimes it has been difficult to distinguish such benefits. Particularly after 1969, VEBAs presented opportunities for businesses to claim tax deductions for contributions that would not be paid out in benefits until many years afterwards, with the investments earning income free from tax. In many cases, the benefits were disproportionately available to corporate officers and higher-income employees. After passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA, P.L. 97-248), there was increased marketing of benefit plans providing readily available deferred benefits (for severance pay, for example) to owners of small businesses. These plans appeared to circumvent restrictions the Act had placed on qualified pensions.

In response, the Deficit Reduction Act of 1984 (DEFRA, P.L. 98-369) placed tight restrictions on employer contributions (Section 419) and limitations on accounts (Section 419A). In addition, tighter nondiscrimination rules were adopted for highly compensated individuals. These changes applied to welfare benefit funds generally, not just VEBAs. The nondiscrimination rules were further modified by the Tax Reform Act of 1986 (TRA86, P.L. 99-514). TRA86 also exempted collectively bargained welfare benefit funds and employee pay-all plans from account limits, thereby exempting the investment income on such VEBA trusts from the UBIT.

DEFRA did not apply these restrictions to collectively bargained plans or MEWA plans. In practice, both exemptions allowed arrangements that the IRS and others criticized as tax shelters. In 2003, IRS Notice 2003-24 stated that tax benefits purportedly generated by sham labor negotiations were not allowable for federal income tax purposes. The IRS also issued final

regulations defining experience-rating arrangements that preclude employer deductions for MEWAs.

The Pension Protection Act of 2006 (P.L. 109-280) authorized an additional reserve for non-retirement medical benefits of bona fide association plans.

In October 2007, IRS Notices 2007-83 and 2007-84 cautioned taxpayers against using VEBAs to provide cash value life insurance or to provide post-retirement benefits such as health care on a seemingly nondiscriminatory basis that in practice primarily benefits the owners or other key employees. The notices were aimed at welfare benefit plans considered abusive by the IRS that were being sold to professional corporations and other small businesses. In addition, the IRS clarified that deductions are not allowed under Section 419 for contributions to pay cash value life insurance premiums (Rev. Rul. 2007-65). Deductions are disallowed whether the trust provides insurance as a benefit or uses the proceeds to fund other benefits.

The Patient Protection and Affordable Care Act of 2010 (ACA, P.L. 111-148) enacted a provision that pertains to employer-provided and self-insured health plans, which includes plans that use VEBAs. Section 501(c)(9), as amended by the ACA, provides that, for purposes of providing for the payment of sick and accident benefits to VEBA members and their dependents, the term dependent includes any individual who is a member's child (as defined in Section 152(f)(1)) and who has not attained age 27 as of the end of the calendar year.

Assessment

VEBA withdrawals that are exempt from federal income taxes could lead to inefficient use of employee fringe benefits. By lowering the after-tax cost of these benefits, the tax preferences for VEBAs could encourage overconsumption of these benefits compared to a situation where there was no tax preference for these benefits.

VEBAs could also lead to inequality among employers and employees with similar abilities to pay income tax. While the Internal Revenue Code excludes certain fringe benefits from federal income taxation (e.g., certain health and medical benefits), employees can withdraw from their VEBA accounts to pay for qualified medical claims without incurring income tax on the distributions. By comparison, an employee with a more common, employer-sponsored insurance plan would typically use after-tax dollars for

their co-pays (unless they were using another tax-exempt method, such as a Section 223 health savings account). Benefits from VEBAs that are not for tax-qualified medical purposes may be subject to tax.

A VEBA may provide a valuable option for both employers and employees by providing tax-free contributions for employers and benefits to employees. In addition, the irrevocable trust fund associated with a VEBA helps protect the benefits.

VEBAs associated with an employer's chapter 11 bankruptcy proceedings (reorganizations) may both protect the fund's beneficiaries and make it more likely that the debtor-company will be able to successfully reorganize. Even if underfunded, establishing a VEBA would provide the beneficiaries with some future benefits. At the same time, it would improve the company's financial position by removing future costs of the covered benefits from the debtor-company's obligations.

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Education, Training, Employment, and Social Services

EXCLUSION OF MISCELLANEOUS FRINGE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	7.6	—	7.6
2021	7.8	—	7.8
2022	8.2	—	8.2
2023	8.5	—	8.5
2024	8.9	—	8.9

Authorization

Sections 132 and 117(d).

Description

Individuals do not include as income certain miscellaneous fringe benefits provided by employers, including services provided at no additional cost, employee discounts, working condition fringes, certain de minimis fringes, and certain tuition reductions.

These benefits also may be provided to spouses and dependent children of employees, retired and disabled former employees, and widows and widowers of deceased employees. Certain nondiscrimination requirements apply to benefits provided to highly compensated employees.

Impact

Exclusion from taxation of miscellaneous fringe benefits provides a subsidy to employment in those businesses and industries in which such fringe benefits are common and feasible. Employees of retail stores, for example, may receive discounts on purchases of store merchandise. Such benefits may

not be feasible in other industries—for example, for manufacturers of heavy equipment.

The subsidy provides benefits both to the employees (they receive higher compensation) and to their employers (who have lower wage costs).

Rationale

This provision was enacted in the Deficit Reduction Act of 1984 (P.L. 98-369). Congress recognized that in many industries employees receive either free or discounted goods and services that the employer sells to the general public. In many cases, these practices had been long established and generally had been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income.

Employees receive a benefit from the availability of free or discounted goods or services, but the benefit may not be as great as the full amount of the discount. Employers may have valid business reasons, other than simply providing compensation, for encouraging employees to use the products they sell to the public. For example, a retail clothing business may want its salespersons to wear its clothing rather than clothing sold by its competitors. As with other fringe benefits, placing a value on the benefit in these cases is difficult.

In enacting these provisions, Congress also wanted to establish limits on the use of tax-free fringe benefits. Prior to enactment of the provisions, the Treasury Department had been under a congressionally imposed moratorium on issuance of regulations defining the treatment of these fringes. There was a concern that without clear boundaries on use of these fringe benefits, new approaches could emerge that would further erode the tax base and increase inequities among employees in different businesses and industries.

As new types of benefits appeared, IRS issued Announcement 2002-18 in 2002 indicating that frequent flyer miles are excluded, and Notice 2011-72 in 2011 indicating that personal use of employer-provided cell-phones is excluded.

Assessment

The exclusion subsidizes employment in those businesses and industries in which fringe benefits are feasible and commonly used. Both the employees and their employers benefit from the tax exclusion. Under normal market

circumstances, more people are employed in these businesses and industries than would otherwise be, and they receive higher compensation (after tax). Their employers receive their services at lower cost. Both sides of the transaction benefit, because the loss is imposed on the Treasury in the form of lower tax collections.

Because the exclusion applies to practices which are common and may be feasible only in some businesses and industries, it creates inequities in tax treatment among different employees and employers. For example, consumer-goods retail stores may be able to offer their employees discounts on a wide variety of goods ranging from clothing to hardware, while a manufacturer of aircraft engines cannot give its workers compensation in the form of tax-free discounts on its products.

The 1984 legislation that defined excludable fringe benefits was before the advent of many benefits deriving from modern technology. Although the IRS has clarified cell-phone use and frequent flyer miles, the connections between work and personal use via computers, related devices, and internet usage have become blurred. The result may be uncertainty about the tax treatment and lack of compliance with the law.

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Education, Training, Employment, and Social Services

TREATMENT OF EMPLOYEE MOVING EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	-1.3	—	-1.3
2021	-1.3	—	-1.3
2022	-1.4	—	-1.4
2023	-1.5	—	-1.5
2024	-1.5	—	-1.5

Authorization

Section 132(g).

Description

Individuals must include in their gross income employer-provided reimbursements for qualified moving expense received after December 31, 2017, and before January 1, 2026. Members of the Armed Forces of the United States on active duty who move pursuant to a military order may exclude reimbursements for qualified moving expenses.

The inclusion in gross income of employer-provided reimbursements for qualified moving expenses is treated as a negative tax expenditure by the Joint Committee on Taxation (JCT) because an employee would be permitted to exclude such reimbursements under a normal income tax system.

Impact

This provision impacts employees whose employers provide moving expense reimbursement by increasing the tax burden of these individuals relative to a normal income tax system.

Rationale

This provision was enacted by the 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act. Previously, individuals were allowed to exclude employer-provided reimbursements for qualified moving expenses. This exclusion was not viewed as a subsidy, but rather a part of a normal income tax system. The original report in the House indicated that this treatment would be simpler and fairer, and was part of a general base broadening to allow lower rates.

Assessment

Moving expense reimbursements are primarily provided by employers when requiring an employee to relocate. By requiring inclusion of these reimbursements by the employee, it imposes an increased tax burden on these individuals. In response, some employers may increase employees' salaries to compensate, although this is not certain. This provision is estimated to generate a moderate amount of revenue for the U.S. Treasury.

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Education, Training, Employment, and Social Services

EXCLUSION OF EMPLOYER-PROVIDED (ON-SITE) GYMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.4	—	1.4
2021	1.5	—	1.5
2022	1.5	—	1.5
2023	1.6	—	1.6
2024	1.6	—	1.6

Authorization

Section 132(j).

Description

Individuals may exclude from gross income the value of an employer-provided gym or any other athletic facility as long as the gym or facility is located on the premises of the employer, is operated by the employer, and is primarily for the use of employees and their immediate families.

Impact

The exclusion for the value of employer-provided gyms and athletic facilities provides a subsidy to employment in those businesses that offer such benefits. The subsidy provides benefits to both employees (they receive higher compensation) and to their employers (who have lower wage costs).

Rationale

This provision was enacted in the Deficit Reduction Act of 1984 (P.L. 98-369) as part of a more general provision that excludes a variety of benefits provided by employers. Congress recognized that in many industries

employees receive free or discounted goods and services. In many cases, these practices had been long established and generally had been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income. Congress felt that codifying the rules that apply to the general practice that was prevalent at the time would improve the equity and administration of the tax system.

In enacting this provision, Congress also wanted to establish limits on the use of tax-free fringe benefits. Prior to enactment of the provision, the Treasury Department had been under a congressionally imposed moratorium on issuance of regulations defining the treatment of these fringes. There was a concern that without clear boundaries on use of these fringe benefits, new approaches could emerge that would further erode the tax base and increase inequities among employees in different businesses and industries.

Assessment

The exclusion subsidizes employment in those businesses and industries in which employer-provided gyms and athletic facilities are feasible and commonly used. Both the employees and their employers benefit from the tax exclusion. Under normal market circumstances, more people are employed in these businesses and industries than would otherwise be, and they receive higher compensation (after tax). Employers receive their employees' services at lower cost. Both sides of the transaction benefit because the loss is imposed on the U.S. Treasury in the form of lower tax collections.

Because the exclusion applies only to those who are offered use of gym and athletic facilities by their employer, it creates inequities in tax treatment among different employees and employers. For example, a business with a large campus where most workers are located may be able to offer their employees access to on-premises gym facilities, while a service-oriented business with a workforce that works remotely cannot.

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Education, Training, Employment, and Social Services

TREATMENT OF MEALS AND ENTERTAINMENT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	-2.8	-2.4
2021	0.4	-2.5	-2.1
2022	0.4	-2.5	-2.1
2023	0.4	-2.6	-2.2
2024	0.4	-2.8	-2.4

Note: This estimate does not reflect the temporary allowance of a full deduction for business meals through 2022. This provision was enacted by P.L. 116-260 and is estimated to cost \$6.3 billion over FY2021-FY2025.

Authorization

Section 274.

Description

In general, businesses are not allowed to claim a deduction for any activity that is considered entertainment, amusement, or recreation; a facility used in connection with such activities; or membership dues for any club organized for business, pleasure, recreation, or other social purpose. The inability to claim these items as a deduction is a departure from normal income tax law and results in a negative tax expenditure.

Current law provides a deduction equal to 50 percent of the cost of business meals (e.g., a client meal) as long as there is no entertainment provided. It was unclear, however, as to whether the recently enacted provision fully disallowing the deduction of entertainment costs applies to business meals for clients or prospects. The IRS issued temporary guidance (Notice

2018-76) indicating the conditions under which meals for clients or prospects are deductible, including that expenses not be lavish, that the taxpayer or employee of the taxpayer is present, and that when entertainment is provided the cost of the meal is purchased separately or separately stated. This interim guidance was generally incorporated in regulations (T.D. 9925).

The Taxpayer Certainty and Disaster Relief Act of 2020 (P.L. 116-260) allows for a 100 percent deduction for the expense of food and beverages purchased in a restaurant in 2021 and 2022.

The individuals (e.g., clients) who enjoy the entertainment or meals provided by a business are generally not required to include the value of the benefit in their gross income. This exclusion results in a positive tax expenditure.

Impact

The disallowance of a deduction for entertainment expenses primarily impacts businesses that regularly incur such expenses. Impacted businesses will generally be those that use entertainment as part of their client and employee development strategies.

Rationale

Historically, entertainment expenses have been deductible to some extent as long as the taxpayer could substantiate that the expense was directly related to the active conduct of business or was incurred directly preceding or following a bona fide business discussion that was associated with the active conduct of business. This is in accord with the ability to deduct ordinary and necessary business expenses.

The Revenue Act of 1978 (P.L. 95-600) prohibited the cost of entertainment facilities (e.g., skyboxes, bowling alleys, hunting lodges, vacation resorts, etc.) from qualifying for the deduction. The Tax Reform Act of 1986 (TRA86, P.L. 99-514) generally limited the deductibility of entertainment expenses to 80 percent of expenses, and tightened the rules that were intended to prevent taxpayers from deducting entertainment facility expenses. The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) further restricted the deduction to 50 percent for expenses directly related to the active conduct of business. The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) generally eliminated the deduction for entertainment expenses. Most recently, the Taxpayer Certainty and

Disaster Relief Act of 2020 (P.L. 116-260) provided a 100 percent deduction for the expense of food and beverages purchased in a restaurant in 2021 and 2022 to help alleviate the economic effects associated with the COVID-19 pandemic.

The evolution of limiting the deduction for entertainment expenses appears to be mostly driven by concern over federal subsidization of personal consumption rather than providing a deduction for legitimate business expenses. Some changes were also motivated by reports of abuses as outlined by Stern and Halperin.

Assessment

Most entertainment expenses represent partly a business expense and partly personal consumption. Given the practical difficulty in separating the two, administrative simplicity calls for a rule to determine how much of an entertainment expense is and is not deductible. It is not clear exactly what the percentage allocation should be. By not allowing a deduction, however, the current rule effectively treats entertainment expenses as entirely personal consumption and discourages the use of entertainment by taxpayers as part of business development strategies.

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Education, Training, Employment, and Social Services

**DISALLOWANCE OF DEDUCTION FOR EXCESS
PARACHUTE PAYMENTS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	-0.1	-0.1
2021	—	-0.1	-0.1
2022	—	-0.1	-0.1
2023	—	-0.1	-0.1
2024	—	-0.1	-0.1

Authorization

Sections 280G and 4999.

Description

Corporations may enter into agreements with key personnel that are called parachute payments or “golden parachutes,” under which the corporation agrees to pay these individuals substantial amounts contingent on a change in the ownership or control of the corporation. An “excess parachute payment” is the amount by which a parachute payment exceeds three times a base amount and is made to a disqualified individual. The base amount is the individual’s average annual compensation from the five previous years and a disqualified individual is either a shareholder or an officer of the corporation or is among the highest paid 1 percent of employees of the corporation or, if less, the 250 highest paid employees of the corporation.

Excess parachute payments are not deductible by the corporation. In addition, an individual receiving the payments must pay an excise tax (in addition to income taxes) equal to 20 percent of the amount that the excess

parachute payment exceeds the base amount. Parachute payments are subject to FICA taxes when paid to recipients.

The parachute payment provisions do not apply to certain types of payments, including reasonable compensation, qualified plan payments, payments by a domestic small business corporation, and payments by corporations that, immediately before a change in control, have no stock that is readily tradable on an established securities market.

Impact

The disallowance of the deduction for excess parachute payments removes a deduction for businesses in industries where excess parachute payments are common and feasible. They increase the after-tax cost to the corporation of this form of compensation, relative to deductible forms of compensation. The excise tax component also lowers the after-tax value of excess parachute payments to executives. All else equal, these effects should reduce the desirability of excess parachute payments.

Because this provision limits the corporate deductibility of employee compensation, while the employee is still subject to the individual income tax, it is a negative tax expenditure.

Rationale

The golden parachute provisions were enacted by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), in part because the agreements were thought to hinder acquisition activity in the marketplace. In particular, agreements to pay key personnel large amounts could make a target corporation less attractive to an acquiring corporation. In other situations, payments made to key personnel to encourage a takeover might not be in the best interests of the shareholders. And, regardless of whether a friendly or hostile takeover is involved, the amounts paid to key personnel reduce the amounts available for the shareholders.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) expanded the definition of an excess parachute payment for corporations that benefited from the public's participation in their economic recovery. One factor motivating this change was concern over the fairness or equity of parachute payments being given to executives of companies that benefited from the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

Assessment

The use and magnitude of excess parachute payments have increased since the enactment of provisions designed to make them less desirable forms of compensation. In the absence of these provisions, however, it is possible that excess parachute payments would be even more prevalent.

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Education, Training, Employment, and Social Services

LIMITS ON DEDUCTIBLE COMPENSATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	-1.6	-1.6
2021	—	-1.6	-1.6
2022	—	-1.6	-1.6
2023	—	-1.5	-1.5
2024	—	-1.5	-1.5

Authorization

Section 162(m).

Description

Publicly held corporations can generally deduct employee compensation in the calculation of taxable income. An exception to this rule pertains to executive compensation, for which only \$1 million is deductible. This limit is reduced to \$500,000 for each year a corporation has more than \$300,000,000 in outstanding assets acquired under the troubled asset relief program (TARP, P.L. 110-343). Beginning in 2013, the \$500,000 limit also applies to remuneration to officers, employees, directors, and service providers of covered health insurance providers. The threshold is reduced by the amount (if any) of excess golden parachute payments and any excise tax paid with respect to insider stock compensation. Beginning in 2027, no deduction will be allowed for compensation in excess of \$1 million paid to an employee who is among the five highest compensated employees aside from the CEO, CFO, and the three highest compensated officers (those individuals are already covered by the limits under current law).

Impact

The cap on deductible executive compensation does not appear to have impacted corporate executive compensation in recent years. The reduction in the corporate tax rate from a top rate of 35 percent to 21 percent enacted by the 2017 tax revision (P.L. 115-97) lessened any affect the provision may have had on executive compensation levels. The deduction limitation positively impacts federal tax revenue.

Rationale

Before the Omnibus Budget Reconciliation Act of 1993 (OBR93; P.L. 103-66) all non-excessive executive compensation was deductible. OBR93 codified a \$1 million cap on non-excessive executive compensation in response to concerns over the size of executive compensation packages.

The Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343) reduced this cap to \$500,000 for corporations that benefited from the public's participation in their financial recovery. One factor motivating this change was the concern over the fairness or equity of high executive compensation for companies that benefited from EESA.

The Patient Protection and Affordable Care Act (P.L. 111-148) added the lower limit of \$500,000 for health insurance providers.

The 2017 tax revision (P.L. 115-97) made a number of modifications to the deductible compensation limitation. It specified that the limitation applied to any "covered" employee, which includes anyone who holds the position of chief executive officer or financial executive officer any time during the taxable year. Additionally, the revision also specified covered employees to include the three other most highly compensated company officers. Any person who is designated a covered employee after 2016 is considered a covered employee in all future years, including after retirement, termination, or death. P.L. 115-97 also repealed the exception to the deduction limit for qualified performance-based compensation and commissions. As a result, there is no deduction for any compensation in excess of the limitation that applies to covered employees. The 2017 tax revision also expanded the definition of companies subject to the limitation to include all domestically publicly traded corporations and foreign companies that issue securities which are required to register their security issuances with the Security and Exchange Commission (SEC). Under the new rules, some large private C and

S corporations may also be subject to the deduction limitation. Previously, only corporations that had their stock publicly traded were impacted.

The American Rescue Plan Act of 2021 (P.L. 117-2), beginning in 2027, expanded the definition of covered employees to include the five highest compensated employees aside from the CEO, CFO, and the three highest compensated officers. No deduction will be allowed for compensation paid to these employees in excess of \$1 million.

Assessment

Since the early 1970s the real wages of non-managerial workers have been stagnant, while executive compensation has risen dramatically. Supporters of executive pay caps suggest that this is indicative of a larger social equity concern—inequality—and view the limit on deductible compensation as a tool to achieve greater equality. Opponents of the limitation, in contrast, argue that the limitation is inefficient because it creates a wedge between the marginal product and compensation of the executive.

Supporters of current executive pay levels argue that executive compensation is determined by normal private market bargaining, that rising pay reflects competition for a limited number of qualified candidates, and that even the richest pay packages are appropriate compared with the billions in shareholder wealth that successful executives create. Others, however, view executive pay as excessive. Some see a social equity problem, taking executive pay as symptomatic of a troublesome rise in income and wealth inequality. Others see excessive pay as a form of shareholder abuse made possible by weak corporate governance structures and a lack of clear, comprehensive disclosure of the various components of executive compensation.

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Education, Training, Employment, and Social Services

WORK OPPORTUNITY TAX CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	2.9	2.9
2021	(¹)	1.7	1.7
2022	—	0.6	0.6
2023	—	0.2	0.2
2024	—	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 51 and 52.

Description

The Work Opportunity Tax Credit (WOTC) is a non-refundable wage credit for hiring individuals who have had difficulty finding and holding a private-sector job because of certain attributes. The credit encourages employers to hire such persons by reducing their after-tax cost of hiring eligible individuals, relative to the after-tax cost of hiring ineligible individuals. The WOTC has always been a temporary subsidy; it is due to expire at the end of 2025.

Employers that hire persons from nine designated groups benefit from the credit. Not all groups have been eligible throughout the 26 years the credit has been available. In the credit's history, a total of 11 groups have been eligible for the WOTC; nine are currently eligible. The 11 groups are:

- (since 1997) members of families that receive benefits under the Temporary Assistance for Needy Families (TANF) program during nine of the 18 months before the hiring date;
- (since 1996) individuals who are 18- to 39-years old and are members of families that received supplemental food assistance under the Food and Nutrition Act of 2008 (P.L. 88-525, FNA) during the six months preceding the hiring date; or able-bodied individuals with no dependents who no longer are eligible for food assistance under section 6(o) of the act and are part of families that received supplemental food assistance in at least three of the five months preceding the hiring date;
- (since 2001) “designated community residents” (i.e., persons who are between 18 and 39 years old on the hiring date) whose principal place of residence is in an empowerment zone, an enterprise community, a renewal community, or a rural renewal county;
- (since 2001) “summer youth,” who are defined as 16- to 17-year-olds hired for any 90-day period between May 1 and September 15 and who reside in an empowerment zone or renewal community;
- (since 1996) ex-felons who are hired within one year of the date of their conviction or their release from prison;
- (since 1996) vocational rehabilitation referrals, who are individuals with physical or mental disabilities and are referred to employers upon completion of or while receiving rehabilitative services under one of the following plans: (a) an individual written plan for employment based on a state plan for vocational rehabilitation services approved under the Rehabilitation Act of 1973 (P.L. 93-112); (b) a vocational rehabilitation program for veterans carried out under chapter 31 of title 38, United States Code; or (c) an individual work plan developed and implemented by an employment network under section 1148(g) of the Social Security Act (P.L. 74-271);
- (since 1997) Supplemental Security Income (SSI) recipients who received benefits under Title XVI of the Social Security Act for a month during the 60 days before the hiring date;

- (since 1996) veterans who are members of families receiving food stamps under the FNA during at least three of the 15 months preceding the hiring date, or veterans who are entitled to compensation for a service-connected disability and are hired not more than one year after having been discharged or released from active duty in the Armed Forces, or after being unemployed in at least six of the twelve months preceding the hiring date;
- (since 2016) persons who have been unemployed for 27 or more weeks, as certified by a local state workforce agency; the period of joblessness may include weeks when an unemployed person received unemployment compensation under federal or state law;
- (2009 and 2010 only) “disconnected” 16- to 24-year-olds, who were persons in that age group who did not regularly attend school or were not regularly employed during the six months before the hiring date and were hard to employ because of inadequate skills;
- (2009 and 2010 only) unemployed veterans who were discharged or released from active duty in the Armed Forces during the five years preceding the hiring date and who received unemployment compensation for at least four weeks during the previous year.

An employer cannot claim the WOTC until the workforce agency in the state where the employer is located has certified that its new hires are members of one of the designated groups.

During a WOTC-certified individual’s first year of employment (except for certain qualified veterans and summer youth), an employer may claim a tax credit equal to 40 percent of the individual’s first \$6,000 in wages if that person works 400 or more hours; the credit drops to 25 percent if an individual is employed for 120 to 399 hours. No credit is available if a WOTC-eligible employee works fewer than 120 hours. Qualified wages for summer youth are the first \$3,000 in wages.

For WOTC-certified veterans who are entitled to compensation for a service-related disability, an employer may claim the WOTC for the first \$12,000 of their wages. The credit applies to the first \$14,000 in wages paid to veterans who were unemployed for at least six months in the year before the hiring date. Finally, employers may claim the credit for the first \$24,000 in wages paid to veterans who are entitled to compensation for a service-

related disability and were unemployed for at least six months during the year before the hiring date.

Employers claiming the WOTC must reduce their deduction for employee compensation by the amount of the credit they claim to prevent them from benefiting twice from the same expenditures.

The WOTC is a component of the general business credit under section 38. As a result, unused current-year WOTCs may be carried back one year or forward up to 20 years to offset an employer's tax liability.

Impact

Administration of the credit is split between the federal government and state governments. At the federal level, the Internal Revenue Service (IRS) processes and verifies claims for the WOTC, while the U.S. Department of Labor's Employment and Training Administration (ETA) oversees the certification process. State workforce agencies (SWAs), assisted by certain other agencies (e.g., job corps centers, local welfare agencies, food stamp program agencies, and Veterans Administration offices), certify that newly hired employees in their states qualify for the credit.

A certification verifies that someone is a member of an eligible WOTC group. The total number of certifications issued in a year will exceed the number of credits claimed unless all WOTC-certified hires remain on their employers' payroll for a minimum of 120 days.

In 2020, SWAs issued 1.6 million certifications of WOTC eligibility for new hires, down from 2.1 million certifications in 2019. Some of the decline reflected disruptions in the job market caused by the COVID-19 pandemic. During the first 10 years of the program (1996 to 2006), the majority of WOTC certifications went to members of the TANF group. Since 2007, the vast share of certifications has gone to 18- to 24-year-olds in families receiving supplemental nutrition assistance. In FY2019, for example, this group accounted for 65 percent of all WOTC certifications.

Rationale

The WOTC encourages employers to hire individuals who have had difficulty obtaining employment in the private sector. It does so by reducing the relative cost of hiring such persons through a temporary employer wage credit. In effect, the credit leverages private funds so that the subsidy

overcomes the reluctance of many employers to hire persons with relatively few skills, little work experience, and presumed lower productivity than other workers. For individuals eligible for the credit, it creates opportunities to earn an income and gain skills and work experience that otherwise may be unavailable.

The WOTC is a successor to an earlier tax credit aimed at encouraging firms to hire hard-to-employ individuals: the Targeted Jobs Tax Credit (TJTC), which was available from 1978 to 1994. Evaluations of the TJTC found that it did not achieve its stated objectives largely for two reasons. First, it subsidized the hiring of numerous people who probably would have been hired without the credit. Second, the TJTC did little to provide eligible individuals with the work experience and on-the-job training they might need to move into higher-paying jobs.

Congress retained this approach, although with some changes, in adopting the WOTC. The Small Business Job Protection Act of 1996 (P.L. 104-188) created the credit and made it available from October 1, 1996, through September 31, 1997.

The Taxpayer Relief Act of 1997 (P.L. 105-34) added eight groups to the list of designated individuals and changed the WOTC into a two-tiered credit based on length of employment. The act also extended the WOTC from October 1, 1997, through June 30, 1998.

The credit expired before Congress further extended the credit through June 30, 1999, with the passage of the Omnibus Consolidated and Emergency Appropriations Act, 1999 (P.L. 105-277).

The Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) extended the WOTC through December 31, 2001.

The Consolidated Appropriations Act, 2001 (P.L. 106-554) expanded the “high risk” and “summer youth” groups to include residents of “renewal communities.” Employers claiming the WOTC for such residents had to reconcile it with a recently enacted New Markets Tax Credit for hiring renewal community residents.

Congress extended the WOTC through December 31, 2003, for qualified individuals hired after December 31, 2001, in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). The act expanded the groups eligible for the credit to include New York Liberty Zone (NYLZ) residents hired in

2002 and 2003. Only firms with 200 or fewer employees located in the immediate vicinity of the World Trade Center at the time of the terrorist attacks on September 11, 2001, could claim the credit.

The Taxpayer Relief Act of 1997 (P.L. 105-34) established a new wage credit called the Welfare-to-Work tax credit (WTWTC). It was extended three times before Congress allowed the WTWTC to expire on December 31, 2003. The credit was intended to complement the WOTC by increasing job opportunities for individuals who had received 18 or more months of federal welfare benefits. Although someone could be eligible for both credits, an employer was permitted to claim only one. For eligible individuals who worked at least 400 hours in a year, the WTWTC was equal to 35 percent of the first \$10,000 of their wages in the first year of employment and 50 percent of the same amount in the second year.

The Working Families Tax Relief Act of 2004 (P.L. 108-311) retroactively extended the WOTC and WTWTC to December 31, 2005, following a 10-month lapse.

Under the Katrina Emergency Tax Relief Act of 2005 (P.L.109-73), employees directly affected by Hurricane Katrina were added to the groups eligible for the WOTC from August 28, 2005, to August 28, 2007. To qualify, workers had to be hired for jobs located in the core disaster area.

The Tax Relief and Health Care Act of 2006 (P.L. 109-432) retroactively extended the WOTC through December 31, 2007, and combined the WTWTC and the WOTC into a single wage credit. As a result, employers that hired long-term recipients of family assistance after December 31, 2006, were allowed to claim a credit equal to 25 percent of wages for recipients who were employed between 120 and 399 hours in their first year of employment, and 40 percent of wages for recipients who worked 400 or more hours during their first year. Wages eligible for the credit were capped at \$10,000 in each of a recipient's first two years of employment. The credit's top rate rose to 50 percent for the second year.

Under the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Act of 2007 (P.L. 110-28), the WOTC was extended through August 31, 2011. The act also added "rural renewal counties" to the places of residence for "designated community residents."

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) expanded the WOTC to cover unemployed veterans and “disconnected” youth hired in 2009 and 2010.

An extension of the WOTC through December 31, 2011, was included in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2012 (P.L. 111-312).

The American Jobs Act of 2011 (P.L. 112-56) further extended the credit for veterans through December 31, 2012, expanded the group of veterans eligible for the credit, and increased the first-year wages against which it can be claimed for veterans.

Under the American Taxpayer Relief Act of 2012 (P.L. 112-240), the WOTC was extended through December 31, 2013, for all eight of the designated groups established by the Taxpayer Relief Act of 1997.

Congress extended the WOTC through the end of 2014 in the Tax Increase Prevention Act of 2014 (P.L. 113-295).

The Protecting Americans from Tax Hikes Act of 2015 (P.L. 114-113) added persons who have been unemployed 27 or more weeks to the list of designated groups for the WOTC, beginning in 2016. It also extended the credit through the end of 2019.

The credit was extended through the end of 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94).

Congress extended the credit to the end of 2025 through the Consolidated Appropriations Act, 2021 (Section 113 of Division EE, P.L. 116-260).

Assessment

To assess the effects of the WOTC, it is useful to keep in mind what the credit is and is not intended to do. The WOTC is a wage subsidy designed to encourage employers to hire specific groups of individuals for generally low-skill, low-wage jobs. The credit is not designed to spur faster job creation or promote recovery in labor markets from an economic downturn.

The WOTC raises several policy issues. One relates to its efficacy in increasing the employment opportunities for disadvantaged groups. Another issue concerns the credit’s cost-effectiveness relative to alternative approaches to expanding employment opportunities for these groups.

Lawmakers may also want to know how the credit's overall costs stack up against its overall benefits.

There is a small literature on the effects of the WOTC on the long-term employment and wages prospects of participants. Most of what is known about the credit's effects comes from a series of studies done since 2001. On the whole, the studies examine the credit's impact on selected groups and employers over one to three years.

The following conclusions may be drawn from this research:

- The take-up (or participation) rate for the credit has been unexpectedly low. This rate is measured as the number of WOTC-certified workers divided by the total number of eligible workers for whom the credit is not claimed. Hamersma (2003) estimated that the take-up rate was no more than 17 percent for eligible youth and 33 percent for welfare recipients. In her view, the main reason for these results was the relatively short job tenures of most WOTC-certified employees.
- Employers generally have not tried to game the credit by replacing ineligible workers with WOTC-certified workers, or by letting WOTC-certified workers go after one year and hiring other such workers to replace them.
- On average, WOTC-certified employees have earned higher wages than other employees doing the same work.
- The employment of WOTC-certified disabled veterans has expanded by as much as 2 percent because of the credit.
- The credit seems to have enhanced long-term employment opportunities for one of the disadvantaged groups: welfare recipients.
- A significant beneficiary of the credit has been temporary employment agencies.

Available evidence sheds little light on how effective the WOTC has been over its 26-year existence. Nor does this evidence provide a definitive answer to the question of whether the credit is more cost-effective than other policy options, such as federal grants for job training and education for the same disadvantaged individuals. There is no evidence addressing the question of whether the WOTC has produced benefits that have exceeded its cost.

Some critics of the WOTC argue that replacing it with federal formula grants to states to support local programs that combine training, employment subsidies, and support services would be a more cost-effective way to expand job opportunities for the individuals targeted by the WOTC. In their view, lawmakers might benefit from a comparison of the advantages and disadvantages of the WOTC and other policy options (especially labor demand subsidies), should they again consider whether to retain the WOTC in its current form.

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Education, Training, Employment, and Social Services

**CREDIT FOR CHILD AND DEPENDENT CARE AND
EXCLUSION OF EMPLOYER-PROVIDED CHILD CARE**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	4.7	—	4.7
2021	4.7	—	4.7
2022	4.7	—	4.7
2023	4.7	—	4.7
2024	4.8	—	4.8

Note: Estimates include outlay effects associated with the exclusion of employer-provided child care. This exclusion results in less income, which for some taxpayers may result in a larger refundable tax credit like the EITC or additional child tax credit than if employer-provided child care was included as income. These outlay effects are \$0.8 billion (FY2020), \$1.2 billion (FY2021), \$0.9 billion (FY2022), \$0.8 billion (FY2023) and \$0.8 billion (FY2024).

These provisions were temporarily expanded by P.L. 117-2. Changes to the credit are estimated to reduce revenues by \$8 billion between FY2021-FY2026 (of which \$3.8 billion are outlay effects) and changes to the exclusion are estimated to cost \$0.1 billion over the same time period according to JCT (JCX-14-21).

Authorization

Sections 21, 125, and 129.

Description

Taxpayers may be eligible for two tax benefits that subsidize the cost of child and dependent care: the child and dependent care credit and the exclusion for employer-sponsored child care.

Child and Dependent Care Credit

The child and dependent care tax credit is a nonrefundable tax credit that reduces a taxpayer's federal income tax liability based on child and dependent care expenses incurred so the taxpayer can work or look for work. (As described later in this section and chapter, the credit was temporarily made refundable for 2021.)

The credit amount equals a percentage (or "credit rate") of the taxpayer's qualifying child and dependent care expenses. The credit rate varies based on income, with a maximum of 35 percent which is reduced by one percentage point for each \$2,000 of income above \$15,000 until the credit rate equals 20 percent for taxpayers with income above \$43,000. These income levels are not adjusted annually for inflation.

Since the credit (sometimes referred to as the child care credit or CDCTC) is nonrefundable, the credit amount cannot be greater than a taxpayer's federal income tax liability. Taxpayers with little or no federal income tax liability—including many low-income taxpayers—generally receive little if any benefit from nonrefundable credits like the CDCTC.

The dollar limit of qualifying expenses that can be claimed for the credit is \$3,000 for one qualifying individual and \$6,000 for two or more qualifying individuals. In addition to the statutory dollar limit, the amount of work-related expenses used to calculate the credit may not exceed the earned income of the taxpayer.

Qualifying expenses for the credit are generally defined as expenses for the care of a qualifying individual so that a taxpayer (and their spouse, if filing jointly) can work or look for work. An expense is not considered work-related merely because a taxpayer paid or incurred the expense while working or looking for work. The *purpose* of the expense must be to enable the taxpayer to work or look for work. Whether an expense has such a purpose is dependent on the facts and circumstances of each particular case. These expenses can include those for providing care for a qualifying individual or individuals both in and outside the taxpayer's home.

A qualifying individual is defined as (1) the taxpayer's child who is under age 13 and for whom the taxpayer can claim the dependent exemption; (2) the taxpayer's spouse who is not physically or mentally able to care for himself or herself and lived with the taxpayer for more than half the year; or (3) a person who is not physically or mentally able to care for himself or herself and lived with the taxpayer for more than half the year and either (a) was the taxpayer's dependent for purposes of the dependent exemption, or (b) would have been the taxpayer's dependent in certain limited circumstances.

In-home care expenses include costs of care provided in the taxpayer's home such as the cost of a nanny to look after a child or a housekeeper to look after an elderly parent. The payroll taxes associated with these services, as well as meals and lodging provided to the caregiver as part of their employment, may be qualifying expenses. For household services that are in part for the care of qualifying individuals and in part for other purposes, generally only the portion for the care of a qualifying individual can be applied to the credit.

There are different types of care provided outside the taxpayer's home that may be considered qualifying expenses for the purposes of the credit. To qualify, the care must be provided to the taxpayer's dependent child under age 13 or another qualifying person who regularly spends at least eight hours each day in the taxpayer's home (in other words, a non-child dependent must generally live with the taxpayer even if that dependent spends the day at a care facility). This means, for example, that care provided at a live-in nursing home for a taxpayer's parent or spouse is not a qualifying expense. Common types of qualifying out-of-home care expenses can include the care provided at a dependent care center, pre-K education, before- and after-school care, and day camp.

In order to claim the credit, the taxpayer (and if married, their spouse) must have earned income during the year. A taxpayer (and if married, their spouse), is treated as having earned income for the purposes of the credit if they are (1) a full-time student, or (2) mentally or physically unable to care for themselves. Married taxpayers must generally file a joint return to take the credit, but special rules exist for couples who are legally separated or living apart.

For 2021 only, the credit was temporarily expanded in three ways. First, the credit was made refundable, meaning the amount of the credit was no longer limited by a taxpayer's income tax liability. Second, the limit on qualifying expenses was increased from \$3,000 to \$8,000, if a taxpayer had

one qualifying individual and from \$6,000 to \$16,000, if a taxpayer had two or more qualifying individuals. Third, the credit rate for many low- and moderate-income taxpayers was increased. Specifically, the maximum credit rate was 50% for taxpayers with income of \$125,000 or less. For those with income between \$125,000 and \$183,000, the credit rate gradually declined to 20% for taxpayers with income between \$183,000 to \$400,000. For workers with income over \$400,000, the credit rate gradually declined to zero such that workers with \$438,000 of income or more would not receive the credit. (These dollar amounts were the same for all tax filing statuses.)

Exclusion for Employer-Sponsored Dependent Care

In addition to this credit, a taxpayer can exclude from their income up to \$5,000 of employer-sponsored dependent care.

The definitions for qualified dependent care expenses and qualified dependent used for the exclusion are the same as for the CDCTC. The maximum exclusion amount is \$5,000, and may not exceed the lesser of the earned income of the employee or the employee's spouse, if married.

For each dollar a taxpayer receives through an employer-provided dependent care assistance program, a reduction of one dollar is made in the maximum qualified expenses that can be applied towards calculating the dependent care tax credit. For example, if a family had one child, \$10,000 in annual child care expenses, and received \$5,000 annually in tax-free dependent care assistance under the exclusion, the family could not claim the CDCTC. The amount of tax-free assistance (\$5,000) would eliminate the maximum amount of expenses that could be applied to the credit (\$3,000).

Employer-sponsored child and dependent care benefits eligible for the exclusion under section 129 can be provided in various forms, including: direct payments by an employer to a child care or adult day care provider; on-site child or dependent care offered by an employer; and employer reimbursement of employee child care costs, or flexible spending accounts (FSAs) that allow employees to set aside a portion of their salary on a pretax basis (i.e., under a "cafeteria plan") to be used for qualifying expenses.

Dependent care FSAs are offered to employees as part of a *cafeteria plan*. Under a cafeteria plan, employees are offered the option to set aside a portion of their salary on a pretax basis. Employees typically determine the amount they wish to contribute to an FSA at the beginning of a *plan year*. Once an employee has set the amount they wish to contribute to an FSA for a plan year,

changes are allowed only in limited circumstances (like the birth of a child or marriage).

Employees then use these contributions to pay for expenses incurred for a *qualified benefit*. Generally, under a dependent care FSA, employees pay out of pocket for the expenses and are then reimbursed from their FSA.

FSA contributions are subject to a “use-or-lose” rule, whereby employees forfeit any unused contributions remaining in their dependent care FSA at the end of the plan year. Specifically, when an employer chooses to offer a dependent care FSA, it generally must select one of two mutually exclusive options for handling any unused balance: forfeit unused FSA balances, which then revert to the employer; or employees are given a “grace period” of up to two and a half months after the end of the plan year to spend the remaining balance.

For 2021, the amount of tax-free dependent care assistance that could be excluded from wages was increased from \$5,000 to \$10,500.

Impact

Because the credit is nonrefundable, it does not benefit people who owe nothing in income taxes, including low-income taxpayers who often have no income tax liability.

Distribution by Income Class of the Tax Expenditure for the Child and Dependent Care Credit, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.3
\$30 to \$40	1.8
\$40 to \$50	4.0
\$50 to \$75	10.6
\$75 to \$100	9.7
\$100 to \$200	41.6
\$200 and over	31.9

The credit rate phases down from 35 to 20 percent as income rises from \$15,000 to \$43,000, theoretically providing a larger benefit to parents with incomes of \$43,000 or less. However, given the credit's non-refundable nature, it is not available to the lowest-income taxpayers. Indeed, the credit primarily benefits middle- and upper-income taxpayers, with more than 73 percent of the credit claimed by taxpayers with \$100,000 or more of income.

The tax exclusion for employer-provided dependent care provides an incentive for employers to provide, and employees to receive, compensation in the form of dependent-care assistance rather than cash. The assistance is free from income and employment taxes, while cash income (i.e., wages) is not. As is the case with all deductions and exclusions, the tax savings of the exclusion is proportional to the taxpayer's marginal tax rate and, thus, provides a greater benefit to taxpayers in high tax brackets than those in low tax brackets, all else being equal. For some taxpayers, especially higher-income taxpayers, the amount of their CDCTC will be affected by the amount of tax-free employer-sponsored child care they receive. If a taxpayer's marginal tax rate is greater than the applicable credit rate, the taxpayer will receive a larger tax savings from claiming the exclusion rather than the credit (in addition, the exclusion lowers their payroll taxes). For example, \$100 of employer-sponsored child care saved in an FSA would lower a taxpayer's income tax bill by \$35 if they were in the 35 percent tax bracket. The tax savings associated with applying that \$100 to the CDCTC would, by contrast, be \$20. Hence, if employer-sponsored child care is offered by their employer, a taxpayer may claim this benefit first and apply any remaining eligible expenses (if applicable) toward the credit, lowering their credit amount in comparison to if the exclusion was not available.

Rationale

A deduction for child and dependent care services was first enacted in 1954 (P.L. 83-591). The allowance was limited to \$600 per year and was phased out for families with income between \$4,500 and \$5,100. Single parents and widow(er)s did not have an income limitation for the deduction. The provision was intended to recognize the similarity of child care expenses to employee business expenses and provide a limited benefit.

The Tax Reduction Act of 1975 (P.L. 94-12) substantially increased the income limits (\$18,000 to \$35,000) for taxpayers who could claim the deduction.

The deduction was replaced by a nonrefundable credit with enactment of the Tax Reform Act of 1976 (P.L. 94-455). The credit formula was 20 percent of eligible expenditures subject to a maximum level of expenditures of \$2,000 for one qualifying individual and \$4,000 for two or more qualifying individuals. These amounts were not adjusted for inflation. Congress believed that such expenses were a cost of earning income for all taxpayers and that its benefits should be made available to those taking the standard deduction. Also, the tax credit provided relatively more benefit than the deduction to taxpayers in the lower tax brackets.

The Revenue Act of 1978 (P.L. 95-600) provided that the child care credit was available for payments made to relatives. The stated rationale was that, in general, relatives provide better attention and the allowance would help strengthen family ties.

P.L. 97-34 created the current “sliding-scale” credit rate whereby the credit rate decreases as income increases. The sliding scale began at 30 percent for taxpayers with adjusted gross income of \$10,000 or less, with the rate reduced by one percentage point for each \$2,000 (or fraction thereof) above \$10,000 until the lowest rate of 20 percent was reached at \$28,000 of income. The law also increased the maximum expenditures from \$2,000 to \$2,400 for one qualifying individual and from \$4,000 to \$4,800 for two or more qualifying individuals. The congressional rationale for increasing the maximum amounts noted the substantial increases in costs for child care. The purpose of switching to a sliding-scale credit was to target the increases in the credit toward low- and middle-income taxpayers. The law also enacted the exclusion for employer-sponsored child and dependent care as a way to encourage employers to sponsor child care for their employees.

The Family Support Act of 1988 (P.L. 100-485) modified the dependent care tax credit. First, the credit became available for care of children under age 13 rather than 15. Second, a dollar-for-dollar offset was provided against the amount of expenses eligible for the dependent care credit for amounts excluded under an employer-provided dependent care assistance program. Finally, the act provided that the taxpayer must report on his or her tax return the name, address, and taxpayer identification number of the dependent care provider.

With passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), the sliding-scale credit rate was increased 5 percentage point (from 30 percent to 35 percent) while the maximum

expenditure amounts were raised from \$2,400 to \$3,000 for one qualifying individual and from \$4,800 to \$6,000 for two or more qualified individuals. It seems likely that these changes were made because the qualifying expense dollar limits are not subject to an automatic inflation provision. These changes were originally set to expire on December 31, 2010.

The credit was further amended by the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) which determined that the amount of “deemed” earned income in the case of a nonworking spouse incapable of self-care or who is a full-time student is increased to \$250 if there is one qualifying child or dependent, or \$500 if there are two or more children.

In 2004, the Working Families Tax Relief Act (P.L. 108-311) imposed a requirement that a disabled dependent (or spouse), who is not a qualifying child under age 13, live with the taxpayer for more than half the tax year. It also eliminated the requirement that the taxpayer maintain a household in which the qualifying dependent resides.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the temporary EGTRRA provisions adopted in 2001 (and which were originally scheduled to expire after 2010) for an additional two years—2011 and 2012. The provisions were made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

To address the impacts of the COVID-19 pandemic, the Internal Revenue Service (IRS) provided temporary flexibilities to employers offering certain benefits through cafeteria plans in 2020 (see IRS Notice 2020-29). These flexibilities allowed, but did not require, employers to change some policies related to dependent care FSAs to allow for mid-year changes to FSA contributions (without a qualifying life event) and to allow for extended grace periods for 2020 dependent care FSAs.

The American Rescue Plan Act of 2021 (ARPA; P.L. 117-2) temporarily expanded the credit and the exclusion. The law temporarily expanded the child and dependent care credit for 2021 by making the credit refundable, increasing the maximum amount of expenses, and modifying the credit rate. Specifically, the law increased the cap on qualifying expenses from \$3,000 for one qualifying individual to \$8,000 and from \$6,000 for two or more qualifying individuals to \$16,000. For those with less than \$125,000 of income, the credit rate increased to 50% (from 35%) of expenses, gradually phasing down to 20% until taxpayers had \$183,000 of income. For those with

more than \$183,000 of income up to \$400,000, the credit rate remained at 20%, gradually falling to zero when income exceeded \$438,000. The law also temporarily increased the maximum amount of qualifying child care expenses that could be excluded from an employees' wages for 2021 from \$5,000 to \$10,500.

Assessment

The child and dependent care tax credit tends to benefit middle and upper-middle income households. Analysis by the Tax Policy Center indicates that the average credit amounts for the 20 percent of families with the lowest incomes were significantly less than the average amounts for moderate-income families. Low-income families generally receive little if any benefit from non-refundable credits like the CDCTC and tend to have less in eligible child care expenses than moderate-income families. Lower out-of-pocket child care expenses does not necessarily mean that lower-income families do not have child care needs; rather, it may indicate that these needs are met informally—such as having a neighbor or relative watch a child during the workday. These informal arrangements may not result in formal child care payment that is eligible for the credit. Higher-income families may have access to the exclusion through work, and hence also receive a smaller credit because the exclusion reduces qualifying expenses for the credit.

The Tax Policy Center estimates that most families with children do not benefit from this credit. Specifically, about one in eight families (12 percent) benefit from the credit. This may be because these families do not have qualifying child care expenses (e.g., they do not pay out of pocket for care) for a variety of reasons including they cannot afford to do so (as described above) or because they rely on family caregivers (e.g., grandparents). Or it can arise when they do pay for out-of-pocket care but the expenses they incur do not qualify for the credit (e.g., like overnight camp, or because their children are 13 years old or older). It also may be because the taxpayer does not work, or if married, both spouses do not work.

To administer the dependent care tax credit, the Internal Revenue Service requires submission of a tax identification number for the provider of care (unless the taxpayer can show that they exercised due diligence in attempting to provide the required information). A taxpayer must include this information on the tax return to claim the credit. This requirement may reduce the number of taxpayers who erroneously claim this credit for non-qualifying care (for example, care provided by an older sibling). However, other aspects of the

credit may result in lower compliance rates and additional administrative issues. For example, the rule for determining whether a child or family member is a qualifying individual for the child and dependent care tax credit is complex, and differs from the eligibility requirements for other child and dependent-related tax benefits. This may lead to confusion and error on the part of the taxpayer. In addition, it may be difficult for the IRS to verify that children and dependents are accurately claimed for the credit. Finally, determining whether expenses count towards the credit calculation may also increase the complexity of this provision.

The exclusion tends to benefit middle- and higher-income households for a variety of reasons, including that higher-income workers are more likely to work for employers that offer these benefits. And higher-income workers in higher tax brackets will receive a greater tax savings from a given amount of the exclusion than lower-income workers in a lower tax bracket.

Advocates for the exclusion argue that the availability of dependent care can reduce employee absenteeism and unproductive work time. The tax exclusion may also encourage full participation of women in the work force as the lower after-tax cost of child care may not only affect labor force participation but hours of work.

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Education, Training, Employment, and Social Services

CREDIT FOR EMPLOYER-PROVIDED DEPENDENT CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 45F.

Description

Employers are allowed to claim a tax credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. Qualified child care expenses include the cost of acquiring, constructing, rehabilitating or expanding property used for a qualified child care facility, costs for the operation of the facility (including training costs and certain compensation for employees, and scholarship programs), or costs for contracting with a qualified child care facility to provide child care.

A qualified child care facility must have child care as its principal purpose and must meet all applicable state and local laws and regulations. A facility operated by a taxpayer is not a qualified child care facility unless, in addition to these requirements, the facility is open to all employees and, if qualified child care is the principal trade or business of the taxpayer, at least 30 percent of the enrollees at the facility are dependents of employees of the

taxpayer. Use of a qualified child care facility and provision of child care resource and referral services cannot discriminate in favor of highly paid employees.

The maximum total credit that may be claimed by a taxpayer cannot exceed \$150,000 per taxable year. (The amount of employer-provided dependent care expenses that can be deducted as a business expense is reduced by the amount of the credit.) Any credit claimed for acquiring, constructing, rehabilitating, or expanding property is recaptured if the facility ceases to operate as a qualified child care facility, or for certain ownership transfers within the first 10 years. The credit recapture is a percentage, based on the year when the cessation as a qualified child care facility or transfer occurs.

Impact

A 25 percent credit can significantly decrease the cost of on-site facilities for employers and encourage some firms to develop on-site facilities. Firms have to be large enough to make the facility viable; i.e., have enough employees with children in need of child care. Thus, large firms will most likely be those that provide on-site child care.

This nonrefundable tax credit has the potential to violate the principle of horizontal equity, which requires that similarly situated taxpayers should bear similar tax burdens. Mid- and small-sized firms may not have sufficient tax liability to claim the credit. Even for those firms that are able to claim the credit, they may not be able to claim the full amount because of limited tax liability.

Although the credit is contingent on non-discrimination in favor of more highly compensated employees, this provision, unlike child care tax benefits in general, may provide greater benefits to middle-income and upper-income individuals because its relative cost effect is dependent on the size of the firm and not the income of the employees. Indeed, lower-income employees may not be able to afford the higher quality child care facilities offered by some firms (although some employers subsidize costs for lower-income workers).

Rationale

This provision was adopted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) and was designed to encourage on-site employer child care facilities. It was scheduled to expire after 2010 but was extended through 2012 by the Tax Relief, Unemployment

Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). It was made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

Assessment

Specific subsidies for on-site employer-provided child care would be economically justified if there were a market failure that prevented firms from providing this service. Few firms offer such facilities, although small firms may not have enough potential clients to allow the center to be economically viable. The limit on the subsidy amount is intended to target smaller firms, but it is not clear why such activities are under-supplied by the market. Some research has suggested that on-site care produces benefits that firms may not take into account, such as reduced absenteeism and increased productivity, but not all evidence is consistent with that view. In addition, employers may be reluctant to commit to on-site child care because of uncertainties regarding costs and return.

A 2022 study by GAO found few employers used the credit. An estimated 169 to 278 corporate returns claimed the credit as part of the general business credit in 2016 and an estimated 16,846 to 21,378 individual income tax returns claimed the credit in 2018. GAO identified several factors that may limit the use of the tax credit including the substantial startup and long-term costs of providing child care; employee preference for child care nearer their homes; employers' lack of awareness of the credit; and the size of the credit, which may not be sufficiently large to affect employers' decisions to provide child care.

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Education, Training, Employment, and Social Services

**ADOPTION CREDIT AND EMPLOYEE ADOPTION
BENEFITS EXCLUSION**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.4	—	0.4
2021	0.4	—	0.4
2022	0.4	—	0.4
2023	0.5	—	0.5
2024	0.5	—	0.5

Authorization

Sections 23 and 137.

Description

In 2022, taxpayers may be able to receive an adoption credit of up to \$14,890 (this amount is annually adjusted for inflation). The credit is reduced for taxpayers with income over \$223,410 and is phased out completely for taxpayers with more than \$263,410 in income (these amounts are subject to annual inflation adjustment). The adoption credit is not refundable. However, the credit may be carried forward and claimed on future tax returns for up to five years after initially claimed. (The credit was temporarily refundable for 2010 and 2011 only.)

The amount of the credit is based on the expenses related to the adoption of an eligible child. The term *eligible child* refers to children under age 18 and to older individuals who are physically or mentally incapable of taking care of themselves. Qualifying expenses must be directly related to the adoption of an eligible child. They include: reasonable and necessary adoption fees, court costs, and attorney fees; travelling expenses while away from home (including

amounts spent on meals and lodging); and other expenses directly related to, and for the principal purposes of the legal adoption of an eligible child by the taxpayer (e.g., home study costs).

Qualified adoption expenses *do not include*: any expense for which a deduction or credit is allowed under any other provision of the tax code; expenses for which funds are received under any federal, state, or local program; expenses incurred to carry out any surrogate parenting arrangement; expenses incurred in connection with adopting a spouse's child (i.e., a stepchild); or adoption expenses reimbursed under an employer program.

In the case of a special needs adoption, the maximum tax credit is allowed regardless of actual qualified adoption expenses (i.e., in 2022, adoptive parents of special needs children are assumed to have expenses equal to \$14,890 and hence eligible for a credit of \$14,890). A special needs child for the purposes of the adoption tax credit (and the exclusion for employer-provided adoption assistance; discussed below) does not necessarily mean the child has a medical condition or a disability. Instead, a child is considered to have special needs if the child's state of residence determines that: the child cannot or should not be returned to the birth parents' home; there is a specific factor or condition (e.g., age of child; child is member of sibling group seeking adoption together; child has medical, physical, or social-emotional disability; or child is member of a minority race/ethnicity) that leads to the reasonable conclusion that the child will not be adopted without assistance provided to the adoptive parents; and the child is a citizen or legal resident of the United States. This last rule generally excludes any international adoptions from being considered special needs adoptions. (The definition of "special needs" for purposes of adoption tax benefits is largely the same as "special needs" for purposes of the federal adoption assistance program that is included in Title IV-E of the Social Security Act.) Most foster care adoptions (i.e., domestic public adoptions) are special needs adoptions (few other adoptions are special needs adoptions).

For domestic adoptions, qualified adoption expenses are eligible for the tax credit and income tax exclusion when incurred. For intercountry (international) adoptions, qualified adoption expenses are not eligible for the tax credit or income tax exclusion until after the adoption is finalized.

Taxpayers *cannot* claim a credit for expenses that violate federal or state law, are incurred in carrying out any surrogate parenting agreement, or are for the adoption of a child who is the child of the taxpayer's spouse, though they may be able to claim expenses for the adoption of a child of a domestic partner.

To claim the adoption tax credit, a taxpayer must file IRS Form 8839 and include the name of the adopted child (if known), their age, and the child's taxpayer identification number (TIN). In most cases, the child's TIN is their Social Security number (SSN). However, in cases where the adopting parents do not have or cannot obtain the child's SSN, they may be able to use an adoption TIN (ATIN). If the child's name, age, and TIN are not provided, the IRS may disallow the credit until additional information about the adopted child is provided by the taxpayer. In addition, a married couple generally must file a joint tax return to claim the adoption tax credit. If two taxpayers who are registered domestic partners adopt a child together, they may split the qualified expenses and the resulting credit by mutual agreement, but the total amount of the credit that can be claimed for a given adopted child is still subject to the same limit (\$14,890 in 2022).

Taxpayers whose employers offer qualifying adoption assistance programs as a fringe benefit may not have to pay income taxes on some or all of the value of this benefit. The maximum amount that can be excluded from the taxpayer's income is capped at a maximum amount per adoption which is the same maximum amount of the credit: \$14,890 in 2022. Since the exclusion *reduces income* subject to taxation, it *reduces taxes* in proportion to the taxpayer's tax bracket. For example, if a taxpayer receives \$2,000 of excludible employer-provided adoption assistance and is in the 10% tax bracket, the exclusion results in a \$200 reduction in income taxes owed. If a taxpayer is in the 35% tax bracket, the same \$2,000 exclusion is worth \$700 in tax savings. (By contrast, the tax credit reduces tax liability dollar for dollar of the value of the credit. For example, if a taxpayer had \$2,000 of qualifying adoption expenses and applied those expenses toward the adoption credit, they could receive a credit of \$2,000—lowering income tax liability by \$2,000—irrespective of the taxpayer's tax bracket).

Taxpayers can claim the exclusion and the credit concurrently for the same adoption, but cannot claim both tax benefits for the same expenses. Hence, in 2022 for one adoption, a taxpayer is eligible for up to \$14,890 in tax-free employer-provided adoption assistance and a \$14,890 adoption credit. However, taxpayers who claim both benefits for the same adoption must reduce the amount of qualified adoption expenses eligible for the credit by the amount of qualified adoption expenses excluded under an employer-provided adoption assistance plan. Combined, the maximum value of these two tax benefits could equal up to \$20,399 in *reduced income tax liability* per adoption in 2022 depending on a taxpayer's expenses, income level, income tax

liability, and availability of employer-sponsored adoption assistance program at their work ($\$14,890 + \$14,890 \times 0.37 = \$20,399$).

In addition to having the same per-adoption maximum as the adoption tax credit, the exclusion for employer-provided adoption assistance is subject to the same income limitation (i.e., phaseout) and the same definitions of “qualified adoption expenses” and “eligible child.” Similar rules that apply to special needs children for the credit also apply for the exclusion. In other words, if a taxpayer adopts a child with special needs and an employer has a qualified adoption assistance program, the taxpayer will be able to exclude up to \$14,890 of income regardless of what the actual adoption expenses are and even if the taxpayer or the employer does not actually pay any qualified adoption expenses. The filing requirements for the exclusion are the same as for the credit. Finally, the same timing rules that apply to the adoption credit for domestic versus international adoption also apply to the exclusion. Thus, in order for the employer-provided adoption benefits to be excludable from income (and hence not taxable) for an international adoption, the amounts paid under the adoption assistance program must be paid either during or after the year the adoption becomes final.

Impact

Both the tax credit and employer exclusion may reduce the costs associated with adoptions through lower income taxes. The tax credit is claimed by a small proportion of taxpayers. For 2019, approximately 0.04 percent of tax returns (slightly less than 65,000 returns) claimed the adoption tax credit, with an average credit of \$4,783 per tax return. In addition, as illustrated in the table below, the majority (79.9 percent) of the tax benefit is received by taxpayers with income over \$75,000. One factor limiting the use of the credit is the nonrefundable nature of the credit. As a nonrefundable credit, the adoption tax credit is taken against tax liability *after* certain other nonrefundable tax credits are claimed.

Distribution by Income Class of Adoption Credit Dollars, 2019

Income Class (in thousands of \$)	Percentage Distribution
Below \$30	0.0
\$30 to under \$50	2.9
\$50 to under \$75	17.2
\$75 to under \$100	21.9
\$100 to under \$200	51.0
\$200 and over	7.0

Source: IRS, *Statistics of Income*, Table 3.3. This is a distribution of total dollars of the credit by adjusted gross income.

The refundability of the credit for tax years 2010 and 2011 was expected to expand usage of the adoption tax credit for those two years. Data from 2011 indicate that when the credit was refundable about one-quarter of adoption tax credit dollars were claimed by taxpayers with adjusted gross income of less than \$30,000.

Distribution by Income Class of Adoption Credit Dollars, 2011

Income Class (in thousands of \$)	Total Percentage Distribution	Refundable Portion Percentage Distribution	Non- refundable Portion Percentage Distribution
Below \$30	24.6	24.6	0.0
\$30 to under \$50	11.6	10.9	0.8
\$50 to under \$75	21.3	17.8	3.5
\$75 to under \$100	8.7	4.7	4.0
\$100 to under \$200	33.1	10.2	22.9
\$200 and over	0.5	0.0	0.6
Total	100.0	68.3	31.7

Source: IRS, *Statistics of Income*, Table 3.3. This is a distribution of total dollars of the credit classified by adjusted gross income. The sum of the refundable and non-refundable percentage distribution may not sum to the total due to rounding.

In addition, when the credit was refundable, taxpayers claimed a larger credit on average. For example, in 2010, the average adoption credit per taxpayer was \$12,430, while the average adoption credit in 2011 was \$12,729. In contrast, the average adoption credit in 2019 was \$4,783.

Rationale

Before the enactment of the adoption tax credit and exclusion for employer-provided adoption assistance in the mid-1990s, Congress enacted an itemized deduction for adoption expenses associated with the adoption of a special needs child as part of the Economic Recovery Tax Act of 1981 (P.L. 97-34). This deduction was repealed five years later by the Tax Reform Act of 1986 (P.L. 99-514). The Joint Committee on Taxation provided several reasons for the repeal of this tax benefit including: adoption assistance for special needs children was more appropriate through an expenditure program; the itemized deduction provided its greatest benefits to higher-income taxpayers who had less need for federal assistance for adoption; and agencies with expertise in adoption (i.e., not the IRS) should have budgetary control over adoption assistance

The tax credit and income tax exclusion for qualified adoption expenses were enacted by Congress as part of the Small Business Job Protection Act of 1996 (P.L. 104-188). The maximum amount of the tax credit and exclusion was \$5,000 (\$6,000 for a special needs child). The credit and exclusion phased out for income between \$75,000 and \$115,000. Neither the maximum amount of the exclusion nor the phaseout levels were annually adjusted for inflation under this law. The tax credit was enacted as a permanent tax provision for the adoption of a child with special needs, while it was not available for expenses incurred after December 31, 2001, for other adoptions. The exclusion was also scheduled to expire at the end of 2001. According to the Joint Committee on Taxation, Congress enacted the credit and exclusion because of the belief that the financial costs associated with the adoption process should not be a barrier to adoptions.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) extended temporarily the availability of the adoption credit for children other than special needs children. The law also temporarily increased the maximum qualified adoption expenses for the tax credit and

income exclusion to \$10,000 per eligible child, including special needs children. The act also temporarily extended the exclusion from income for employer-provided adoption assistance, and temporarily increased the beginning point of the income phase-out range for the credit and the exclusion to \$150,000. The law also provided for an annual inflation adjustment beginning in 2003 for the limit on qualified adoption expenses and the phase-out income level. EGTRRA also included a sunset provision for the legislation. All of these EGTRRA changes were scheduled to expire at the end of 2010. For taxable years after 2010, the adoption credit was scheduled to revert to a maximum credit of \$6,000 for special needs adoptions and no tax credit for non-special needs adoptions. Also, the credit phase-out range was scheduled to revert to the pre-EGTRRA levels (i.e., a ratable phase-out for modified adjusted gross income between \$75,000 and \$115,000). Congressional reports noted that both the credit and exclusion had been successful in reducing the after-tax cost of adoption for affected taxpayers. It was believed that increasing the size of both the credit and exclusion along with expanding the number of taxpayers who qualify for the tax benefit would encourage more adoptions and allow more families to afford adoption.

The Job Creation and Worker Assistance Act (P.L. 107-147) clarified that qualifying expenses for the adoption of children with special needs do not need to be documented. Therefore, a family seeking to adopt a child with special needs could claim the maximum credit without having to document expenses. The conference report accompanying H.R. 1836 (EGTRRA, P.L. 107-16) provided that the maximum amount of qualifying expenses was assumed to have been claimed (without the documentation requirement) in the case of a special needs adoption for tax years beginning after 2002. However, the legislative language of EGTRRA did not make this provision clear. Therefore, a technical correction was made in P.L. 107-147.

The Patient Protection and Affordable Care Act of 2010 (P.L. 111-148) increased the amount of qualified expenses for the adoption tax credit and the exclusion. Adjusted for inflation, this level was originally \$12,170 in 2010. This law increased this level to \$13,170 and subsequently adjusted the level for inflation in 2011. The law also made the credit refundable for tax years 2010 and 2011. These changes and the temporary changes enacted under EGTRRA (that were originally scheduled to expire at the end of 2010) were scheduled to expire at the end of 2011.

The EGTRRA modifications to the credit and exclusion were extended for one year—2012—by the Tax Relief, Unemployment Insurance

Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The EGTRRA modifications to the credit and the exclusions were made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240).

Assessment

There are several ways economists evaluate tax benefits, including adoption tax benefits. Specifically, economists may assess whether adoption tax benefits encourage adoptions, the distribution of these benefits among taxpayers, and the complexity of administering the tax provision.

Adoption is generally viewed as beneficial to all individuals involved in the process (adopted children, adopted parents, and birth parents) and society more broadly. Hence, many believe that adoption should be encouraged, including through federal policies like tax benefits. There is currently little evidence, however, that adoption tax benefits are an effective policy tool to increase adoptions. Although the amount of adoption tax benefits has increased over time, the actual number of children adopted has not. Current adoption tax benefits may be too small in comparison to the actual costs of adoption to encourage families to adopt, or a family's decision to adopt may not be heavily influenced by financial incentives, but instead may be influenced by more personal issues or beliefs. If adoption tax benefits do not lead to additional adoptions, they are considered economically inefficient by economists and are instead a windfall benefit to families that would have adopted even in the absence of these benefits.

Given little evidence that adoption tax benefits encourage adoption, the fairness of these benefits may be of particular interest. As previously discussed, the vast majority of adoption tax benefits go to upper-income Americans, even though data suggest that a significant number of lower- and middle-income Americans adopt. In 2019, while less than half (about 42 percent) of adoption tax credit *claimants* had income under \$75,000, these taxpayers received one-fifth of adoption credit *dollars*.

The majority of adoption tax credit dollars (79.9 percent) went to taxpayers with income of \$75,000 or more, with 51 percent of adoption tax credit dollars going to those with income between \$100,000 and \$200,000. While comparable data are not available for the exclusion of employer-provided adoption benefits, exclusions generally tend to provide the largest tax savings to those paying the highest marginal tax rates (i.e., upper-income taxpayers).

Under several economic definitions of “fairness,” adoption tax benefits would be considered unfair (or inequitable). For example, the principle of *vertical equity* implies that taxpayers with greater income, and hence more economic resources, should pay more in tax. The principle of vertical equity underpins the progressive nature of the federal income tax code, where those with more income pay a greater share of that income in taxes through higher tax rates. Under the definition of vertical equity, adoption tax benefits which primarily benefit higher-income taxpayers would lessen the progressivity of the federal income tax and hence be inequitable.

Adoption tax benefits may also be considered inequitable under the definition of “horizontal equity.” According to the principle of horizontal equity, *similar taxpayers* should pay a *similar amount in taxes*. Many economists consider taxpayers to be similar if they have similar levels of income. Hence, if two households earn \$40,000 and both pay \$8,000 in taxes, then the tax system is horizontally equitable. However, adoption tax benefits (like many tax preferences) can result in taxpayers with the same income paying different amounts in taxes, depending on their characteristics such as whether they own a home (the mortgage interest deduction), send a child to college (higher education tax benefits), or adopt (adoption tax benefits).

Evidence suggests that adoption tax benefits have been difficult for the IRS to administer to keep both erroneous benefit claims *and* taxpayer burden low. In 2012—when the IRS was processing mostly 2011 income tax returns and the adoption tax credit was refundable—they selected 69 percent of returns with adoption tax credit claims for audit. In most cases, these returns were selected because the IRS flagged the required adoption documentation as missing, invalid, or insufficient. However, after auditing these returns the IRS “disallowed \$11 million—or one and one half percent—in adoption credit claims” according to the IRS Taxpayer Advocate Service (TAS). One reason the IRS may have flagged a relatively large proportion of returns for audit—even when relatively few dollars of benefits were improperly claimed—was the IRS’s lack of familiarity with adoption documentation.

The IRS’s challenges with administering the refundable adoption credit highlight fundamental challenges with having the IRS—which is focused on collecting revenue—administer a social policy like an adoption incentive.

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Education, Training, Employment, and Social Services

EXCLUSION OF CERTAIN FOSTER CARE PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.5	—	0.5
2021	0.5	—	0.5
2022	0.6	—	0.6
2023	0.6	—	0.6
2024	0.6	—	0.6

Authorization

Section 131.

Description

Qualified foster care payments for the care of qualified foster individuals are excludable from gross income and hence not subject to income taxation, subject to certain limitations (discussed below). Since the exclusion applies to payments received, rather than expenses incurred, foster parents do not have to keep detailed records of their foster care expenditures to qualify for the exclusion. (Non-taxable foster care payments are not considered “earned income” for purposes of the Earned Income Tax Credit (EITC) or child tax credit, except as discussed below.)

A qualified foster individual is an individual placed by a state or local governmental agency or a qualified foster care placement agency. A qualified placement agency is a placement agency that is licensed or certified by a state (or its political subdivision), or an entity designated by the state (or its political subdivision), for the foster care program of the state (or its political subdivision) to make foster care payments to foster care providers.

“Qualified foster care payments” include payments made by state or local governmental agencies and any “qualified foster care placement agency” to a foster care provider for caring for a qualified foster individual in the provider’s home or a difficulty of care payment. Thus, payments made by for-profit and non-profit agencies contracting with state and local governments to provide foster home placements are excludable from gross income by foster care providers.

“Difficulty of care payments” are payments to provide additional care in the foster care provider’s home for a qualified foster individual who has a physical, mental, or emotional handicap.

Although the exclusion applies to foster care for individuals over the age of 18, payments for such individuals are not excludable from gross income to the extent payments are made for more than five recipients. No limitation exists for foster care recipients under the age of 19. The exclusion for foster care difficulty-of-care payments is limited to payments for the care of 10 qualified foster individuals who are under 19 years of age, and five who are over 18 years of age.

In 2014, the Internal Revenue Service (IRS) issued a notice announcing that “certain payments received by an individual care provider under a state Medicaid Home and Community-Based Services Waiver (Medicaid waiver) program” would be treated as excludable from gross income under section 131 of the Internal Revenue Code, regardless of whether the care provider was related to the qualified foster individual. In light of this notice, the IRS subsequently took the position that these payments could not be “earned income” for purposes of the EITC and child tax credit because they were excluded from income under section 131. However, a 2019 ruling in U.S. Tax Court (*Feigh v. Commissioner*) held that these Medicaid waiver payments could not be excluded from earned income for purposes of calculating the EITC, reasoning that the plain language of section 131 did not exclude these payments from income when the care provider was related to the qualified individual. In acquiescing to that ruling, the IRS stated that when it permits taxpayers to treat these payments as excludable pursuant to the 2014 notice, it will not argue that the payments are not earned income for purposes of the EITC and child tax credit. The IRS continues to allow taxpayers to treat these payments as excludable under section 131 pursuant to the 2014 notice.

Impact

Both foster care and difficulty-of-care payments qualify for a tax exclusion, subject to certain limitations. Since these payments are not counted as part of gross income, the tax savings reflect the marginal tax bracket of the foster care provider. Thus, the exclusion has greater value for taxpayers with higher incomes (and higher marginal tax rates) than for those with lower incomes (and lower marginal tax rates). In general, foster care providers who have other income, would receive a larger tax benefit than foster care providers without other income.

Rationale

In 1977, the IRS, in Revenue Ruling 77-280, 1977-2 CB 14, held that payments made by charitable child-placing agencies or governments (such as child welfare agencies) were not taxable when the payments were reimbursements or advances for expenses incurred on behalf of the agencies or governments by the foster parents.

In the case of payments made to providers which exceed reimbursed expenses, the Internal Revenue Service ruled that the foster care providers were engaged in a trade or business with a profit motive and the amounts which exceed reimbursements were taxable income to the foster care provider.

Section 131 was added to the tax code with the passage of the Periodic Payments Settlement Tax Act of 1982 (P.L. 97-473). That act codified the ruling's tax treatment of foster care payments and provided a tax exclusion for difficulty-of-care payments made to foster parents who provide additional services in their homes for physically, mentally, or emotionally handicapped children, regardless of whether the difficulty-of-care payments exceeded reimbursements.

In the Tax Reform Act of 1986 (P.L. 99-514), the provision was modified to exempt all qualified foster care payments from taxation. This change was made to relieve foster care providers from the detailed record-keeping requirements of prior law. Congress feared that detailed and complex record-keeping requirements might deter families from accepting foster children or from claiming the full tax exclusion to which they were entitled.

This act also extended the exclusion of foster care payments to adults placed in a taxpayer's home by a government agency.

Under a provision included in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), the definition of “qualified foster care payments” was expanded to include for-profit agencies contracting with state and local governments to provide foster home placements. The change was made in recognition that states often contract services out to for-profit firms. Generally, the tax code had not recognized the role of private for-profit agencies in helping the states provide foster care services for placement and delivery of payments. The law also modified the definition of qualified foster individuals to include individuals placed by a qualified foster care placement agency. These provisions are thought to reduce complexity with the hope that simpler rules may encourage more families to provide foster care services.

Assessment

It is unclear to what extent the tax-treatment of foster payments affects families’ decisions to foster children, given that these payments tend to already be much less than the costs associated with raising a child. A 2018 study by the Government Accountability Office found that two-thirds of states reported challenges with recruiting and retaining foster families. The GAO study cited research that found that basic payment rates in the majority of states were less than the estimated costs of caring for a child.

On the other hand, it is generally understood that the tax law treatment of foster care payments prevents unnecessary accounting and record-keeping burdens for foster care providers, which may affect some families’ decision to foster. The tax treatment of these payments also provides administrative convenience for the Internal Revenue Service.

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Education, Training, Employment, and Social Services

**DEDUCTION FOR CHARITABLE CONTRIBUTIONS, OTHER
THAN FOR EDUCATION AND HEALTH**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	40.0	1.8	41.8
2021	39.7	2.0	41.7
2022	41.9	1.9	43.8
2023	36.3	1.8	38.1
2024	40.7	1.9	42.6

Note: This table does not reflect the effects of the Consolidated Appropriations Act of 2021, which caused an additional loss of \$1.3 billion in FY2021 and \$4.8 billion in FY2022 for all charitable contributions. It also caused a gain of \$1.6 billion in FY2023 and of \$0.5 billion in FY2024.

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations: charitable, religious, educational, and scientific organizations; non-profit hospitals; other public charities and private foundations; and federal, state, and local governments.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI) (30 percent for gifts of capital gain property). For 2018-2025, the limit is increased to 60 percent. For contributions to non-operating foundations and certain organizations,

deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over the amount of contributions which qualified for the 50 percent deduction ceiling (including carryovers from previous years). Gifts of capital gain property to these organizations are limited to 20 percent of AGI. Excess contributions can be carried forward for five years.

The limit was temporarily increased to 100 percent for 2020 for cash contributions to public charities (not to private foundations, supporting organizations, or donor advised funds). An above-the-line deduction for contributions of up to \$300 was also allowed for non-itemizers for 2020. These provisions were extended through 2021, and the \$300 amount was increased to \$600 for joint returns.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. This limit was temporarily increased to 25 percent for 2020 and 2021. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts has been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. An accrual-basis corporation, however, is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

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

Taxpayers are required to obtain written substantiation from a donee organization for contributions which exceed \$250. This substantiation must be

received no later than the date the donor-taxpayer files the required income tax return. The written acknowledgment must contain sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the federal government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Individuals who use the standard deduction or who pay no taxes normally receive no benefit from the provision.

A limitation (temporarily suspended for 2018-2025) applies to the itemized deductions of high-income taxpayers, whereby itemized deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds an inflation adjusted dollar amount (\$320,000 for joint returns in 2018). The limit is capped at 80 percent of itemized deductions. However, because the limitation is triggered by income rather than deductions it is not effectively a limit on itemized deductions unless the cap is reached, which is unusual. The limit acts as an additional tax rate.

The following table below provides the distribution of all charitable contributions. In general, contributions outside of those to educational and health organizations are relatively less concentrated among higher-income taxpayers.

Distribution by Income Class of the Tax Expenditure for the Charitable Deduction, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.1
\$30 to \$40	0.2
\$40 to \$50	0.3
\$50 to \$75	0.4
\$75 to \$100	1.7
\$100 to \$200	2.4
\$200 and over	94.9

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the sponsor, argued that high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were contributed to charitable organizations. The deduction was originally limited to individuals; a deduction for trusts and estates was added in 1918, but a deduction for corporations was not allowed until 1935.

The deduction allowed in 1917 was limited to 15 percent of taxable income. Most of the revisions in the early tax law related to this limit. In 1924, it was changed to 15 percent of adjusted gross income. The corporate deduction was limited to 5 percent of income when introduced in 1935. In 1952, the individual limit was increased to 20 percent. The limit was increased to 30 percent in 1954, but the additional 10 percent had to go to a public charity (thus retaining a 20 percent limit for foundations). A carryover of unused deductions for two years was first allowed for corporations in 1954. In 1964, the carryover was increased to five years and extended to individuals. The percentage limit on individual contributions to charities was increased to 50 percent by the Tax Reform Act of 1969 (P.L. 91-172) but was restricted to 30 percent for gifts of appreciated property. The percentage limit on corporate charitable contributions was increased to 10 percent of taxable income in the Economic Recovery Tax Act of 1981 (P.L. 97-34). The limit on contributions to private foundations was increased to 30 percent for cash contributions by the Deficit Reduction Act of 1984 (P.L. 98-369).

The Economic Recovery Tax Act of 1981 also allowed a temporary deduction for non-itemizers, but this provision was not extended.

Concerns about abuse led to provisions requiring greater substantiation of gifts. The Deficit Reduction Act of 1984 (P.L. 98-369) required written substantiation of contributions in excess of \$2,000 and the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) lowered that amount to \$250. The American Jobs Creation Act of 2004 (P.L. 108-357) increased reporting requirements of donors of noncash charitable contributions, including vehicles. The provisions enacted in 2004 resulted from Internal Revenue Service and congressional concerns that taxpayers were claiming inflated charitable deductions, causing the loss of federal revenue. In the case of vehicle donations, concern was expressed about the inflation of deductions. GAO reports published in 2003 indicated that the value of benefit to charitable

organizations from donated vehicles was significantly less than the value claimed as deductions by taxpayers.

The Pension Protection Act of 2006 (P.L. 109-280) also provided for some temporary additional benefits which were part of the “extenders,” effective through 2007. The 2006 act also added restrictions on donor advised funds (where sponsors receive contributions and then make donations advised by the original contributor) and certain supporting organizations (organizations that receive donations used to support other active charities). The 2006 law also tightened rules governing charitable giving in certain areas, including gifts of taxidermy, contributions of clothing and household items, contributions of fractional interests in tangible personal property, and record-keeping and substantiation requirements for certain charitable contributions. The 2006 enactments were, in part, a result of continued concerns from 2004.

Temporary charitable giving incentives were extended through 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343), enacted in October 2008, and further extended through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). Some provisions were extended through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240). These provisions were made permanent in 2015 by the Consolidated Appropriations Act, 2016 (P.L. 114-113).

The 2017 tax revision (P.L. 115-97), commonly referred to as the Tax Cuts and Jobs Act, increased the percentage of income limit for contributions of cash to public charities to 60 percent on a temporary basis.

For 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) increased the limit for cash contributions by individuals to charities to 100% for 2020, allowed a \$300 above-the-line deduction for non-itemizers, and increased the limit to 25% for corporations. The Consolidated Appropriations Act of 2021 (P.L. 116-260) extended these provisions through 2021 and increased the above-the-line deduction for non-itemizers to \$600 for joint returns.

Assessment

Supporters note that contributions finance socially desirable activities. Further, the federal government could be forced to step in to assume some activities currently provided by charitable, nonprofit organizations if the deduction were eliminated. Public spending, however, might not be available

to make up all of the difference. In addition, many believe that the best method of allocating general welfare resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect which varies with the marginal tax rate of the giver. There are a number of studies that find significant behavioral responses, although a study by Randolph (1995) suggests that such measured responses may largely reflect transitory timing effects. Most recent estimates indicate that the induced giving is less than the revenue cost.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. The volume of donations to religious organizations, however, is greater than to other organizations. For example, Giving USA and its research partner, the Center on Philanthropy at Indiana University, estimated that giving to religious institutions amounted to 28 percent of all contributions (\$485 billion) in calendar year 2021. This was in comparison to the next largest component of charitable giving recipients, educational institutions, at 15 percent.

Those who support eliminating this deduction note that deductible contributions are made partly with dollars which are public funds. They feel that helping out private charities may not be the optimal way to spend government money.

Opponents further claim that the present system allows wealthy taxpayers to indulge special interests and hobbies. It is also generally argued that the charitable contributions deduction is difficult to administer and adds complexity to the tax code.

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Education, Training, Employment and Social Services

CREDIT FOR DISABLED ACCESS EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 44.

Description

Small businesses can claim a non-refundable tax credit equal to 50 percent of expenses they incur to make their business accessible to disabled individuals. The credit applies to expenses in excess of \$250 and below \$10,250, making the maximum credit \$5,000. Only businesses with gross receipts of less than \$1 million or with no more than 30 full-time employees qualify. None of these values are indexed to inflation.

Eligible expenses include removing barriers to access for disabled individuals in buildings that were constructed before this provision's enactment on November 5, 1990. Costs related to providing interpreters, readers, or similar services also qualify, as do the costs of acquiring or modifying equipment or devices that benefit individuals with disabilities.

The credit is included in the general business credit, and is subject to present-law limits. Businesses cannot adjust their property's basis upwards to

reflect investments for which they claimed the credit, nor can they claim any other credits or deductions for such expenses. In particular, expenditures used to claim the tax credit may not also be used to expense costs under section 190. (See the entry on “Expensing of Costs to Remove Architectural and Transportation Barriers to the Handicapped and Elderly.”) The credit also may not be carried back to tax years before the date of enactment.

Impact

The provision lowers the after-tax cost to small businesses of expenditures to remove architectural, communication, physical, or transportation access barriers for persons with disabilities. The direct beneficiaries of this provision are small businesses who make access expenditures that qualify for the credit.

This tax treatment has two advantages relative to the standard tax treatment of claiming a depreciation deduction for capital expenditures. First, the 50-percent credit provides a greater reduction in taxes than the business owner would receive by deducting the access expenditures at a marginal tax rate of 37 percent (the maximum statutory marginal rate for individuals in 2020) or less. Second, the credit can be claimed in the year of the expenditure, rather than being depreciated over a number of years (absent the extension of temporary accelerated depreciation policies).

The lack of inflation adjustments in the statute means that the value of the maximum access expenditures eligible for deduction has declined since the provision was first enacted in 1990. Similarly, a smaller share of businesses may earn less than the \$1 million in gross receipts definition of a “small business” (for the purpose of this provision). Fewer expenses made by eligible businesses may qualify for the credit as well, as fewer businesses operate in buildings placed in service before November 5, 1990.

Rationale

The disabled access tax credit was introduced by the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). Lawmakers intended for this provision to assist small businesses in complying with the Americans With Disabilities Act of 1990 (ADA; P.L. 101-336). That act requires restaurants, hotels, and department stores that are either newly constructed or renovated to provide facilities that are accessible to persons with disabilities. It also calls for the removal of existing barriers, where readily achievable, in previously built facilities.

While the provision is intended to encourage compliance with the ADA, subsequent access improvements are not covered by the provision. As such, businesses already in compliance with the ADA may not claim the disabled access credit for expenditures paid or incurred to improve disabled access further.

Assessment

Because the tax credit is non-refundable, an eligible business's ability to benefit from the credit depends on whether its income tax liability is large enough to take full advantage of the credit.

The tax credit may not be the most efficient method to promote access to businesses for disabled individuals. Some of the tax benefit may go for expenditures that the small business would have made absent the credit, and the credit's special treatment of small businesses relative to large businesses is also arguably arbitrary. Some may also question whether small businesses still need a tax benefit to help them comply with the ADA, which became law over 30 years ago. Proponents of the credit could still argue that accommodating people with disabilities imposes a legitimate hardship on some small businesses, and warrants a subsidy.

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Education, Training, Employment, and Social Services

CREDIT FOR CHILDREN AND OTHER DEPENDENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	117.6	—	117.6
2021	115.4	—	115.4
2022	115.6	—	115.6
2023	116.7	—	116.7
2024	117.2	—	117.2

Note: Estimates include outlay effects associated with the refundable portion of the child tax credit (the refundable portion of the child tax credit is often referred to as the additional child tax credit or ACTC). These outlay effects are \$62.0 billion (FY2020), \$45.9 billion (FY2021), \$45.7 billion (FY2022), \$46.6 billion (FY2023), and \$46.8 billion (FY2024).

This provision was temporarily modified by P.L. 116-260 and P.L. 117-2. The changes included in P.L. 116-260 are estimated to cost \$4.136 billion between FY2021-FY2025 according to JCT, of which \$3.853 billion are from increased outlays (JCX-24-20). (This includes the impact of this provision on the EITC and the child tax credit.) The changes included in P.L. 117-2 are estimated to cost \$107.953 billion between FY2021-FY2026, of which \$87.233 billion reflect increased outlays (JCX-14-21).

Authorization

Section 24.

Description

The child tax credit (CTC, sometimes referred to as the child credit) is a refundable tax credit available to families with qualifying children. The child credit is provided to individuals and families once a year, in a lump-sum payment after individuals and families file their federal income tax returns.

Like all tax credits for individuals, the child credit can reduce income tax liability. And because the child credit is a refundable tax credit, if a taxpayer's total child credit is greater than what the taxpayer owes in income taxes, the taxpayer may be able to receive part of the difference (up to \$1,500 per child in 2022) as a part of their tax refund. The refundable portion of the credit is sometimes referred to as the *additional child tax credit* or ACTC.

Eligibility for, and the amount of, the child credit is based on a variety of factors, including the number of qualifying children, the recipient's earned income and adjusted gross income (AGI), and taxpayer ID requirements.

Several temporary modifications to the credit were enacted during the COVID-19 pandemic and are discussed throughout the subsections of this chapter, including a temporary expansion of the amount and eligibility for the child credit for 2021.

Calculating the Credit

The child credit amount is calculated based on the number of qualifying children a household has and, in some cases, their earned income (lower-income households) or their AGI (higher-income households). The maximum credit a family can receive is equal to the number of qualifying children a taxpayer has, multiplied by \$2,000. If the value of the credit exceeds the amount of tax a family owes, the family may be eligible to receive the difference as the refundable portion of the tax credit. Most taxpayers calculate the amount of the ACTC using the *earned income formula*. Under the earned income formula, the total amount of their refund is calculated as 15% (the refundability rate) of earned income that exceeds \$2,500 (the refundability threshold), up to the maximum amount of the refundable portion of the credit (\$1,400 per child multiplied by the number of qualifying children). This \$1,400 amount is adjusted for inflation and equals \$1,500 in 2022.

The child tax credit phases out for higher-income families. The \$2,000-per-child value of the credit falls by a certain amount as a family's income rises. Specifically, for every \$1,000 of income above a threshold amount, the credit falls by \$50, effectively a 5% phaseout rate. For example, the credit will completely phase out for a married couple with two children if their income exceeds \$480,000. Neither the maximum child tax credit amount (\$2,000 per child) nor the phaseout thresholds are indexed for inflation.

For 2021, the child credit formula was modified in two main ways. The maximum amount of the credit was increased from \$2,000 to \$3,000 per child

(\$3,600 per child 0-5 years old). Additionally, the credit was made “fully refundable”, eliminating the phase in of the credit based on earned income. In other words, eligible low-income families could receive the “full” or maximum amount of the credit regardless of their earned income. For 2021, the credit was also delivered in a different way. Taxpayers could receive up to half of their 2021 child credit amount over six monthly advanced payments, claiming the remainder on their 2021 return filed in 2022. (For 2021, the age limit for a qualifying child was also adjusted, discussed in the next section.)

Eligibility Requirements

In order to claim a child for the child tax credit, a taxpayer’s child must meet several requirements (which may differ from eligibility requirements for other child-related tax benefits). These requirements include:

1. The child must be under 17 years of age by the end of the year. (In other words, if the child turns 17 years old on December 31, 2022, the taxpayer cannot claim them as a qualifying child for the child tax credit on their 2022 income tax return.)
2. The child must be eligible to be claimed as a dependent on the taxpayer’s return. Specifically:
 - a. The child must be the taxpayer’s son, daughter, grandson, granddaughter, stepson, stepdaughter, niece, nephew, or an eligible foster child of the taxpayer.
 - b. The child must live at the same principal residence as the taxpayer for more than half the year for which the taxpayer wishes to claim the credit.
 - c. The child cannot provide more than half of their own support during the tax year.
3. The child must be a U.S. citizen or national. If they are not a U.S. citizen or national, they must be a resident of the United States.

The statute requires that taxpayers who intend to claim the child tax credit provide a valid taxpayer identification number (TIN) for each qualifying child on their federal income tax return. Under a temporary change in effect from 2018 through the end of 2025, the child’s TIN must be a work-authorized Social Security number (SSN). The SSN must be issued before the due date of the tax return. Failure to provide the child’s SSN will result in the taxpayer

being denied the credit (both the nonrefundable and refundable portions of the credit). In addition, in order to claim the child tax credit in a given tax year, the taxpayer must also provide their own TIN that must be issued before the due date of the tax return.

For 2021, the age requirements for a qualifying child were temporarily modified so that a child had to be under 18 years of age. In other words, an otherwise eligible 17-year-old in 2021 could be claimed for the credit.

The Other Dependent Credit (ODC)

Taxpayers may also be eligible to claim a non-refundable tax credit for non-child tax-credit-eligible dependents. This credit is equal to \$500 per non-child credit-eligible dependent and added to any child credit amount before subjecting the total to the income phaseout (e.g., phaseout thresholds of \$400,000 married filing jointly, \$200,000 other taxpayers, 5 percent phaseout rate). The \$500 amount is not annually adjusted for inflation. This credit is generally available for dependents not eligible for the child tax credit. This includes otherwise eligible children who do not have an SSN or older dependents. Non-child credit-eligible dependents do not need to provide a SSN in order to be eligible for this credit. Non-child credit-eligible dependents exclude otherwise eligible dependents who are not U.S. citizens and are residents of Mexico or Canada.

Temporary Changes Scheduled to Expire at the end of 2025

The child credit in effect in 2022 reflects a variety of temporary changes that are currently scheduled to expire at the end of 2025. Hence, absent any legislative changes, beginning in 2026, a variety of aspects of the child tax credit are scheduled to expire, including:

- The maximum amount of the credit is scheduled to revert to \$1,000 per qualifying child.
- The refundability threshold is scheduled to increase to \$3,000 and the maximum ACTC per child (the amount that exceeds income tax liability) is scheduled to decrease to \$1,000 per child.
- The phaseout threshold will revert to \$75,000 for unmarried taxpayers (\$110,000 for married taxpayers filing joint returns); the phaseout threshold for taxpayers filing married separate returns reverts to \$55,000.
- A valid TIN for qualifying children will include individual taxpayer identification numbers (ITINs) as well as SSNs. ITINs are issued by

the IRS to noncitizens who do not have and are not eligible to receive SSNs. ITINs are supplied solely so that noncitizens are able to comply with federal tax law, and do not affect immigration status.

- The Other Dependent Credit is scheduled to expire (note that the personal exemption for dependents is scheduled to go back into effect beginning in 2026).

Impact

The child tax credit reduces tax liability dollar for dollar of the value of the credit for all families with qualifying children, whose incomes fall below the AGI phaseout ranges.

The distribution of the tax expenditure associated with the child tax credit is concentrated primarily among upper-income taxpayers. Taxpayers in the lowest income classes account for a disproportionately smaller share (relative to the total distribution of tax filers) of the tax expenditure associated with the credit. Available research indicates the temporary changes for 2021 primarily expanded the availability and amount of the credit to low-income taxpayers, although estimates by JCT (like those below) are not currently available for 2021.

Distribution by Income Class of the Tax Expenditure for the Child Tax Credit, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.7
\$10 to \$20	6.1
\$20 to \$30	7.6
\$30 to \$40	8.2
\$40 to \$50	8.6
\$50 to \$75	16.1
\$75 to \$100	12.6
\$100 to \$200	28.4
\$200 and over	17.0

Note: Calculations include the refundable portion of the credit.

Rationale

The child tax credit was enacted as part of the Taxpayer Relief Act of 1997 (P.L. 105-34). Initially, for tax year 1998, families with qualifying children were allowed a credit against their federal income tax of \$400 for each qualifying child. For tax years after 1998, the credit increased to \$500 for each qualifying child. The credit was refundable, but only for families with three or more children and only using an alternative formula. (The alternative formula is the amount by which Social Security taxes paid exceed the earned income tax credit (EITC) up to the maximum refundable credit. For most families, the ACTC under the earned income formula will be larger than the ACTC under the alternative formula.)

Congress indicated that the tax structure at that time did not adequately reflect a family's reduced ability to pay as family size increased. The decline in the real value of the personal exemption over time was cited as evidence of the tax system's failure to reflect a family's ability to pay. Congress further determined that the child tax credit would reduce a family's tax liabilities, would better recognize the financial responsibilities of child rearing, and would promote family values.

The amount and coverage of the child tax credit was substantially increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and subsequent legislation. EGTRRA increased the child tax credit to \$1,000 with the increase scheduled to be phased in between 2001 and 2010. It also made the credit partially refundable for families with fewer than three children using the earned income formula. The refundability threshold was set at \$10,000, adjusted annually for inflation. Proponents of this increase argued that a \$500 child tax credit was inadequate. It was argued that the credit needed to be increased to better reflect the reduced ability to pay taxes of families with children. Furthermore, many felt that the credit should be refundable for all families with children.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) increased the child tax credit to \$1,000 for tax years 2003 and 2004. The Working Families Tax Relief Act of 2004 (P.L. 108-311) effectively extended the \$1,000 child tax credit through 2010. It also authorized inclusion of combat pay, which is not subject to income tax, in earned income for purposes of calculating the refundable portion of the credit, which may increase the amount of the credit for certain service members.

The Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) allowed taxpayers affected by Hurricanes Katrina, Rita, and Wilma to use their prior year's (2004) earned income to compute the amount of their 2005 refundable child credit.

In 2008 and 2009, Congress enacted legislation, the Emergency Economic Stabilization Act of 2009 (EESA; P.L. 110-343) and the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5), which further expanded the availability and amount of the credit to taxpayers whose income was too low to either qualify for the credit or be eligible for the full credit. EESA lowered the refundability threshold to \$8,500 in 2008, while ARRA lowered the refundability threshold to \$3,000 for 2009 through 2010. The \$3,000 threshold was not adjusted annually for inflation. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended both the EGTRRA provisions of the child tax credit and the expansion of refundability under ARRA for two years through the end of 2012.

The American Taxpayer Relief Act (ATRA; P.L. 112-240) made the EGTRRA changes to the child tax credit permanent and extended the \$3,000 refundability threshold enacted as part of ARRA for five years, through the end of 2017. In addition, the child tax credit can permanently offset the AMT as a result of ATRA. The Protecting Americans from Tax Hikes Act (PATH; P.L. 114-113) made the \$3,000 refundability threshold permanent.

At the end of 2017, Congress enacted P.L. 115-97 (commonly referred to as the Tax Cuts and Jobs Act) which, in addition to making numerous changes to the tax code, temporarily changed the child tax credit. Specifically, the law increased the credit for many (though not all) taxpayers by doubling the maximum amount of the credit from \$1,000 to \$2,000 per qualifying child (and increasing the maximum amount of the ACTC to \$1,400 per qualifying child), increasing the income at which the credit begins to phase out from \$75,000 to \$200,000 for unmarried taxpayers and from \$110,000 to \$400,000 for married taxpayers filing jointly, and reducing the refundability threshold from \$3,000 to \$2,500. In addition, this law temporarily modified the identification (ID) number requirement of the credit, requiring taxpayers to provide the SSN for every child for whom they claimed the credit.

P.L. 115-97 also provided a new temporary credit for non-child credit-eligible dependents (children ineligible for the child tax credit or older non-child dependents). All the modifications to the child tax credit and the credit

for non-child credit-eligible dependents are currently scheduled to expire at the end of 2025.

The Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 116-94, Division Q) and the Bipartisan Budget Act of 2018 (BBA18; P.L. 115-123) permitted individuals affected by 2018 and 2019 disasters or California wildfires in 2017 to elect to use their earned income from the previous year for computing the child tax credit (and the EITC) instead of their disaster-year income, if previous-year income was greater than disaster-year income. The Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63) also included this provision for those affected by Hurricanes Harvey, Irma, and Maria.

The Consolidated Appropriations Act, 2021 (CAA21; P.L. 116-260) created a temporary income-lookback rule for the 2020 EITC and the 2020 child tax credit that temporarily allowed taxpayers to use their 2019 earned income if it would result in a larger EITC and/or child credit than using their 2020 income.

The American Rescue Plan Act (ARPA; P.L. 117-2) made several temporary changes to the child credit, including expanding the eligibility age of children to include 17-year-olds; eliminating the phase-in of the credit for low-income taxpayers (i.e., making the credit “fully refundable”) such that eligible low-income families could receive the maximum amount of the credit; increasing the maximum credit amount to \$3,600 for children 0-5 years old / \$3,000 for children 6-17 years old (the increase in the credit over the \$2,000 per child amount—the additional \$1,600 and \$1,000 per child depending on age—was subject to a phaseout) and delivering 50 percent of the credit in advance payments in 2021 with the remaining 50 percent claimed on a 2021 tax return. These changes were temporary for 2021 only and were in addition to the changes made by the TCJA discussed above.

Assessment

The child tax credit generally increases the after-tax income of taxpayers with children. The most recent data from the IRS indicates that in 2019, 39.7 million households received \$83.1 billion in the non-refundable portion of the child tax credit and the ODC, while 19.9 million households received \$35.7 billion in the refundable portion of the credit. These households are not mutually exclusive—a household that receives part of the credit as an offset to

their income tax liability (non-refundable portion) may also receive part of it as the ACTC (the refundable portion).

Much of the benefit of the child credit goes to middle and upper-middle income households, increasing the after-tax incomes of all but the poorest and wealthiest families with children. Lower-income families are *less likely* to receive the child credit under current law than moderate- and some higher-income families and tend to receive a smaller credit. Estimates from the Tax Policy Center (T20-0091) indicate that approximately 90% of all taxpayers with children receive the child tax credit, averaging \$2,370 per taxpayer. In contrast, among the poorest families with children (income under \$10,000), slightly less than half receive the credit (47.8%), averaging \$250 per taxpayer in that income group (including nonrecipients). Low-income families are less likely to have income tax liability and have less earned income compared to higher-income families. Low levels of tax liability limit the amount of the nonrefundable portion of the credit, while low levels of earned income limit the amount of the ACTC. The highest-income families are also less likely to receive the child credit and receive a smaller credit on average, as a result of the credit's phaseout. For example, among some of the wealthiest families with children (income between \$500,000 and \$1 million), less than half receive the credit (38.6%), which averages \$930 per taxpayer in that income group. The child credit also results in a lower income tax liability for households with children than similarly situated households (e.g., those with similar income) without children. This could reflect a belief that these households have a reduced ability to pay taxes compared to those without children.

Research indicates that the refundable portion of the child tax credit (the ACTC) in conjunction with the larger earned income tax credit (EITC) reduces poverty, especially child poverty. CRS estimates that refundable tax credits (the ACTC and EITC) may have helped prevent 8.1 million individuals—of whom 4.2 million were children—from falling into poverty in 2016. In the context of the federal income tax system, these refundable tax credits may have helped to reduce poverty among all individuals by more than two percentage points (from 14.5% to 12.3%), while reducing child poverty by more than five percentage points (from 17.5% to 12.0%).

The child tax credit, like other child-related tax benefits in the tax code, is a complex provision which can be difficult for taxpayers to comply with and difficult for the IRS to administer. According to a Treasury Inspector General for Tax Administration (TIGTA) report, the IRS estimated that 13 percent of

ACTC payments in FY2021—or about \$5.2 billion of a total of \$39.4 billion—were issued improperly. Complexity associated with child-related tax provisions may be particularly burdensome for lower-income families. Complexity may reduce the share of eligible taxpayer claiming the credit and reduces the value of the benefits among those who do claim them, because they often rely on a paid preparer for assistance. Complexity can thus undermine the ultimate goal of policymakers, whether it be poverty reduction or increased fairness.

For 2021, a substantial amount of research was conducted looking at the *expanded* child credit's impact on poverty, food insecurity and employment decisions of adult recipients. The U.S. Census Bureau found that when government tax and transfer programs were included as part of a family's resources, refundable tax credits moved 9.6 million people out of poverty in 2021. This analysis included both the EITC and the child tax credit which was temporarily expanded to lower-income families in 2021, as well as the temporarily refundable child and dependent care tax credit and the third stimulus payment enacted during the COVID-19 pandemic. This research found that the expanded child credit was estimated on its own to lift 5.3 million children above poverty in 2021. Similar research by CRS estimated that if all eligible families received the child credit in a non-recessionary economy (i.e., 100% take-up), that child poverty would fall by about 46%. Researchers at Columbia University who assumed less than 100% take-up of the credit estimated that it would reduce child poverty by about 30%.

Researchers found that reductions in poverty paralleled improvement in other measures of social well-being. One survey (Hamilton et al., 2022) found that receipt of the credit was associated with reduced use of high risk-financial products and more investments in education. Numerous studies found that after receipt of monthly payments of the expanded child credit, food insecurity among many low-income families declined. Adams et al. (2022) found that “(f)rom before to midway through the CTC expansion [in 2021], very low food security decreased from 12.7 percent to 5.6 percent, and simultaneously, food security increased from 57.4 percent to 66.4 percent.” Shafer et al. (2022) found that “the first round of advance CTC payments in July 2021 was associated with a 26% reduction in food insufficiency in US households with children.” Parolin et al. (2021) found that “the July 2021 CTC payment strongly reduced food insufficiency among low-income households with children; a \$100 increase in CTC benefits (adjusted for household-size) is

associated with a 7-percentage point, or roughly 25 percent, decline in food insufficiency among low-income families who report receipt of the CTC.”

Even with these benefits, there were concerns that the expanded child credit would lead to a reduction in labor force participation among recipients. Unlike the permanent credit, which phases in based on earned income for low-income taxpayers, the expanded credit has no phase-in (it was “fully refundable”). Data collected in 2021 suggests that in the short run, the advance payments of the credit had limited, if any, impact on whether people worked or how much they worked. That could be due to the policy being relatively new or other factors like the COVID-19 pandemic having a larger impact on labor decisions among workers. In the long run, other researchers attempted to simulate what could happen if the 2021 expansion was made permanent, making various assumptions about how responsive workers at different income levels and different marital statuses would be to an expanded child credit not tied to work. Most researchers (Bastian, 2022; Brill and Pomerleau, 2021; National Academy of Sciences, 2019) simulated a modest effect on employment based on their models’ assumptions. Those who assumed that low-income workers were very responsive to this policy in terms of whether or how much they worked simulated larger responses (Corinth et al., 2021). Given the expiration of the 2021 expansion, it is ultimately unclear what the long-term effect on employment will actually be, although this research suggests that most experts would expect a modest number of recipients of the expanded credit to choose not to work or work fewer hours.

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Health

HEALTH SAVINGS ACCOUNTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	11.9	—	11.9
2021	12.2	—	12.2
2022	12.8	—	12.8
2023	14.0	—	14.0
2024	15.1	—	15.1

Note: This provision was modified by P.L. 116-260, P.L. 117-103, and P.L. 117-169. JCT did not estimate revenue losses from these changes.

Authorization

Section 223.

Description

Health Savings Accounts (HSAs) are a tax-advantaged account designed to help people save and pay for unreimbursed medical expenses such as health insurance cost sharing (e.g., deductibles, copayments, and co-insurance) and services not covered by insurance. Although eligibility to contribute to an HSA is associated with enrollment in high-deductible health insurance plans (HDHPs), HSAs are a trust/custodial account and are not health insurance. As such, HSAs and HDHPs are two separate products and individuals may have one without the other so long as the *establishment of* and contributions to an HSA occur when an individual is eligible, including when the individual is enrolled in a qualifying HDHP.

More specifically, eligible individuals can establish and fund HSAs when they are enrolled in a qualifying HDHP and have no other health care coverage, with some exceptions. Qualifying HDHPs must have a deductible of at least \$1,400 for single coverage and \$2,800 for family coverage in 2022 (plus other criteria described in this paragraph). The minimum deductible

levels do not apply to preventive care, which the IRS has defined through guidance, and temporarily do not apply to telehealth services. Prescription drugs may not be exempted from the deductibles unless they are for preventive care. HSA-qualified HDHP maximum out-of-pocket limits are \$7,050 for single coverage and \$14,100 for family coverage in 2022.

The annual HSA contribution limit from all sources for HSA account holders enrolled in qualifying single coverage is \$3,650 and for those enrolled in qualifying family coverage it is \$7,300 in 2022. Individuals who are at least 55 years of age but not yet enrolled in Medicare may make an additional contribution of \$1,000 each year.

Eligible individuals may make direct contributions to their HSAs, and employers, family members, and other individuals may make contributions to an individual's HSA on the individual's behalf. Individuals may deduct from gross income their HSA contributions as an "above-the-line" deduction. Employer contributions to an HSA (and individual contributions made through a payroll deduction) cannot be deducted by employees as HSA contributions; however, as previously discussed, they are excluded from employees' gross income in determining their income tax liability.

Withdrawals from HSAs are exempt from federal income taxes if used for qualified medical expenses, which include the costs of diagnosis, cure, mitigation, treatment, or prevention of disease and the costs for treatments affecting any part of the body; the amounts paid for transportation to receive medical care; qualified long-term care services; and menstrual care products. Health insurance premiums generally are not considered qualifying medical expenses, with the exception of: (1) long-term care insurance premiums; (2) health insurance premiums during periods of continuation coverage required by federal law (i.e., Consolidated Omnibus Budget Reconciliation Act coverage, or COBRA); (3) health insurance premiums during periods the individual is receiving unemployment compensation; and (4) for individuals age 65 years and older, any health insurance premiums (including Medicare Part B premiums) other than a Medicare supplemental policy.

Withdrawals from HSAs not used for qualified medical expenses are included in gross income and hence subject to federal income taxes; they also are subject to a 20 percent penalty tax. The penalty is waived in cases of disability or death and for individuals age 65 and older. HSA account earnings are tax-exempt and unused balances may accumulate without limit.

Account holders retain access to their accounts if they change employers, insurers, or subsequently become ineligible to contribute to the HSA. Individual members of a family may have their own HSA, provided they each meet the eligibility rules. They can also be covered through the HSA of someone else in the family; for example, an individual may use an HSA to pay a spouse's qualified medical expenses (including if the spouse has their own HSA).

Impact

HSAs and HSA-qualified HDHPs are collectively seen as one of the primary types of consumer-driven health care. The HSA-qualified HDHP generally puts more of the initial medical care costs on the individual, relative to a traditional health plan. With individuals bearing more of the initial cost under an HDHP, HSA-qualified HDHPs were intended to make individuals more cost-conscious about the care that they received. The HSA makes HDHPs more financially appealing to certain individuals and provides tax incentives to build a reserve for routine and other unreimbursed health care expenses. As such, HSAs and HSA-qualified HDHPs are predicated upon market-based rather than regulatory solutions to certain health care problems.

There are many factors that may impact an individual's decision to enroll in an HSA-qualified HDHP in order to satisfy one of the eligibility criteria for HSAs. One such factor may be premiums, which generally tend to be lower for HDHPs relative to non-HDHP health insurance. Another factor may be an individual's desire to establish and contribute to an HSA. HSAs are more attractive to individuals with higher marginal tax rates since their tax savings from HSAs are greater; however, some younger, lower-income taxpayers might try to build up account balances in anticipation of when their income will be higher. A third factor may be an individual's health status. For example, some individuals may be reluctant to enroll in high-deductible health insurance (thereby forgoing the ability to start or continue funding HSAs) if they have health problems for which non-HDHP insurance would be more attractive, even taking into account the tax benefits of an HSA.

Interest in, and the prevalence of, HSA-qualified HDHPs continues to grow in both the employer and individual health insurance markets. Qualifying insurance was initially offered by insurers that previously had been selling high-deductible policies (including policies associated with Archer medical savings accounts, a precursor to HSAs), but today many insurers and even some health maintenance organizations sell qualifying coverage. Some of the

first employers to offer HSA-qualified HDHPs previously had health reimbursement accounts (HRAs) that were coupled with high-deductible coverage. (First authorized by the IRS in 2002, HRAs are accounts that employees can use for unreimbursed medical expenses; they can be established and funded only by employers and normally terminate when employees leave.) The federal government began offering HSA-qualified HDHPs to its employees in 2005. More recently, employer interest in HSA-qualified HDHPs may have been in response to efforts to provide a wider variety of health insurance options to employees or efforts to address employee health insurance costs.

According to the Kaiser Family Foundation's 2021 Annual Employer Health Benefits Survey, the share of employers offering an HSA-qualified HDHP generally trended upwards after 2005, before reaching 26 percent in 2012. The share of employers offering HSA-qualified HDHPs has since fluctuated between 17 percent and 26 percent. Of the firms offering health benefits in 2021, 51 percent of employers with 200 or more workers offered an HSA-qualified HDHP as compared to 16 percent of smaller firms.

From the enrollment perspective, total enrollment in HSA-qualified HDHPs in the individual and group markets collectively has also continued to grow, though the rate of growth has more recently fluctuated. The Employee Benefit Research Institute (EBRI) summarized recent HSA-qualified HDHP enrollment trends from multiple surveys and found that most HSA-qualified HDHP enrollment sources showed little to no growth in the percentage of enrollees in HSA-qualified HDHPs from 2017 to 2018, followed by a period of increased enrollment from 2018-2020. Of the two surveys with data for 2021, both show a decline in the percentage of enrollees in HSA-qualified HDHPs from 2020 to 2021. According to EBRI, the total number of people enrolled in HSA-qualified HDHPs was estimated to range from 23 million individuals to 36.8 million individuals in 2018. These trends describe a population that *may* be eligible to contribute to an HSA, since these individuals are enrolled in an HSA-qualified HDHP. However, some individuals may not actually be eligible to contribute to an HSA because of enrollment in additional, disqualifying health coverages (e.g., Medicare). Relatedly, these data do not represent the total population that has or utilizes an HSA, since, in addition to the previously mentioned eligibility concern, some eligible individuals may not have established an HSA.

Other sources have analyzed the population of individuals that have or have utilized HSAs. Some research using National Health Interview Survey

data evaluated the demographics of individuals enrolled in an HDHP with an HSA. One study of adults aged 18-64 with employer-based coverage found that enrollment in HDHPs with an HSA increased as educational attainment increased and also increased as family income levels increased. Other research found that of those who are enrolled in HDHPs, non-Hispanic Black HDHP enrollees and Hispanic HDHP enrollees were less likely than non-Hispanic White HDHP enrollees to have an HSA.

The Kaiser Family Foundation survey found that in 2021, roughly 78 percent of workers enrolled in an employer-sponsored, single-coverage HSA-qualified HDHP received some employer contribution to the account or an employer match to employee contributions. A similar ratio existed for those enrolled in family coverage. The average annual employer contribution was \$575 for individuals enrolled in single coverage, and \$987 for those enrolled in family coverage.

In 2019, according to IRS data 2.02 million tax returns included an above-the-line deduction for HSA individual contributions. IRS data also indicate that 11.25 million tax returns received an employer contribution to their HSA (i.e., employer contributions to HSAs were reported on 11.25 million IRS Forms 8889). Because these IRS data are per return, it is not possible to discern from the publicly available data how many individuals (as opposed to how many tax returns or filed forms) made HSA contributions in 2019. Because each tax return is filed on behalf of at least one individual, the actual number of individuals with individual or employer HSA contributions would be no fewer than the number of returns indicating such activity.

Administrative data released by the U.S. Department of the Treasury, Office of Tax Analysis shows that the benefits of tax-advantaged HSA contributions accrued primarily to upper-middle- and higher-income families in 2014. In the table below, the “tax value of deduction” (second column) reflects the revenue loss to the federal government from the deduction of HSA contributions. These contributions are individual contributions made outside the employer setting and taken as an “above-the-line” deduction on an employee’s annual income tax return. The “tax value of exclusion” (third column) reflects the revenue loss to the federal government associated from the exclusion of HSA contributions made through employer payroll deductions or made by the employer. In total, the revenue loss from HSA contributions totaled \$20 billion across all income levels in 2014.

***Distribution of the Tax Value of Health Savings Account Contribution
Deduction and Exclusion by Adjusted Gross Income, 2014***

Adjusted Gross Income (in thousands of \$)	Percentage Distribution of Tax Value of Deduction	Percentage Distribution of Tax Value of Exclusion
Below \$15	0	0
\$15 to \$30	2	3
\$30 to \$40	2	5
\$40 to \$50	3	6
\$50 to \$60	4	5
\$60 to \$75	6	8
\$75 to \$100	8	15
\$100 to \$200	29	35
\$200 to \$500	31	17
\$500 to \$1,000	11	4
\$1,000 or more	5	2

Source: Analysis of data from U.S. Department of the Treasury, Office of Tax Analysis.

Note: CRS is unaware of more recent analysis regarding both the tax deduction and tax exclusion.

More recent IRS data on amounts deducted (i.e., individual contributions claimed for the above-the-line deduction) also indicate that in 2019, the deduction primarily benefited upper-middle- and higher-income families. As noted in the table below, roughly 65 percent of the amounts deducted are taken by tax filing units with adjusted gross incomes over \$100,000, with more than 36 percent claimed by those with adjusted gross incomes above \$200,000. In total, \$5.7 billion was deducted by individuals for HSA contributions across all income levels in 2019.

***Distribution of Amounts Deducted
for Health Savings Account Individual Contributions by Adjusted Gross
Income 2019***

Adjusted Gross Income (in thousands of \$)	Percentage Distribution
Below \$10	1

Adjusted Gross Income (in thousands of \$)	Percentage Distribution
\$10 to \$20	1
\$20 to \$30	3
\$30 to \$40	4
\$40 to \$50	5
\$50 to \$75	11
\$75 to \$100	10
\$100 to \$200	29
\$200 and over	36

Source: IRS *Statistics of Income Table 1.4*.

Note: This is not a distribution of the tax expenditures, but of the amount deducted, classified by adjusted gross income. *Statistics of Income Table 1.4* does not include data on the HSA tax exclusion.

Rationale

HSAs were authorized by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173). Congress adopted them as a replacement for Archer medical savings accounts (MSAs), which proponents considered unduly constrained by limitations on eligibility and contributions. Archer MSAs are another type of health-related tax-advantaged account that are paired with high-deductible health plans. Archer MSA contributions are limited to 65 percent of the insurance deductible (75 percent for family policies) or the amount of earned income from the employer sponsoring the qualifying health insurance, whichever is less. Individuals cannot make contributions if their employer does. At the time HSAs were authorized, Archer MSAs were restricted to self-employed individuals and employees covered by a high-deductible plan established by their small employer (50 or fewer workers).

The Patient Protection and Affordable Care Act (ACA; P.L. 111-148), as amended, included two provisions that changed the HSA rules beginning in 2011. ACA raised the penalty on non-qualified distributions from 10 to 20 percent of the disbursed amount. ACA also modified the definition of qualified medical expenses to exclude over-the-counter medications (except insulin and those prescribed by a physician) as a qualified medical expense. (The qualified medical expense definition modification was later repealed, see below.)

P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act, permanently changed the inflation adjustment measure for selected tax parameters, including HSA contribution limits, from the Consumer Price Index for All Urban Consumers (CPI-U) to the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) effective with the 2018 tax year.

In response to the Coronavirus Disease 2019 (COVID-19) pandemic, Congress, through the CARES Act (P.L. 116-136), temporarily allowed HSA-qualified HDHPs to cover telehealth services prior to the deductible being met. This allowance applied to telehealth and other remote care services provided on or after January 1, 2020, with respect to plans that began on or before December 31, 2021. In addition, coverage for telehealth and other remote care also was not considered disqualifying health coverage with respect to services provided on or after January 1, 2020, for plan years that began on or before December 31, 2021. Finally, the CARES Act permanently allowed over-the-counter medicines and drugs (without a prescription) and menstrual care products to be considered qualified medical expenses.

As part of the No Surprises Act within the Consolidated Appropriations Act, 2021 (P.L. 116-260), Congress enacted provisions to prevent individuals from losing HSA eligibility as a result of the implementation of certain surprise billing requirements.

Congress extended the two CARES Act HSA provisions relating to telehealth and other remote care services in the Consolidated Appropriations Act, 2022 (P.L. 117-103). As such, from April through December 2022, HSA-qualified HDHPs may have no deductible (or a deductible less than the aforementioned minimum annual deductible requirement) for telehealth and other remote care benefits, and separately, coverage for telehealth and other remote care is not considered disqualifying health coverage.

Most recently, the enacted budget reconciliation measure commonly referred to as the Inflation Reduction Act of 2022 (P.L. 117-169) included a provision to allow HSA-qualified HDHPs to cover select insulin products prior to the deductible being met. This allowance applies to plan years beginning after December 31, 2022.

Assessment

HSAs in concert with HDHPs allow individuals to save for routine and other medical costs while insuring against large or catastrophic medical expenses. Properly designed, they may encourage more cost-conscious health

care use and the accumulation of funds for medical care. For these outcomes to occur, however, individuals will have to establish and put money into their accounts (especially if their employer does not), and refrain from spending it on things other than health care.

HDHPs and HSAs have also been touted as a way to lower overall health care costs, as consumers are incentivized to find out what health care providers charge and be willing to switch to lower-cost providers or forgo a doctor's visit for what they may consider a minor ailment. This raises an important issue about the distinction between cost and quality and whether consumers can tell the difference. Similarly, incentives created by an HDHP/HSA to lower expenditures may unintentionally lower expenditures on "necessary" rather than "unnecessary" care.

Generally, research that looks across multiple firms has demonstrated that enrollment in employer-sponsored HSA-qualified HDHPs has resulted in decreases in health care spending; however, research that focuses on the effects on enrollees within a particular firm tend to be less conclusive regarding the effects of HDHP enrollment on health care spending. Reductions in spending are most commonly attributed to reductions in spending on prescription drugs and outpatient services. With respect to the effects on prescription drugs, these reductions have been most commonly shown to be the result of decreased utilization and, to a lesser extent, switching to generic drugs. Reductions in utilization stemming from HDHP enrollment often have been found to reduce both necessary and unnecessary care, though some studies have revealed limited instances where HDHP enrollees reduce utilization of less clinically appropriate care or do not reduce utilization of necessary care. For example, one study found that HDHP enrollment reduced low-severity condition visits to the emergency department amongst women, while men substantially reduced emergency department visits at all severity levels and subsequently saw a relative increase in hospitalizations. Another study found that HDHP enrollment did not impact utilization of recommended prenatal and postpartum care.

The extent to which HSAs and HDHPs can substantially reduce aggregate health care spending may be limited, even assuming their widespread adoption. Individuals in HDHPs (with and without HSAs) have been shown to have low rates of cost-conscious consumer behaviors. Furthermore, individuals in HDHPs may not be aware of, or have access to, appropriate cost and quality information that they could use to make cost-conscious decisions. In addition, since medical care decisions are generally

made by an individual in consultation with a doctor, the individual may be reluctant to discuss costs with their provider or question medical advice.

HSA and HDHP plan design may also limit reductions in health care spending. Most health care spending is attributable to costs for high-cost patients that exceed the high-deductible levels; consumers generally have little control over these expenditures. Even for smaller expenditures, the tax subsidies associated with HSAs may effectively reduce patient cost-sharing compared to non-high-deductible health insurance, or employer contributions to HSAs may be viewed by some employees as additional income resulting in more utilization. A further complication is that HSAs with large account balances might be seen as readily-available funds for health care, which could lead to increased spending, just the opposite of the usual prediction.

Regardless of their impact on aggregate expenditures, HSAs provide more economically equitable treatment for certain employed taxpayers who choose to pay for more of their health care costs out-of-pocket. This is because amounts contributed to employer-sponsored health insurance have different tax benefits than amounts used to pay for health care. Specifically, employer-sponsored health insurance is excluded from employees' gross income regardless of the amount of medical care used by the individual or the proportion of medical care costs it covers. Outside of certain tax-advantaged accounts, out-of-pocket medical expenses generally only are tax advantaged if they can be claimed for an itemized deduction. Under an HDHP and absent an HSA, employees would have to pay for expenses associated with the increase in the deductible with after-tax dollars, while generally receiving a smaller tax exclusion as a result of a smaller HDHP premium (relative to non-HDHP health insurance). HSAs alter the relationship between the tax advantages of paying for certain types of private health insurance and the tax advantages of paying for medical care.

Finally, some people could use HSAs as substitutes or complements to tax-preferred retirement savings accounts. Like a traditional 401(k), contributions to an HSA are tax deductible, the earnings grow tax-deferred, and withdrawals for nonmedical HSA distributions are taxed as ordinary income. Although individuals who withdraw HSA contributions for purposes other than qualified health expenditures incur a 20 percent penalty, this penalty does not apply for individuals 65 or older. HSAs can be more advantageous than a traditional 401(k) if withdrawals are used for qualified medical expenses, since such withdrawals would not be taxed as ordinary income.

The research discussed in this chapter generally evaluates HSAs/HSA-qualified HDHPs specifically or consumer-driven health plans more generally. Consumer-driven health plans are typically defined to include both HSA-qualified HDHPs and HDHPs that are paired with another type of health-related tax-advantaged account: health reimbursement arrangements (HRAs). There are differences between HSAs and HRAs and the types of HDHPs that HSAs/HRAs may be paired with. For example, the structure of HRAs and HSAs may create slightly different incentives for enrollees that could have a minor impact on behavior. Although there is this distinction, the findings of research on consumer driven health plans are described within this section as applying only to HSAs/HDHPs to facilitate easy reading.

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Health

DEDUCTION FOR MEDICAL EXPENSES AND LONG-TERM CARE EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	7.4	—	7.4
2021	9.3	—	9.3
2022	9.3	—	9.3
2023	9.3	—	9.3
2024	9.5	—	9.5

Authorization

Section 213.

Description

Most medical expenses that are paid for by an individual, but not reimbursed by an employer or insurance company, may be deducted from taxable income to the extent they exceed 7.5 percent of adjusted gross income (AGI). If an individual receives reimbursements for medical expenses deducted in a previous tax year, the reimbursements must be included in income for the year when they were received. Any reimbursement received for medical expenses incurred in a previous year for which no deduction was used may be excluded from an individual's income in the tax year received.

A complicated set of rules governs the expenses eligible for the deduction. These expenses include amounts paid by the taxpayer on behalf of himself or herself, his or her spouse, and eligible dependents for the following purposes:

- health insurance premiums, including a variable portion of premiums for long-term care insurance, employee payments for employer-sponsored health plans, Medicare Part B premiums, and other self-paid premiums;

- diagnosis, treatment, mitigation, or prevention of disease, or for the purpose of affecting any structure or function of the body, including dental care and personal protective equipment;
- prescription drugs and insulin (but not over-the-counter medicines);
- transportation primarily for and essential to medical care; and
- lodging away from home primarily for and essential to medical care, up to \$50 per night for each individual.

In general, the cost of programs entered by an individual on his or her own initiative to improve general health or alleviate physical or mental discomfort unrelated to a specific disease or illness may not be deducted. But the cost of similar programs prescribed by a physician to treat a particular disease is deductible. The same distinction applies to procedures intended to improve an individual's appearance. For instance, the IRS does not consider the cost of whitening teeth discolored by aging to be a deductible medical expense, but the cost of breast reconstruction after a mastectomy or vision correction through laser surgery are deductible expenses.

There are limits on deductions for long-term care insurance. The limits depend on the age of the insured person and are adjusted annually for inflation: in 2022, they range from \$450 for individuals age 40 and under to \$5,640 for individuals over age 70.

Impact

For individual taxpayers who itemize, the deduction can ease the financial burden imposed by costly medical expenses. The federal tax code, in part, regards these expenses as involuntary expenses that reduce a taxpayer's ability to pay taxes by absorbing a substantial part of income.

But the deduction is not limited to strictly involuntary expenses. It also covers some costs of preventive care, rest cures, and other discretionary expenses. A significant share of deductible medical expenses relates to procedures and care not covered by many insurance policies (such as orthodontia).

Relative to other itemized deductions, a large share of low- and middle-income taxpayers claim the deduction. Taxpayers with an AGI below \$75,000 accounted for 54.8 percent of the returns claiming the medical deduction in 2019. Medical spending constitutes a larger fraction of household budgets

among low-income taxpayers than it does among high-income taxpayers, making it easier for low-income taxpayers to exceed the 7.5 percent AGI threshold. Finally, low-income households are more likely to suffer large declines in their incomes than high-income households when serious medical problems cause working adults to lose time from work.

In contrast, the distribution of *tax expenditure values* for the itemized deduction for medical expenses is primarily concentrated in upper middle- and higher-income taxpayers. Taxpayers with an AGI less than \$100,000 accounted for a cumulative share of 25.0 percent of the tax expenditure values. Taxpayers with an AGI between \$100,000 and \$200,000 accounted for 43.1 percent of the tax expenditure value, and a relatively small number of taxpayers with an AGI greater than \$200,000 accounted for 31.9 percent of the tax expenditure values. As with any deduction, the medical expense deduction yields the largest tax savings per dollar of expense for taxpayers in the highest income tax brackets.

***Distribution by Income Class of the Tax Expenditure for
the Itemized Deduction for Medical and Dental Expenses, 2020***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.2
\$30 to \$40	0.7
\$40 to \$50	1.6
\$50 to \$75	8.9
\$75 to \$100	13.6
\$100 to \$200	43.0
\$200 and over	31.9

Rationale

Since the early 1940s, numerous changes have been made in the rules governing the deduction for medical expenses. These changes have focused on where to set the income threshold, whether to cap the deduction and at what amount, the maximum deductible amount for taxpayers who are 65 and over and disabled, whether to carve out separate income thresholds for spending on

medicines and drugs and for health insurance expenditures, and the medical expenses that qualify for the deduction.

Taxpayers were first allowed to deduct health care expenses above a specific income threshold in 1942. The deduction was a provision of the Revenue Act of 1942 (P.L. 77-753). In adopting such a rule, Congress was trying to encourage improved standards of public health and ease the burden of high tax rates during World War II. The original deduction covered medical expenses (including spending on health insurance) above five percent of AGI and was capped at \$2,500 for a married couple filing jointly and \$1,250 for a single filer.

Under the Revenue Act of 1948 (P.L. 80-471), the five-percent income threshold remained intact, but the maximum deduction was changed so that it equaled the then personal exemption amount of \$1,250 multiplied by the number of exemptions claimed. The act placed a cap on the deduction of \$5,000 for joint returns and \$2,500 for all other returns.

The Revenue Act of 1951 (P.L. 82-183) repealed the five-percent floor for taxpayers and spouses who were age 65 and over. No change was made in the maximum deduction available to other taxpayers.

Congress passed legislation that substantially revised the Internal Revenue Code in 1954 (P.L. 83-591). One of its provisions reduced the AGI threshold to three percent and imposed a one-percent floor for spending on drugs and medicines. In addition, the maximum deduction was increased to \$2,500 per personal exemption, with a ceiling of \$5,000 for an individual return and \$10,000 for a joint or head-of-household return.

In 1959, the maximum deduction rose to \$15,000 for taxpayers who were 65 and over and disabled, and to \$30,000 if their spouse also met both criteria.

The threshold was removed on deductions for dependents age 65 and over the following year.

In 1962 (P.L. 87-863), the maximum deduction was increased to \$5,000 per exemption, with a limit of \$10,000 for individual returns, \$20,000 for joint and head of household returns, and \$40,000 for joint returns filed by taxpayers and their spouses who were 65 or over and disabled.

Congress eliminated the one-percent floor on medicine and drug expenses for those age 65 or older (taxpayer, spouse, or dependent) in 1964

(P.L. 88-272). In the following year (P.L. 89-97), a three-percent floor for medical expenses and a one-percent floor for drugs and medicines were reinstated for taxpayers and dependents aged 65 and over. At the same time, the limitations on maximum deductions were abolished, and a separate deduction not to exceed \$150 was established for health insurance payments.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA; P.L. 97-248) made a number of significant changes in the deduction. First, it raised the floor from three percent to five percent of AGI. Second, it eliminated the separate deduction for health insurance payments and allowed taxpayers to combine them with other qualified medical expenses in computing the deduction. Finally, TEFRA removed the separate one-percent floor for drug costs, excluded non-prescription or over-the-counter drugs from the deduction, and merged the deduction for prescription drugs and insulin with the deduction for other medical expenses.

Under the Tax Reform Act of 1986 (TRA86; P.L. 99-514), the income threshold for the medical expenses deduction increased from five percent of AGI to 7.5 percent.

The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) disallowed deductions for the cost of cosmetic surgery, with certain exceptions. It also exempted the medical expense deduction from the overall limit on itemized deductions for high-income taxpayers.

Under the Health Insurance Portability and Accountability Act of 1996 (HIPAA; P.L. 104-191), spending on long-term care and long-term care insurance was granted the same tax treatment as spending on health insurance and medical expenses. This meant that starting January 1, 1997, taxpayers were allowed to include expenditures for long-term care and long-term care insurance in the medical expenses eligible for the deduction. The act also imposed annual dollar limits, indexed for inflation, on the long-term care insurance payments a taxpayer may deduct, subject to the 7.5 percent of AGI threshold.

HIPAA also specified that periodic reimbursements received under a qualified long-term care insurance plan were considered payments for personal injuries and sickness and could be excluded from gross income, subject to a cap that was indexed for inflation. These payments could not be added to the expenses eligible for the section 213 deduction because they were considered reimbursement for health care received under a long-term care

contract. Insurance payments above the cap that did not offset the actual costs incurred for long-term care services had to be included in income.

Under the Patient Protection and Affordable Care Act (ACA; P.L. 111-148), the threshold increased to 10 percent of AGI in 2013 for taxpayers who were under the age of 65. This effectively further limited the amount of medical expenses that could be deducted. Taxpayers age 65 and older were temporarily excluded from this provision and were still subject to the 7.5 percent limit from 2013 through 2016. The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) provided a temporary 7.5 percent limitation for all taxpayers through 2018, the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) extended the limitation through tax year 2020, and the Consolidated Appropriations Act, 2021 (P.L. 116-260) made the 7.5 percent limitation permanent.

Assessment

The deduction is intended to assist taxpayers who have high out-of-pocket medical expenses relative to their income. Taxpayers are more likely to use the deduction if they can shift several large medical expenditures into a single tax year. Unlike the itemized deduction for casualty losses, a taxpayer cannot carry medical expenses that cannot be deducted in the current tax year over to previous or future tax years.

Some argue that the deduction serves the public interest by expanding health insurance coverage. In theory, it could have this effect, as it lowers the after-tax cost of such coverage. This reduction can be as large as 37.0 percent for someone in the highest tax bracket. Yet there appears to be a tenuous link, at best, between the deduction and health insurance coverage. So few taxpayers claim the deduction that it is unlikely to have much impact on the decision to purchase health insurance, especially among individuals whose only option for coverage is to buy health insurance in the non-group market. Premiums tend to be higher and gaps in coverage more numerous in the non-group market than in the group market. What is more, few among those who itemize and have health insurance coverage are likely to qualify for the deduction because insurance covers most of the medical care they use. It is possible that the deduction assists taxpayers with one-off, unanticipated medical expenses (or chronic conditions that are expensive, relative to AGI), rather than promote insurance coverage.

Current tax law runs counter to the principles of vertical and horizontal equity in its treatment of health insurance expenditures. Taxpayers who receive health benefits from their employers receive a larger tax subsidy, at the margin, than taxpayers who purchase health insurance on their own or self-insure. Employer-paid health care is excluded from income and payroll taxes, whereas the cost of health insurance bought in the non-group market can be deducted from taxable income only to the extent it exceeds a set percent of AGI. Lowering or abolishing the AGI threshold for the deduction would narrow but not eliminate the difference between the tax benefits for health insurance available to the two groups.

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Health

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS FOR PRIVATE NONPROFIT HOSPITAL FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.4	0.3	1.7
2021	1.4	0.3	1.7
2022	1.4	0.3	1.7
2023	1.4	0.3	1.7
2024	1.4	0.3	1.7

Authorization

Sections 103, 141, 145(b), 145(c), 146, and 501(c)(3).

Description

Interest income on state and local bonds used to finance the construction of nonprofit hospitals and nursing homes is tax-exempt. These bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals or businesses rather than to the general public. These nonprofit hospital bonds are not subject to the state private-activity bond annual volume cap. For more discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Impact

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

Some of the benefits of the tax exemption also flow to bondholders. According to the most recent available data published by the Internal Revenue Service, in 2017, \$37.9 billion of qualified hospital bonds were issued. For a discussion of the factors that determine the shares of benefits going to bondholders and users of the hospitals and nursing homes, and estimates of the distribution of tax-exempt interest income by income class, see the “Impact” discussion under *General Government: Exclusion of Interest on Public Purpose State and Local Debt*.

Rationale

The income tax adopted in 1913, in conformance with long-standing principles regarding government support for charitable organizations that provide public benefit, exempted from taxation virtually the same organizations now included under Section 501(c)(3). In addition to their tax-exempt status, these institutions were permitted to receive the benefits of tax-exempt bonds. Almost all states have established public authorities to issue tax-exempt bonds for nonprofit hospitals and nursing homes. Where issuance by public authority is not feasible, Revenue Ruling 63-20 allows nonprofit hospitals to issue tax-exempt bonds “on behalf of” state and local governments.

Before enactment of the Revenue and Expenditure Control Act of 1968 (RECA, P.L. 90-364), states and localities were able to issue bonds to finance construction of capital facilities for private (proprietary or for-profit) hospitals, as well as for public sector and nonprofit hospitals.

After the 1968 Act, tax-exempt bonds for proprietary (for-profit) hospitals were issued as small-issue industrial development bonds, which limited the amount for any institution to \$5 million over a six-year period. The Revenue Act of 1978 raised this amount to \$10 million.

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) established December 31, 1986, as the sunset date for tax-exempt small-issue industrial development bonds. The Deficit Reduction Act of 1984 (P.L. 98-369) extended the sunset date for bonds used to finance manufacturing facilities, but left in place the December 31, 1986 sunset date for non-manufacturing facilities, including for-profit hospitals and nursing homes. The private-activity status of these bonds subjects them to restrictions that would not apply if they were classified as governmental bonds.

The 2017 tax revision (P.L. 115-97) retained the general income exclusion for interest earned on the private-activity bonds of nonprofit hospitals but restricted a refinancing option for these hospitals. Specifically, P.L. 115-97 repealed the exclusion of interest income earned from an advanced refunding bond for bonds issued after December 31, 2017. Advanced refunding bonds are bonds that are sold to refund (or retire) outstanding bonds that have not yet reached full maturity. Generally, an issuer will use proceeds from an advanced refunding bond with a lower interest rate to pay off an outstanding bond with a higher interest rate. Bonds with a governmental purpose (for which interest income is excluded from federal income taxation) may generally be advance refunded once.

Assessment

Some efforts have been made to reclassify nonprofit bonds, including nonprofit hospital bonds, as governmental bonds. The proponents of such a change suggest that the public nature of services provided by nonprofit organizations justify such a reclassification. Opponents argue that the expanded access to subsidized loans coupled with the absence of sufficient government oversight may lead to greater misuse than if the facilities received direct federal spending. Questions have also been raised about whether nonprofit hospitals fulfill their charitable purpose and deserve continued access to tax-exempt bond financing.

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

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Health

**DEDUCTION FOR CHARITABLE CONTRIBUTIONS TO
HEALTH ORGANIZATIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.1	0.9	6.0
2021	5.0	1.0	6.0
2022	5.3	1.0	6.3
2023	4.6	1.0	5.6
2024	5.2	1.0	6.2

Note: This table does not reflect the effects of the Consolidated Appropriations Act of 2021, which caused an additional loss of \$1.3 billion in FY2021 and \$4.8 billion in FY2022 for all charitable contributions. It also caused a gain of \$1.6 billion in FY2023 and of \$0.5 billion in FY2024.

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts. The contributions must be made to specific types of organizations, including organizations whose purpose is to provide medical or hospital care, or medical education or research. To be eligible, organizations must be not-for-profit.

Individuals who itemize may deduct qualified contribution amounts of up to 50 percent of their adjusted gross income (AGI) and up to 30 percent for gifts of capital gain property. For 2018-2025, the limit is increased to 60 percent. For contributions to non-operating foundations and organizations, deductibility is limited to the lesser of 30 percent of the taxpayer's contribution base, or the excess of 50 percent of the contribution base for the tax year over

the amount of contributions that qualified for the 50-percent deduction ceiling (including carryovers from previous years). Gifts of capital gain property to these organizations are limited to 20 percent of AGI. Excess contributions can be carried forward for five years.

The limit was temporarily increased to 100 percent for 2020 for cash contributions to public charities (not to private foundations, supporting organizations, or donor advised funds). An above-the-line deduction for contributions of up to \$300 was also allowed for non-itemizers for 2020. These provisions were extended through 2021, and the \$300 amount was increased to \$600 for joint returns.

The maximum amount deductible by a corporation is 10 percent of its adjusted taxable income. This limit was temporarily increased to 25 percent for 2020 and 2021. Adjusted taxable income is defined to mean taxable income with regard to the charitable contribution deduction, dividends-received deduction, any net operating loss carryback, and any capital loss carryback. Excess contributions may be carried forward for five years. Amounts carried forward are used on a first-in, first-out basis after the deduction for the current year's charitable gifts has been taken. Typically, a deduction is allowed only in the year in which the contribution occurs. However, an accrual-basis corporation is allowed to claim a deduction in the year preceding payment if its board of directors authorizes a charitable gift during the year and payment is scheduled by the 15th day of the third month of the next tax year.

Donors of noncash charitable contributions have increased reporting requirements. For charitable donations of property valued at \$5,000 or more, donors must obtain a qualified appraisal of the donated property. For donated property valued in excess of \$500,000, the appraisal must be attached to the donor's tax return. Deductions for donations of patents and other intellectual property are limited to the lesser of the taxpayer's basis in the donated property or the property's fair market value. Taxpayers can claim additional deductions in years following the donation based on the income the donated property provides to the donee. There are also additional reporting requirements for charitable organizations receiving vehicle donations from individuals claiming a tax deduction for the contribution, if it is valued in excess of \$500.

Taxpayers are required to obtain written substantiation from a donee organization for contributions that exceed \$250. This substantiation must be received no later than the date the donor-taxpayer files the required income tax return. Donee organizations are obligated to furnish the written

acknowledgment when requested with sufficient information to substantiate the taxpayer's deductible contribution.

Impact

The deduction for charitable contributions reduces the net cost of contributing. In effect, the federal government provides the donor with a corresponding grant that increases in value with the donor's marginal tax bracket. Individuals who use the standard deduction or who pay no taxes normally receive no benefit from the provision.

A limitation (temporarily suspended for 2018-2025) applies to the itemized deductions of high-income taxpayers, whereby itemized deductions are reduced by 3 percent of the amount by which a taxpayer's adjusted gross income (AGI) exceeds an inflation adjusted dollar amount (\$320,000 for joint returns in 2018). The limit is capped at 80 percent of itemized deductions. However, because the limitation is triggered by income rather than deductions, it is not effectively a limit on itemized deductions unless the cap is reached, which is unusual. The limit acts as an additional tax rate.

The following table provides the distribution of all charitable contributions, not just those to health organizations. In general, contributions to health are more heavily concentrated among higher-income taxpayers (similar to contributions to the arts and education), as compared to contributions for religion, combined purpose charities, and charities to meet basic needs, which are more concentrated in lower-income classes.

Distribution by Income Class of the Tax Expenditure for the Charitable Deduction, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.1
\$30 to \$40	0.2
\$40 to \$50	0.3
\$50 to \$75	0.4
\$75 to \$100	1.7
\$100 to \$200	2.4

Income Class (in thousands of \$)	Percentage Distribution
\$200 and over	94.9

Rationale

This deduction was added by passage of the War Revenue Act of October 3, 1917. Senator Hollis, the sponsor, argued that high wartime tax rates would absorb the surplus funds of wealthy taxpayers, which were contributed to charitable organizations. The deduction was originally limited to individuals. A deduction for trusts and estates was added in 1918, but a deduction for corporations was not allowed until 1935.

The deduction allowed in 1917 was limited to 15 percent of taxable income. Most of the revisions in the early tax law related to this limit. In 1924, it was changed to 15 percent of adjusted gross income. The corporate deduction was limited to 5 percent of income when introduced in 1935. In 1952, the individual limit was increased to 20 percent. The limit was increased to 30 percent in 1954, but the additional 10% had to go to a charity (thus retaining a 20 percent limit for foundations). A carryover of unused deductions for two years was first allowed for corporations in 1954. In 1964, the carryover was increased to five years and extended to individuals.

The percentage limit on individual contributions to charities was increased to 50 percent by the Tax Reform Act of 1969 (P.L. 91-172), restricted to 30 percent for gifts of appreciated property. The percentage limit on corporate charitable contributions was increased to 10 percent of taxable income in the Economic Recovery Tax Act of 1981 (P.L. 97-34). The limit on contributions to private foundations was increased to 30 percent for cash contributions by the Deficit Reduction Act of 1984 (P.L. 98-369).

The Economic Recovery Tax Act of 1981 also allowed a temporary deduction for non-itemizers. This provision was not extended by the Tax Reform Act of 1986 (P.L. 99-514).

Concerns about abuse led to provisions requiring greater substantiation of gifts. The Deficit Reduction Act of 1984 (P.L. 98-369) required written substantiation of contributions in excess of \$2,000, and the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) lowered that amount to \$250. The American Jobs Creation Act of 2004 (P.L. 108-357) increased reporting requirements of donors of noncash charitable contributions, including

vehicles. The provisions enacted in 2004 resulted from Internal Revenue Service and congressional concerns that taxpayers were claiming inflated charitable deductions, causing the loss of federal revenue. In the case of vehicle donations, concern was expressed about the inflation of deductions. GAO reports published in 2003 indicated that the value of benefit to charitable organizations from donated vehicles was significantly less than the value claimed as deductions by taxpayers.

The Pension Protection Act of 2006 (P.L. 109-280) also provided for some temporary additional benefits which are part of the “extenders,” effective through 2007. The 2006 act also added restrictions on donor advised funds (where sponsors receive contributions and then make donations advised by the original contributor) and certain supporting organizations (organizations that receive donations used to support other active charities). The 2006 law also tightened rules governing charitable giving in certain areas, including gifts of taxidermy, contributions of clothing and household items, contributions of fractional interests in tangible personal property, and record-keeping and substantiation requirements for certain charitable contributions. The 2006 enactments were, in part, a result of continued concerns from 2004.

Temporary charitable giving incentives were further extended through 2009 by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) enacted in October 2008, and through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). Some charitable extenders were extended through 2013 by the American Taxpayer Relief Act of 2012 (P.L. 112-240). These provisions were made permanent in 2015 by the Consolidated Appropriations Act, 2016 (P.L. 114-113).

The 2017 tax change, P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act, increased the percentage of income limit for contributions of cash to public charities to 60 percent and eliminated the phaseout of itemized deductions on a temporary basis.

For 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) increased the limit for cash contributions by individuals to charities to 100% for 2020, allowed a \$300 above-the-line deduction for non-itemizers, and increased the limit to 25% for corporations. The Consolidated Appropriations Act of 2021 (P.L. 116-260) extended these provisions through 2021 and increased the above-the-line deduction for non-itemizers to \$600 for joint returns.

Assessment

Supporters note that contributions finance desirable activities such as hospital care for the poor. Further, the federal government would be forced to assume some of the activities currently provided by health care organizations if the deduction were eliminated; however, public spending might not be available to make up all of the difference. In addition, many believe that the best method of allocating general welfare resources is through a dual system of private philanthropic giving and governmental allocation.

Economists have generally held that the deductibility of charitable contributions provides an incentive effect that varies with the marginal tax rate of the giver. There are a number of studies that find significant behavioral responses, although a study by Randolph (1995) suggests that such measured responses may largely reflect transitory timing effects.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than are contributions to health organizations, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. The volume of donations to religious organizations, however, is greater than to other organizations. In 2021, according to Giving USA and its research partner at Indiana University, charitable contributions from individuals, corporations, bequests, and foundations totaled \$485 billion, of which 28 percent (\$136 billion) was for religious institutions. Contributions to health care providers and associations amounted to 8 percent (\$40.6 billion).

There has been a debate concerning the amount of charity care being provided by health care organizations with tax-exempt status. In the 109th Congress, hearings were held by both the Senate Committee on Finance and the House Committee on Ways and Means to examine the charitable status of nonprofit health care organizations. The Patient Protection and Affordable Care Act of 2010 (P.L. 111-148) imposed a number of additional regulations and reporting requirements on nonprofit hospitals that receive deductible charitable contributions.

Those who support eliminating charitable deductions note that deductible contributions are made partly with dollars which are public funds. They feel that helping out private charities may not be the optimal way to spend government money.

Opponents further claim that the present system allows wealthy taxpayers to indulge special interests and hobbies. To the extent that charitable giving is independent of tax considerations, federal revenues are lost without having provided any additional incentive for charitable gifts. It is generally argued that the charitable contributions deduction is difficult to administer and that taxpayers have difficulty complying with it because of complexity.

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Health

**EXCLUSION OF WORKERS' COMPENSATION BENEFITS
(MEDICAL BENEFITS)**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	6.0	—	6.0
2021	6.0	—	6.0
2022	6.3	—	6.3
2023	7.2	—	7.2
2024	7.2	—	7.2

Authorization

Section 104(a)(1).

Description

Workers' compensation includes payments to an employee for medical treatment of work-related injury or disease. Various state and federal laws govern workers' compensation. Employers finance workers' compensation benefits through commercial insurance or self-insurance arrangements (with no employee contribution) and their costs are deductible as a business expense. Employees are not taxed on the value of insurance contributions for workers' compensation medical benefits made on their behalf by employers, or on the medical benefits or reimbursements they actually receive. This is similar to the tax treatment of other employer-paid health insurance.

Impact

The exclusion from taxation of employer contributions for workers' compensation medical benefits provides a tax benefit to any worker covered by the workers' compensation program, not just those actually receiving medical benefits in a particular year.

The cost to employers for workers' compensation in 2019 was \$100.2 billion, equivalent to 1.17 percent of covered payrolls. Figures are not

available that distinguish employer contributions specifically for workers' compensation medical benefits from the portion for disability and survivors' benefits. However, in 2019, medical payments under workers' compensation programs totaled \$31.3 billion. This represented 49.6 percent of total workers' compensation benefits. The remainder consisted mainly of earnings-replacement cash benefits. (See entry on Exclusion of Workers' Compensation Benefits: Disability and Survivors Payments.)

Rationale

The exclusion of workers' compensation medical benefits was first codified in the Revenue Act of 1918 (P.L. 65-254). The committee reports accompanying the Act suggest that workers' compensation payments were not subject to taxation before the 1918 Act. No rationale for the exclusion is found in the legislative history. However, it has been maintained that workers' compensation should not be taxed because it is in lieu of court-awarded damages for work-related injury or death that, before enactment of workers' compensation laws (beginning shortly before the 1918 Act), would have been payable under tort law for personal injury or sickness and not taxed. Workers' compensation serves as an exclusive remedy for injured workers and these workers are generally prohibited from seeking damages from their employers through the court system.

Assessment

Not taxing employer contributions to workers' compensation medical benefits subsidizes these benefits relative to taxable wages and other taxable benefits, for both the employee and employer. The exclusion allows employers to provide their employees with workers' compensation coverage at a lower cost than if they had to pay the employees additional wages sufficient to cover a tax liability on these medical benefits. In addition to the income tax benefits, workers' compensation benefits are excluded from payroll taxation.

The tax subsidy reduces the employer's cost of compensating employees for accidents on the job and can be viewed as blunting financial incentives to maintain safe workplaces. Employers can reduce their workers' compensation costs if the extent of accidents is reduced. If the insurance premiums were taxable to employees, a reduction in employer premiums would also lower employees' income tax liabilities. Employees might then be willing to accept lower before-tax wages, thereby providing additional savings to the employer from a safer workplace.

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Health

CREDIT FOR PURCHASE OF HEALTH INSURANCE BY CERTAIN DISPLACED PERSONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	—	0.1
2021	(¹)	—	(¹)
2022	—	—	—
2023	—	—	—
2024	—	—	—

(¹) Positive tax expenditure of less than \$50 million.

Note: The credit was extended an additional year in the Consolidated Appropriations Act, 2021, at a cost of less than \$50 million in FY2021 and FY2022.

Authorization

Section 35.

Description

Eligible displaced workers and retirees can claim a refundable tax credit for 72.5 percent of the premiums they pay for qualified health insurance for themselves and family members for eligible coverage months. The credit is commonly known as the health coverage tax credit (HCTC). The HCTC acts as partial reimbursement for premiums paid for qualified health insurance coverage and can now be claimed for qualified coverage through 2021.

Eligible individuals include: (1) individuals who are receiving a Trade Readjustment Assistance (TRA) allowance, or who would be except their state unemployment benefits are not yet exhausted; (2) individuals who are receiving an Alternative Trade Adjustment Assistance (ATAA) / Reemployment Trade Adjustment Assistance (RTAA) allowance for people age 50 and over; (3) individuals who are receiving a pension paid in part by the Pension Benefit Guaranty Corporation (PBGC); and (4) the family member of an eligible TRA, ATAA, or RTAA recipient or PBGC payee who

is deceased or who finalized a divorce. An individual is not eligible for the HCTC if they (1) can be claimed as a dependent on another person's federal income tax return; or (2) are enrolled in Medicare, Medicaid, the Children's Health Insurance Program, or the Federal Employees Health Benefits Program or are eligible to receive benefits under the U.S. military health system (TRICARE).

An individual has an eligible coverage month if, as of the first day of the month, the taxpayer: (1) is an eligible individual; (2) is covered by qualified health coverage, the premium for which is paid by the taxpayer; (3) does not have other specified coverage; and (4) is not imprisoned under federal, state, or local authority.

The statute limits qualified health insurance to 11 categories of coverage, identified below. Individuals are not allowed to claim the tax credit for any other type of coverage. Four of the coverage categories are referred to as automatically qualified health plans. Individuals may elect these options without state involvement. These options are as follows:

1. Coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA, P.L. 99-272).
2. Coverage under a group health plan available through a spouse's employer.
3. Coverage under individual health insurance. For tax years 2014 and 2015, the HCTC could be claimed for all individual insurance, including coverage through a health insurance exchange. However, exchange coverage may not be used to claim the HCTC for 2016.
4. Coverage funded by a voluntary employees' beneficiary association (VEBA).

The other seven categories of coverage are known as state-qualified health plans. Individuals may choose these options only if their state has established these plans. These options are as follows:

5. State-based continuation coverage provided under a state law requiring such coverage.
6. Coverage offered through a state high-risk pool (HRP).

7. Coverage under a plan offered for state employees.
8. Coverage under a state-based plan that is comparable to the plan offered to state employees.
9. Coverage through an arrangement entered into by a state and a group health plan, an issuer of health insurance, an administrator, or an employer.
10. Coverage through a state arrangement with a private-sector health care purchasing pool.
11. Coverage under a state-operated plan that does not receive any federal financing.

Coverage under state-qualified health plans is required to provide four consumer protections, specified in statute, to all qualifying individuals. Qualifying individuals are defined as HCTC- eligible individuals (as described above) who had three months of creditable coverage under another health plan prior to applying for a state-qualified plan and did not have a significant break in coverage (defined as 63 days or more without coverage). For such individuals, state-qualified health plans must provide the following four protections:

- The plan must be guaranteed issue, meaning coverage may not be denied to any qualifying applicant.
- Coverage may not be denied based on preexisting health conditions.
- Premiums (without regard to subsidies) may not be greater for qualifying individuals than for other similar individuals.
- Benefits for qualifying individuals must be the same as or substantially similar to benefits for others.

Certain types of coverage are not considered qualified health insurance, even if they otherwise meet one of the categories listed above. Such coverage includes accident or disability income insurance, liability insurance, workers' compensation insurance, automobile medical payment insurance, credit-only insurance, coverage for on-site medical clinics, limited-scope dental or vision benefits, long-term care insurance, coverage for a specified disease or illness, hospital and other fixed indemnity insurance, and supplemental insurance.

Impact

The HCTC substantially reduces the after-tax cost of health insurance for eligible individuals and enables some to maintain or acquire coverage. According to estimates by the Urban Institute, done before changes made by the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5), 362,000 households a year met the TRA, ATAA, or PBGC requirements, and, of these, between 181,000 and 232,000 qualified for the HCTC. In 2006, between 12 percent and 15 percent of those eligible received the credit (about 26,000 households). However, the temporary changes made by ARRA increased the credit amount to 80 percent and made it easier for unemployed TAA participants to receive the HCTC. As a result, a 2010 Government Accountability Office (GAO) study found that while there was a 26 percent increase among potentially eligible individuals following the implementation of the ARRA provisions, there was a 36 percent increase in actual participation in the program. Improved participation was mostly among TAA eligible individuals rather than PBGC eligibles. The key reason cited for participation was improved affordability of health insurance coverage. The number of taxpayers claiming the credit fell from 2016 to 2019. In 2019, Internal Revenue Service data indicated that 15,250 taxpayers claimed credits totaling \$32.9 million.

Rationale

The HCTC was enacted by the Trade Act of 2002 (P.L. 107-210). One impetus for the legislation was to assist workers who had lost their jobs, and consequently their health insurance coverage, due to economic dislocations in the wake of the September 11, 2001 terrorist attacks. Difficulties in reaching consensus on who should be included in this group contributed to the decision to restrict eligibility for the credit to workers adversely affected by international trade (e.g., imported goods contributed importantly to their unemployment, or their companies shifted production to other countries). Extension to taxpayers receiving pensions paid by the PBGC occurred late in the legislative process.

The HCTC was temporarily expanded under the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5). Specifically, ARRA made temporary changes (through December 31, 2010) including: increasing the HCTC subsidy rate from 65 percent to 80 percent, allowing retroactive payments, expanding the eligibility to include individuals receiving unemployment compensation but not enrolled in training, and allowing family

members to continue to receive the HCTC for up to two years after a death or divorce or the policy holder becomes Medicare eligible.

By adopting the tax credit, Congress signaled its intention to help individuals maintain or acquire private market health insurance rather than expand public insurance programs like Medicaid or CHIP. Both proponents and opponents initially saw the credit as a possible legislative precedent for a broader tax credit to reduce the number of uninsured, which is similar to the broader health care reform legislation enacted in 2010.

The Trade Adjustment Assistance Extension Act of 2011 (P.L. 112-40) retroactively changed the subsidy rate to 72.5 percent (from 65 percent) for coverage months beginning after February 12, 2011, and terminated the HCTC at the end of 2013.

The Trade Preferences Extensions Act of 2015 (P.L. 114-27) reinstated, modified and extended the HCTC at the 72.5 percent rate through the end of 2019. Modifications include allowing health plans purchased through exchanges to be considered qualified health plans for 2014 and 2015 only, addressing interactions between the premium assistance tax credit and the HCTC if a qualifying individual is eligible for both, and reauthorizing monthly advance payments of the HCTC. Advance payments of the credit are paid out in advance of a taxpayer filing their federal income tax return.

The credit was extended through December 31, 2020, in the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94). The credit was extended through December 31, 2021, in the Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as Division EE of the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Assessment

Tax credits for health insurance can be assessed by their effectiveness in continuing and expanding coverage, particularly for those who would otherwise be uninsured, as well as from the standpoint of equity. The HCTC is helping some unemployed and retired workers keep their insurance, at least temporarily. The impact may be greatest in the case of individuals who most need insurance (those with chronic medical conditions, for example) and who have the ability to pay the 27.5 percent of the cost not covered by the credit. For many eligible taxpayers, the effectiveness of the credit may depend on the advance payment arrangements; these might work well where there is a

concentration of eligible taxpayers (where a plant is closed, for example) and if the certification process is simple and not perceived as part of the welfare system.

Before the temporary changes made by ARRA to the HCTC, estimates by the Urban Institute presented above found the HCTC had not reached many of the people it was intended to benefit. Participation did increase, however, after the HCTC was raised to 80 percent following ARRA. However, the ARRA provisions expired on December 31, 2010, and the HCTC credit rate decreased to 72.5 percent for 2011 through 2013 (and subsequently extended to the end of 2021). Administrative data from the IRS indicate that by 2013 participation had decreased in comparison to levels after ARRA. However, those same data indicate the number of claimants has increased in later years.

The HCTC is available to all eligible taxpayers with qualified insurance, regardless of income. From the standpoint of inclusiveness, this seems equitable. Using ability to pay as a measure, however, the one rate appears inequitable since it provides the same dollar subsidy to taxpayers regardless of income. An unemployed taxpayer with an employed spouse, for example, can receive the same credit amount as a taxpayer in a household where no one works. At the same time, the credit is refundable, so it is available to low-income Americans who have little or no federal income tax liability.

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Health

DEDUCTION FOR HEALTH INSURANCE PREMIUMS AND LONG-TERM CARE INSURANCE PREMIUMS BY THE SELF-EMPLOYED

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	7.4	2.9	10.3
2021	7.6	1.7	9.3
2022	7.9	0.6	8.5
2023	8.2	0.2	8.4
2024	8.4	(¹)	8.4

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 162(l).

Description

Generally, a self-employed individual may deduct the entire amount he or she pays for health insurance (with some restrictions, discussed below), or long-term care insurance, for himself or herself and his or her immediate family. The deductible share of eligible health insurance expenses rose from 25 percent in 1987 to 100 percent in 2003 and each year thereafter. For the purpose of this deduction only, self-employed individuals are defined as sole proprietors, working partners in a partnership, and employees of an S corporation who each own more than two percent of the corporation's stock. The deduction is taken above-the-line, which is to say that it may be used regardless of whether a self-employed individual itemizes deductions on their tax return.

Use of the deduction for health insurance expenditures by the self-employed is subject to several limitations. First, the deduction cannot exceed a taxpayer's net earned income from the trade or business in which the health insurance plan was established, less the deductions for 50 percent of the self-

employment tax and any contributions to qualified pension plans. Second, the deduction is not available for any month when a self-employed individual is eligible to participate in an employer-sponsored health plan (e.g., a plan sponsored by their spouse's employer). Third, if a self-employed individual claims an itemized deduction for medical expenses under IRC section 213, those expenses must be reduced by any deduction for health insurance premiums claimed under section 162(1). Fourth, any health insurance premiums that cannot be deducted under section 162(1) may be included with these medical expenses, to the extent the total expenses exceed the statutory threshold of 10 percent of adjusted gross income (AGI). Fifth, the deduction for long-term care premiums is limited, based on age. In 2022, these limits range from \$450 for individuals under age 40 to \$5,640 for individuals over age 70.

Impact

In 2019, nearly 3.8 million tax filers claimed over \$31.4 billion under the health insurance deduction for the self-employed. It is not known how many self-employed individuals claimed the deduction for long-term care insurance premiums, or how much they spent for that purpose.

The deduction under section 162(1) reduces the after-tax cost of health insurance or long-term care insurance for self-employed individuals and their immediate families. The tax savings are greater for taxpayers in higher marginal tax brackets (although the amount that can be deducted for long-term care insurance premiums is limited based on age). As a result, higher-income individuals reap greater tax savings from the deduction than do lower-income individuals, all else being equal.

The relationship between the size of the subsidy and income is illustrated in the following table. It shows the percentage distribution by AGI of self-employed filers that claimed health insurance expenditures for 2019, and the average amount claimed per tax return for each income class. Individuals with an AGI greater than \$100,000 accounted for 48.1 percent of the total returns filed that claimed this deduction. The average claim amount increased with income to the extent that for individuals with an AGI of \$200,000 and above, it was more than triple the average claim for individuals with an AGI below \$30,000 (\$14,023 versus \$3,670). If the deductions were translated into tax savings by income class, the distribution of the tax expenditure would be even more concentrated in the higher-income groups.

Distribution by Income Class of the Number of Filers Who Deduct Medical and Long-Term Care Insurance Premiums for the Self-Employed and the Average Amount Deducted Among Claimants, 2019

Income Class (in thousands of \$)	Percentage Distribution	Average Amount of Deduction
Below \$15	10.2	\$4,001
\$15 to under \$30	9.3	\$3,308
\$30 to under \$50	11.0	\$4,398
\$50 to under \$100	21.4	\$6,594
\$100 to under \$200	22.0	\$9,148
\$200 and over	26.1	\$14,023

Source: IRS *Statistics of Income Table 1.4*. This is not a distribution of the tax expenditure, but of the number of tax returns which included a claim for this deduction, by adjusted gross income.

Rationale

The health insurance deduction for the self-employed first entered the tax code as a temporary provision in the Tax Reform Act of 1986 (P.L. 99-514). Under the act, the deduction was equal to 25 percent of qualified health insurance expenditures and was set to expire on December 31, 1989. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) made a few minor corrections to the provision.

A series of laws extended the deduction for brief periods during the early 1990s. The Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) extended the deduction for nine months (through September 30, 1990) and made it available to subchapter S corporation shareholders; the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) extended the deduction through December 31, 1991; the Tax Extension Act of 1991 (P.L. 102-227) extended the deduction through June 30, 1992; and the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) extended it through December 31, 1993. Throughout this period, the deductible share of eligible health insurance expenditures remained at 25 percent.

Congress allowed the deduction to expire at the end of 1993 and took no action to extend it during 1994. A law enacted in April 1995, P.L. 104-7, reinstated the deduction, retroactive to January 1, 1994, and made it a

permanent provision. Under the act, the deductible share of eligible health insurance expenditures was to remain at 25 percent in 1994 and then rise to 30 percent in 1995 and beyond.

The Health Insurance Portability and Accountability Act of 1996 (HIPAA, P.L. 104-191) increased the deductible share of health insurance expenditures by the self-employed from 30 percent in 1995 and 1996 to 40 percent in 1997 and gradually to 80 percent in 2006 and each year thereafter. HIPAA also allowed self-employed persons to include in the expenditures eligible for the deduction any payments they made for qualified long-term care insurance, beginning January 1, 1997. The act imposed dollar limits on the amount of long-term care premiums that could be deducted in a single tax year and indexed these limits for inflation.

The Omnibus Consolidated and Emergency Supplemental Appropriations Act for FY1999 (P.L. 105-277) increased the deductible share to its present level: 70 percent of eligible expenditures in 2002 and 100 percent in 2003 and each year thereafter.

The Small Business Jobs Act of 2010 (P.L. 111-240) allowed business owners a temporary deduction for the cost of health insurance incurred in 2010 for themselves and their family members in the calculation of their 2010 self-employment tax.

Assessment

In establishing the deduction for spending on health insurance and long-term care insurance by the self-employed, Congress seemed to have two motivations. One was to provide those individuals with a tax benefit comparable to the exclusion from the taxable income of any employer-provided health benefits received by employees. A second motive was to improve access to health care by the self-employed.

The deduction lowers the after-tax cost of health insurance purchased by the self-employed proportional to a self-employed individual's marginal income tax rate. Individuals who purchase health insurance coverage in the non-group market but are not self-employed receive no such tax benefit. There is some evidence that the deduction has contributed to a significant increase in health insurance coverage among the self-employed and their immediate families. As one would expect, the gains appear to have been concentrated in higher-income households.

Proponents of allowing the self-employed to deduct 100 percent of health insurance expenditures cite equity as the main justification for such tax treatment. In their view, it is only fair that the self-employed receive a tax subsidy for health insurance coverage comparable to what is available to employees who receive employer-provided health insurance.

While the section 162(l) deduction greatly narrows the gap between the self-employed and employees, it does not go far enough to achieve true equality in the tax treatment of health insurance coverage for the two groups. Recipients of employer-provided health insurance (including shareholder-employees of S corporations who own more than 2 percent of stock) are allowed to exclude employer contributions from the wage base used to determine their Social Security and Medicare tax contributions. By contrast, the self-employed must include their spending on health insurance in the wage base used to calculate their self-employment taxes under the Self-Employment Contributions Act.

The deduction also raises some concerns about its efficiency effects. Critics of current federal tax subsidies for health insurance contend that a 100-percent deduction is likely to encourage higher-income self-employed individuals to purchase more health insurance coverage than they otherwise would. That overconsumption leads to wasteful or inefficient use of health care. To reduce the likelihood of such an outcome, some favor capping the deduction at an amount commensurate with a standardized health benefits package, adjusted for regional variations in health care costs.

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Health

EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR HEALTH CARE, HEALTH INSURANCE PREMIUMS, AND LONG-TERM CARE INSURANCE PREMIUMS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	169.6	—	169.6
2021	179.2	—	179.2
2022	190.1	—	190.1
2023	198.8	—	198.8
2024	205.7	—	205.7

Authorization

Sections 105, 106, and 125.

Description

Employers may offer their employees a variety of health benefits that are not subject to taxation (i.e., they are excluded under either section 105 or 106). These benefits include employer-sponsored health insurance (ESI), health flexible spending accounts (health FSAs), health savings accounts (HSAs), and health reimbursement accounts (HRAs). In some cases (i.e., HSAs) individuals can also use these accounts outside of the employer-employee relationship.

Some of these health benefits may be offered through cafeteria plans (section 125). Cafeteria plans are employer-established benefit plans under which employees can choose between receiving a taxable benefit, such as compensation, and certain non-taxable benefits, such as employer-sponsored health insurance. Among the many requirements applicable to a cafeteria plan is that benefits attributable to salary reduction contributions generally must be provided by the end of the plan year (referred to as the “use-it-or-lose-it” rule).

One of the most common employer-sponsored health benefits that qualifies for the exclusion is ESI. The exclusion applies to the health insurance premiums paid by the employer. The exclusion also applies to qualified long-term care insurance provided by an employer. As a result, the employer's premium payments and the benefits payable under the contract are generally excludable from an employee's wages. (This exclusion does not apply, however, to long-term care insurance provided under a cafeteria plan.)

Health FSAs, which are generally provided by an employer under a cafeteria plan, are an arrangement which allows employees to set aside money on a pre-tax basis to pay certain medical care expenses that are not covered by insurance. The funds available to an employee through a health FSA generally consist of the employee's salary reduction contributions under a cafeteria plan and may also include limited funds provided by the employer. The amount that an employee can contribute to a health FSA is limited to \$2,850 in 2022 and a limited amount may be rolled over to the next year (\$570 in 2022).

HSAs provided by an employer under a cafeteria plan also qualify for the exclusion. HSAs can be used by employees to save and pay for unreimbursed medical expenses on a pre-tax basis. Eligibility to contribute to an HSA is associated with enrollment in a high-deductible health plan (HDHP). The total amount that an individual may contribute to his or her HSA is capped based on the type of HDHP coverage the individual had during those months (self-only or family), the individual's age, and the months during the year that the individual was considered HSA-eligible. More information on HSAs is provided in a separate chapter in the compendium.

Finally, health reimbursement arrangements (HRAs) also qualify for the exclusion. Employees can use HRAs to cover the cost of qualified health care costs, including medical expenses not otherwise reimbursed by health insurance and, in some cases, health insurance premiums. Unlike FSAs and HSAs, HRAs are entirely funded by employer contributions and hence are not available under a cafeteria plan.

Impact

In 2021, 54.3 percent of the U.S. population received health insurance coverage through their or a family member's employer, according to the Census Bureau. Among workers ages 19 to 64, this percentage was 71.2 percent, with variation among different types of workers (e.g., full-time vs. part-time).

The following table presents the Department of the Treasury's 2020 estimates for family sources of health insurance coverage by income. Income is expressed as a percentage of the federal poverty level (FPL) for that year. The likelihood of having employer-sponsored health insurance increases with income. In 2020, an estimated 14 percent of families with incomes below the FPL had employer-sponsored coverage, compared to approximately 78 percent of families with incomes more than four times the FPL. At the same time, the likelihood of receiving public health insurance declined as family income rose. The percentage of those covered by public insurance (e.g., Medicaid; see column 3) in 2020 dropped from an estimated 54 percent for those in the lowest income group to 14 percent for those in the highest income group. A similar pattern is apparent among the uninsured: the percentage of uninsured declined from an estimated 28 percent for those in the lowest income group to 3 percent for those in the highest income group.

Estimated Percent of Families with Health Insurance Coverage of Specified Types by Family Income Relative to the Federal Poverty Level, 2020

Income Relative to Federal Poverty Level	Percent with Type of Insurance			
	Employer-Sponsored	Public	Non-group ^a	Uninsured
Under 100%	14	54	2	28
100% under 133%	22	53	2	21
133% under 150%	26	50	1	19
150% under 200%	38	39	2	16
200% under 250%	47	32	2	13
250% under 300%	54	29	2	10
300% under 350%	59	28	2	8
350% under 400%	63	25	3	7
Over 400%	78	14	3	3

Income Relative to Federal Poverty Level	Percent with Type of Insurance			
	Employer-Sponsored	Public	Non-group ^a	Uninsured
Total	49	32	2	13

Source: Analysis of data from U.S. Department of the Treasury, Office of Tax Analysis, Treasury Estimates of Health Care Coverage, FY 2020, September 2019.

^a Includes individual coverage on marketplace exchanges, people with “other insurance,” and people claiming the deduction for self-employed health coverage (excluding people in families with both employer-sponsored coverage and the self-employed health insurance deduction; these people appear under employer-sponsored insurance).

The following table shows the Department of the Treasury’s estimated tax value of the exclusion by income to families in 2018, measured as a percentage of the 2017 FPL. Treasury estimated that the total value of the exclusion to families in 2018 will be \$394 billion. Although the tax exclusion benefits a majority of families (as shown in the previous table), the distribution of the benefits accrue more to higher-income taxpayers than to lower-income ones. Higher-paid employees tend to be more likely to be enrolled in more generous employer-paid health insurance coverage as compared to their low-paid counterparts. And higher-paid employees fall in higher tax brackets. The value of an exclusion depends in part on a taxpayer’s marginal tax rate. For a given amount of employer-provided health insurance coverage, the higher the tax rate, the greater the tax savings.

Estimated Distribution of the Tax Value of the Exclusion for Employer-Sponsored Insurance Coverage by Family Income Relative to the Federal Poverty Level, 2018

Income Relative to Poverty Level	Percentage Distribution of Tax Value of Exclusion
Under 100%	2
100% to 133%	1
133% to 150%	1
150% to 200%	4

Income Relative to Poverty Level	Percentage Distribution of Tax Value of Exclusion
200% to 250%	5
250% to 300%	6
300% to 350%	7
350% to 400%	7
400% to 600%	23
600% to 800%	15
800% to 1,000%	8
1,000% or more	14

Source: Analysis of data from U.S. Department of the Treasury, Office of Tax Analysis, Treasury's Baseline Estimates of Health Coverage Methodology and Tables "Table 2: Families with Employer-Sponsored Insurance Coverage by Income Relative to Federal Poverty Level and Family Type, 2018," in Tables 1 – 3, Types of Coverage, ESI and PTC, 2018, December 2016.

Rationale

The exclusion of compensation in the form of employer-provided health benefits originated with the Revenue Act of 1918. But the Internal Revenue Service (IRS) did not rule until 1943 that employer contributions to health insurance policies for employees can be excluded from employees' income. This ruling did not address all outstanding issues surrounding the tax treatment of employer-provided health benefits.

The tax status of those contributions remained in doubt until the IRS ruled in 1953 that they should be subject to taxation. This ruling had a brief existence, as the enactment of IRC section 106 in 1954 (P.L. 83-591) effectively reversed it. Henceforth, employer contributions to all accident and

health plans were considered deductible expenses for employers and non-taxable compensation to employees.

Under the Employee Retirement Income Security Act of 1974 (ERISA; P.L. 93-406), an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, was required to be included in an employee's gross income only to the extent the employee *actually* elected taxable benefits. For plans not in existence on June 27, 1974, the employer contribution was included in gross income to the extent the employee *could* have elected taxable benefits.

The Tax Reform Act of 1976 (P.L. 94-455) extended these rules to employer contributions made before January 1, 1978. The Foreign Earned Income Act of 1978 (P.L. 95-615) made a further extension until the effective date of the Revenue Act of 1978 (P.L. 95-600) (i.e., through 1978 for calendar-year taxpayers).

In the Revenue Act of 1978 (P.L. 95-600), the current provision as outlined above was added to the Code to ensure that the tax exclusion was permanent. The Revenue Act of 1978 (P.L. 95-600) also added non-discrimination provisions to section 105(h). These provisions specified that the benefits paid to highly compensated employees under self-insured medical reimbursement plans were taxable if the plan discriminated in favor of these employees. The Tax Reform Act of 1986 (P.L. 99-514) repealed section 105(h) and replaced it with a new section 89 of the Internal Revenue Code, which extended non-discrimination rules to group health insurance plans.

The Deficit Reduction Act of 1984 (P.L. 98-369) limited permissible benefits and established additional reporting requirements for cafeteria plans. The Tax Reform Act of 1986 (P.L. 99-514) imposed stricter nondiscrimination rules (regarding favoritism towards highly compensated employees) on cafeteria and other employee benefit plans. In 1989, the latter rules were repealed by legislation to increase the public debt limit (P.L. 101-140).

In 1989, P.L. 101-140 repealed IRC section 89 and reinstated the pre-1986 Act rules under section 105(h).

Under the Health Insurance Portability and Accountability Act of 1996 (HIPAA; P.L. 104-191), employer contributions to the cost of qualified long-term care insurance could be excluded from employees' income. This exclusion does not apply to long-term care benefits received under a cafeteria plan or flexible spending account (FSA).

In 2005, by administrative ruling, the Internal Revenue Service (IRS) allowed employees an additional 2½ months to use remaining balances in their health care FSAs at the end of the year. Previously, unused balances at the end of the year were forfeited to employers.

Amounts in health care FSAs could be rolled over into HSAs under legislation enacted at the end of 2006 (P.L. 109-432) through January 1, 2012.

The Patient Protection and Affordable Care Act of 2010, often referred to as the Affordable Care Act (ACA; P.L. 111-148, as amended) also extended nondiscrimination provisions under P.L. 101-140 to fully insured plans. Effective for plan years beginning on or after September 23, 2010, the sponsors of health plans are prohibited from establishing eligibility criteria, for any full-time employee, that are based on the total hourly or annual salary of the employee. Beginning in 2013, contributions to health care FSAs were limited to \$2,500, indexed for inflation. The law also excluded over-the-counter drugs from being a qualified FSA or HRA expense. It also prohibited employees from using their FSA to purchase individual coverage through the health exchanges, beginning in 2014 (Treasury Notice 2013-54). (A 2019 administrative rule created individual coverage HRAs, which employees could use to purchase individual market coverage.)

On October 31, 2013, the Internal Revenue Service (IRS) issued Notice 2013-71 which allowed a limited carryover of unused benefits in health care FSAs. IRS Notice 2020-33 modified Notice 2013-71 to index that amount for inflation.

In 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) permanently expanded the list of health FSA and HRA qualified medical expenses to include, beginning in 2020, over-the-counter medicines and drugs and menstrual care products. In May 2020, the IRS provided employers with the ability to offer two types of temporary flexibilities with respect to health FSAs. First, employers could provide employees with the ability to make prospective, midyear changes (during CY2020) to the amount the employees contributed to their health FSAs. Employers that offer health FSAs with plan years (or grace periods) that ended in 2020 also could extend the period in which employees may access such funds through December 31, 2020.

Assessment

The exclusion for employer-provided health benefits is thought to exert a strong influence on the health insurance coverage for a substantial share of the nonelderly working population. Because of the subsidy, employers face a significant incentive to offer employee compensation in the form of health benefits rather than taxable wages salaries.

As with other employment benefits, however, the favored tax treatment of health benefits plans leads to different tax burdens for individuals with the same economic income. One justification for this outcome might be that it is in the public interest for employers to provide social benefits to workers if otherwise the workers would enroll in public programs or go without coverage. Providing social benefits through employment, however, puts burdens on employers, particularly those with a small number of workers, and may impede workers' willingness and ability to move among jobs.

The exclusion has some social benefits. Owing to the pooling of risk that employment-based group health insurance provides, the exclusion makes it possible for many employees to purchase health insurance plans that simply would not be available on the same terms or at the same cost in the individual market.

Such a preference, however, has at least one notable drawback: it may lead employees to select more health insurance coverage than they need. Most health economists think the unlimited exclusion for employer-provided health benefits has distorted the markets for both health insurance and health care. Generous health plans encourage subscribers to use health services that are not cost-effective, putting upward pressure on health care costs.

Proposals to limit the tax exclusion for employer-provided health benefits periodically receive serious consideration. Generally, these proposals aim to retain the main social benefit of the exclusion—expanded access to group health insurance—while curbing its main social cost—overly generous health insurance coverage. One way to achieve this goal would be to cap the exclusion at or somewhat below the average cost of group health insurance in major regions.

The ACA had included a 40 percent excise tax on health insurers whose plan values exceed certain thresholds for 2022 and after. The cost of the tax was deductible for coverage providers, who bear the statutory burden of the tax. In theory, coverage providers would have passed the economic cost of the

tax onto employees who could have ultimately reduced the value of the employer-provided health benefits consumed or accepted a greater share of their compensation in the form of wages. Not all analysts agreed with such an approach. Critics said that it would have been difficult to distinguish between reasonable and excessive health insurance coverage. They also contended that any limit on the exclusion would have had to consider the key factors determining health insurance premiums, including a firm's geographic location, size of its risk pool, and the risk profile of its employees. Ultimately, at the end of 2020, the 40 percent excise tax was repealed before it went into effect as part of the Further Consolidated Appropriation Act, 2020 (Division N of P.L. 116-44).

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Health

EXCLUSION OF MEDICAL CARE AND TRICARE MEDICAL INSURANCE FOR MILITARY DEPENDENTS, RETIREES, AND RETIREE DEPENDENTS NOT ENROLLED IN MEDICARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.3	—	3.3
2021	3.9	—	3.9
2022	4.3	—	4.3
2023	4.5	—	4.5
2024	4.6	—	4.6

Authorization

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

Description

Active-duty and reserve component military personnel are provided with a variety of benefits (or cash payments in lieu of such benefits) that are not subject to taxation. Among such benefits are medical and dental care. Dependents of active-duty personnel, retired military personnel and their dependents, and survivors of deceased members are also eligible for these health benefits—and thus can take advantage of the tax exclusion.

Military dependents and retirees may be allowed to receive some of their medical care in military facilities and from military doctors, provided there is enough capacity. These individuals also have the option of being treated by civilian health-care providers working under contract with the Department of Defense (DOD). DOD currently relies on a program known as TRICARE to coordinate the medical care supplied by military and civilian providers. TRICARE gives most beneficiaries two options for receiving medical care: TRICARE Prime, a DOD-managed health maintenance organization (HMO)

in which most care is delivered through military treatment facilities; and non-DOD delivered care available through participating providers (TRICARE Extra) or non-participating providers (TRICARE Standard) coverage options that may be used concurrently. TRICARE Extra, the preferred-provider organization type plan, provides a discount on copayments for beneficiaries who use participating network providers, and TRICARE Standard, the fee-for-service option, provides access to non-participating providers but at a higher copayment. TRICARE Extra and TRICARE Standard have no enrollment requirement or premiums but do have an annual deductible and relatively higher copayments than TRICARE Prime, which features an annual enrollment fee but no annual deductible and minimal copayments.

Impact

As with the exclusion for employer-provided health insurance, the value of the tax exclusion for health benefits for military personnel and their dependents, retirees, and other eligible individuals depend on a recipient's tax bracket. The higher the tax bracket, the greater the tax savings. For example, an individual in the 10-percent tax bracket (the lowest federal income tax bracket) avoids \$10 in tax liability for every \$100 of health benefits he or she may exclude; the tax savings rises to \$35 for someone in the 35-percent tax bracket.

Tax savings for beneficiaries may be partly offset by changes to requirements for beneficiary cost-sharing. Various legislative changes to the TRICARE program have changed the overall amount that different categories of beneficiaries are required to pay out-of-pocket under the program. Active duty service members do not pay anything out-of-pocket. Active duty service members' family members may pay annual deductibles and copayments if they elect to use the TRICARE Standard/Extra options rather than TRICARE Prime. Military retirees and their dependents who are not Medicare-eligible pay an annual enrollment fee if they enroll in TRICARE Prime.

Rationale

The tax exclusion for health care received by the dependents of active-duty military personnel, retirees and their dependents, and other eligible individuals has evolved over time. The main forces driving this evolution have been legal precedent, legislative action by Congress, a series of regulatory rulings by the Treasury Department, and long-standing administrative practices.

In 1925, the United States Court of Claims, in its ruling in *Jones v. United States*, 60 Ct. Cl. 552 (1925), drew a sharp distinction between the pay and the allowances received by military personnel. The court ruled that housing and housing allowances for these individuals constituted reimbursements similar to other tax-exempt benefits received by employees in the executive and legislative branches.

Under the Dependents Medical Care Act of 1956 (P.L. 84-569), the dependents of active-duty military personnel and retired military personnel and their dependents were allowed to receive medical care at military medical facilities on a “space-available” basis. Military personnel and their dependents gained access to civilian health care providers through the Military Medical Benefits Amendments Act of 1966 (P.L. 89-614), which created the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), the precursor of the TRICARE system.

The Tax Reform Act of 1986 (P.L. 99-514) consolidated various provisions related to military compensation into a new section 134 of the Internal Revenue Code. In taking this step, Congress wanted to make the tax treatment of military fringe benefits more transparent and consistent with the tax treatment of fringe benefits under the Deficit Reduction Act of 1984 (P.L. 98-369). Section 134 specifically excludes from gross income any “qualified military benefit” which is defined to include any allowance or in-kind benefit (other than personal use of a vehicle) that was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice (outside of the income tax code), among certain other benefits.

Assessment

Most military fringe benefits resemble those offered by private employers, such as allowances for housing, subsistence, moving and storage expenses, higher living costs abroad, uniforms, medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits. While few would dispute that medical readiness of active-duty personnel is critical to the military’s mission and thus related medical treatment should not be taxed, health benefits for dependents of active-duty personnel and retirees and their dependents have more in common with an employer-provided fringe benefit.

Most of the economic issues raised by the tax treatment of military health benefits are similar to those associated with the tax treatment of civilian and employer-provided health benefits. A central concern is that a tax exclusion for health benefits encourages individuals to purchase excessive health insurance coverage and to use inefficient amounts of health care.

Nonetheless, some of the issues raised by military health benefits have no counterpart in the civilian sector. Direct care provided in military facilities may at times be difficult to value for tax purposes. At the same time, such care may be the only feasible option for dependents living with service members who have been assigned to regions where adequate civilian medical facilities are lacking.

Proposals to make the tax treatment of health care received by dependents of active-duty personnel less generous may have important implications for rates of enlistment in the military. Some argue that limiting the tax exclusion for health care received by dependents would need to be coupled with an increase in military pay to prevent adverse impacts on the retention of active-duty military personnel with dependents and incomes high enough to incur tax.

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Health

**EXCLUSION OF HEALTH INSURANCE BENEFITS FOR
MILITARY RETIREES AND RETIREE DEPENDENTS
ENROLLED IN MEDICARE**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.1	—	1.1
2021	1.2	—	1.2
2022	1.3	—	1.3
2023	1.4	—	1.4
2024	1.5	—	1.5

Authorization

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

Description

Active-duty and reserve component military personnel are provided with a variety of benefits (or cash payments in lieu of such benefits) that are not subject to taxation. Among such benefits are medical and dental care. Dependents of active-duty personnel, retired military personnel and their dependents, and survivors of deceased members are also eligible for these health benefits—and thus can take advantage of the tax exclusion.

Military dependents and retirees may be allowed to receive some of their medical care in military facilities and from military doctors, provided there is enough capacity. These individuals also have the option of being treated by civilian health-care providers working under contract with the Department of Defense (DOD). DOD currently relies on a program known as TRICARE to coordinate the medical care supplied by military and civilian providers.

TRICARE for Life is available to TRICARE beneficiaries who are eligible for Medicare. The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001 (P.L. 106-398) included a provision that authorized

the TRICARE for Life program by amending the law to allow uniformed services retirees and their dependents who are eligible for Medicare Part A and participate in Medicare Part B to retain their TRICARE coverage as a secondary payer to Medicare. In most cases, an individual must have served at least 20 years in the military or be medically retired to qualify for the coverage. Under the plan, in most cases, TRICARE for Life pays the out-of-pocket costs that a beneficiary would have to pay if they only had Medicare coverage. There is no enrollment fee or premiums for TRICARE for Life. Coverage is automatic once an eligible individual is enrolled in Medicare Part B.

Most medical services are covered by both Medicare and TRICARE for Life and for these there are no out-of-pocket costs for the beneficiary. When a TRICARE for Life beneficiary sees a Medicare provider (participating or nonparticipating) for medically necessary care covered by Medicare and TRICARE, the beneficiary will have no out-of-pocket costs. As the first payer, Medicare determines if the care provided was medically necessary. Tricare for Life follows Medicare's determination. If Medicare determines that the care is medically necessary, Medicare pays its portion of the claim first. Then, TRICARE pays the remaining amount if the care is a TRICARE-covered service. If Medicare determines that the care is not medically necessary, neither Medicare nor TRICARE pays, and the beneficiary is responsible for the whole bill, but can appeal the decision. If Medicare reconsiders and decides to cover the service, TRICARE for Life also will reprocess the claim.

For care that is only covered by Medicare, like chiropractic care, Medicare processes the claim and pays its portion. TRICARE pays nothing, and the beneficiary is responsible for the Medicare deductible and cost-shares.

When a beneficiary gets care that only TRICARE covers, like TRICARE-covered services received overseas, TRICARE pays the TRICARE allowable charge and Medicare pays nothing. The beneficiary pays the TRICARE for Life deductible, cost-shares and any amount billed in excess of TRICARE-allowable charges.

Impact

As with the exclusion for employer-provided health insurance, the value of the tax exclusion for health benefits for military personnel and their dependents, retirees, and other eligible individuals depends on a recipient's tax bracket. The higher the tax bracket, the greater the tax savings. For example,

an individual in the 10-percent tax bracket (the lowest federal income tax bracket) avoids \$10 in tax liability for every \$100 of health benefits he or she may exclude; the tax savings rise to \$35 for someone in the 35-percent tax bracket.

Tax savings for beneficiaries may be partly offset by changes to requirements for beneficiary cost-sharing. TRICARE for Life beneficiaries pay copayments for name brand prescription drugs and for prescriptions filled at retail pharmacies. The shifting of costs from the TRICARE program to the beneficiary reduces the tax savings realized by the beneficiary.

Rationale

The tax exclusion for health care received by the dependents of active-duty military personnel, retirees and their dependents, and other eligible individuals has evolved over time. The main forces driving this evolution have been legal precedent, legislative action by Congress, a series of regulatory rulings by the Treasury Department, and long-standing administrative practices.

In 1925, the United States Court of Claims, in its ruling in *Jones v. United States*, 60 Ct. Cl. 552 (1925), drew a sharp distinction between the pay and the allowances received by military personnel. The court ruled that housing and housing allowances for these individuals constituted reimbursements similar to other tax-exempt benefits received by employees in the executive and legislative branches.

Under the Dependents Medical Care Act of 1956 (P.L. 84-569), the dependents of active-duty military personnel and retired military personnel and their dependents were allowed to receive medical care at military medical facilities on a “space-available” basis. Military personnel and their dependents gained access to civilian health care providers through the Military Medical Benefits Amendments Act of 1966 (P.L. 89-614), which created the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), the precursor of the TRICARE system.

The Tax Reform Act of 1986 (P.L. 99-514) consolidated various provisions related to military compensation into a new section 134 of the Internal Revenue Code. In taking this step, Congress wanted to make the tax treatment of military fringe benefits more transparent and consistent with the tax treatment of fringe benefits under the Deficit Reduction Act of 1984 (P.L. 98-369). Section 134 specifically excludes from gross income any “qualified

military benefit” which is defined to include any allowance or in-kind benefit (other than personal use of a vehicle) that was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice (outside of the income tax code), among certain other benefits.

Assessment

Most military fringe benefits resemble those offered by private employers, such as allowances for housing, subsistence, moving and storage expenses, higher living costs abroad, uniforms, medical and dental benefits, education assistance, group term life insurance, and disability and retirement benefits. While few would dispute that medical readiness of active-duty personnel is critical to the military’s mission and thus related medical treatment should not be taxed, health benefits for dependents of active-duty personnel and retirees and their dependents have more in common with an employer-provided fringe benefit.

Most of the economic issues raised by the tax treatment of military health benefits are similar to those associated with the tax treatment of civilian and employer-provided health benefits. A central concern is that a tax exclusion for health benefits encourages individuals to purchase excessive health insurance coverage and use inefficient amounts of health care.

Nonetheless, some of the issues raised by military health benefits have no counterpart in the civilian sector. Direct care provided in military facilities may at times be difficult to value for tax purposes. At the same time, such care may be the only feasible option for dependents living with service members who have been assigned to regions where adequate civilian medical facilities are lacking.

Proposals to make the tax treatment of health care received by dependents of active-duty personnel less generous may have important implications for rates of enlistment in the military. Some argue that limiting the tax exclusion for health care received by dependents would need to be coupled with an increase in military pay to prevent adverse impacts on the retention of active-duty military personnel with dependents and incomes high enough to incur tax.

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Health

CREDIT FOR ORPHAN DRUG RESEARCH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	1.3	1.3
2021	(¹)	1.5	1.5
2022	(¹)	1.7	1.7
2023	(¹)	2.0	2.0
2024	(¹)	2.4	2.4

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 41(b), 45C, and 280C.

Description

Since 1983, U.S. businesses investing in the development of drugs to diagnose, treat, or prevent rare diseases and conditions—drugs known as orphan drugs—have been able to claim a non-refundable tax credit (IRC section 45C) for qualified clinical testing expenses (CTEs) they incur or pay. Between 1984 and 2017, the credit rate was 50 percent; P.L. 115-97 (commonly referred to as the Tax Cuts and Jobs Act) reduced it to 25 percent beginning in 2018 and thereafter. To qualify for the credit, clinical testing expenses must be incurred or paid after the U.S. Food and Drug Administration’s (FDA) Office of Orphan Products Development (OOPD) grants orphan status to a drug but before the FDA approves it for use in the United States.

Section 526 of the Federal Food, Drug, and Cosmetic Act defines a rare disease or condition as one that afflicts fewer than 200,000 persons in the United States, or one that afflicts more than 200,000 people in the United States but for which there is no “reasonable expectation” of recovering the cost of developing the drug from U.S. sales alone.

The section 45C credit applies to qualified clinical testing performed in the United States, but generally does not apply to testing done outside the United States, except in cases where the company developing an orphan drug cannot obtain reliable and reproducible clinical testing data from trials conducted in the United States and the testing is done by an unrelated entity.

CTEs are the sum of the in-house and contract research expenses a company pays or incurs to determine if a new investigative drug is safe and effective in treating targeted diseases and conditions. Not all clinical trial expenses for orphan drugs qualify for the credit. While supplies used in the trials and the salaries of employees or third-parties conducting the trials do qualify, depreciable property related to the trials (such as buildings and equipment) does not.

To prevent a company from receiving a double tax benefit from the same expenditures, IRC section 280C restricts the credits and deductions a company claiming the orphan drug tax credit (ODTC) may take in the same year. Expenses used to claim the ODTC are also eligible for the IRC section 41 research tax credit. Under Section 280C, those expenses may be used to claim one credit or the other, but not both.

In addition, CTEs also qualify for the 5-year amortization of qualified research expenditures under section 174. A company claiming the ODTC is required to reduce its allowable section 174 deduction by the amount of the credit. This is known as a basis adjustment. For tax years beginning after December 31, 2017, a company has the option of claiming a reduced ODTC instead of reducing its section 174 deduction. In this case, the credit is equal to a firm's full credit minus the credit multiplied by a company's marginal income tax rate. For instance, if a corporation is able to claim a section 45C credit of \$500 in the current tax year, its reduced credit would be \$395 (i.e., $\$500 - (\$500 \times 0.21)$). In this case, the company does not have to reduce its section 174 deduction for clinical trial expenses.

A drug does not qualify for the section 45C credit if the FDA has already approved another drug to treat the same disease or condition and its producer has already claimed the credit.

The ODTC has been a component of the section 38 general business credit (GBC) since 1997, subjecting it to the GBC's limitations. For most of the 32 credits (including the orphan drug tax credit) that make up the GBC,

any unused credit for the current tax year can be carried back one year or forward up to 20 years to reduce tax liability.

Impact

The ODTC incentivizes investment in the development of drugs that drug companies might otherwise eschew because of their relatively small markets and limited profit potential. This incentive has two components. The credit lowers the cost of capital for investments in orphan drug development, relative to other investments a drug company might make. It also increases the short-term cash flow of companies investing in orphan drug development if they have sufficient tax liability.

The orphan drug credit is similar to the research tax credit, except that the former provides a larger benefit at the margin. For example, a corporation conducting clinical trials for a new non-orphan drug would be able to claim a section 41 research tax credit for these expenses of 15.8 percent or 11.1 percent for the regular research credit and the alternative simplified credit, respectively. In contrast, if the firm were to invest the same amount in clinical trials for a new orphan-designated drug, it could claim a section 45C credit of 19.75 percent of qualified expenses. These percentages take into account the basis adjustment for the credits only.

Since the credit is non-refundable, its benefit is greatest for companies with an income tax liability in the same year. The typical small start-up company investing in orphan drug development may be unable to benefit from the credit until a few years later, a delay that lowers the credit's present value.

To the extent that the section 45C credit has expanded and accelerated the development of orphan drugs (more on this later), it has extended and improved the lives of many people suffering from certain rare diseases and conditions. According to the OOPD, only 10 such medicines were approved during the decade before the enactment of the Orphan Drug Act, but 88 orphan drugs were approved during the following decade. Between 1983 and 2021, the FDA approved 721 such drugs for marketing in the United States. According to the National Institutes of Health, 25 to 30 million Americans may suffer from one of the 7,000 or so known rare diseases or conditions.

Rationale

The ODTC was established by the Orphan Drug Act of 1983 (ODA, P.L. 97-414). It was one of four incentives for orphan drug development included

in the act. The others were (1) federal grants for research expenses, (2) a seven-year period of marketing exclusivity for orphan drugs approved by the FDA, and (3) a waiver of FDA application fees for investigative orphan drugs.

Under the act, the sole test for determining whether a drug should have orphan status was the absence of a reasonable expectation of recovering its development cost from U.S. sales alone. The test hindered new private investment in orphan drug development, as it required drug companies to prove that a drug in development would end up being unprofitable. To remove this obstacle, Congress established a new eligibility test for orphan drug status in the Health Promotion and Disease Prevention Amendments of 1984 (P.L. 98-551). Under the new test, a drug qualified for orphan status if it passed one of two tests: (1) the estimated domestic market did not exceed 200,000 persons, or (2) the estimated domestic market exceeded 200,000 persons but there was no realistic prospect of earning a profit from U.S. sales alone in the long run.

The initial orphan drug credit was scheduled to expire at the end of 1987, but it was extended four times by the following laws: the Tax Reform Act of 1986 (P.L. 99-514), the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), the Tax Extension Act of 1991 (P.L. 102-227), and the Omnibus Reconciliation Act of 1993 (P.L. 103-66).

The credit expired at the end of 1994 but was reinstated from July 1, 1996, through May 31, 1997, by the Small Business Job Protection Act of 1996 (P.L. 104-88). The act also allowed taxpayers with unused orphan drug credits earned in that period to carry them back up to three tax years or forward up to 15 tax years. Congress has not retroactively extended the credit from January 1, 1995, to June 30, 1996.

The Taxpayer Relief Act of 1997 permanently extended the credit and made it a component of the section 38 general business credit.

In addition, sellers of orphan drugs for which the section 45C credit has been taken are exempt from the annual fee imposed on manufacturers and importers that receive more than \$5 million in gross receipts from the sale of eligible branded prescription drugs to specified federal government health programs. The fee was established by the Patient Protection and Affordable Care Act (ACA, P.L. 111-148). Under final regulations (26 C.F.R. Parts 51 and 602) issued by the Internal Revenue Service (IRS) on July 28, 2014, no fee may be imposed on any drug for which a credit “was allowed for any

taxable year under section 45C,” as specified in section 9008(e)(3) of the ACA.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) lowered the rate for the credit from 50 percent to 25 percent and gave companies the option of claiming a reduced credit in lieu of reducing otherwise allowable section 174 deductions by the amount of the credit. These changes took effect in 2018.

Assessment

Assessing the effects of the section 45C credit is complicated. It is one of several incentives enacted as a package in 1983 to stimulate increased private investment in orphan drug development. Since then, these incentives have operated in tandem to promote the objectives of the ODA. The increase in orphan drug approvals since 1983 reflects the combined influence of the entire package of incentives, not just the tax credit.

Nonetheless, supporters of the section 45C credit and the other ODA incentives say there is ample evidence that they have been highly effective in increasing the domestic availability of medicines to treat, diagnose, or prevent rare diseases and conditions. According to a 2015 study by Ernst & Young for the Biotechnology Industry Organization and the National Organization for Rare Disorders, 277 fewer new orphan drugs would have been developed from 1983 to 2014 without the section 45C credit. The study also estimated that repeal of the credit would result in 276 fewer orphan drugs entering the development pipeline from 2015 to 2024. These declines were attributed to the higher cost of capital and reduced short-term cash flow for orphan drug development without the credit.

While most agree that the ODA incentives have elevated domestic investment in orphan drug development, some question the desirability of those results.

Critics note that even with the passage of the ODA, only 10 percent of registered rare diseases in the United States have been treated with some kind of drug.

They also point out that some pharmaceutical and biotechnology firms have leveraged the ODA’s incentives to develop and market drugs that have earned billions of dollars in sales revenue worldwide after their approval by

the FDA as orphan drugs. In their view, these companies probably would have developed many of these drugs without the ODA incentives.

In addition, critics contend that numerous large pharmaceutical drug companies have taken advantage of the rules governing federal subsidies for orphan drug development to claim the subsidies for FDA-approved, repurposed, mass-market drugs for common conditions that they developed and for drugs approved to treat more than one rare disease. According to one estimate, about one-third of orphan drug approvals from 1983 to 2016 fell into these two categories altogether.

The billions in sales revenue earned by orphan drugs developed since 1983 is due in part to the high prices companies charge for the drugs. In some cases, the annual cost of treatment totals six digits, and annual price increases have reached as much as 1,000 percent. Critics say that current orphan drug pricing practices are having the perverse effect of denying timely access to life-sustaining and life-enhancing medicines to many persons because they cannot afford them.

Another issue raised by critics concerns the desirability of using federal subsidies to alter the allocation of investment within the drug industry. Some argue that it makes no sense during a period of large federal budget deficits for federal policy to encourage the diversion of private capital from the development of drugs to treat diseases and conditions that affect a broad range of people to the development of orphan drugs. This issue has become more urgent in recent years as larger pharmaceutical firms have begun to shift more of their research budgets to the development of personalized therapies (mainly drugs targeting specific cancers) that may qualify as an orphan drug.

The economics of new drug development has changed in recent years in ways that have made investment in orphan drug development more profitable than investment in non-orphan drug development, on average. On the whole, orphan drugs have lower development costs and a greater likelihood of commanding high prices than most other medicines. One consequence of this pervasive shift in the research priorities has been less interest in developing new drugs with a broader demographic reach. This includes drugs to treat bacterial infections, cardiovascular disease, HIV/AIDS, depression, and Alzheimer's disease.

To address these concerns about orphan drugs, some recommend modifying the ODA incentives to encourage greater competition in the

development of specific orphan drugs and to limit the profits from orphan drug development. One option would be to reduce the economic barriers to early-phase orphan drug development by making the credit refundable for new start-up companies with net operating losses. Another option would be to limit the revenue a company can earn from worldwide sale of an FDA-approved orphan drug. Limiting an orphan drug's worldwide profits could be accomplished by taxing profits above a certain limit or shortening the period for marketing exclusivity when worldwide revenue from the sale of an orphan drug exceeds a certain percentage of development cost.

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Health

**TAX CREDIT FOR SMALL BUSINESSES PURCHASING
EMPLOYER INSURANCE**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

Note: Estimates include outlay effects associated with the refundability of tax credits for small businesses purchasing employer insurance. These outlay effects are less than \$50 million for each year 2020-2024.

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 45R.

Description

Small businesses with fewer than 25 full-time equivalent employees and average wages less than \$56,000 per employee in 2021 may be eligible for a credit of 50 percent of the employer's qualifying payments for their employees' health insurance for two years. (The average wage threshold is adjusted annually for inflation.) Qualified payments are generally payments for plans adopted through the Small Business Health Options Program (SHOP) Marketplace. Special rules apply to tax-exempt organizations.

Employers must pay 50 percent of the health plan cost to be eligible. The credit is against income tax, so small employers without any income tax liability will receive no current benefit and those with insufficient tax liability may not receive the full current benefit. Credits can be carried backward one year (except in the first year offered) and forward 20 years.

The credit is phased out both by size and average income in an additive fashion. The credit is reduced by the number of employees minus 10, divided by 15; the credit is also reduced by average wages over \$27,000 divided by \$27,000 (adjusted annually for inflation; these amounts are for 2021). A business with 10 or fewer employees and \$27,000 or less in average wages will receive a credit of 50 percent. If the wages remain at \$27,000 or less but employee size rises to 15, the credit is reduced by 33.3 percent (15 minus 10, all divided by 15, or 1/3); i.e., from a 50 percent credit to 33.3 percent credit. If average wages are \$30,000 but size is 10 or less, the credit is reduced by 11.1 percent (\$30,000 minus \$27,000, all divided by \$27,000, or 0.111); i.e., from a 50 percent credit to 44.45 percent credit. If both situations occur then the two phaseouts are added; i.e., for a firm with 15 employees and \$30,000 in average wages both the 33.3 percent and the 11.1 percent apply for a total reduction of 44.4 percent. This phaseout would reduce the 50 percent credit to a 27.8 percent credit.

For tax-exempt organizations, the maximum credit rate is reduced from 50 percent to 35 percent. In addition, for these organizations the credit will be in the form of a reduction in income and Medicare tax the employer is required to withhold from employees' wages and the employer share of Medicare tax on employees' wages (with the credit thus limited by these amounts). Other aspects of the credit are similar to those previously described.

Impact

This provision reduces the cost to some small employers of providing health insurance coverage for their employees. Smaller businesses also tend to have a lower rate of offering employee health benefits. According to the Kaiser Family Foundation's 2021 Employer Health Benefits Survey, 49 percent of firms employing three to nine workers offered health benefits, and 65 percent of firms employing 10 to 24 workers offered health benefits. By comparison, 74 percent of firms employing 25 to 49 workers offered health benefits, 93 percent of firms employing 50 to 199 workers, and 99% of firms employing 200 or more workers offered health benefits.

Rationale

This provision was enacted as part of the Patient Protection and Affordable Care Act (P.L. 111-148), as amended by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), to offset the cost to small businesses of providing health insurance coverage for their employees.

Assessment

The Internal Revenue Service indicated 228,000 taxpayers claimed \$278 million in credits in 2010, according to the Department of the Treasury’s Inspector General. A 2012 report by the Government Accountability Office (GAO) indicated an even smaller number of beneficiaries for the 2010 tax year: 170,300 beneficiaries claiming a total of \$468 million in credits. GAO suggested that the credit was not as popular as expected because it was not generous enough to induce firms to offer insurance. Most small businesses that would otherwise be eligible for the credit did not offer health insurance (either because it was too costly for the business or the employees). Additionally, many small businesses said that claiming the credit was too complex.

This credit is not available to all businesses. In addition to those disqualified by the size and average wage limitations, firms with insufficient or no tax liability receive limited or no current benefit from the provision. (They may receive a benefit by either carrying the credit forward or backward.) This may reduce the effectiveness of the credit in increasing the provision of employer-sponsored health insurance by small firms.

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Health

SUBSIDIES FOR INSURANCE PURCHASED THROUGH HEALTH BENEFIT EXCHANGES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	52.5	—	52.5
2021	55.1	—	55.1
2022	52.6	—	52.6
2023	52.4	—	52.4
2024	53.9	—	53.9

Note: Estimates include outlay effects associated with the refundability of subsidies for insurance purchased through health benefit exchanges for certain tax filers. These outlay effects are \$43.1 billion (2020), \$45.2 billion (2021), \$43.2 billion (2022), \$43.0 billion (2023), and \$44.2 billion (2024).

This provision was temporarily expanded by P.L. 117-2 (American Rescue Plan Act of 2021) and P.L. 117-169 (the budget reconciliation measure commonly referred to as the Inflation Reduction Act of 2022). Changes to the credit from P.L. 117-169 are estimated to increase direct spending by approximately \$33.3 billion between FY2022-2026 and reduce revenues by approximately \$31.3 billion for the same time period, according to CBO.

Authorization

Section 36B.

Description

The Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended) established health insurance exchanges; marketplaces in which individuals, families and small businesses may shop for and purchase private health insurance. Exchanges offer comprehensive health plans which differ in the percentage of total costs paid by the plan, on average; such percentage is identified according to a metal designation: platinum, gold, silver or bronze. The ACA also authorized a refundable, advanceable tax credit for individuals and families who meet income and other eligibility criteria. The premium tax credit (PTC) limits consumers' required spending on premiums (i.e., required

premium contribution) for health insurance purchased through exchanges only. Calculation of the credit amount is based in part on the premium for the second lowest-cost silver plan in an individual's local area.

For 2021 through the end of 2025, households with annual incomes at or above 100% of the federal poverty line (FPL) (except in states where Medicaid eligibility exceeds that income level) meet the PTC's income eligibility criteria. After 2025, income eligibility will be capped at 400% of FPL. Eligibility for a given year is based on the previous year's federal poverty guidelines and the household's income during the current year. For example, the tax credit for 2022 is based on 2021 poverty guidelines and annual household income for 2022.

In addition to the income eligibility criteria, the individual cannot be eligible for other health coverage, including Medicare, Medicaid (with exceptions), the State Children's Health Insurance Program (CHIP), military coverage, a grandfathered plan, or any other coverage recognized by the Secretary of Health and Human Services, in coordination with the Treasury Secretary. Also, individuals who are offered coverage by employers are not eligible for the credit unless the employer coverage is unaffordable (employee-only premium exceeds 9.61 percent of income in 2022) or the plan's average share of medical expenses is less than 60 percent, and the employee declines the coverage.

For PTC-eligible households, the required premium contribution varies by income, with lower-income households required to contribute a smaller percentage of annual income to cover premiums as compared to higher-income households. For 2021 through the end of 2025, households with incomes between 100% and 150% of FPL are required to contribute 0% of income towards premiums; in other words, such households receive full premium subsidies. The percentage of income (used to calculate the required premium contribution) rises incrementally as income increases up to 400% of FPL. Households with incomes at or above 400% of FPL are required to contribute 8.5% of income towards the premium. After 2025, calculation of the required premium contribution will revert back to ACA-established rules. The ACA requires the formula for calculating required contributions to be annually adjusted by accounting for any excess in the premium growth rate over the income growth rate for the preceding year.

Eligible individuals can choose to either: (1) have the credit paid in advance to their insurance company to lower the cost of monthly premiums,

or (2) claim all of the credit when they file a tax return for the year. If the individual chooses to have the credit paid in advance, they are to reconcile the amount paid in advance with the actual credit computed on their tax return. For purposes of the credit, income is adjusted gross income plus excluded income earned abroad, tax-exempt interest income, and the nontaxable portion of Social Security benefits.

The credit can be applied to any metal plan offered through the exchange in the state in which an eligible individual resides, but is calculated as the difference between the premium for the second lowest-cost silver plan in an individual's local area and the amount of their required premium spending limited by income level. Therefore, the credit amount varies from individual to individual. Advanced payment of the credit is payable directly to the insurer. It is not taxable to individuals and families.

Impact

According to the Centers for Medicare & Medicaid Services (CMS), approximately 13.8 million people were enrolled in exchanges during February 2022. This includes individuals enrolled in both state- and federally-administered exchanges. Of these 13.8 million enrollees, 12.5 million enrollees (approximately 90 percent of enrollees) received advanced payments of premium tax credits which lowered monthly spending on premiums. Because eligible individuals may wait to claim the credit during the tax filing season, the final count of individuals who receive the credit for 2022 will differ from the CMS count. These subsidies are greatest for households with income at the lower end of the income eligibility threshold. Given that the required premium contribution increases as income grows, a higher-income household may be required to contribute a dollar amount that exceeds the actual premium for the marketplace plan it intends to enroll in. For such a household, the individual or family would pay the entire premium amount, despite meeting the PTC eligibility criteria.

Rationale

This provision was enacted as part of the Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended). One of the primary objectives of the legislation was to expand access to private and public sources of health coverage. The premium credit is provided to relieve the financial burden of health insurance premiums, with greater assistance provided to lower-income households.

For 2021 and 2022, the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2) expands eligibility and the amount of the PTC. To expand income eligibility, the ARPA eliminates the phaseout for households with annual incomes above 400% of FPL. To increase the credit amount, ARPA reduces the percentage of income used to calculate the required premium contribution. The temporary percentages range from 0.0% to 8.5% of annual household income, effectively reducing the amount eligible individuals would pay to enroll in certain exchange plans compared to what they would have paid pre-ARPA. This ARPA provision is most significant for those with incomes at or below 150% of FPL; such individuals receive full subsidies to cover benchmark plan premiums.

For 2021 through the end of 2025, the enacted budget reconciliation measure (P.L. 117-169; commonly referred to as the Inflation Reduction Act of 2022) extends the ARPA's PTC provisions. After 2025, the rules applicable to income eligibility and calculation of the required premium contribution revert back to ACA-established rules.

Assessment

The ACA tax credit not only provides relief from the financial burden of health insurance, but also creates incentives for eligible households to purchase health insurance.

As with certain other tax expenditures (such as the earned income credit or tuition tax credits), the tax system is used as a delivery mechanism to achieve goals of programs (such as education, health and income transfers) that could be provided through other mechanisms. While using the tax system increases the complexity of tax administration, the tax system has some administrative advantages. As compared to an alternative delivery system (where, for example, monthly income is used), tax administration allows subsidies to be based on annual family income. The credit also avoids some of the drawbacks of certain tax benefits, as many qualifying households elect to take the benefits in the form of advance payments rather than wait to claim the credit when they file their taxes.

On October 13, 2017, the Trump Administration decided to halt the ACA's cost-sharing reduction (CSR) payments to insurers participating in the exchanges. CSRs reduce out-of-pocket costs (e.g., co-payments and deductibles) of certain lower-income exchange enrollees who have been determined to be eligible for the credit. CSR payments reimburse insurers for

reducing such costs. As a consequence of the Administration's action, many insurers increased their premiums on select exchange plans, specifically silver plans, in order to account for the lost reimbursement ("silver loading"). Given that credit amounts are benchmarked to the second lowest cost silver plan in the enrollee's local area, the Congressional Budget Office projected larger federal outlays for the credit as a result of silver loading.

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Income Security

EXCLUSION OF DISASTER MITIGATION PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 139.

Description

Payments made for disaster mitigation (that is, payments made to mitigate damages from future disasters) under the Robert T. Stafford Disaster Relief and Emergency Insurance Act or the National Flood Insurance Act are excluded from income for tax purposes. Gain from the sale of property is not eligible, but sale under a disaster mitigation program is treated as an involuntary conversion, with deferral of gain pending replacement. The basis of any property is not increased as a result of improvements due to disaster mitigation payments.

Impact

Disaster mitigation grants cover a variety of mitigation expenditures such as securing items (e.g., wall-mounting appliances) to reduce potential damage from earthquakes, putting houses on stilts to reduce flood damage, tie-downs for mobile homes to protect against hurricanes and other windstorms, creating safe rooms, and securing roofs and windows from wind damage. The tax exclusion from mitigation payments increases the value of these payments. The tax exclusion is most beneficial for higher-income individuals who have higher marginal tax rates. Even individuals with relatively low incomes could

be subject to tax, however, since the mitigation payments can be large when used for major construction projects (such as putting houses in flood plains on stilts). These individuals might not have enough income to pay taxes on these grants and taxation might cause them not to participate in the program.

To the extent the payments increase the value of the property, they could be taxed as capital gains in the future, although most individuals do not pay capital gains tax on owner-occupied housing, and the capital gains tax rate is reduced for individuals.

Rationale

This provision was added by P.L. 109-7, To amend the Internal Revenue Code of 1986, to provide for the proper tax treatment of certain disaster mitigation payments. The mitigation program had been in effect for about 15 years, but did not specify that these amounts would be taxable. In general, recipients had not paid tax on these grants. In June 2004, the IRS ruled that these payments, without a specific exemption in the law, were taxable income, and indicated the possibility of retroactive treatment of their ruling. The tax legislation was in response to that ruling and reflected the general view that individuals and businesses should not be discouraged from mitigation activities due to tax treatment on these payments.

Assessment

The Multihazard Mitigation Council has reported that the return on disaster mitigation expenditures is estimated at \$6 of benefit for each dollar spent, and since the programs are grants controlled by the federal government, these expenditures should continue to be cost effective. Some of these expenditures might have been undertaken in any case, without the grant, or with the grant but without tax exemption.

An argument can be made that individuals should be responsible for undertaking their own measures to reduce disaster costs since those expenditures would benefit them. At the same time, the government is heavily involved in disaster relief, and by providing programs such as subsidized flood insurance and direct disaster aid, may make the returns to individual investors smaller than they are to society as a whole. Disaster mitigation expenditures for individuals and businesses can also have benefits that spill over to the community at large, and an individual would not take these benefits into account when making an investment decision.

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Income Security

**EXCLUSION OF WORKERS' COMPENSATION BENEFITS
(DISABILITY AND SURVIVORS PAYMENTS)**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	2.1	—	2.1
2021	2.1	—	2.1
2022	3.0	—	3.0
2023	3.3	—	3.3
2024	3.3	—	3.3

Authorization

Section 104(a)(1).

Description

Workers' compensation benefits to employees in cases of work-related injury, and to survivors in cases of work-related death, are not taxable. Employers finance benefits through insurance or self-insurance arrangements (with no employee contribution), and their costs are deductible as a business expense.

Benefits are provided as directed by various state and federal laws and consist of cash earnings-replacement payments, payment of injury-related medical costs, special payments for physical impairment (regardless of lost earnings), and coverage of certain injury or death-related expenses (e.g., burial costs). Employees and survivors receive compensation if the injury or death is work-related. Benefits are paid regardless of the party at fault (employer, employee or third party), and workers' compensation is treated as the exclusive remedy for work-related injury or death.

Cash earnings replacement payments typically are set at two-thirds of lost pre-tax earning capacity, up to legislated maximum amounts. Payments are

provided for both total and partial disability, generally last for the term of the disability, may extend beyond normal retirement age, and are paid as periodic (e.g., monthly) payments or lump-sum settlements.

Employees are not taxed on the value of insurance contributions for workers' compensation medical benefits made on their behalf by employers, or on the medical benefits or reimbursements they actually receive.

Impact

Generally, any amounts received for personal injury or sickness through an employer-paid accident or health plan must be reported as income for tax purposes. This includes disability payments and disability pensions, as well as sick leave payments. In contrast, an exception is made for the cash payments paid under state workers' compensation programs, which are excluded from income taxation.

The cost to employers for workers' compensation in 2019 was \$100.2 billion, equivalent to 1.17 percent of covered payrolls. Figures are not available that distinguish the portion of employer contributions specifically for workers' compensation disability and survivors benefits from the portion for medical benefits. Workers' compensation benefits in 2019 totaled \$63.0 billion, approximately 50.4 percent of which consisted of cash payments to injured employees and survivors replacing lost earnings, and 49.6 percent of which was paid for medical and rehabilitative services.

The Census Bureau's 2021 Annual Social and Economic Supplement to the Current Population Survey provides the following profile of those who reported receiving workers' compensation in 2020.

Workers' compensation cash benefits were less than \$5,000 annually for 43 percent of recipients, between \$5,000 and \$10,000 for 19 percent, between \$10,000 and \$15,000 for 8 percent, and more than \$15,000 for 30 percent.

Recipients' total annual income (including workers' compensation) was below \$15,000 for 10 percent, between \$15,000 and \$30,000 for 20 percent, between \$30,000 and \$45,000 for 23 percent, and above \$45,000 for 47 percent. Ten percent of recipients reported annual incomes above \$100,000.

Total family income (including workers' compensation) for the families with at least one workers' compensation recipient was below \$15,000 for 6 percent of families with workers' compensation recipients, between \$15,000

and \$30,000 for 11 percent, between \$30,000 and \$45,000 for 12 percent, and above \$45,000 for 71 percent. Thirty-four percent of recipient-families reported annual incomes above \$100,000. Seven percent had family incomes below the federal poverty level, based on their family size and number of minor children.

Rationale

The exclusion of worker's compensation from federal taxation was first codified in the Revenue Act of 1918 (P.L. 65-254). The committee reports accompanying the Act suggest that workers' compensation payments were not subject to taxation before the 1918 Act. No rationale for the exclusion is found in the legislative history. However, it has been maintained that workers' compensation should not be taxed because it is in lieu of court-awarded damages for work-related injury or death that, before enactment of workers' compensation laws (beginning shortly before the 1918 Act), would have been payable under tort law for personal injury or sickness and not taxed.

Assessment

Exclusion of workers' compensation benefits from taxation increases the value of these benefits to injured employees and survivors, without direct cost to employers, through a tax subsidy. Taxation of workers' compensation would put it close to being on par with the earned income it replaces since benefits generally replace approximately two-thirds of lost income. It also would place the "true" cost of workers' compensation on employers if compensation benefits were increased in response to taxation. It is possible that "marginal" claims would be reduced if workers knew their benefits would be taxed like their regular earnings.

Not taxing employer contributions to workers' compensation benefits subsidizes these benefits relative to taxable wages and other taxable benefits, for both the employee and employer. The exclusion allows employers to provide their employees with workers' compensation coverage at a lower cost than if they had to pay the employees additional wages sufficient to cover a tax liability on these benefits. In addition to the income tax benefits, workers' compensation benefits are excluded from payroll taxation.

Furthermore, exclusion of workers' compensation payments from taxation is a relatively regressive subsidy because it replaces more income for (and is worth more to) those with higher earnings and other taxable income than for poorer households. States, and the federal government (for the federal

programs), have tried to correct for this with legislated maximum benefits and by calculating payments based on replacement of after-tax income. However, the maximums provide only a rough adjustment and few jurisdictions have moved to after-tax income replacement.

On the other hand, a case can be made for tax subsidies for workers' compensation because the federal and state governments have required provision of this "no-fault" benefit. Moreover, because most workers' compensation benefit levels, especially the legal maximums and the standard benefit of two-thirds of a workers' pre-injury wage, have been established knowing there would be no taxes levied, it is likely that taxation of compensation could lead to pressure to increase payments.

If workers' compensation were subjected to taxation, those who could continue to work or return to work (such as those with partial or short-term disabilities) or who have other sources of taxable income (such as a working spouse or investment earnings) are likely to be the most affected since their combined incomes would likely be above the taxable threshold level. These groups represent the majority of beneficiaries. Those who receive only workers' compensation payments (such as permanently and totally disabled beneficiaries) would be less affected, because their incomes are likely to be below the taxable threshold level.

Some administrative issues would arise in implementing a tax on workers' compensation. Although most workers' compensation awards are made as periodic cash income replacement payments, with separate payments for medical and other expenses, a noticeable proportion of the awards are in the form of lump-sum settlements. In some cases, the portion of the settlement attributable to income replacement can be distinguished from that for medical and other costs, in others it cannot. A procedure for pro-rating lump-sum settlements over time would be called for. If taxation of compensation were targeted on income replacement and not medical payments, some method of identifying lump-sum settlements (e.g., a new kind of "1099") would have to be devised. In addition, a reporting system would have to be established for insurers (who pay most benefits), state workers' compensation insurance funds, and self-insured employers, and a way of withholding taxes might be needed.

Equity questions also would arise in taxing compensation. Some of the workforce is not covered by traditional workers' compensation laws. For example, interstate railroad employees and seafaring workers have a special

court remedy that allows them to sue their employer for negligence damages, similar to the system for work-related injury and death benefits that workers' compensation laws replaced for most workers. Their jury-awarded compensation is not taxed. Some workers' compensation awards are made for physical impairment, without regard to lost earnings. Under current tax law, employer-provided accident and sickness benefits generally are taxable, but payments for loss of bodily functions are excluded. Thus, equity considerations might result in continuing to exclude those workers' compensation payments that are made for loss of bodily functions as opposed to lost earnings.

The tax subsidy reduces the employer's cost of compensating employees for accidents on the job and can be viewed as blunting financial incentives to maintain safe workplaces. Employers can reduce their workers' compensation costs if the extent of accidents is reduced. If the insurance premiums were taxable to employees, a reduction in employer premiums would also lower employees' income tax liabilities. Employees might then be willing to accept lower before-tax wages, thereby providing additional savings to the employer from a safer workplace.

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Income Security

EXCLUSION OF DAMAGES ON ACCOUNT OF PERSONAL PHYSICAL INJURIES OR PHYSICAL SICKNESS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.8	—	1.8
2021	1.8	—	1.8
2022	1.8	—	1.8
2023	1.9	—	1.9
2024	1.9	—	1.9

Authorization

Sections 104(a)(2).

Description

Damages paid, through either a court award or a settlement, to compensate for physical injury and sickness are not included in income of the recipient. This exclusion applies to both lump-sum payments and periodic payments. It does not apply to punitive damages—except in limited cases where states only permit punitive damage awards for wrongful death claims. Because the injury or sickness must be physical, the exclusion does not apply to compensatory damages for discrimination or emotional distress (unless attributable to a physical injury or sickness).

Impact

Income received in the form of compensatory damages due to physical injury or sickness is not taxable to individuals. There is no tax on the interest earnings that may be included in annuities or periodic payments. To the extent that damage payments substitute for medical payments that individuals would have received from their own insurance, the tax treatment is consistent with the non-taxation of medical payments. To the extent that the payments compensate for forgone wages, however, the payments are beneficially treated compared with regular wages, which would be taxed. The recipient of the

settlement or award benefits because the damage award net-of-tax is larger. The exclusion may also benefit the defendant—and his or her insurance company—because the payment to the injured party would likely need to be larger if it were subject to tax.

Rationale

A provision allowing an exclusion for payments for damages has been part of the tax law since 1918. It is based on the reasoning that these payments are compensating for a loss. The statute was amended by the Periodic Payment Settlement Act of 1982 (P.L. 97-473) to allow full exclusion of periodic payments as well as lump-sum payments. Normally, periodic payments would be partially taxable—on the interest component. An argument for the full exclusion of periodic payments was to avoid circumstances where individuals used up their lump-sum payments and might then require public assistance.

The provision was amended in 1996 by the Small Business Job Protection Act (P.L. 104-188) to specify that the injury or sickness must be physical, thus meaning that damages arising from claims for discrimination or emotional distress were not to be excluded from income. The act also amended the law to make it clear that punitive damages (except for those cases where state law requires damages in wrongful death suits to be paid as punitive damages) were not to be excluded from income. These changes were intended to settle and clarify the law, following considerable variation in the interpretation by the courts.

The Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134) expanded the existing exclusion from gross income for disability income of U.S. civilian employees attributable to a terrorist attack outside the United States. Effective for taxable years ending on or after September 11, 2001, the exclusion applies to disability income received by any individual attributable to a terrorist or military action.

Interpretation of the provisions of these sections of the Internal Revenue Code is frequently affected by case law.

Assessment

The exclusion benefits individuals who receive cash compensatory damages for physical injuries and illness. It parallels the treatment of workers' compensation which covers on-the-job injuries. It especially benefits higher-

income individuals whose payments would typically be larger, reflecting larger lifetime earnings, and subject to higher tax rates.

By restricting tax benefits to compensatory rather than punitive damages, the provision may encourage plaintiffs to settle out of court so that the damages can be characterized by the parties as compensatory. (That outcome may be preferred by defendants as well.) There is also an incentive to characterize damages as received on account of a *physical* injury—for example, to demonstrate that emotional distress was attributable to physical injury—so that damages are excluded.

In recent years, scientific and public awareness has grown concerning the serious nature of psychiatric and emotional reactions that individuals can experience in response to harassment or situational trauma. Perhaps the best-known current example is Post-Traumatic Stress Disorder (PTSD). Some courts have opined that damage awards for emotional distress should also be excluded from taxation under section 104(a)(2).

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Income Security

**EXCLUSION OF SPECIAL BENEFITS FOR
DISABLED COAL MINERS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

30 U.S.C. §922(c), Section 104(a)(1), Revenue Ruling 72-400, 1972-2 C.B. 75.

Description

Cash and medical benefits to coal mine workers or their survivors for total disability or death resulting from coal workers' pneumoconiosis (black lung disease) paid under the Black Lung Benefits Act generally are not taxable. Comparable benefits paid under state workers' compensation laws also are not taxed.

Black lung eligibility claims must meet the following general condition: the worker must be totally disabled from, or have died of, pneumoconiosis arising out of coal mine employment. However, the statute's broad definition of total disability makes it possible for a beneficiary to be working outside the coal industry, although earnings tests apply in some cases.

Black lung benefits consist of monthly cash payments and payment of black-lung-related medical costs. There are two distinct black lung programs, known as Part B and Part C. They pay the same benefits, but differ in eligibility rules and funding sources.

The Part B program provides cash benefits to those miners who filed eligibility claims prior to June 30, 1973 (or December 31, 1973, in the case of survivors). It is financed by annual federal appropriations. The Part C program pays medical benefits for all eligible beneficiaries (both Parts B and C) and cash payments to those whose eligibility claims were filed after the Part B deadlines. Part C benefits are paid either by the “responsible” coal mine operator or, in most cases, by the Black Lung Disability Trust Fund.

To pay their obligations under the Part C program, coal mine operators may set up special “self-insurance trusts,” contributions to which are tax-deductible and investment earnings on which are tax-free. Otherwise, they may fund their liability through a third-party insurance arrangement and deduct the insurance premium costs. The Black Lung Disability Trust Fund is financed by an excise tax on coal mined in and sold for use in the United States and by borrowing from the federal Treasury.

Impact

Generally, any income-replacement amounts received for personal injury or sickness through an employer-paid accident or health plan must be reported as income for tax purposes. This includes disability payments and disability pensions, as well as sick leave. An exception is made for the monthly cash payments paid under the federal black lung program, and comparable cash benefits paid under state workers’ compensation programs, which are excluded from income taxation.

Black lung medical benefits are treated like other employer-paid or government-paid health insurance. Recipients are not taxed on the employer or federal contributions for their black lung health insurance, or on the value of medical benefits or reimbursements actually received.

In FY2021, cash benefits were paid to 30,375 beneficiaries. Both the Part B and the Part C rolls are declining as elderly recipients die. Part B cash payments totaled \$51 million and Part C cash payments totaled \$149 million in 2019. In 2022, monthly black lung cash payments under Part B and Part C ranged from \$708.90 for a miner or widow alone, to \$1,417.70 for a miner or widow with three or more dependents.

Rationale

Part B payments are excluded from taxation under the terms of title IV of the original Federal Coal Mine Health and Safety Act of 1969 (P.L. 91-173,

now entitled the Black Lung Benefits Act). No specific rationale for this exclusion is found in the legislative history. Part C benefits have been excluded because they are considered to be in the nature of workers' compensation under a 1972 revenue ruling and fall under the workers' compensation exclusion of Section 104(a)(1) of the Internal Revenue Code. Like workers' compensation and in contrast to other disability payments, eligibility for black lung benefits is directly linked to work-related injury or disease. (See entry on "Exclusion of Workers' Compensation Benefits: Disability and Survivors Payments.")

Assessment

Excluding black lung payments from taxation increases their value to beneficiaries with taxable income. The payments themselves fall well below federal income-tax thresholds. The effect of taxing black lung benefits and the factors to be considered in deciding on their taxation differ between Part B and Part C payments.

Part B benefits could be viewed as earnings-replacement payments and, thus, appropriate for taxation (as has been argued for workers' compensation). However, it would be difficult to argue for their taxation, especially now that practically all recipients are elderly miners or widows. When Part B benefits were enacted, the legislative history emphasized that they were not workers' compensation, but rather a "limited form of emergency assistance." They also were seen as a way of compensating for the lack of health and safety protections for coal miners prior to the 1969 Act and for the fact that existing workers' compensation systems rarely compensated for black lung disability or death. Furthermore, it can be maintained that taxing Part B payments would take back with one hand what federal appropriations give with the other, although almost no beneficiaries would likely pay tax, given their age, retirement status, and low income.

A stronger argument can be made for taxing Part C benefits. If workers' compensation were to be made taxable, Part C benefits would automatically be taxed because their tax-exempt status flows from their treatment as workers' compensation. Taxing Part C payments would give them the same treatment as the earnings they replace. It would remove a subsidy to those with other taxable income. On the other side, black lung benefits are legislatively established (as a percentage of minimum federal salaries). They do not directly reflect a worker's pre-injury earnings as does workers' compensation. They can be viewed as a special kind of disability or death "grant" that should not

be taxed. Because the number of beneficiaries on both the Part B and Part C rolls is declining, the revenue forgone from not taxing these benefits should decrease over time.

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Income Security

EARNED INCOME CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	68.3	—	68.3
2021	70.2	—	70.2
2022	71.3	—	71.3
2023	72.5	—	72.5
2024	74.1	—	74.1

Note: Estimates include outlay effects associated with the refundable portion of the EITC. These outlay effects are \$59.9 billion (FY2020), \$61.7 billion (FY2021), \$62.7 billion (FY2022), \$63.7 billion (FY2023), and \$65.0 billion (FY2024).

This provision was temporarily modified by P.L. 116-260 and P.L. 117-2. The changes included in P.L. 116-260 are estimated to cost \$4.136 billion between FY2021-FY2025 according to JCT, of which \$3.853 billion are from increased outlays (JCX-24-20). (This includes the impact of this provision on the EITC and the child tax credit.) The changes included in P.L. 117-2 are estimated to cost \$20.228 billion between FY2021-FY2026, of which \$14.055 billion reflect increased outlays (JCX-14-21).

Authorization

Section 32.

Description

The earned income credit, often referred to as the earned income tax credit (EITC), is a refundable tax credit available to eligible low-wage workers. The EITC is provided to individuals and families once a year, in a lump-sum payment after individuals and families file their federal income tax returns. Like all tax credits for individuals, the EITC can reduce income tax liability. And because the EITC is a refundable tax credit, if a taxpayer's EITC is greater than what the taxpayer owes in income taxes, the taxpayer can

receive the difference (the portion of the credit that remains after offsetting any income tax liability) as a tax refund.

Eligibility for, and the amount of, the EITC are based on a variety of factors, including residence and taxpayer ID requirements, the presence of qualifying children, age requirements for certain recipients, amount of investment income, and the recipient's earned income.

Several temporary modifications to the credit were enacted during the COVID-19 pandemic and are discussed throughout the subsections of this chapter, including a temporary expansion of the amount and eligibility for the EITC for taxpayers with no qualifying children—the childless EITC.

Calculating the Credit

The EITC is calculated based on a recipient's earnings. Specifically, the EITC equals a fixed percentage (the "credit rate") of earned income until the credit reaches its maximum amount. The EITC then remains at its maximum level over a dollar range of earned income, between the "earned income amount" and the "phase-out threshold." Finally, the credit gradually decreases in value to zero at a fixed rate (the "phase-out rate") for each additional dollar of earnings (or AGI, whichever is greater) above the phase-out threshold. The specific values of these EITC parameters (e.g., credit rate, earned income amount) vary depending on the several factors, including the number of qualifying children and the marital status of the taxpayer, as illustrated below, and the dollar amounts are adjusted annually for inflation.

EITC Parameters By Marital Status and Number of Qualifying Children, 2022

Number of children	0	1	2	3 or more
<i>Unmarried (single and head of household filers)</i>				
credit rate (percent)	7.65%	34%	40%	45%
earned income amount	\$7,321	\$15,410	\$15,410	\$15,410
maximum credit amount	\$560	\$3,733	\$6,164	\$6,935
phase-out threshold	\$9,160	\$20,130	\$20,130	\$20,130
phase-out rate (percent)	7.65%	15.98%	21.06%	21.06%
income where credit = 0	\$16,480	\$43,492	\$49,399	\$53,057
<i>Married (married filing jointly)</i>				

Number of children	0	1	2	3 or more
credit rate (percent)	7.65%	34%	40%	45%
earned income amount	\$7,321	\$15,410	\$15,410	\$15,410
maximum credit amount	\$560	\$3,733	\$6,164	\$6,935
phase-out threshold	\$15,290	\$26,260	\$26,260	\$26,260
phase-out rate (percent)	7.65%	15.98%	21.06%	21.06%
income where credit = 0	\$22,610	\$49,622	\$55,529	\$59,187

Source: Internal Revenue Service (IRS) Revenue Procedure 2021-45

For 2021, the credit formula for taxpayers with no qualifying children—the childless EITC—was temporarily increased. Specifically, for 2021 the credit rate doubled from 7.65% to 15.3%, the earned income amount increased from \$7,100 to \$9,820, the phaseout threshold increased from \$8,880 to \$11,610 if unmarried and from \$14,820 to \$17,560 if married, and the phaseout rate doubled from 7.65% to 15.3%. These changes nearly tripled the maximum credit amount of the childless EITC in 2021 compared to permanent law.

Eligibility Requirements

Earned income for calculation of the credit includes wages, tips, and other compensation included in gross income and self-employment income after the deduction for self-employment taxes.

To be considered a “qualifying child” of an EITC recipient, three requirements must be met. First, the child must have a specific *relationship* to the taxpayer (son, daughter, stepchild or foster child, brother, sister, half-brother, half-sister, step brother, step sister, or descendent of such a relative). Second, the child must share a *residence* with the taxpayer for more than half the year in the United States. Third, the child must meet certain *age requirements*; namely, the child must be under the age of 19 (or age 24, if a full-time student) or be permanently and totally disabled.

If a taxpayer has *no qualifying children*, he or she must be between 25 and 64 years of age. Childless taxpayers under age 25 or older than 64 are not eligible for the EITC. There is no age requirement for taxpayers *with qualifying children*.

For 2021, the lower age limit for the EITC for taxpayers with no qualifying children was reduced from 25 to 19 for most childless workers. For students who were attending school at least part-time in 2021, the age limit was temporarily reduced from 25 to 24. For former foster children and youth who were homeless in 2021, the minimum age was temporarily reduced from 25 to 18. The upper age limit was also eliminated, so childless workers aged 65 and older were eligible for the credit in 2021.

Taxpayers with investment income greater than \$10,330 in 2022 are ineligible for the EITC. Investment income includes interest income (including tax-exempt interest), dividends, net rent, and royalties that are from sources other than the filer's ordinary business activity, net capital gains, and net passive income.

To be eligible for the credit, the taxpayer must provide Social Security numbers (SSNs) for work purposes for themselves, spouses if married filing jointly, and any qualifying children. The SSNs must be issued before the due date of the income tax return. (U.S. citizenship is not required to be eligible for the credit. SSNs do not indicate U.S. citizenship.) Nonresident aliens—those who do not have green cards or do not spend sufficient time in the United States—are generally ineligible for the EITC.

Impact

The earned income tax credit increases the after-tax income of lower- and moderate-income working couples and individuals, particularly those with children.

The following table provides estimates of the earned income tax credit tax expenditure distribution by income level. Because the estimates use an expanded definition of income, the distribution includes incomes above the statutory limits. (These estimates are for 2020 and so do not include the impact of the expanded childless EITC in 2021.)

Distribution by Income Class of the Tax Expenditure for the Earned Income Tax Credit, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	6.4
\$10 to \$20	34.0
\$20 to \$30	26.9

Income Class (in thousands of \$)	Percentage Distribution
\$30 to \$40	16.9
\$40 to \$50	9.1
\$50 to \$75	6.0
\$75 to \$100	0.6
\$100 to \$200	0.0
\$200 and over	0.0

Rationale

The earned income tax credit was enacted by the Tax Reduction Act of 1975 (P.L. 94-12) as a temporary refundable credit to offset the effects of the Social Security tax and rising food and energy costs on lower-income workers and to provide a work incentive for parents with little or no earned income.

The credit was temporarily extended by the Revenue Adjustment Act of 1975 (P.L. 94-164), the Tax Reform Act of 1976 (P.L. 94-455), and the Tax Reduction and Simplification Act of 1977 (P.L. 95-30). The Revenue Act of 1978 (P.L. 95-600) made the credit permanent, raised the maximum amount of the credit, and provided for advance payment of the credit. The 1978 Act also created a range of income for which the maximum credit is granted before the credit begins to phase out.

The maximum credit was raised by both the Deficit Reduction Act of 1984 (P.L. 98-369) and the Tax Reform Act of 1986 (P.L. 99-514). The 1986 Act also indexed the maximum earned income and phase-out income amounts to inflation. The Omnibus Budget Reconciliation Act of 1990 (OBRA90; P.L. 101-508) increased the percentage used to calculate the credit, created an adjustment for family size, and created supplemental credits for young children (under age 1) and health insurance costs.

The Omnibus Budget Reconciliation Act of 1993 (OBRA93, P.L. 103-66) increased the credit, expanded the family-size adjustment, extended the credit to individuals without children, and repealed the supplemental credits for young children and health insurance. To increase compliance, the Taxpayer Relief Act of 1997 (P.L. 105-34) included a provision denying the credit to persons improperly claiming the credit in prior years.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) simplified calculation of the credit by excluding nontaxable employee compensation from earned income, eliminating the credit reduction due to the alternative minimum tax, and using adjusted gross income rather than modified adjusted gross income for calculation of the credit phase-out. EGTRRA provided marriage penalty relief for the EITC by raising the phase-out income level of the EITC for married couples by \$3,000 in comparison to the phase-out income level for unmarried EITC recipients. The EGTRRA changes were scheduled to expire after 2010.

The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) created a new credit category for three or more eligible children with a 45 percent credit rate. ARRA also temporarily increased marriage penalty relief for the EITC by raising the phase-out income level by \$5,000 for married couples in 2009 and indexing the \$5,000 for tax year 2010.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the EGTRRA and ARRA provisions through 2012. The American Taxpayer Relief Act of 2012 (P.L. 112-240) made the EGTRRA changes permanent and extended the two ARRA modifications (marriage penalty relief of \$5,000 and a larger credit for families with three or more children) through the end of 2017. The Protecting Americans from Tax Hikes Act (PATH Act, Division Q of P.L. 114-113) made these two temporary changes permanent.

The PATH Act (P.L. 114-113) also included several provisions intended to reduce improper payments of refundable credits, including improper payments of the EITC. First, the law included a provision that would prevent retroactive claims of the EITC after the issuance of SSNs. As previously discussed, a taxpayer must provide an SSN for them, their spouse (if married), and any qualifying children. The law stated that the credit will be denied to a taxpayer if the SSNs of the taxpayer, their spouse (if married), and any qualifying children were issued after the due date of the tax return for a given taxable year. For example, if a family had SSNs issued in June 2017, the family could (if otherwise eligible) claim the EITC on its 2017 income tax return (which is due in April 2018), but could not amend its 2016 income tax return and claim the credit on its 2016 return (which is due in April 2017).

In addition, P.L. 114-113 also included a provision requiring the IRS to hold income tax refunds until February 15 if the tax return included a claim for the EITC (or the additional child tax credit, known as the ACTC). This

provision was coupled with a requirement that employers furnish the IRS with W-2s and information returns on nonemployee compensation (e.g., 1099-MISCs) earlier in the filing season. According to the IRS Taxpayer Advocate, these legislative changes were made “to help prevent revenue loss due to identity theft and refund fraud related to fabricated wages and withholdings.” With more time to cross-check income on information returns, with income used to determine the amount of the EITC, it is believed that this will help reduce erroneous payments of the EITC by the IRS. Previous research by the IRS has indicated that the most frequent EITC error was incorrectly reporting income, and the largest error (in dollars) was incorrectly claiming a child for the credit.

The Consolidated Appropriations Act, 2021 (CAA21; P.L. 116-260) created a temporary income-lookback rule for the 2020 EITC that temporarily allowed taxpayers to use their 2019 earned income if it would result in a larger EITC than using their 2020 income.

The American Rescue Plan Act (ARPA; P.L. 117-2) included a similar income-lookback provision for the EITC for 2021. Specifically, taxpayers whose earned income at the end of 2021 was less than their 2019 earned income could elect to use the 2019 figure to calculate the EITC on their 2021 income tax returns. These income lookbacks applied to both those with and without qualifying children.

ARPA also temporarily expanded the childless EITC for 2021 by adjusting the formula and expanding the age range for eligible workers. Specifically, for 2021 the law increased the credit rate from 7.65% to 15.3%, increased the earned income amount (i.e., the range of income over which the credit phases in) from \$7,100 to \$9,820, increased the phaseout threshold (the income level at which the credit begins to phase out) from \$8,880 to \$11,610 if unmarried and from \$14,820 to \$17,560 if married, and increased the phaseout rate from 7.65% to 15.3%. These changes nearly tripled the maximum credit amount in 2021. The law also temporarily modified the age limits of the childless EITC. Under permanent law, taxpayers without qualifying children are eligible to claim the EITC if they are ages 25 to 64. ARPA temporarily reduced the minimum age from 25 to 19 for most childless workers in 2021.

ARPA also made several permanent changes to the credit which were effective beginning in 2021 including raising the amount of investment income a taxpayer could have and remain eligible for the credit (i.e.,

“disqualified income”) from \$3,650 in 2020 to \$10,000 in 2021 (and thereafter adjusted for inflation) and permanently providing the U.S. Treasury with the authority to make payments to Puerto Rico, American Samoa, and mirror-code territories for amounts those territories pay out in their own territorial EITCs.

Assessment

The earned income tax credit raises the after-tax income of millions of lower- and moderate-income families, especially those with children. The most recent data from the IRS indicate that 26.7 million taxpayers received \$64.5 billion of the EITC when they filed their 2019 federal income tax return.

The EITC is one of the federal government’s largest antipoverty programs, reflecting a trend toward reducing poverty through the tax code. The U.S. Census Bureau found that when government tax and transfer programs were included as part of a family’s resources, refundable tax credits moved 9.6 million people out of poverty in 2021. This analysis includes both the EITC and the child tax credit which was temporarily expanded to lower-income families in 2021, as well as the temporarily refundable child and dependent care tax credit. The child credit was estimated on its own to lift 5.3 million children above poverty in 2021. However, outside of 2021 the EITC has been the largest refundable tax credit targeted to the poor in recent history, and previous research indicates that most of the antipoverty impact of refundable tax credits can be attributed to the EITC. Most of the anti-poverty benefits of the credit go to families with children, who historically (excluding the changes in 2021) receive the vast majority of credit dollars.

The EITC provides financial incentives to workers based on their earnings. Economic theory suggests that the EITC may have two effects on the labor force: it can encourage non-workers to begin working and among those already working, it can affect the number of hours they work. For low-income workers eligible for the EITC, the EITC universally increases post-tax earnings, meaning it should theoretically increase labor force participation among eligible non-workers. In contrast, the theoretical impact of the EITC on hours worked depends on the taxpayer’s earnings, because the marginal value of the EITC, and hence the incentive to work more, changes as earnings rise.

Current research indicates that the EITC does have a positive effect on labor force participation (i.e., a non-worker deciding to work), especially among single mothers. Much of the research focuses on how significant legislative expansions of the EITC encouraged previously non-working single

mothers to enter the workforce. However, by contrast, research indicates that the EITC has had little effect on the number of hours EITC recipients work.

While the credit encourages single parents to enter the work force, the decline of the credit above the phase-out threshold can discourage the spouse of a working parent from entering the workforce. This “marriage penalty” may also discourage marriage when one or both parties receive the earned income tax credit. Researchers have looked at the impact of the EITC’s marriage penalty on two different behaviors among low-income workers—the impact it may have on *labor force participation* among those already married and the impact it may have on unmarried workers *to marry*. With respect to labor force participation, some research suggests that the EITC marriage penalty may act as a work disincentive for secondary earners of EITC-eligible married couples whose earnings place them in the plateau or phase-out range of the credit. These couples may decide, for example, that one spouse’s EITC is sufficiently large to allow the other spouse to stay out of the workforce and instead raise children. These couples could determine that having two earners would not only reduce their EITC, but may also increase the cost of other expenses, like child care, ultimately lowering their disposable income.

In terms of the marriage penalty’s impact on marriage, the actual impact may depend on whether either individual has children before marriage as well as each individual’s earnings. For example, two single, low-income adults who then marry and have children may see their EITC increase. In contrast, a single working mother may be discouraged to marry another working person for fear of a reduced EITC. However, research indicates that the EITC’s effects on marriage patterns are small and ambiguous.

Recent economic and public health research suggests that the EITC may improve the health of some poor Americans. Decades of research has linked poverty to poorer health outcomes among infants and children, suggesting that measures to alleviate poverty—like the EITC—could improve certain health outcomes. Recent research indicates that in addition to its broad antipoverty impact, the EITC may also improve the health of children born to low-income mothers. One widely used indicator of infant health is the infant’s weight at birth and whether the baby is considered low birth weight (LBW), which is defined as weighing less than 2,500 grams at birth. LBW babies have been found to have a number of health complications at above-average levels. Several recent studies suggest that the EITC is associated with increases in birth weight and a reduction in the incidence of LBW.

In addition to exploring the effects of the EITC on health outcomes, researchers have studied the effects of the credit on education outcomes of low-income populations. Researchers looking at the test scores of children in elementary school in a large urban school district found that children in families that received larger EITCs (and the refundable portion of the child tax credit) tended to score higher on English and math tests. (Similar results were found by researchers looking at the impact of legislative expansions to the EITC in the 1990s. They found that the children in families that received the largest increase in the credit tended to score higher on math and reading tests.)

The EITC is difficult for taxpayers to comply with and for the IRS to administer. Historically, the Treasury has estimated that about 20 to 25 percent of payments are issued improperly every year meaning they were higher (overpayments) or lower (underpayments), than they should have actually been. In August 2014, the IRS released a new EITC compliance study examining the causes of EITC overclaims on 2006 to 2008 tax returns. This study found the most frequent EITC error was related to misreporting of income (i.e., underreporting income in order to receive a larger credit), and the largest error in terms of dollar amount was related to qualifying child errors (incorrectly claiming a child for the EITC). Filing status errors (claiming a credit as unmarried when the taxpayer was in fact married) were also a source, though a relatively smaller one, of EITC overclaims.

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Income Security

**ADDITIONAL STANDARD DEDUCTION FOR THE
BLIND AND THE ELDERLY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	5.1	—	5.1
2021	5.2	—	5.2
2022	5.6	—	5.6
2023	6.0	—	6.0
2024	6.5	—	6.5

Authorization

Section 63(f).

Description

An additional standard deduction is available for blind and elderly taxpayers. To qualify for the additional standard deduction amount, a taxpayer must be age 65 or blind before the close of the tax year. The additional standard deduction amount for the aged and blind (for each condition) is \$1,400 in 2022. For an individual who is unmarried and not a surviving spouse, the additional standard deduction amount (for each condition) is \$1,750 in 2022. These amounts, like the basic standard deduction, are adjusted annually for inflation.

Impact

The additional standard deduction amounts raise the income threshold at which taxpayers begin to pay individual income taxes. The benefit depends on the marginal tax rate of the individual. Approximately half of the dollars deducted under this provision (50.4%) go to taxpayers with incomes under \$50,000.

***Distribution by Income Class of Amounts Deducted
for the Additional Standard Deduction for the Blind and Elderly, 2019***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	11.8
\$10 to \$20	12.9
\$20 to \$30	10.5
\$30 to \$40	8.3
\$40 to \$50	6.9
\$50 and over	49.6

Source: IRS *Statistics of Income Table 1.4*. This is not a distribution of the tax expenditure, but of the amount deducted, classified by adjusted gross income.

Rationale

Special tax treatment for the blind first became available under a provision of the Revenue Act of 1943 (P.L. 78-235), which provided a \$500 itemized deduction. The purpose of the deduction was to help cover the additional expenses directly associated with blindness, such as the hiring of readers and guides. The deduction evolved to a \$600 personal exemption in the Revenue Act of 1948 (P.L. 80-471) so that the blind did not forfeit use of the standard deduction and so that the tax benefit could be reflected directly in the withholding tables.

At the same time that the itemized deduction was converted to a personal exemption for the blind, relief was also provided to the elderly by allowing them an extra personal exemption. Relief was provided to the elderly because of a heavy concentration of low-income individuals in that population, the rise in the cost of living, and to counterbalance changes in the tax system after World War II. It was argued that those who were retired could not adjust to these changes and that a general personal exemption was preferable to piecemeal exclusions for particular types of income received by the elderly.

As the personal and dependency exemption amounts increased, so too did the amount of the additional exemption. The exemption amount increased to \$625 in 1970, \$675 in 1971, \$750 in 1972, \$1,000 in 1979, \$1,040 in 1985, and \$1,080 in 1986.

Under the Tax Reform Act of 1986 (P.L. 99-514), the personal exemptions for age and blindness were replaced by an additional standard deduction. This change was made to better target the benefit to lower- and moderate-income elderly and blind taxpayers. Higher-income taxpayers are more likely to itemize their deductions (instead of claiming the standard deduction). The additional standard deduction, however, will be used only by those who forgo itemizing deductions.

The 2017 tax revision, commonly referred to as the Tax Cuts and Jobs Act (P.L. 115-97), increased the share of the additional deduction claimed by higher-income individuals for 2018-2025 by increasing the standard deduction and reducing some itemized deductions, resulting in more higher-income taxpayers claiming the standard deduction.

Assessment

Advocates of the blind justify special tax treatment based on higher living costs and additional expenses associated with earning income. However, other taxpayers with disabilities (deafness, paralysis, loss of limbs) are not accorded similar treatment and may be in as much need of tax relief. Just as the blind incur special expenses, so too do others with different impairments.

Advocates for the elderly justify special tax treatment based on need, arguing that the elderly face increased living costs primarily due to inflation; medical costs are frequently cited as one example. However, Social Security benefits are adjusted annually for inflation, and the federal government has established the Medicare program. Opponents of the provision argue that if the provision is retained, the eligibility age should be raised. It is noted that life expectancy has been growing longer and that most 65-year-olds are healthy and could continue to work. The age for receiving full Social Security benefits has been increased for future years, rising to 67 for those born in 1960 or later.

One notion of fairness is that the tax system should be based on ability to pay and that ability is based upon the income of taxpayers—not age or disability. The additional standard deduction violates the economic principle of horizontal equity in that similar taxpayers are not treated equally. The provision also fails the effectiveness test since low-income blind and elderly individuals who already are exempt from tax without the benefit of the additional standard deduction amount receive no benefit from the additional standard deduction. Nor does the provision benefit those blind or elderly taxpayers who itemize deductions (such as those with large medical

expenditures in relation to income). Additionally, the value of the additional standard deduction is of greater benefit to taxpayers with a higher rather than lower marginal income tax rate. Alternatives would be a refundable tax credit or a direct grant.

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Income Security

DEDUCTION FOR CASUALTY AND THEFT LOSSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.2	—	0.2
2021	0.2	—	0.2
2022	0.2	—	0.2
2023	0.2	—	0.2
2024	0.2	—	0.2

Authorization

Sections 165(c)(3), 165(e), 165(h) - 165(k) and various public laws.

Description

For tax years 2018 through 2025, eligible losses associated with a disaster declared by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act are potentially deductible. Eligible unreimbursed personal casualty or theft losses in excess of \$100 per event and in excess of 10 percent of adjusted gross income (AGI) for combined net losses during the tax year are generally deductible. These losses may be claimed in addition to the standard deduction. As discussed below, Congress has created more generous rules in response to specific natural disasters.

Under permanent law, after 2025 an individual may claim a miscellaneous itemized deduction for eligible losses including losses arising from fire, storm, shipwreck, or other casualty, or from theft regardless of whether the loss occurred due to a declared disaster. The deduction is unavailable for taxpayers who do not itemize. The cause of the loss should be considered a sudden, unexpected, and unusual event. Losses associated with a federally declared disaster may be applied against the prior year's tax return.

Impact

The deduction grants some financial assistance to taxpayers who suffer substantial casualties and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer and thus serves as a form of government coinsurance. Use of the deduction is low for all income groups.

There is no maximum limit on the casualty loss deduction. If losses exceed the taxpayer's income for the year of the casualty, the excess can be carried back or forward to another year without reapplying the \$100 and 10 percent floors. A dollar of deductible losses is worth more to taxpayers in higher-income tax brackets because of their higher marginal tax rates.

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and non-business-related losses. No rationale was offered then.

The Revenue Act of 1964 (P.L. 88-272) placed a \$100-per-event floor on the deduction for personal casualty losses, corresponding to the \$100 deductible provision common in property insurance coverage at that time. The deduction was intended to be for extraordinary, nonrecurring losses which go beyond the average or usual losses incurred by most taxpayers in day-to-day living.

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) provided that the itemized deduction for combined nonbusiness casualty and theft losses would be allowed only for losses in excess of 10 percent of the taxpayer's AGI. While Congress wished to maintain the deduction for losses having a significant effect on an individual's ability to pay taxes, it included a percentage-of-adjusted-gross-income floor because it found that the size of a loss that significantly reduces an individual's ability to pay tax varies with income.

The Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) eliminated limitations of deductible losses arising from the consequences of Hurricane Katrina. Such losses were deductible without regard to whether aggregate net losses exceeded 10 percent of the taxpayer's adjusted gross income, and were not subject to the \$100 per casualty or theft floor. Similarly, the limitations were removed for losses arising from Hurricanes Rita and Wilma, the 2007

Kansas storms and tornados, and the 2008 Midwestern floods, severe storms, and tornados.

The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) expanded the applicability of the deduction and increased the per casualty limitation to \$500 for losses attributable to a federally declared disaster occurring in 2008 and 2009. Taxpayers could claim the deduction for losses in addition to the standard deduction. Such losses were deductible without regard to whether the losses exceeded 10 percent of a taxpayer's AGI.

The 2017 tax revision commonly referred to as the Tax Cuts and Jobs Act (P.L. 115-97) repealed the deduction for casualty losses except for disasters declared by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act through the end of 2025. The 2017 tax revision also provided that 2016 and 2017 disasters declared by the President qualified for an enhanced deduction. Specifically, losses in excess of \$500 per casualty were not subject to the 10 percent AGI threshold and were deductible. Further, these losses could be claimed in addition to the standard deduction. The enhanced deduction has subsequently been extended to California wildfires in the Bipartisan Budget Act of 2018 (BBA18; P.L. 115-123), the 2018 and 2019 disasters in the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Division Q of the Further Consolidated Appropriations Act, 2020; P.L. 116-94), and disasters prior to February 26, 2021, in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of the Consolidated Appropriations Act, 2021; P.L. 116-260).

Assessment

Critics have pointed out that when uninsured losses are deductible but insurance premiums are not, the income tax discriminates against those who carry insurance and favors those who do not. It similarly discriminates against people who take preventive measures to protect their property but cannot deduct their expenses. No distinction is made between loss items considered basic to maintaining the taxpayer's household and livelihood versus highly discretionary personal consumption. The taxpayer need not replace or repair the item in order to claim a deduction for an unreimbursed loss.

Up through the early 1980s, while tax rates were as high as 70 percent and the floor on the deduction was only \$100, higher-income taxpayers could have a large fraction of their uninsured losses offset by lower income taxes, providing them reason not to purchase insurance.

The imposition of the 10-percent-of-AGI floor, effective in 1983, together with other changes in the tax code since the 1980s, substantially reduced the number of taxpayers claiming the deduction. In 1980, 2.9 million tax returns, equal to 10.2 percent of all itemized returns, claimed a deduction for casualty or theft losses. In 2019, the latest year available, an estimated 11,524 returns claimed such a deduction out of the 17.6 million returns that itemized deductions, with an average claim of roughly \$33,560.

Use of the casualty and theft loss deduction can fluctuate widely from year to year. Deductions have risen substantially for years witnessing a major natural disaster—such as a hurricane, flood, or earthquake. In some years, the increase in the total deduction claimed is due to a jump in the number of returns claiming the deduction. In others, it reflects a large increase in the average dollar amount of deduction per return claiming the loss deduction.

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Income Security

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS: PLANS COVERING PARTNERS AND SOLE PROPRIETORS (SOMETIMES REFERRED TO AS “KEOGH PLANS”)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	12.7	—	12.7
2021	13.4	—	13.4
2022	15.1	—	15.1
2023	16.7	—	16.7
2024	18.0	—	18.0

Authorization

Sections 401-407, 410-418E.

Description

Employer contributions to qualified pension, profit-sharing, stock-bonus, and annuity plans on behalf of an employee are not taxable to the employee. The employer is allowed a current deduction for these contributions (within limits). Earnings on these contributions are not taxed until distributed. These plans can include partners and proprietors (the self-employed), with or without employees.

Plans covering the self-employed are subject to the same restrictions as employer plans, although non-discrimination rules are not relevant when there are no employees (see entries on Net Exclusion of Pension Contributions and Earnings: Defined Benefit Plans; and Net Exclusion of Pension Contributions and Earnings: Defined Contribution Plans for plan requirements). The partner, proprietor, or employee is generally taxed on benefits when benefits are distributed. (In some cases, participants make direct contributions to plans that are taxed to them as wages; these previously taxed contributions are not subject to tax when paid as benefits.)

There are two major types of pension plans: defined benefit plans, where employees are ensured of a certain benefit on retirement; and defined contribution plans, where employees have a right to accumulated contributions (and earnings on those contributions). For owners of unincorporated businesses, these plans are sometimes referred to as Keogh plans after the sponsor of the legislation that extended benefits to unincorporated businesses. Standard plans for the self-employed have more generous contribution limits than simplified plans but are complicated and administratively costly. A number of options for defined contribution benefit plans exist for the self-employed without employees or for small firms to simplify pensions that have lower contribution limits, including 401(k) plans (see entry on Net Exclusion of Pension Contributions and Earnings: Defined Contribution Plans), Simplified Employee Plans (SEPs), and Savings Incentive Match Plans (SIMPLEs), which is a savings plan.

The tax expenditure is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid on pensions by those who are currently receiving retirement benefits.

Impact

Pension plan treatment allows an up-front tax benefit by not including contributions in wage income. In addition, earnings on invested contributions are not taxed, although tax is paid on both original contributions and earnings when amounts are paid as benefits. The net effect of these provisions, assuming a constant tax rate, is effectively a tax exemption on the return. That is, the rate of return on the after-tax contributions is equal to the pre-tax rate of return. If tax rates are lower during retirement years than during the years of contribution and accumulation, there is a “negative” tax. In present value terms, the government loses more than it receives in taxes.

While some of the beneficiaries of the plans for unincorporated businesses include employees of small firms, the plans also benefit self-employed individuals who have no employees or only a spouse working in the business. This population includes independent contractors; although these individuals cannot participate in traditional plans, they can participate in 401(k), SEP and SIMPLE plans. According to Census data on businesses by number of employees, in 2019, 77 percent of all business establishments had no employees.

According to the Census Bureau, in 2017, pension income constituted 6.2 percent of total family income for elderly individuals in the poorest decile (the lowest 10 percent of elderly individuals). Pension income accounted for about 23.4 percent of total family income for those in the highest decile (the highest 10%). (These distributions were adjusted for family size, so that families of larger size are ranked lower than smaller families with the same income.)

There are several reasons that the tax benefit accrues disproportionately to higher-income individuals. First, according to the Labor Department's survey, employees with lower salaries are less likely to be covered by an employer plan. In 2021, 45 percent of workers in the bottom 25 percent of wages were covered by a pension plan. In contrast, 92 percent of workers in the top 25 percent were covered by a pension plan.

Second, in addition to fewer lower-income individuals being covered by the plans, the dollar contributions are much larger for higher-income individuals. This disparity occurs not only because of their higher salaries, but also because of the integration of many plans with Social Security. Under a plan that is integrated with Social Security, employer-derived Social Security benefits or contributions are taken into account as if they were provided under the plan in testing whether the plan discriminates in favor of employees who are officers, shareholders, or highly compensated. These integration rules allow a smaller fraction of income to be allocated to pension benefits for lower-wage employees.

Finally, higher-income individuals derive a larger benefit from tax benefits because their tax rates are higher and thus the value of tax reductions is greater.

In addition to differences across incomes, workers are more likely to be covered by pension plans if they work in certain industries, if they are employed by large firms, or if they are unionized. Thus, much of the benefit for unincorporated plans may be for self-employed individuals with no employees.

Rationale

While tax benefits for employee plans were allowed beneficial treatment by regulation shortly after the income tax was enacted, benefits for self-employed individuals were not allowed until 1962. The Self-Employed Individuals Retirement Act (P.L. 87-792) allowed self-employed individuals

to establish tax-qualified pension plans, known as Keogh (or H.R. 10) plans, which also benefitted from deferral.

The Revenue Act of 1978 (P.L. 95-600) allowed simplified employee pensions (SEPs) and tax-deferred savings (401(k)). The limits on SEPs and 401(k) plans were raised in the Economic Recovery Act of 1981 (P.L. 97-34). In the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), limits on pensions were cut back and made the same for all employer plans, and special rules were established for “top-heavy” plans. The 1982 legislation also eliminated disparities in treatment between corporate and noncorporate (i.e., Keogh) plans, and introduced further restrictions on vesting and coverage.

The Deficit Reduction Act of 1984 (P.L. 98-369) maintained lower limits on contributions, and the Retirement Equity Act of that same year revised rules regarding spousal benefits, participation age, and treatment of breaks in service.

In the Tax Reform Act of 1986 (P.L. 99-514), various changes were enacted, including substantial reductions in the maximum contributions under defined contribution plans, and other changes (anti-discrimination rules, vesting, integration rules). In the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), rules to limit under-funding and over-funding of pensions were adopted. The Small Business Job Protection Act of 1996 (P.L. 104-188) made a number of changes to increase access to plans for small firms, including safe-harbor nondiscrimination rules. In the Taxpayer Relief Act of 1997 (P.L. 105-34), taxes on excess distributions and accumulations were eliminated.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised the contribution and benefit limits for pension plans, allowed additional contributions for those over age 50, increased the full-funding limit for defined benefit plans, allowed additional ability to roll over limits on 401(k) and similar plans, and provided other regulatory changes. These provisions were to sunset at the end of 2010, but were made permanent by the Pension Protection Act of 2006. The 2001 act also created the Roth 401(k), which went into effect on January 1, 2006. Contributions to Roth 401(k)s are made on a post-tax basis, but qualified distributions are not taxed.

The Pension Protection Act of 2006 (P.L. 109-280) made a variety of changes relating to minimum funding requirements, disclosure, and increasing limits.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, part of the Further Consolidated Appropriations Act, 2020 (P.L. 126-94), made a number of changes to both defined benefit and defined contribution plans that also apply to self-employed plans, including to ages to withdraw funds in service, and required minimum distributions.

Assessment

The major economic justification for the favorable tax treatment of pension plans is that they arguably increase savings and increase retirement income security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty.

Allowing plans for the self-employed may largely benefit higher-income owners, although the availability of coverage may encourage owners with employees to adopt pension plans.

One incentive to save relies on an individual realizing tax benefits on savings about which he can make a decision. Since individuals cannot directly control their contributions to plans in many cases (defined benefit plans), or are subject to a ceiling on contributions, the tax incentives to save may not be very powerful, because tax benefits relate to savings that would have taken place in any case. This effect may be particularly pronounced for high-income individuals.

There has been some criticism of tax benefits to pension plans, because they are only available to individuals covered by employer plans. Thus they violate the principle of horizontal equity (equal treatment of equals). They have also been criticized for disproportionately benefitting high-income individuals.

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Income Security

**NET EXCLUSION OF PENSION CONTRIBUTIONS AND
EARNINGS: DEFINED BENEFIT PLANS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	102.3	—	102.3
2021	115.7	—	115.7
2022	131.0	—	131.0
2023	147.7	—	147.7
2024	166.2	—	166.2

Authorization

Sections 401-407, 410-418E, and 457.

Description

Employer contributions to qualified pension, profit-sharing, stock-bonus, and annuity plans on behalf of an employee (hereinafter referred to as “pension plans”) are not taxable to the employee. The employer is allowed a current deduction for these contributions (within limits). Earnings on these contributions are not taxed.

The employee or the employee’s beneficiary is generally taxed on benefits when benefits are distributed for defined benefit plans. (In some cases, employees make direct contributions to plans that are taxed to them as wages; these previously taxed contributions are not subject to tax when paid as benefits.)

A pension, profit-sharing, or stock-bonus plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. In addition, a plan must meet certain requirements, including standards relating to nondiscrimination, vesting, requirements for participation, and survivor benefits. Nondiscrimination rules are designed to prevent the plans from primarily benefitting highly paid, key employees.

Vesting refers to the period of employment necessary to obtain non-forfeitable pension rights.

There are two major types of pension plans: defined benefit plans, where employees are ensured of a certain benefit on retirement; and defined contribution plans (see entry on Net Exclusion of Pension Contributions and Earnings: Defined Contribution Plans), where employees have a right to accumulated contributions (and earnings on those contributions). Defined benefit plans are subject to a variety of requirements to make sure that they are neither underfunded (and thus could not meet their promises of payment) nor overfunded (which creates a tax sheltering opportunity for the firm). Private sector plans are also insured by the Pension Benefit Guaranty Corporation (PBGC). Portfolio choices are made by the employer.

Some plans are multiemployer plans, sponsored by several employers as part of a collective bargaining agreement.

The tax expenditure is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid on pensions by those who are currently receiving retirement benefits.

Impact

Pension plan treatment allows an up-front tax benefit by not including contributions in wage income. In addition, earnings on invested contributions are not taxed as they accrue, although tax is paid on both original contributions and earnings when amounts are paid as benefits. The net effect of these provisions, assuming a constant tax rate, is effectively tax exemption on the return. That is, the rate of return on the after-tax contributions is equal to the pre-tax rate of return. If tax rates are lower during retirement years than during the years of contribution and accumulation, there is a “negative” tax. In present value terms, the government loses more than it receives in taxes.

Defined benefit plans have important benefits for employees because they guarantee an annuity in retirement, and thus decrease risk to employees due to uncertainties about investment returns, compared to defined contribution plans. Defined benefit plans, for the same reason, may be less attractive to employers because employers bear the risk. Defined benefit plans, once the major source of retirement earnings, have been declining in favor of defined contribution plans. In 1980, 38 percent of private workers had defined benefit plans compared to 25 percent in 2021. Aside from employers wanting

to reduce risk, other reasons for the decline that are sometimes cited are the increasing regulatory and administrative costs of defined benefit plans, the shift of workers from the manufacturing sector (where such plans began) to the service sector, and the preferences of employees, especially with the introduction of 401(k) plans that allow more control by the employees.

The employees who benefit most from defined benefit plans are taxpayers whose employment is covered by a plan and whose service has been sufficiently continuous for them to qualify for benefits in a company- or union-administered plan. The benefit derived from the provision by a particular employee depends upon the level of tax that would have been paid by the employee if the provision were not in effect.

According to the Census Bureau, in 2017, pension income constituted 6.2 percent of total family income for elderly individuals in the poorest decile (the lowest 10 percent of elderly individuals). Pension income accounted for about 23.4 percent of total family income for those in the highest decile (the highest 10%). (These distributions were adjusted for family size, so that families of larger size are ranked lower than smaller families with the same income.)

According to the Labor Department's 2021 Employee Benefit Survey, more workers are covered by defined contribution plans (61 percent) than by defined benefit plans (25 percent). Participation rates are lower relative to availability, 43 percent for defined contribution compared to 20 percent for defined benefit.

There are several reasons that the tax benefit accrues disproportionately to higher-income individuals. First, according to the Labor Department's survey, employees with lower salaries are less likely to be covered by an employer plan. In 2021, 45 percent of workers in the bottom 25 percent of wages were covered by a pension plan. In contrast, 92 percent of workers in the top 25 percent were covered by a pension plan.

Second, in addition to fewer lower-income individuals being covered by the plans, the dollar contributions are much larger for higher-income individuals. This disparity occurs not only because of their higher salaries, but also because of the integration of many plans with Social Security. Under a plan that is integrated with Social Security, employer-derived Social Security benefits or contributions are taken into account as if they were provided under the plan in testing whether the plan discriminates in favor of employees who are officers, shareholders, or highly compensated. These integration rules

allow a smaller fraction of income to be allocated to pension benefits for lower-wage employees.

Finally, higher-income individuals derive a larger benefit from tax benefits because their tax rates are higher and thus the value of tax reductions in terms of tax savings is greater.

In addition to differences across incomes, workers are more likely to be covered by pension plans if they work in certain industries, if they are employed by large firms, or if they are unionized.

Rationale

The first income tax law did not address the tax treatment of pensions, but Treasury Decision 2090 in 1914 ruled that pensions paid to employees were deductible to employers. Subsequent regulations also allowed pension contributions to be deductible to employers, with income assigned to various entities (employers, pension trusts, and employees). Earnings were also taxable. The earnings of stock-bonus or profit-sharing plans were exempted in the Revenue Act of 1921 (P.L. 67-98), and the treatment was extended to pension trusts in the Revenue Act of 1926 (P.L. 69-20).

The rationale for these early decisions as for many other early provisions was not clear, since there was no recorded debate. It seems likely that the exemptions may have been adopted in part to deal with technical problems of assigning income. In the Revenue Act of 1928 (P.L. 70-562), deductions for contributions to reserves were allowed.

In the Revenue Act of 1938 (P.L. 75-552), because of concerns about tax abuse (firms making contributions in profitable years and withdrawing them in loss years), restrictions were placed on withdrawals unless all liabilities were paid.

In the Revenue Act of 1942 (P.L. 77-753) the first anti-discrimination rules were enacted, although these rules allowed integration with Social Security. These regulations were designed to prevent the benefits of tax deferral from being concentrated among highly compensated employees. Rules to prevent over-funding (which could allow pension trusts to be used to shelter income) were adopted as well.

Non-tax legislation in the Taft-Hartley Act of 1947 (P.L. 80-101) affected collectively bargained multi-employer plans, and the Welfare and Pensions

Plans Disclosure Act of 1958 (P.L. 87-420) added various reporting, disclosure, and other requirements.

Another milestone in the pension area was the Employee Retirement Income Security Act of 1974 (ERISA; P.L. 93-406), which provided minimum standards for participation, vesting, funding, and plan asset management, along with creating the Pension Benefit Guaranty Corporation to provide insurance of benefits. Limits were established on the amount of benefits paid or contributions made to the plan, with both dollar limits and percentage-of-pay limits.

Legislation in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) eliminated disparities in treatment between corporate and noncorporate (i.e., Keogh) plans, and introduced further restrictions on vesting and coverage.

The Deficit Reduction Act of 1984 (P.L. 98-369) imposed lower limits on contributions, and the Retirement Equity Act of that same year revised rules regarding spousal benefits, participation age, and treatment of breaks in service.

In the Tax Reform Act of 1986 (TRA86; P.L. 99-514), various changes were enacted, including modifications to anti-discrimination rules, vesting, and integration rules. In the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), rules to limit under-funding and over-funding of pensions were adopted. The Small Business Job Protection Act of 1996 (P.L. 104-188) made a number of changes to increase access to plans for small firms, including safe-harbor nondiscrimination rules. In the Taxpayer Relief Act of 1997 (P.L. 105-34) taxes on excess distributions and accumulations were eliminated.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised the contribution and benefit limits for pension plans, increased the full-funding limit for defined benefit plans, and provided other regulatory changes. These provisions were to sunset at the end of 2010, but were made permanent by the Pension Protection Act of 2006 (P.L. 109-280). The 2006 Act also made a variety of changes relating to minimum funding requirements, disclosure, and increasing limits, and required firms to address underfunding and make up shortfalls (within seven years).

The Consolidated and Further Continuing Appropriations Act, 2015 (P.L. 113-235) addressed some funding problems associated with multiemployer defined benefit plans.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act 2019, part of the Further Consolidated Appropriations Act, 2020 (P.L. 126-94) made several changes that modified defined benefit plans, including non-discrimination rules, and the age at which in-service distributions are allowed. The American Rescue Plan Act of 2021 (ARPA: P.L. 117-2) provided financial assistance to troubled multiemployer defined benefit plans to maintain benefits. ARPA also contained provisions that provided funding relief for single-employer defined benefit plans.

Assessment

Taxing defined benefit plans can be difficult, since it is not always easy to allocate pension accruals to specific employees. It would be particularly difficult to allocate accruals to individuals who are not vested. This complexity would not, however, preclude taxation of trust earnings at some specified rate.

The major economic justification for the favorable tax treatment of pension plans is that they arguably increase savings and increase retirement income security. Retirement security objectives are more effectively achieved by defined benefit plans. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty.

One incentive to save relies on an individual realizing tax benefits on savings about which he can make a decision. Since individuals cannot directly control their contributions to defined benefit plans, the tax incentives to save may not be very powerful, because tax benefits relate to savings that would have taken place in any case. At the same time, pension plans may force saving and retirement income on employees who otherwise would have total savings less than their pension-plan savings. The empirical evidence is mixed, and it is not clear to what extent forced savings is desirable.

There has been some criticism of tax benefits to pension plans because they are only available to individuals covered by employer plans. Thus they violate the principle of horizontal equity (equal treatment of equals). They have also been criticized for disproportionately benefitting high-income individuals.

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Income Security

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS: DEFINED CONTRIBUTION PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	153.6	—	153.6
2021	174.3	—	174.3
2022	199.5	—	199.5
2023	226.7	—	226.7
2024	256.0	—	256.0

Authorization

Sections 401-407, 410-418E, and 457.

Description

Employer contributions to qualified pension, profit-sharing, stock-bonus, and annuity plans on behalf of an employee are not taxable to the employee in the case of traditional plans. The employer is allowed a current deduction for these contributions (within limits). Earnings on these contributions are not taxed.

For traditional plans, the employee or the employee's beneficiary is generally taxed on benefits when benefits are distributed. (In some cases, employees make direct contributions to plans that are taxed to them as wages; these previously taxed contributions are not subject to tax when paid as benefits.) Roth plan distributions are not taxed because contributions are not excluded by the employee

A pension, profit-sharing, or stock-bonus plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. In addition, a plan must meet certain requirements, including standards relating to nondiscrimination, vesting, requirements for participation, and survivor benefits. Nondiscrimination rules are designed to

prevent the plans from primarily benefitting highly paid, key employees. Vesting refers to the period of employment necessary to obtain non-forfeitable pension rights.

There are two major types of pension plans: defined benefit plans (see entry on Net Exclusion of Pension Contributions and Earnings: Defined Benefit Plans), where employees are assured of a certain benefit on retirement; and defined contribution plans, where employees have a right to accumulated contributions (and earnings on those contributions). Defined contribution plans include those where employee contributions are elective, such as 401(k) plans used in the private sector, thrift savings plans used by the federal government, and 403(b) and 457 plans used by government and nonprofit entities. Employee contributions are made on a pre-tax basis (excluded from employee income), except for employee contributions to Roth-style plans, which are made on a post-tax basis.

The tax expenditure is measured as the tax revenue that the government does not currently collect on contributions and earnings amounts, offset by the taxes paid on pensions by those who are currently receiving retirement benefits. Roth 401(k) plan contributions are not deductible from income, but no tax is paid on earnings or benefits; the tax expenditure is the loss of revenue on the earnings.

All plans are subject to dollar limits on contributions that are adjusted for inflation. Total contributions (employer and employee combined) to defined contribution plans are limited to \$61,000 for 2022; for plans where employees have elective contributions, such as 401(k) plans, the employee is limited to a \$20,500 contribution for 2022. Employees over age 50 can make additional catch up contributions of \$6,500, which are in addition to the combined limits and employee limits (increasing the overall limit to \$67,500 and the employee limit to \$27,000). Plans may impose lower limits on elective deferrals.

Required minimum distributions from individual retirement plans maintained by employers (e.g., 401(k)s, 403(b)s, 457s) must begin for those retired by age 72 (70½ for those who turned 70½ before 2020). These required distributions were suspended for 2020.

Individuals may withdraw funds from plans for hardship purposes without penalty, including up to \$100,000 for issues related to the COVID-19

pandemic in 2020; these COVID-19 amounts may be taxed over three years and may be recontributed.

Impact

For plans other than Roth-style plans, pension plan treatment allows an up-front tax benefit by not including contributions in wage income. In addition, earnings on invested contributions are not taxed, although tax is paid on both original contributions and earnings when amounts are paid as benefits. The net effect of these provisions, assuming a constant tax rate, is effectively tax exemption on the return. That is, the rate of return on the after-tax contributions is equal to the pre-tax rate of return. If tax rates are lower during retirement years than during the years of contribution and accumulation, there is a “negative” tax. In present value terms, the government loses more than it receives in taxes.

Distributions from Roth 401(k) plans and similar Roth-style plans are subject to a zero tax rate because the contributions are made post-tax and earnings are exempt.

The employees who benefit from these provisions consist of taxpayers whose employment is covered by a plan. The benefit derived by a particular employee depends upon the level of tax that would have been paid by the employee if the provision were not in effect.

According to the Labor Department’s 2021 Employee Benefit Survey, more workers are covered by defined contribution plans (61 percent) than by defined benefit plans (25 percent). Participation rates are lower relative to availability, 43 percent for defined contribution compared to 20 percent for defined benefit.

According to the Census Bureau, in 2017, pension income constituted 6.2 percent of total family income for elderly individuals in the poorest decile (the lowest 10 percent of elderly individuals). Pension income accounted for about 23.4 percent of total family income for those in the highest decile (the highest 10%). (These distributions were adjusted for family size, so that families of larger size are ranked lower than smaller families with the same income.)

There are several reasons that the tax benefit accrues disproportionately to higher-income individuals. First, according to the Labor Department’s survey, employees with lower salaries are less likely to be covered by an

employer plan. In 2021, 45 percent of workers in the bottom 25 percent of wages were covered by a pension plan. In contrast, 92 percent of workers in the top 25 percent were covered by a pension plan.

Second, in addition to fewer lower-income individuals being covered by the plans, the dollar contributions are much larger for higher-income individuals. This disparity occurs not only because of their higher salaries, but also because of the integration of many plans with Social Security. Under a plan that is integrated with Social Security, employer-derived Social Security benefits or contributions are taken into account as if they were provided under the plan in testing whether the plan discriminates in favor of employees who are officers, shareholders, or highly compensated. These integration rules allow a smaller fraction of income to be allocated to pension benefits for lower-wage employees.

Finally, higher-income individuals derive a larger benefit from tax benefits because their tax rates are higher and thus the value of tax reductions is greater.

In addition to differences across incomes, workers are more likely to be covered by pension plans if they work in certain industries, if they are employed by large firms, or if they are unionized.

Rationale

The first income tax law did not address the tax treatment of pensions, but Treasury Decision 2090 in 1914 ruled that pensions paid to employees were deductible to employers. Subsequent regulations also allowed pension contributions to be deductible to employers, with income assigned to various entities (employers, pension trusts, and employees). Earnings were also taxable. The earnings of stock-bonus or profit-sharing plans were exempted in the Revenue Act of 1921 (P.L. 67-98), and the treatment was extended to pension trusts in the Revenue Act of 1926 (P.L. 69-20).

The rationale for these early decisions as for many other early provisions was not clear, since there was no recorded debate. It seems likely that the exemptions may have been adopted in part to deal with technical problems of assigning income. In the Revenue Act of 1928 (P.L. 70-562), deductions for contributions to reserves were allowed.

In the Revenue Act of 1938 (P.L. 75-552), because of concerns about tax abuse (firms making contributions in profitable years and withdrawing them

in loss years), restrictions were placed on withdrawals unless all liabilities were paid.

In the Revenue Act of 1942 (P.L. 77-753), the first anti-discrimination rules were enacted, although these rules allowed integration with Social Security. These regulations were designed to prevent the benefits of tax deferral from being concentrated among highly compensated employees. Rules to prevent over-funding (which could allow pension trusts to be used to shelter income) were adopted as well.

Non-tax legislation in the Taft-Hartley Act of 1947 (P.L. 80-101) affected collectively bargained multi-employer plans, and the Welfare and Pensions Plans Disclosure Act of 1958 (P.L. 87-420) added various reporting, disclosure, and other requirements.

In the Revenue Act of 1978 (P.L. 95-600), simplified employee pensions (SEPs) and tax-deferred savings (401(k)) plans were allowed. The limits on SEPs and 401(k) plans were raised in the Economic Recovery Tax Act of 1981 (P.L. 97-34).

In the Tax Reform Act of 1986 (P.L. 99-514), various changes were enacted, including substantial reductions in the maximum contributions under defined contribution plans, and other changes (anti-discrimination rules, vesting, integration rules). The Small Business Job Protection Act of 1996 (P.L. 104-188) made a number of changes to increase access to plans for small firms, including safe-harbor nondiscrimination rules.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised the contribution and benefit limits for pension plans, allowed additional contributions for those over age 50, allowed additional ability to roll over limits on 401(k) and similar plans, and provided other regulatory changes. These provisions were scheduled to sunset at the end of 2010, but were made permanent by the Pension Protection Act of 2006 (P.L. 109-280). The 2001 Act also created the Roth 401(k), which went into effect on January 1, 2006. Contributions to Roth 401(k)s are taxed, but qualified distributions are not taxed.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, part of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), made several changes to defined contribution plans including increasing the age for required minimum distributions from individual retirement accounts to 72 for those who turn 70½ after 2019 and

increasing the limits on automatic contributions from \$10,000 to \$15,000. It also required individuals who inherit individual accounts to make withdrawals in 10 years rather than over their lifetime (with exceptions for the spouse or child of the employee, disabled or chronically ill individuals, or individuals not more than 10 years younger than the employee).

The Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 (P.L. 116-136) allowed the withdrawal of up to \$100,000 without penalty for 2020 and allowed suspension of minimum required distributions.

Assessment

Taxing defined contribution pension plans would not be difficult, but extending the same treatment to defined benefit plans would be since it is not always easy to allocate pension accruals to specific employees.

The major economic justification for the favorable tax treatment of pension plans is that they arguably increase savings and increase retirement income security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty.

The incentive to save relies on an individual understanding the tax benefits of doing so (salience) and proactively deciding to save. Evidence indicates that workers are more likely to participate in retirement savings plans (such as 401(k) plans) if the default when they are hired is to be automatically included rather than having to choose to opt in. For those who participate, there may be a limited marginal incentive to save. Because individuals cannot directly control employer contributions to plans, or are subject to a ceiling on contributions, tax benefits may relate to savings that would have taken place in any case. At the same time, pension plans may force saving and retirement income on employees who otherwise would have total savings less than their pension-plan savings. Elective defined contribution plans such as 401(k) plans do not have this problem, although those who do not participate lose matching contributions. The empirical evidence is mixed, and it is not clear to what extent forced savings is desirable.

There has been some criticism of tax benefits to pension plans (both defined contribution and defined benefit), because they are only available to individuals covered by employer plans. Thus they violate the principle of horizontal equity (equal treatment of equals). They have also been criticized for disproportionately benefitting high-income individuals.

The Enron collapse in 2001 focused attention on another issue in pension plans: the displacement of defined benefit plans by defined contribution plans (particularly those with voluntary participation, such as the 401(k) plan, which are not insured) and the instances in which defined contribution plans were heavily invested in employer securities, increasing the risk to the employee who could lose retirement savings (as well as a job) when his or her firm failed. Research has suggested that individuals often do not diversify their portfolios and actually increase the share of their own contributions invested in employer stock when the employer stock is also used to make matching contributions. These individuals are thus strongly affected by default choices in the level and allocation of investment.

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Income Security

INDIVIDUAL RETIREMENT ACCOUNTS: TRADITIONAL IRAS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	15.8	—	15.8
2021	16.5	—	16.5
2022	17.9	—	17.9
2023	19.4	—	19.4
2024	20.5	—	20.5

Authorization

Sections 219, 408, and 408A.

Description

There are two types of individual retirement accounts (IRAs): the traditional IRA and the Roth IRA. This chapter discusses traditional IRAs.

The traditional IRA allows for the tax deferred accumulation of investment earnings, and some individuals are eligible to make tax-deductible contributions to their traditional IRAs while others are not. Some or all distributions from traditional IRAs are taxed at retirement. In contrast, contributions to Roth IRAs are not tax deductible, but distributions from Roth IRAs are not taxed on withdrawal in retirement.

The annual limit for traditional IRA contributions is the same as for Roth IRAs: the lesser of \$6,000 or 100 percent of compensation. (This ceiling applies to total contributions made to both traditional and Roth IRAs.) The ceiling is indexed for inflation in \$500 increments. Individuals age 50 and older may make an additional catch-up contribution of \$1,000. As with Roth IRAs, a married taxpayer who is eligible to set up an IRA is permitted to make contributions up to \$6,000 to an IRA for the benefit of the spouse.

Contributions to traditional IRAs may be tax deductible. The deduction for contributions for traditional IRAs is phased out by income for individuals who are covered by certain retirement plans at work (e.g., 401(k)-type plans or pensions). Individuals not covered by retirement plans at work and whose spouse is also not covered can deduct the full amount of their IRA contribution regardless of income. For those subject to the phase out, in 2022 the amount of the contribution that can be deducted is reduced for unmarried taxpayers with income between \$68,000 and \$78,000 (\$109,000 to \$129,000 for joint returns). Hence taxpayers with more than \$78,000 (\$129,000 if married filing jointly) cannot deduct their contributions.

Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax unless they are rolled over to another IRA or to an employer plan. Exceptions include withdrawals of up to \$10,000 used to purchase a first home, for education expenses, or for unreimbursed medical expenses.

Individuals could withdraw up to \$100,000 without penalty for issues related to the COVID-19 pandemic in 2020; these COVID-19 amounts may be taxed over three years and may be recontributed.

Required minimum distributions from IRAs must begin by age 72 if reaching age 70½ after 2019; other distributions must begin at age 70½. Amounts may be withdrawn, on a one-time basis, from IRAs and contributed to Health Savings Accounts (HSAs) without tax or penalty. Beginning in 2010, the income limitations on converting a traditional IRA to a Roth IRA are eliminated. Contributions may be made at any age.

Individuals are allowed to roll over employer retirement account balances into individual IRAs.

The current tax expenditure reflects the net effect from three types of revenue losses and gains. The first is the forgone taxes from the deduction of IRA contributions by certain taxpayers (for deductible IRAs). The second is the forgone taxes from not taxing IRA earnings (for all types of IRAs). The third is the revenue gain from the taxation of IRA distributions. Distributions from traditional IRAs are taxed. If the contributions were deductible, then the entire distribution is taxed. Only the investment earnings are taxed for distributions from nondeductible traditional IRAs.

Impact

Deductible IRAs allow an up-front tax benefit by deducting contributions along with no taxing of earnings, although tax is paid when earnings are withdrawn. The net overall effect of these provisions, assuming a constant tax rate, is the equivalent of tax exemption on the return (as in the case of Roth IRAs). That is, the individual earns the pre-tax rate of return on his or her after-tax contribution. If tax rates are lower during retirement years than they were during the years of contribution and accumulation, there is a “negative” tax on the return. Non-deductible IRAs benefit from a postponement of tax rather than an effective forgiveness of taxes, as long as they incur some tax on withdrawal.

Assets held in traditional IRAs are about nine times the size of those held in Roth IRAs: \$11.8 trillion compared to \$1.3 trillion in 2021. Most contributions to traditional IRAs are the result of rollovers from employer plans. Roth IRAs have more generous income limits but are also relatively newer. About two-thirds of the revenue loss from IRAs overall is due to traditional IRAs, which suggests that the offset from taxing withdrawals is probably larger than the loss from deducting contributions, offsetting some of the revenue loss from the lack of taxation of earnings.

IRAs tend to be less concentrated among higher-income taxpayers than some other types of capital tax subsidies, in part because they are capped at a dollar amount and in part because of the income limits in some cases. Their benefits do tend, nevertheless, to accrue more heavily to the upper half of the income distribution. This effect occurs in part because of the low participation rates at lower-income levels. Further, the lower marginal tax rates at lower income levels make the tax benefits less valuable.

As shown in the table below, taxpayers with incomes over \$75,000 (about 30 percent of the income distribution) received over half of the deductions for traditional IRA. Taxpayers with incomes below \$30,000 (about a third of the income distribution) accounted for about 11 percent of the deductions. Contributions to Roth IRAs are not reported on the tax return but might be more concentrated in higher-income levels because the income limits are higher.

***Distribution by Income Class of Amounts Deducted
for the IRA Deduction, 2019***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	1.1
\$10 to \$20	2.9
\$20 to \$30	6.0
\$30 to \$40	6.4
\$40 to \$50	6.7
\$50 to \$75	18.2
\$75 to \$100	13.6
\$100 to \$200	32.6
\$200 and over	12.5

Source: IRS *Statistics of Income Table 1.4*. This is not a distribution of the tax expenditure, but of the amount deducted, classified by adjusted gross income.

Rationale

The provision for IRAs was enacted in the Employee Retirement Income Security Act of 1974 (P.L. 93-406), but it was limited to individuals not covered by pension plans. The purpose of IRAs was to reduce discrimination against these individuals.

In the Tax Reform Act of 1976 (P.L. 94-555), the benefits of IRAs were extended to a limited degree to the nonworking spouse of an eligible employee. It was thought to be unfair that the nonworking spouse of an employee eligible for an IRA did not have access to a tax-favored retirement program.

In the Economic Recovery Tax Act of 1981 (P.L. 97-34), the deduction limits for all IRAs were increased to the lesser of \$2,000 or 100 percent of compensation (\$2,250 for spousal IRAs). The 1981 legislation extended the IRA program to employees who are active participants in tax-favored employer plans, and permitted an IRA deduction for qualified voluntary employee contributions to an employer plan.

The current rules limiting IRA deductions for higher-income individuals not covered by plans at work were added as part of the Tax Reform Act of 1986 (P.L. 99-514). Part of the reason for this restriction arose from the

requirements for revenue and distributional neutrality. The broadening of the base at higher income levels through restrictions on IRA deductions offset the tax rate reductions. The Taxpayer Relief Act of 1997 (P.L. 105-34) increased phase-outs and added Roth IRAs to encourage savings.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised the IRA contribution limit to \$3,000, with an eventual increase to \$5,000 and inflation indexing. These provisions were to sunset at the end of 2010, but were made permanent by the Pension Protection Act of 2006 (P.L. 109-280). The 2001 tax act also added the tax credit and catch-up contributions. The elimination of the income limit on Roth IRA conversions starting in 2010 was added by the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222).

Under legislation adopted at the end of 2006 (the Tax Relief and Health Care Act of 2006, P.L. 109-432), amounts may be withdrawn, on a one-time basis, from IRAs and contributed to Health Savings Accounts (HSAs) without tax or penalty.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, part of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), made several changes to traditional IRAs, including increasing the age for required minimum distributions to 72 for those who turn 70½ after 2019 and allowing contributions to be made after 70½ (which were previously disallowed for traditional IRAs). It also required individuals who inherit IRAs to make withdrawals in 10 years rather than over their lifetime (with exceptions for the spouse or minor child of the original owner, individuals less than ten years younger than the original owner, and chronically ill individuals).

The Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 (P.L. 116-136) allowed individuals to withdraw up to \$100,000 without penalty from their traditional IRAs for 2020 and allowed suspension of minimum required distributions.

Assessment

The tendency of capital income tax relief to benefit higher-income individuals has been reduced in the case of IRAs by the dollar ceiling on the contribution, and by the phase-out of the deduction as income rises for those covered by certain retirement plans at work. Providing IRA benefits without income ceilings to those not covered by retirement plans may be justified as a

way of providing more equity between those covered and not covered by an employer plan.

Another economic justification for IRAs is that they arguably increase savings and increase retirement security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty, and this issue has been the subject of a considerable literature.

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Income Security

INDIVIDUAL RETIREMENT ARRANGEMENTS: ROTH IRAS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	8.0	—	8.0
2021	8.8	—	8.8
2022	9.3	—	9.3
2023	10.2	—	10.2
2024	11.1	—	11.1

Authorization

Sections 219, 408, and 408A.

Description

There are two types of individual retirement accounts (IRAs): the traditional IRA and the Roth IRA. This chapter discusses Roth IRAs.

The traditional IRA allows for the tax-deferred accumulation of investment earnings, and some individuals are eligible to make tax-deductible contributions to their traditional IRAs while others are not. Some or all distributions from traditional IRAs are taxed at retirement. In contrast, contributions to Roth IRAs are not tax deductible (i.e., they are made with after-tax dollars), but distributions from Roth IRAs are not taxed on withdrawal in retirement. Roth IRAs are sometimes referred to as backloaded IRAs.

The annual limit for Roth IRA contributions is the same as for traditional IRAs: the lesser of \$6,000 or 100 percent of compensation. (This ceiling applies to total contributions made to both traditional and Roth IRAs.) The ceiling is indexed for inflation in \$500 increments. Individuals age 50 and older may make an additional catch-up contribution of \$1,000. As with traditional IRAs, a married taxpayer who is eligible to set up an IRA is

permitted to make contributions up to \$6,000 to an IRA for the benefit of the spouse.

Contributions to Roth IRAs are phased out by income. For 2022, the maximum amount that can be contributed to a Roth IRA is phased out for married taxpayers with incomes between \$204,000 to \$214,000 and \$129,000 to \$144,000 for single filers and heads of household filers. Married taxpayers with more than \$214,000 in income (\$144,000 for single and head of household) cannot contribute to a Roth IRA. Beginning in 2010, the income limitations on converting a traditional IRA account to a Roth IRA have been eliminated. Hence, an individual can pay tax on the distributions from a traditional IRA and roll them over into a Roth IRA.

Distributions from any IRA (traditional or Roth) made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax unless they are rolled over to another IRA or to an employer plan. Exceptions include withdrawals of up to \$10,000 used to purchase a first home, for education expenses, or for unreimbursed medical expenses. Amounts may be withdrawn, on a one-time basis, from IRAs and contributed to Health Savings Accounts (HSAs) without tax or penalty.

Roth IRAs are not subject to minimum distribution requirements as are traditional IRAs. Contributions to Roth IRAs can continue to be made at any age. Individuals are allowed to roll over employer retirement account balances into individual Roth IRAs (after paying tax if a traditional account).

The current tax expenditure reflects the forgone taxes from not taxing Roth IRA earnings.

Impact

Earnings from Roth IRAs are exempt from tax and thus subject to a zero tax rate.

Assets held in traditional IRAs are about nine times the size of those held in Roth IRAs: \$11.8 trillion compared to \$1.3 trillion in 2021.

IRAs tend to be less concentrated among higher-income levels than some other types of capital tax subsidies, in part because they are capped at a dollar amount and in part because of the income limits in some cases. Their benefits do tend, nevertheless, to accrue more heavily to the upper half of the income distribution, at least according to data on traditional IRA deductions. This

effect occurs in part because of the low participation rates at lower-income levels. Further, the lower marginal tax rates at lower-income levels make the tax benefits less valuable.

Rationale

The Taxpayer Relief Act of 1997 (P.L. 105-34) added Roth IRAs to encourage savings. (See entry on traditional IRAs for the prior history.)

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) raised the IRA contribution limit to \$3,000, with an eventual increase to \$5,000 and inflation indexing. These provisions were scheduled to sunset at the end of 2010, but were made permanent by the Pension Protection Act of 2006 (P.L. 109-280). The 2001 tax act also added the tax credit and catch-up contributions. The elimination of the income limit on Roth IRA conversions starting in 2010 was added by the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222).

Under legislation adopted at the end of 2006 (the Tax Relief and Health Care Act of 2006, P.L. 109-432), amounts may be withdrawn, on a one-time basis, from IRAs and contributed to Health Savings Accounts (HSAs) without tax or penalty.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, part of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), required individuals who inherit IRAs to make withdrawals in 10 years rather than over their lifetime (with exceptions for the spouse or minor child of the original owner, individuals less than ten years younger than the original owner, and chronically ill individuals).

Assessment

The tendency of capital income tax relief to benefit higher-income individuals has been reduced in the case of IRAs by the dollar ceiling on the contribution, and by the phase-out of the IRA contributions as income rises.

Another economic justification for Roth IRAs (as with traditional IRAs) is that they arguably increase savings and increase retirement security. The effects of these plans on savings and overall retirement income are, however, subject to some uncertainty, and this issue has been the subject of a considerable literature.

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Income Security

**CREDIT FOR CERTAIN INDIVIDUALS FOR ELECTIVE
DEFERRALS AND IRA CONTRIBUTIONS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.3	—	1.3
2021	1.4	—	1.4
2022	1.4	—	1.4
2023	1.4	—	1.4
2024	1.4	—	1.4

Authorization

Section 25B.

Description

Taxpayers who are age 18 or over and not full-time students or dependents can claim a tax credit for elective contributions to qualified retirement plans or IRAs. The maximum contribution amount eligible for the credit is \$2,000. Credit rates depend on filing status and adjusted gross income. In 2022, for joint returns the credit is 50 percent for adjusted gross income under \$41,000, 20 percent for incomes between \$41,000 and \$44,000, and 10 percent for incomes above \$44,000 and less than \$68,000. Income categories are half as large for singles (\$20,500, \$22,000, and \$34,000) and between those for singles and joint returns for heads of household (\$30,750, \$33,000, and \$51,000). The income thresholds are indexed to inflation. The credit may be taken in addition to general deductions or exclusions. The credit is not refundable, meaning it is effectively capped by a taxpayer's income tax liability. Taxpayers with little to no income tax liability, including many low-income taxpayers, receive little to no benefit from nonrefundable tax credits.

Contributions made to a beneficiary under an ABLE account (see entry for ABLE Accounts) for disabled individuals are eligible for the credit for taxable years from 2018-2025.

Impact

Because of the phaseout, the credit's benefits are targeted to lower-income individuals. However, the ability to use the credit is limited because many lower-income individuals have no tax liability. In 2019, 9.6 million returns took the credit, and the average credit was \$191. One study finds that the credit has a modest effect on take-up and on amounts contributed to retirement savings plans by low- and moderate-income families.

Historically, most lower-income individuals do not tend to save or participate in voluntary plans such as individual retirement accounts, perhaps because of pressing current needs. Thus, the number of families and individuals claiming the credit may be relatively small. In tax year 2019, about 9 percent of taxpayers with adjusted gross income of \$50,000 or less took the retirement savings contribution credit.

Rationale

This provision was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-116) and was set to expire after 2006. The Pension Protection Act of 2006 (P.L. 109-280) made this credit permanent. Its purpose was to provide savings incentives for lower-income individuals who historically have had inadequate retirement savings or none at all. The credit is comparable to a matching contribution received by many 401(k) participants from their employers.

The provision allowing temporary credits for beneficiaries of ABLE accounts was added by the 2017 tax revision, P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act.

Assessment

The credit has limited impact on increasing savings for its target group because so many lower-income individuals do not have enough tax liability to benefit from the credit. Among those who are eligible, the higher incomes necessary for them to have tax liability mean that the credit rate is lower. The credit could be redesigned to cover more lower-income individuals by making it refundable.

Some data suggests that the credit primarily increased contributions among those with only transitorily low income.

As with other savings incentives, there is no clear evidence that these incentives are effective in increasing savings. The credit also has a cliff effect: because the credit is not phased down slowly, a small increase in income can trigger a shift in the percentage credit rate and raise taxes significantly.

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Income Security

EXCLUSION OF OTHER EMPLOYEE BENEFITS: PREMIUMS ON GROUP TERM LIFE INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.5	—	3.5
2021	3.5	—	3.5
2022	3.6	—	3.6
2023	3.7	—	3.7
2024	3.8	—	3.8

Authorization

Section 79 and L.O. 1014, 2 C.B. 8 (1920).

Description

The cost of some employer-provided group-term life insurance plans is excluded from employees' gross income. Qualifying plans provide a death benefit and satisfy "anti-discrimination" provisions, net of employee after-tax contributions, above a \$50,000 coverage threshold. According to the 2022 Bureau of Labor Statistics Employee Benefits Survey, 60 percent of civilian workers are offered life insurance benefits, and 98 percent of those workers take up those benefits.

The cost of group-term life insurance imputed for an individual employee is usually calculated by multiplying the amount of insurance (in thousands of dollars) by an age-group-specific monthly unit cost factor taken from a U.S. Treasury table (published in Treasury Regulations, Subchapter A, Sec. 1.79-3). For example, suppose a 37-year-old employee receives \$150,000 in group-term life insurance coverage for a full year from his employer and pays no premiums himself. The coverage eligible for the exclusion (\$100,000) is then multiplied by the unit cost factor for employees aged 35-39 (\$.09/month per \$1,000 of coverage) taken from the Treasury table, giving an imputed monthly cost of \$9 and an annual imputed cost of \$108. Thus, the term life insurance

coverage of this employee would be considered as increasing his taxable income by \$108, even if the cost of obtaining comparable term life insurance coverage were higher. In some cases, qualifying group plans can also include permanent benefits, such as a cash surrender value, subject to conditions in Treasury Regulations, Subchapter A, Sec. 1.79-3.

The group-term life insurance exclusion is subject to “anti-discrimination” provisions intended to ensure that benefits are spread widely and equitably among employees. In general, qualifying group plans must be provided to at least 10 full-time employees during a given year. Plans may fail to meet those provisions if only a narrow subset of employees receives benefits or if the plan discriminates in favor of “key employees” or if “key employees” comprise the bulk of the beneficiaries. These anti-discrimination provisions exempt religious organizations’ plans for certain employees, except those at colleges and universities. For 2022, key employees generally are officers of a firm paid more than \$200,000; five-percent owners; or one-percent owners earning more than \$150,000. If a group-term life insurance plan fails to satisfy “anti-discrimination” provisions, so that over a quarter of total non-tax benefits accrue to key employees, the plan’s actual cost, rather than the cost given by the Treasury-provided table, is added to the key employee’s taxable income. Plans provided under terms of collective bargaining agreements are not considered to favor key employees.

Impact

Employer-provided group-term life insurance is a form of employee compensation. Because the full value of the insurance coverage is not taxed, a firm can provide this compensation at lower cost than the gross amount of taxable wages sufficient for an employee to buy the same amount of insurance. Group-term life insurance is a significant share of total life insurance. This fringe benefit’s value is partly exempt from income tax because a portion of the value of the term insurance coverage and any life insurance proceeds paid if the employee dies are excluded from gross taxable income.

Self-employed individuals or those who work for an employer without such a plan derive no advantage from this tax subsidy for life insurance coverage. The Bureau of Labor Statistics National Compensation Survey found that large firms and governments are more likely to offer life insurance benefits and that a higher share of higher-wage employees receive them.

Rationale

This exclusion was originally allowed, without limitation of coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). Insurance and pension benefits in a reasonable amount were excluded from World War II era wage and price controls (P.L. 77-729, 56 Stat. 765; Executive Order signed October 2, 1942, Title VI), which may have influenced subsequent court and regulatory opinions.

The \$50,000 limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner. The further limitation on the exclusion available for key employees in discriminatory plans was enacted in 1982 (P.L. 97-248), and expanded in 1984 (P.L. 98-369) to apply to post-retirement life insurance coverage. In 1986, more restrictive rules regarding anti-discrimination were adopted (P.L. 99-514), but were repealed in 1989 as part of debt limit legislation (P.L. 101-140).

Assessment

Concerns that many individuals would fail to buy prudent amounts of life insurance on their own may justify encouraging individuals to purchase more life insurance to protect surviving family members from financial vulnerabilities. Subsidizing life insurance coverage may help ensure a minimum standard of living for surviving dependent individuals. This exclusion may motivate employers and employees to design compensation packages that increase term life insurance coverage of workers. Whether this exclusion is the most efficient method of encouraging purchases of prudent levels of life insurance coverage is unclear.

The unit cost factors in the Treasury table noted above are well above rates for some other group life insurance premiums. For instance, the monthly rates per \$1,000 of coverage are about double those for the standard plan of the Federal Employees Group Life Insurance (FEGLI) program. For broad insurance pools without major adverse selection issues, the IRS imputation may overstate the value of group life insurance benefits above \$50,000.

This exclusion may raise horizontal and vertical equity issues. Aside from administrative convenience, the rationale for subsidizing insurance for employees, but not to the self-employed or those who are not employed is unclear. Higher-income individuals may receive more benefits from fringe

benefit exclusions because their marginal tax rates are higher and because they are more likely to receive group life insurance benefits from their employers. Lower-income individuals, whose surviving dependents are probably more financially vulnerable, may benefit less from income exclusion of premiums paid on their behalf, but may value the insurance protection more.

Some note that untaxed fringe benefits have increased middle class incomes since 1980, while growth in take-home pay has stagnated for some subgroups.

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Income Security

EXCLUSION OF OTHER EMPLOYEE BENEFITS: PREMIUMS ON ACCIDENT AND DISABILITY INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.8	—	3.8
2021	4.0	—	4.0
2022	4.2	—	4.2
2023	4.4	—	4.4
2024	4.6	—	4.6

Authorization

Sections 105 and 106.

Description

Premiums paid by employers for employee accident and disability insurance plans are excluded from the gross taxable income of employees. Although benefits paid to employees are generally taxable, payments that relate to permanent injuries are excluded from taxable income so long as those payments are computed without regard to the amount of time an employee is absent from work.

Impact

As with term life insurance, the cost to employers is less than they would have to pay in wages that are taxable, to confer the same benefit on the employee because the value of this insurance coverage is not taxed. Employers thus are encouraged to buy such insurance for employees. Because some proceeds from accident and disability insurance plans, as well as the premiums paid by the employer, are excluded from gross income, the value of the fringe benefit is generally exempted from federal income tax.

The 2022 Bureau of Labor Statistics Employee Benefits Survey found that 41 percent of civilian workers had access to short-term disability benefits and 40 percent took up those benefits. Long-term disability benefits were

available to 36 percent of civilian workers, 34 percent of which took up those benefits. Higher-wage employees and employees working for large firms and for governments are more likely than others to receive insurance benefits from their employer. As with many other fringe benefits, higher-income individuals also receive more benefits from this exclusion because their marginal tax rates are higher. One analysis of changes in Canadian tax subsidies for employer-provided supplementary health insurance estimated that a 1 percent reduction in tax subsidies led to a 0.5 percent decrease in coverage. This suggests that employers respond to tax incentives when designing benefit packages, albeit not in a one-to-one ratio.

Rationale

Early 20th century income tax law excluded payments connected to injuries or sickness from taxable income if received from accident or health insurance or from workers' compensation plans. In 1939, Congress added an exclusion for sick pay (P.L. 76-1). In 1943, the IRS held that employer payments to employees connected to injury or sickness, even if administered as a well-defined plan, were not exempt from employees' income, while accident and health benefits paid as insurance policy proceeds (according to the IRS definition of 'insurance') were exempted from gross income. In 1954, Congress modified the exemption of accident and health benefits in an attempt to equalize the tax treatment of benefits through an insurance plan and benefits provided in other ways (P.L. 83-591). Encouraging individuals to purchase more accident or disability insurance may be justified by concerns that many would fail to buy prudent amounts of insurance on their own, thus increasing financial vulnerabilities of workers and their families.

Assessment

Public programs (Social Security, Supplemental Security Income, and worker's compensation) provide a minimum level of disability payments for most workers. The rules that determine who qualifies for accident and disability insurance benefits, however, can be very different for public and private plans. The form of the exclusion may raise questions of horizontal and vertical equity. As with many other fringe benefits, higher-income individuals probably receive more benefits from this exclusion because their marginal tax rates are higher and because they are more likely to receive insurance benefits from their employers. The reduction in tax burden would be less for lower-income individuals, who typically face lower marginal tax rates. Such individuals may have less protection from income losses due to accident or

disability, and so may value insurance benefits more than those in less risky occupations. The exclusion may motivate employers to design compensation packages that increase accident and disability insurance coverage of workers. Whether this exclusion is the most efficient method of encouraging purchases of prudent levels of insurance coverage is unclear. Some have noted, however, that untaxed fringe benefits increased middle class effective incomes since 1980, while growth in take-home pay has stagnated for some subgroups.

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Income Security

EXCLUSION OF AMOUNTS RECEIVED UNDER LIFE INSURANCE CONTRACTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	13.0	0.7	13.7
2021	13.2	0.7	13.9
2022	13.3	0.7	14.0
2023	13.4	0.7	14.1
2024	13.6	0.7	14.3

Authorization

Section 101.

Description

Life insurance companies invest premiums they collect, and returns on those investments help pay benefits. Amounts not paid as benefits may be paid as policy dividends or given back to policyholders as cash surrender values or loan values. Under the baseline tax system, individuals and corporations would pay taxes on their income when it is (actually or constructively) received or accrued. However, death benefits for most policies are not taxed at all, and amounts paid as dividends or withdrawn as cash values are taxed only when they exceed total premiums paid for the policy.

Impact

The provision offers preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies and annuity contracts. Middle-income taxpayers, who make up the bulk of the life insurance market, may reap most of this provision's benefits. Many higher-income taxpayers, once their life insurance requirements are satisfied, generally obtain better after-tax yields from tax-exempt state and local obligations or tax-deferred capital gains. Some very wealthy individuals, however, can gain tax advantages through other forms of life insurance, such

as closely held life insurance companies (CHLICs or CICs) or private placement life insurance (PPLI), which may serve as an intergenerational wealth transfer tool.

Rationale

The exclusion of death benefits paid on life insurance dates back to the 1913 tax law (P.L. 63-16). While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests, which also were excluded from the tax base.

Assessment

Many families, according to some economists, fail to buy enough life insurance to protect surviving family members from a sharp drop in income and living standards that the death of a wage-earner could cause. Such families, whose financial vulnerabilities are not offset by insurance benefits, may be described as underinsured. Encouraging families to buy more life insurance could reduce those families' financial vulnerabilities. Whether the tax exemption on life insurance benefits, however, induces families to buy prudent levels of life insurance is unclear. Better financial education, for example, may provide a more direct route to helping families reduce financial vulnerabilities due to death or other serious disruptions.

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Income Security

DISALLOWANCE OF THE STANDARD DEDUCTION AGAINST THE ALTERNATIVE MINIMUM TAX

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	-0.2	—	-0.2
2021	-0.2	—	-0.2
2022	-0.2	—	-0.2
2023	-0.2	—	-0.2
2024	-0.3	—	-0.3

Authorization

Sections 55(d).

Description

Certain tax deductions and exemptions are disallowed for higher-income taxpayers. Specifically, personal and dependent exemptions and certain deductions (including the standard deduction) are disallowed under the alternative minimum tax (AMT). The AMT applies lower tax rates to a broader base—alternative minimum taxable income (AMTI)—with a flat exemption.

Because the AMT is not treated as a normal part of the tax system, the disallowance of exemptions and deductions under the AMT is treated as a negative tax expenditure. This tax expenditure reflects the disallowance of personal and dependency exemptions against the AMT, the disallowance of the standard deduction, as well as the phase out of exemptions under the regular income tax.

In tax years 2018 through 2025, personal exemptions are temporarily suspended and the standard deduction is temporarily increased. In 2022, the standard deduction is \$12,950 for single returns, \$19,400 for head-of-household returns, and \$25,900 for joint returns. Thus, currently, this tax expenditure only reflects the disallowance of the standard deduction for purposes of the AMT.

The AMT is a two-bracket tax rate (26 and 28 percent) which applies to income above an exemption amount that is phased out above a certain income. In 2017, AMT exemptions were significantly revised with an increase in exemption amounts, effective for 2018 through 2025. The AMT exemption amount for single filers was \$54,300 in 2017. For joint, married filers the exemption amount was \$84,500 in 2017. Under the phase-out, these exemption amounts were reduced by \$0.25 for every \$1 of AMTI over the threshold. Personal exemptions were not allowed against AMTI.

In 2018, the individual AMT was significantly modified. The AMT exemption amount for single filers was \$70,300. For joint, married filers the exemption amount was \$109,400. The AMT exemption phase-out thresholds were also increased. These higher amounts are temporarily in effect through 2025, and will be adjusted for inflation in years after 2018. For 2022, these amounts are \$75,900 and \$118,100.

Impact

These provisions are designed to increase taxes on higher-income taxpayers. According to the Joint Committee on Taxation, 98 percent of taxpayers affected by the provision in 2020 have an AGI of \$200,000 or greater.

Distribution by Income Class of the Tax Expenditure for the Disallowance of the Standard Deduction for AMT, 2020

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.0
\$30 to \$40	0.0
\$40 to \$50	0.0
\$50 to \$75	0.0
\$75 to \$100	0.0
\$100 to \$200	2.0
\$200 and over	97.6

Rationale

The Personal Exemption. The Tax Reform Act of 1986 (P.L. 99-514) created a tax structure with two marginal tax rates (15 percent and 28 percent) and a 5 percent surcharge on the taxable income of certain high-income taxpayers. The surcharge was phased out as income increased and consequently created a tax rate “bubble” of 33 percent for some taxpayers. The surcharge was essentially created to phase out the tax benefits of the 15 percent tax rate and personal exemptions for high-income taxpayers. The Omnibus Budget Reconciliation Act of 1990 (OBRA90, P.L. 101-508) repealed the 5 percent surcharge and instituted the current explicit approach for phasing out the tax benefits of the personal exemption. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-15) contained provisions to gradually repeal the personal exemption phase-out. The repeal, set to expire after 2010, was extended for two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The American Taxpayer Relief Act of 2012 (ATRA, P.L. 112-240) allowed the personal exemption phase-out to resume, but raised the threshold amounts above the scheduled rates set under previous law. The 2017 legislation (P.L. 115-98) commonly referred to as the Tax Cuts and Jobs Act (TCJA) repealed the personal exemption for tax years 2018-2025.

The Alternative Minimum Tax. The AMT was first introduced in the Revenue Act of 1978 (P.L. 95-600). Rates and exemptions have been revised numerous times, including frequent adjustments because exemptions were not indexed for inflation. (See CRS Report R44494, *The Alternative Minimum Tax for Individuals: In Brief*, for a history.) The latest permanent revisions were in the American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) which permanently indexed the exemption phase-out thresholds to inflation (beginning with the 2012 tax year), reducing the need for Congress to pass regular legislation to “patch” these amounts for inflation.

The TCJA temporarily repealed personal exemptions for tax years 2018 through 2025 and increased the standard deduction. P.L. 115-97 also increased the base individual AMT exemption amounts (and phase-out thresholds) for 2018 through 2025 and indexed them for inflation.

Assessment

The personal exemption phase-out (PEP) rules were set to expire in 1995 under OBRA90. But budgetary pressures led to tax increases in 1993, which

included making the personal exemption phase-out permanent. By 2001, Congress cited three reasons for eliminating the personal exemption phase-out. First, the personal exemption phase-out is complex. Second, the phase-out is essentially a hidden marginal tax rate increase on higher-income taxpayers. Lastly, the phase-out imposes high marginal tax rates on families in phase-out ranges. Congress ultimately reinstated PEP under ATRA, in part, to offset the revenue costs of other provisions in the law (such as making temporary lower income tax rates for most taxpayers permanent).

The AMT is designed to impose a tax on individuals whose regular tax liability is significantly reduced by deductions and exemptions available in the regular income tax provisions. The AMT has its own exemption designed to focus the tax on high incomes, and excludes the regular standard deduction, as well as some itemized deductions and personal exemptions, creating a larger starting tax base.

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Income Security

**EXCLUSION OF SURVIVOR ANNUITIES PAID TO
FAMILIES OF PUBLIC SAFETY OFFICERS KILLED
IN THE LINE OF DUTY**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	—	(¹)
2021	(¹)	—	(¹)
2022	(¹)	—	(¹)
2023	(¹)	—	(¹)
2024	(¹)	—	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Section 101(h).

Description

The surviving spouse or child (survivor) of a public safety officer killed in the line of duty can exclude from gross income a survivor annuity payment under a governmental pension plan. The annuity must be attributable to the officer's service as a public safety officer. Individuals qualifying as public safety officers include law enforcement officials, firefighters, ambulance crew members, rescue squad members, and chaplains employed by a fire or police department, who were killed while responding to an emergency after September 10, 2001.

Impact

The exclusion is available to all survivors who qualify, regardless of income level.

Rationale

Congress intended to subject annuities paid to surviving spouses of public safety officers killed in the line of duty to the same tax treatment as annuities paid to survivors of military service personnel killed in combat. This provision was part of the Taxpayer Relief Act of 1997 (P.L. 105-34).

Assessment

Annuities paid to survivors of public safety officers killed in the line of duty are now treated consistently with annuities paid to surviving spouses of military service personnel killed in combat. The annual revenue loss from this item has been less than \$50 million since its enactment in 1997.

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Social Security and Railroad Retirement

EXCLUSION OF UNTAXED SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	38.0	—	38.0
2021	39.3	—	39.3
2022	41.9	—	41.9
2023	44.8	—	44.8
2024	47.7	—	47.7

Authorization

Section 86.

Description

Depending on a taxpayer's income, the taxpayer's Social Security and Tier I Railroad Retirement benefits may be subject to income taxation. (Tier I Railroad Retirement benefits are provided by the Railroad Retirement System and are equivalent to Social Security benefits for railroad workers.) Specifically, a portion of Social Security and Tier I Railroad Retirement benefits is included in income for taxpayers whose provisional income exceeds certain thresholds. If a taxpayer's provisional income is below these thresholds, the benefits are not included as income and not subject to the federal income tax.

Provisional income is adjusted gross income, *plus* certain otherwise tax-exempt income (tax-exempt interest), *plus* the addition (or adding back) of certain income specifically excluded from federal income taxation (interest on certain U.S. savings bonds, employer-provided adoption benefits, foreign

earned income or foreign housing, and income earned in Puerto Rico or American Samoa by bona fide residents), *plus* 50 percent of Social Security or Tier 1 Railroad Retirement benefits.

The first tier of thresholds below which no Social Security or Tier I Railroad Retirement benefits are taxable are \$25,000 (single), and \$32,000 (married couple filing a joint return). In the case of taxpayers who are married filing separately, the threshold is \$25,000 if the spouses lived apart all year, but it is \$0 for those who lived together at any point during the tax year.

If provisional income is between the \$25,000 threshold (\$32,000 for a married couple) and a second tier threshold of \$34,000 (\$44,000 for a married couple), the amount of benefits subject to tax is the lesser of: (1) 50 percent of benefits; or (2) 50 percent of provisional income in excess of the first threshold.

If provisional income is above the second tier threshold, the amount of benefits subject to tax is the lesser of: (1) 85 percent of benefits; or (2) 85 percent of income above the second threshold, plus the smaller of (a) \$4,500 (\$6,000 for a married couple), or (b) 50 percent of benefits. These thresholds are not indexed for inflation. For a married person filing separately who has lived with his or her spouse at any time during the tax year, taxable benefits are the lesser of 85 percent of benefits or 85 percent of provisional income.

The tax treatment of Social Security and Tier I Railroad Retirement benefits differs from that of pension benefits. For pension benefits, all benefits that exceed (or are not attributable to) the amount of the employee's contribution are fully taxable.

The proceeds from taxation of Social Security and Tier I Railroad Retirement benefits at the 50 percent rate are credited to the Social Security Trust Funds and the National Railroad Retirement Investment Trust, respectively. The additional revenue generated by increasing the maximum taxable proportion of benefits above the second threshold from 50 percent to 85 percent is credited to the Medicare Hospital Insurance Trust Fund. The 2020 Report of the Social Security and Medicare Trustees indicated that in 2019, these revenues would account for about 3 percent of the tax revenues received by those trust funds. They would receive the other 97 percent of their tax revenues from payroll taxes.

Impact

In 2019, IRS data indicated that 22 million returns had taxable Social Security and Tier 1 Railroad Retirement benefits.

The distribution of the tax expenditure by income class is shown below. In 2020, over three-quarters of the forgone revenue (76.8 percent) goes to taxpayers with more than \$50,000 of income.

***Distribution by Income Class of the Tax Expenditure for
Untaxed Social Security and Railroad Retirement Benefits, 2020***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.2
\$20 to \$30	1.9
\$30 to \$40	9.5
\$40 to \$50	11.8
\$50 to \$75	26.1
\$75 to \$100	19.7
\$100 to \$200	20.3
\$200 and over	10.7

In addition, a greater share of higher-income taxpayers are affected by this tax expenditure and their effective tax rate is higher. For 2020, the Joint Committee on Taxation estimated that 48 percent of beneficiaries (21.9 million out of 45.7 million receiving benefits) would pay income tax on benefits of \$70.2 billion on \$1,057.9 billion in benefits, for an overall tax rate of 6.6 percent. Less than one percent of taxpayers with income below \$40,000 paid taxes, while the share for those paying taxes with income from \$40,000 to \$50,000, \$50,000 to \$75,000, and \$75,000 to \$100,000 was 17 percent, 48 percent, and 80 percent, respectively. All of those with incomes over \$100,000 paid tax. Shares of benefits paid in taxes ranged from zero at the lowest levels to 31.9 percent for taxpayers with economic incomes over \$1 million. Combined with the estimates for the tax expenditure, if the benefits were taxed like pensions, taxes on the benefits would be about 36 percent larger.

Because the income thresholds to determine the taxation of Social Security and Tier 1 Railroad Retirement benefits are not indexed for inflation

or wage growth, the share of beneficiaries affected by these thresholds is increasing over time. Research by the Social Security Administration (SSA) using a microsimulation model projected that an annual average of about 56 percent of beneficiary families would owe federal income tax on part of their benefit income from 2015 through 2050. The SSA study also estimated that the median percentage of benefit income owed as income tax would rise from one percent to five percent between 2015 and 2050.

Rationale

Until 1984, Social Security benefits were exempt from the federal income tax. The original exclusion arose from rulings made in 1938 and 1941 by the then Bureau of Internal Revenue (I.T. 3194, I.T. 3447). The exclusion of benefits paid under the Railroad Retirement System was enacted in the Railroad Retirement Act of 1935 (P.L. 74-399).

Under these rules, the treatment of Social Security benefits was similar to that of certain types of government transfer payments (such as Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and benefits under the Black Lung Benefits Act). This treatment was in sharp contrast to then-current rules for retirement benefits under private pension plans, the federal Civil Service Retirement System (CSRS), and other government pension systems. Benefits from those pension plans were fully taxable, except for the portion of total lifetime benefits (using projected life expectancy) attributable to the employee's own contributions to the system (and on which they have already paid income tax).

Currently (and as in 1941) under the Social Security program, the worker's contribution to the system is half of the payroll tax, officially known as the Federal Insurance Contributions Act (FICA) tax. The amount the worker pays into the Social Security system in FICA taxes is not excluded to determine income subject to the federal income tax, and is therefore taxed. The employer's contributions to the system are not considered part of the employee's gross income, and are deductible from the employer's business income as a business expense. Consequently, neither the employee nor the employer pays taxes on the employer's contribution.

The 1979 Advisory Council on Social Security concluded that because Social Security benefits are based on earnings in covered employment, the 1941 ruling was wrong and that the tax treatment of private pensions was a more appropriate model for tax treatment of Social Security benefits. The

council estimated that the most anyone who entered the workforce in 1979 would pay in payroll taxes during his or her lifetime would equal 17 percent of the Social Security benefits they would ultimately receive. (This was the most any individual would pay; in the aggregate, workers would make payroll tax payments amounting to substantially less than 17 percent of their ultimate benefits.) Because of the administrative difficulties involved in determining the taxable amount of each individual benefit and to avoid “taxing more of the benefit than most people would consider appropriate,” the council recommended instead that half of everyone’s benefit be taxed. They justified this ratio as a matter of “rough justice” and noted that it coincided with the portion of the tax (the employer’s share) on which income taxes had not been paid.

The National Commission on Social Security Reform (often referred to as the “Greenspan Commission”), appointed by President Reagan in 1981, recommended in its 1983 report that, beginning in 1984, 50 percent of Social Security cash benefits and Tier 1 Railroad Retirement benefits be taxable for individuals whose adjusted gross income, excluding Social Security benefits, exceeded \$20,000 for a single taxpayer and \$25,000 for a married couple, with the proceeds of such taxation credited to the Social Security trust funds. The commission did not include any provisions for indexing the thresholds. The commission estimated that 10 percent of Social Security beneficiaries would be subject to taxation of benefits. The commission acknowledged that the proposal had a “notch” problem, in that people with income at the thresholds would pay significantly higher taxes than those with only one dollar less, but trusted that it would be rectified during the legislative process.

In enacting the 1983 Social Security Amendments (P.L. 98-21), Congress essentially adopted the commission’s recommendation, but modified it to phase in the tax on benefits gradually, as income rose above threshold amounts. The threshold amounts under this law were not indexed for inflation. At the same time, it modified the tax treatment of Tier I Railroad Retirement benefits to conform to the treatment of Social Security benefits.

In his FY1994 budget, President Clinton proposed that the taxable proportion of Social Security and Tier I Railroad Retirement benefits be increased to 85 percent effective in 1994, with the proceeds credited to Medicare’s Hospital Insurance (HI) Trust Fund, which had a less favorable financial outlook than Social Security. Doing so also avoided possible procedural obstacles (budget points of order that can be raised regarding changes to the Social Security program in the budget reconciliation process).

This measure was included in the Omnibus Budget Reconciliation Act of 1993 (OBRA; P.L. 103-66), which passed the House on May 27, 1993.

The Senate version of the bill included a provision to tax Social Security benefits up to 85 percent but imposed it only after provisional income exceeded new thresholds of \$32,000 (for single filers) and \$40,000 (for married filers). When the House and Senate versions of the budget package were negotiated in conference, the conference agreement adopted the Senate version of the taxation of benefits provision and raised the thresholds to \$34,000 (for single filers) and \$44,000 (for married filers). President Clinton signed the measure into law (as part of P.L. 103-66) on August 10, 1993.

At that time, it was estimated that the highest paid category of worker would, during the worker's lifetime, contribute 15 percent of the value of the Social Security or Tier 1 Railroad Retirement benefits received by the worker. That is, at least 85 percent of the benefits received by a retiree could not be attributed to contributions by the retiree. Congress approved this proposal as part of the OBRA, but limited it to recipients whose threshold incomes exceed \$34,000 (single) or \$44,000 (couple). This change introduced the current two levels of taxation. There have been no direct legislative changes regarding taxation of Social Security or Tier 1 Railroad Retirement benefits since 1993.

Assessment

Principles of horizontal equity (equal treatment of those in equal circumstances) generally support the idea of treating Social Security and Tier I Railroad Retirement benefits similarly to other sources of retirement income. Horizontal equity suggests that equal income, regardless of source, represents equal ability to pay taxes, and therefore should be equally taxed. Just as the portion of other pension benefits and IRA distributions on which taxes have never been paid are fully taxable, so too should the portion of Social Security and Tier I Railroad Retirement benefits not attributable to the individual's contributions be fully taxed.

In 1993, it was estimated that if Social Security benefits received the same tax treatment as pensions, on average about 95 percent of benefits would be included in taxable income, and that the lowest proportion of benefits that would be taxable for anyone entering the work force that year would be 85 percent of benefits. Because of the administrative complexities involved in calculating the proportion of each individual's benefits, and because in theory it would ensure that no one would receive less of an exclusion than entitled to

under other pension plans, a maximum of 85 percent of Social Security benefits is currently included in taxable income.

Because the taxation of benefits is dependent on other income, the tax increases marginal tax rates on income in the phase-in range and acts as a tax on earnings which can distort labor supply responses. A study by Jones and Li estimated that exempting benefits and replacing them with higher payroll taxes would lead to a higher labor supply and smaller distortions as older beneficiaries are more responsive to taxes on earnings than younger contributors. The same study also estimated welfare gains from taxing Social Security benefits without regard to other income, which would be the case if benefits were taxed in the same way as pensions.

To the extent that Social Security benefits reflect social welfare payments, it can be argued that benefits be taxed similar to other general untaxed social welfare payments and not like other retirement benefits. One exception to the concept of horizontal equity is social welfare payments — payments made for the greater good (social welfare). Not all Social Security payments have a pension or other retirement income component and, unlike other pensions, more than one person may be entitled to benefits for a single worker. In addition, Social Security benefits are based on work earnings history and not contributions, with the formula providing additional benefits to recipients with lower work earnings histories.

Because the calculation of provisional income (to determine if benefits are taxable) includes a portion of Social Security benefits and certain otherwise untaxed income, the provisional income calculation can be compared to the income resources concept often used for means testing of various social benefits. Because the taxation increases as the provisional income increases, the after-tax Social Security benefits will decline as provisional income increases (but not below 15 percent of pre-tax benefits). This has resulted in the taxation of benefits being viewed as a “back-door” means test.

Under the current two-level structure, all Social Security beneficiaries have some untaxed benefits. The Congressional Budget Office estimates that more than 70 percent of benefits are untaxed. Taxes are imposed on at least half of the benefits for middle- and upper-income beneficiaries, while lower-income beneficiaries have no benefits taxed.

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Veterans' Benefits and Services

**EXCLUSION OF INTEREST ON STATE AND LOCAL
GOVERNMENT QUALIFIED PRIVATE ACTIVITY BONDS
FOR VETERANS' HOUSING**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	(¹)	(¹)	(¹)
2021	(¹)	(¹)	(¹)
2022	(¹)	(¹)	(¹)
2023	(¹)	(¹)	(¹)
2024	(¹)	(¹)	(¹)

(¹) Positive tax expenditure of less than \$50 million.

Authorization

Sections 103, 141, 143, and 146.

Description

Interest on veterans' housing bonds is tax-exempt. Veterans' housing bonds are used to provide mortgages at below-market interest rates to veterans purchasing owner-occupied principal residences. These veterans' housing bonds are classified as private-activity bonds rather than governmental bonds because a substantial portion of their benefits accrues to individuals rather than to the general public.

Each state with an approved program is subject to an annual volume cap related to its average veterans' housing bond volume between 1979 and 1985. For further discussion of the distinction between governmental bonds and private-activity bonds, see the entry under *General Government: Exclusion of Interest on Public Purpose State and Local Government Bonds*.

Impact

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

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

Rationale

Veterans' housing bonds were first issued by the states after World War II, when both state and federal governments enacted programs to provide benefits to veterans as a reward for their service to the nation.

The Omnibus Budget Reconciliation Act of 1980 (P.L. 96-499) required that veterans' housing bonds must be general obligations of the state. The Deficit Reduction Act of 1984 (P.L. 98-369) restricted the issuance of these bonds to the five states—Alaska, California, Oregon, Texas, and Wisconsin—that had qualified programs in existence before June 22, 1984, and limited issuance to each state's average issuance between 1979 and 1984.

Loans were restricted to veterans who served in active duty any time before 1977, and whose application for the mortgage financing occurred before the later of 30 years after leaving the service or January 31, 1985, thereby imposing an effective sunset date for the year 2007. Loans were also restricted to principal residences.

The Tax Increase Prevention and Reconciliation Act (P.L. 109-222) required that payors of state and municipal bond tax-exempt interest begin to report those payments to the Internal Revenue Service after December 31, 2005. The manner of reporting is similar to reporting requirements for interest paid on taxable obligations.

The most recent changes to the program were enacted by the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245), which increased the annual issue limits to \$100 million for Alaska, Oregon, and

Wisconsin. In the case of California and Texas, the act removed a provision restricting eligibility to veterans that served before 1977. Additionally, the exception for veterans from the first-time homebuyer requirement was made permanent.

Assessment

The need for these bonds has been questioned because veterans are eligible for numerous other housing subsidies that encourage home ownership and reduce the cost of their housing. As one of many categories of tax-exempt private-activity bonds, veterans' housing bonds have been criticized because they increase the financing costs of bonds issued for public capital stock and increase the supply of assets available to individuals and corporations to shelter their income from taxation.

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Veterans' Benefits and Services

EXCLUSION OF VETERANS' DISABILITY COMPENSATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	10.3	—	10.3
2021	10.3	—	10.3
2022	10.8	—	10.8
2023	12.2	—	12.2
2024	11.9	—	11.9

Authorization

38 U.S.C. Section 5301.

Description

All benefits administered by the Department of Veterans Affairs (VA) are exempt from taxation. Such benefits include those for veterans' disability compensation. Disability compensation is a monthly tax-free benefit paid to veterans with at least a 10 percent disability rating because of injuries or diseases that were incurred in or aggravated during active duty, active duty for training, or inactive duty training. A disability can be the result of physical conditions, such as a chronic knee condition, as well as mental health conditions, such as post-traumatic stress disorder (PTSD). Compensation may also be paid for disabilities that are considered related or secondary to disabilities occurring in service and for disabilities presumed to be related to circumstances of military service, even though they may arise after service.

The benefit amount is graduated according to the degree of the veteran's disability rating on a scale from 10 percent to 100 percent (in increments of 10 percent). Typically, benefits increase with the severity of disability. Veterans whose service-connected disabilities are rated at 30 percent or more are

entitled to additional allowances for dependents. Veterans with either (1) a single disability rated 60 percent or more, or (2) two or more disabilities with a combined rating of 70 percent or more at least one of which is rated 40 percent may receive compensation at the 100-percent level if they are deemed unemployable by the VA.

The basic benefit amount effective December 1, 2021, ranges from \$152.64 to \$3,332.06 per month, depending on the disability rating. Additional amounts can be paid in certain circumstances, including severe disabilities or loss of limbs; having a spouse, dependent children, or dependent parents; or having a disabled spouse.

Impact

Beneficiaries of major veterans' programs pay less tax than other taxpayers with the same or smaller economic incomes. Since these exclusions are not counted as part of income, the tax savings are proportional to the veteran's marginal tax bracket. Thus, the exclusion amounts will have greater value for veterans with higher incomes than for those with lower incomes.

Rationale

The rationale for excluding veterans' benefits from taxation is not clear. The tax exclusion of benefits was adopted in 1917, during World War I. The World War Veterans Act of 1924 (P.L. 68-242), later codified by P.L. 85-56 and P.L. 85-857, established the modern disability compensation program.

Many have concluded that the exclusion is in recognition of the extraordinary sacrifices made by armed forces personnel, especially during periods of war. Another rationale for the tax exclusion of veterans' disability benefits includes serving as an incentive to recruit and retain military personnel.

It could also be argued that this tax benefit provides parity between comparable civilian and military benefits. Specifically, veterans' disability compensation is similar to worker's compensation, which is exempt from taxation. (Members of the military are generally not eligible for workers' compensation.)

Assessment

The exclusion of veterans' benefits alters the distribution of payments and favors higher-income individuals. The rating schedule for veteran's

disability compensation was intended to reflect the average impact of the disability on the average worker. However, because the rating is not directly rated to the impact of disability on the veteran's actual or potential earnings, the tax-exempt status of disability compensation payments may be an inaccurate estimate of the veteran's lost earnings from the disability. Some view veterans' compensation as a career indemnity payment owed to those disabled to any degree while serving in the nation's armed forces. If benefits were to become taxable, higher benefit levels would be required to replace lost income. Some disabled veterans would find it difficult to increase working hours to make up for the loss of expected compensation payments. Some commentators have noted that if veterans with new disability ratings below 30 percent were declared ineligible for compensation it would shift spending to those veterans most impaired. In FY2019, while 35.1 percent of veterans receiving disability compensation had a combined rating of 30 percent or less, their disability compensation payments were 6.1 percent of all disability compensation payments.

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Veterans' Benefits and Services

EXCLUSION OF VETERANS' PENSIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.1	—	0.1
2021	0.1	—	0.1
2022	0.1	—	0.1
2023	0.1	—	0.1
2024	0.1	—	0.1

Authorization

38 U.S.C. Section 5301.

Description

All benefits administered by the Department of Veterans Affairs (VA) are exempt from taxation. Such benefits include veterans' pension payments. There are currently two main veterans' pension programs: (1) the Improved Disability Pension, and (2) the Improved Death Pension Benefit. (There is also a Medal of Honor Pension to veterans who were awarded the Medal of Honor. Fewer than 100 veterans qualify for this type of pension.)

The Improved Disability Pension

The Improved Disability Pension provides a monthly benefit to certain low-income veterans. The monthly benefit is based on a maximum annual benefit, and the actual benefit received by the veteran is reduced by the veteran's "countable" income. A veteran with countable income above the maximum annual benefit amount is not eligible for the pension. To be eligible for the pension benefit, a veteran must meet eligibility criteria related to combat/period of service; income/net worth; and age or disability.

A veteran must meet military service requirements related to combat, or service during a period of war, to be eligible for the pension benefit. Specifically, a veteran must have been discharged from military service under conditions *other than dishonorable* and must have served in the active military either: (1) for at least 90 days during a period of war; (2) during a period of war and was released from service for a service-connected disability; (3) for 90 or more consecutive days which began or ended during a period of war; or (4) for a total of 90 days or more in two or more separate periods of service during one or more periods of war.

The pension benefit for an eligible veteran is calculated by subtracting the veteran's annual countable income from the annual maximum benefit; that is, the benefit amount is reduced dollar-for-dollar by countable income. A veteran with annual countable income above the annual maximum benefit amount receives no pension benefit. Countable income for the veterans' pension benefit includes any Social Security benefits received. Therefore, the receipt of Social Security benefits can reduce or eliminate a veteran's pension benefit. In addition, no benefit is paid to a veteran who has significant wealth, defined as a net worth large enough that it would be reasonable for part of that wealth to be used for the veteran's maintenance.

Veterans under age 65 are eligible if totally disabled due to a non-service connected injury, illness, or combination thereof that is not a result of the veteran's willful misconduct. Veterans aged 65 or older (regardless of disability status) who meet the other pension requirements (combat/period and income/net worth) are eligible for the benefit.

The maximum annual benefit amounts for the veterans' pension benefit are set in statute and are based on the presence of a spouse or dependent child (or children) and whether the beneficiary needs additional care or is housebound. The annual benefit amounts are adjusted automatically each year to reflect a cost-of-living adjustment (COLA) equal to the COLA for Social Security benefits. For example, effective December 1, 2021, the maximum annual amount for the pension benefit is \$14,753 for a veteran and \$19,320 for a veteran with one dependent. If two veterans are married to each other, the maximum annual amount is the same as for a veteran with one dependent (\$19,320). The maximum annual benefit amount is higher if the veteran either requires additional care, known as "aid and attendance," or is housebound. An individual's benefit can be increased for only one of those reasons; the beneficiary cannot receive both aid and attendance benefits and housebound benefits.

The Improved Death Pension Benefit

The low-income surviving spouse or dependent child of a deceased veteran is eligible for the Improved Death Pension Benefit if the deceased veteran and surviving spouse or dependent child meet eligibility requirements.

In general, survivors are eligible for the Improved Death Pension Benefit if the deceased veteran met the veteran's discharge and period of service requirements for the Improved Disability Pension. However, survivors of an individual who had at least two years of honorable military service and who died in military service but not in the line of duty are also eligible for the Improved Death Pension Benefit.

The surviving spouse cannot be remarried and must have been married to the deceased veteran: (1) for at least one year (there is no minimum if the surviving spouse and veteran had a child); or (2) before December 14, 1944, for deceased veterans of the Mexican border period and World War I; before January 1, 1957, for deceased veterans of World War II; before February 1, 1965, for deceased veterans of the Korean conflict; before May 8, 1985, for deceased veterans of the Vietnam era; or before January 1, 2001, for deceased veterans of the Persian Gulf War.

Surviving children must be under the age of 18 (age 23 or under if in school) or must have become incapable of self-care before the age of 18.

The countable income for a surviving spouse or child is calculated like that of a veteran for the Improved Disability Pension. However, for a surviving spouse with custody of a deceased veteran's child, part of the child's income that is available to the surviving spouse may be included in countable income. For a veteran's surviving child, current work income is excluded from countable income if the income is not more than the income level at which a federal income tax return must be filed *plus* postsecondary education or vocational rehabilitation or training expenses paid by the child. In addition, for a surviving spouse or child, any proceeds from a life insurance policy on the veteran are excluded from countable income.

The maximum annual benefit amounts for surviving spouses and dependent children, like those for veterans, are set in statute and are automatically increased to reflect the COLA for Social Security benefits. For example, effective December 1, 2021, the maximum annual benefit amount was \$9,896 for a surviving spouse without a dependent child and \$12,951 for a surviving spouse with a dependent child. Maximum annual benefit amounts

are higher if the surviving spouse is housebound or requires aid and attendance. For a surviving child, the maximum annual benefit amount is \$2,523.

Impact

Beneficiaries of these major veterans' programs pay less tax than other taxpayers with the same or smaller economic incomes. Since these exclusions are not counted as part of income, the tax savings are a percentage of the amount excluded, depending on the marginal tax bracket of the veteran. Thus, the exclusion amounts will have greater value for veterans with higher incomes than for those with lower incomes.

Rationale

The rationale for excluding veterans' benefits from taxation is not clear. The tax exclusion of benefits was adopted in 1917, during World War I. Many have concluded that the exclusion is in recognition of the extraordinary sacrifices made by armed forces personnel, especially during periods of war. In addition, it may be tax-exempt to provide parity with a similar program available to civilians—Supplemental Security Income, or SSI.

Assessment

Income and wealth limitations of pension benefits target the benefit to certain lower-income veterans. As previously discussed, veterans pension benefits generally fall in value as income increases. In addition, no benefit is paid to a veteran who has enough wealth for the veteran's maintenance. (The law does not specify an amount of assets that would make a veteran ineligible for a pension due to excess net worth. In January 2015, the VA published a Notice of Proposed Rulemaking (NPRM) proposing regulatory changes to the pension eligibility rules that would establish a fixed monetary limit on net worth based on spousal allowances under Medicaid and provides for a 36-month look-back period during which assets transferred for less than market value would be counted toward net worth. This regulation was finalized in September 2018.) However, while pension benefits may be targeted to lower-income veterans, the benefit of the tax savings may be limited. Lower-income taxpayers generally do not owe much (if any) in income taxes, so additional exclusions from their income (like veterans' pension benefits) may not result in significant (if any) tax savings.

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Veterans' Benefits and Services

EXCLUSION OF VETERANS' READJUSTMENT BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	1.3	—	1.3
2021	1.1	—	1.1
2022	1.0	—	1.0
2023	1.2	—	1.2
2024	1.3	—	1.3

Authorization

38 U.S.C. Section 5301.

Description

All benefits administered by the Department of Veterans Affairs (VA) are exempt from taxation. Such benefits include readjustment benefit payments.

Readjustment benefits for veterans include cash payments for education or training; vocational rehabilitation training or support payments; grants for adapting automobiles, homes, or equipment; and a clothing allowance for certain disabled veterans.

Impact

Beneficiaries of these major veterans' programs pay less tax than other taxpayers with the same or smaller economic incomes. Since these exclusions are not counted as part of income, the tax savings are proportional to the marginal tax bracket of the veteran. Thus, the exclusion amounts will have

greater value for veterans with higher incomes than for those with lower incomes.

Rationale

The rationale for excluding veterans' benefits from taxation is not clear. The tax exclusion of benefits was adopted in 1917, during World War I. Many have concluded that the exclusion is in recognition of the extraordinary sacrifices made by armed forces personnel, especially during periods of war.

Assessment

The exclusion of veterans' benefits alters the distribution of payments and favors higher-income individuals.

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General Government

**EXCLUSION OF INTEREST ON PUBLIC PURPOSE STATE
AND LOCAL GOVERNMENT BONDS**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	23.4	5.5	28.9
2021	23.6	5.5	29.1
2022	23.8	5.6	29.4
2023	24.1	5.7	29.8
2024	24.3	5.7	30.0

Authorization

Sections 103, 141 and 146.

Description

Certain obligations of state and local governments qualify as “governmental” bonds. The interest income earned by individual and corporate purchasers of these bonds is excluded from taxable income. This interest income is not taxed because the bond proceeds generally are used to build capital facilities that are owned and operated by governmental entities and serve the general public interest, such as highways, schools, and government buildings. These bonds can be issued in unlimited amounts, although state and local governments do have a variety of self-imposed debt limits.

Exemption from federal income taxation is also available for a subset of otherwise taxable *private-activity* bonds if the proceeds are used to finance a qualified activity specified in the Internal Revenue Code. Unlike governmental bonds, many of these tax-exempt, private-activity bonds may

not be issued in unlimited amounts. Each state is subject to a federally imposed annual volume cap on new issues for most of these tax-exempt, private-activity bonds. Each activity included in the list of private activities eligible for tax-exempt financing is discussed elsewhere in this document under the private activity's related budget function. Many of the projects may be considered "public purpose" by some observers but are not included in this tax expenditure.

Impact

The impact of this tax expenditure can be measured by (1) how much additional public capital investment occurs because of this tax provision, and (2) the distributional effects across issuers and taxpayers. In the first case, the empirical evidence on the impact on public capital investment is mixed. The broad range of public projects financed with tax-exempt bonds diminishes the target efficiency of the public subsidy and complicates measurement of the tax subsidy's impact. Nonetheless, economic theory would predict that the lower relative price for government debt likely increases investment in public capital.

The distributional impact of this interest exclusion has two components: first, the division of tax benefits between issuing governments and bond purchasers; and second, the distribution of the tax benefits among income classes. The interest income exclusion lowers the interest rate on state and local government obligations relative to comparable taxable bonds. In effect, the federal government pays part of state and local governments' interest costs. For example, if the market rate on tax-exempt bonds is 5.0 percent when the taxable bond rate is 7.0 percent, there is a 2.0-percentage-point interest rate subsidy to the issuer.

The interest exclusion also raises the after-tax return for some bond purchasers, more so for high-income investors. A taxpayer facing a 12 percent marginal tax rate is better off purchasing a 7 percent taxable bond over a 5 percent tax-exempt bond. The after-tax return on the taxable bond is 6.16 percent which is greater than the 5 percent after-tax return on the tax-exempt bond. But a high-income taxpayer facing a 37 percent marginal tax rate is better off buying a tax-exempt bond because the after-tax return on the taxable bond is 4.41 percent, and on the tax-exempt bond, 5 percent. These "inframarginal" investors in the 37 percent marginal tax bracket receive what have been characterized as "windfall gains."

The allocation of benefits between the bond investors and state and local governments (and, implicitly, its taxpayer citizens) depends on the spread in interest rates between the tax-exempt and taxable bond market, the share of the tax-exempt bond volume purchased by individuals with marginal tax rates exceeding the market-clearing marginal tax rate, and the range of the marginal tax rate structure. The reduction of the top income tax rate of bond purchasers from the 70 percent individual rate that prevailed prior to 1981 to the 37 percent individual rate in effect starting since 2018 has increased the share of the tax benefits going to state and local governments.

The table below provides an estimate of the distribution by income class of tax-exempt interest income (including interest income from both governmental and private-activity bonds). The table also shows the share of total returns and total adjusted gross income for a variety of income ranges. In 2010, 80.8 percent of individuals' tax-exempt interest income is earned by returns with adjusted gross income in excess of \$100,000, although these returns represent 19.7 percent of all returns. Returns below \$40,000 earn 6.6 percent of tax-exempt interest income, although they represent 49.4 percent of all returns.

***Distribution by Income Class of Number of Returns, Adjusted Gross
Income and Tax-Exempt Interest Income, 2019***

Income Class (in thousands of \$)	Percentage Distribution of:		
	Total Returns	Net Adjusted Gross Income	Tax- Exempt Interest Income
Below \$10	13.9	-1.2	3.3
\$10 to \$20	13.4	2.6	0.8
\$20 to \$30	11.9	3.9	1.3
\$30 to \$40	10.2	4.7	1.3
\$40 to \$50	7.9	4.7	2.0
\$50 to \$75	14.1	11.4	5.6
\$75 to \$100	8.9	10.2	5.1
\$100 to \$200	13.9	25.1	15.0
\$200 to \$500	4.6	17.5	20.5

Percentage Distribution of:			
Income Class (in thousands of \$)	Total Returns	Net Adjusted Gross Income	Tax- Exempt Interest Income
\$500 to \$1,000	0.7	6.5	12.4
\$1,000 to \$1,500	0.2	2.6	5.8
\$1,500 to \$2,000	0.1	1.5	3.7
\$2,000 to \$5,000	0.1	3.6	9.3
\$5,000 to \$10,000	< .05	2.0	4.9
\$10,000 and over	< .05	4.9	9.1

Source: IRS *Statistics of Income Table 1.4*. This is not a distribution of the tax expenditures, but of the number of returns, the amount of aggregate adjusted gross income and the amount of tax-exempt interest income, classified by adjusted gross income.

The tax expenditure is more concentrated in the higher-income classes than the interest income because the average marginal tax rate (which largely determines the value of the tax expenditure from the nontaxed interest income) is higher for higher-income classes.

Rationale

This exclusion has been a part of the income tax since 1913, and was based on the belief that state and local interest income had constitutional protection from federal government taxation. The argument in support of this constitutional protection was rejected by the Supreme Court in 1988, *South Carolina v. Baker* (485 U.S. 505). In spite of this loss of protection, many believe the exemption for governmental bonds is still justified on economic grounds, principally as a means of encouraging state and local governments to invest in public capital.

Bonds whose debt service is supported by the full faith and credit of state and local government have been left largely untouched by federal legislation, with a few exceptions such as arbitrage restrictions, denial of federal guarantee, and bond registration requirements. The principle reason is that most of these bonds are issued for the construction of public capital stock, such as schools and government buildings.

This has not been the case for bonds whose debt service is paid from revenue generated by the facilities built with the bond proceeds or by a specific revenue stream. These bonds have been the subject of almost continual legislative scrutiny, beginning with the Revenue and Expenditure Control Act of 1968 (RECA; P.L. 90-364) and peaking with a comprehensive overhaul by the Tax Reform Act of 1986 (TRA86; P.L. 99-514). Both RECA and TRA86 were intended to curb the issuance of a subset of tax-exempt bonds used to finance quasi-public investment activities. These bonds that provided a significant benefit to private businesses and individuals are characterized as “private-activity” bonds. Each private activity eligible for tax exemption and associated revenue cost is discussed elsewhere in this document under the private activity’s related budget function.

Assessment

This tax expenditure subsidizes the provision of state and local public goods and services. A justification for a federal subsidy is that it encourages state and local taxpayers to provide public services that also benefit residents of other states or localities. The form of the subsidy has been questioned because it subsidizes one factor of public sector production, capital, and encourages state and local taxpayers to substitute capital for labor in the public production process.

Critics maintain there is no evidence that state and local governments underprovide capital facilities. These critics argue that, to the extent a subsidy of state and local public service provision is needed to obtain the service levels desired by taxpayers, the subsidy should not be restricted only to capital.

The efficiency of the subsidy, as measured by the federal revenue loss generated by reduced state and local interest costs and the windfall gains for bond investors, has also been the subject of considerable controversy. The state and local share of the benefits depends to a great extent on the number of bond investors with tax rates above the marginal tax rate of the purchaser who clears the market. The share of the subsidy received by state and local governments grew during the 1980s as the highest statutory marginal income tax rate on individuals dropped from 70 percent to 31 percent (and on corporations from 46 percent to 34 percent). The tax cuts provided for by the 2017 tax revision (P.L. 115-97) further decreased the inefficiency of this subsidy, as it decreased the top marginal income tax rates faced by individuals and businesses to 37 percent and 21 percent, respectively, beginning in tax year 2018.

Finally, the open-ended structure of the tax exclusion results in federal tax expenditure being dependent upon the decisions of state and local officials. The limited federal control of the revenue loss arising from governmental bonds could adversely impact federal budgeting.

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General Government

**DEDUCTION OF NONBUSINESS STATE AND LOCAL
GOVERNMENT TAXES**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	21.1	—	21.1
2021	22.4	—	22.4
2022	23.5	—	23.5
2023	24.4	—	24.4
2024	25.2	—	25.2

Authorization

Section 164.

Description

State and local income, sales, personal property, and real property taxes paid by individuals are deductible from adjusted gross income as an itemized deduction. Business sales and property taxes are deductible as business expenses, but those deductions are not tax expenditures because they are included in the measurement of business economic income.

For tax years 2018 through 2025: (1) deductions for state and local income, sales, personal property, and domestic real property taxes paid not in the carrying on of a trade or business cannot exceed \$10,000 (or \$5,000 for married individuals filing separately); and (2) foreign real property tax payment claims are not eligible for the deduction. Under current law, the \$10,000 limitation on claims for state and local taxes (SALT) paid is eliminated and foreign real property tax payment claims are allowed beginning in tax year 2026.

Impact

The deduction of state and local individual income, sales, personal property, and real property taxes increases an individual's after-federal-tax income and reduces the individual's price of the state and local public services provided with state and local tax dollars (after accounting for federal taxes). Some of the benefit goes to the state and local governments (because individuals are willing to pay higher state and local taxes) and some goes to the individual taxpayer. The deductibility of real property (real estate) taxes provides an additional subsidy to home ownership. Like the deduction for home mortgage interest (discussed elsewhere in this Compendium), the deduction for real property taxes reduces the cost of home ownership relative to renting, as renters may not deduct rental costs under the federal income tax. Landlords may deduct the property tax they pay on a rental property but are taxed on the rental income.

The limitation on deduction claims in place for tax years 2018 through 2025 increases the cost of state and local taxes for affected taxpayers. For example, consider a taxpayer with itemized deductions, a 35 percent marginal tax rate, and \$20,000 in eligible SALT payments. Without a SALT cap in place, the net price of those taxes for the taxpayer would be \$13,000 (or $\$20,000 * [1 - 0.35]$), as the taxpayer can use all \$20,000 of those tax payments to reduce federal tax liability. When a \$10,000 SALT cap is imposed, the final price of those taxes rises to \$16,500 (or $\$10,000 + [\$10,000 * (1 - 0.35)]$).

There may also be an impact on the structure of state and local tax systems. Economists have theorized that if a particular state and local tax or revenue source is favored by deductibility in the federal tax code, then state and local governments may rely more upon that tax source. In effect, state and local governments and taxpayers recognize that residents are only paying part of the tax, and that the federal government, through federal deductibility, is paying the remainder.

The distribution of tax expenditures from state and local tax deductions is concentrated in the higher income classes. About 89 percent of the tax expenditures are projected to be taken by families with adjusted gross income in excess of \$100,000 in 2020. As with any deduction, it is worth more as marginal tax rates increase, meaning those with greater taxable income and higher marginal tax rates receive larger savings. The difference in the value of the deduction across income levels may be mitigated in part by the limitation on the value of nonbusiness deductions that may be claimed, though a

subsequent reduction on state and local government services provided may have ramifications for the population at-large.

***Distribution by Income Class of the Tax Expenditure
for the State and Local Government Tax Deduction, 2020***

Income Class (in thousands of \$)	Percentage Distribution
Below \$10	0.0
\$10 to \$20	0.0
\$20 to \$30	0.1
\$30 to \$40	0.2
\$40 to \$50	0.6
\$50 to \$75	3.4
\$75 to \$100	7.0
\$100 to \$200	32.1
\$200 and over	56.7

Rationale

Deductibility of state and local taxes was adopted in 1913 to avoid taxing income that was obligated to expenditures over which the taxpayer had little or no discretionary control. User charges (such as for sewer and water services) and special assessments (such as for sidewalk repairs), however, were not deductible. The Revenue Act of 1964 (P.L. 88-272) eliminated deductibility for motor vehicle operators' licenses, and the Revenue Act of 1978 (P.L. 95-600) eliminated deductibility of the excise tax on gasoline. These decisions represent congressional concern that differences among states in the legal specification of taxes allowed differential deductibility treatment for taxes that were essentially the same in terms of their economic incidence.

The Tax Reform Act of 1986 (P.L. 99-514) eliminated deductibility of sales taxes, partly out of concern that these taxes paid were estimated and therefore did not perfectly represent reductions of taxable income, and partly arising from concerns that some portion of the tax reflects discretionary decisions of state and local taxpayers to consume services through the public sector that might be consumed through private (nondeductible) purchase.

In 2004, the sales tax deductibility option was reinstated for the 2004 and 2005 tax years by the American Jobs Creation Act of 2004 (P.L. 108-357). In

contrast to pre-1986 law, state sales and use taxes can only be deducted *in lieu of* state income taxes, not in addition to. Taxpayers who itemize and live in states without a personal income tax will benefit the most from this provision. The rationale behind the *in lieu of* is the more equal treatment for taxpayers in states that do not levy an income tax. In December 2006, P.L. 109-432 extended the deduction through 2007. In October 2008, P.L. 110-343 extended the sales tax deduction option for an additional two years, through 2009. The sales tax deduction was extended through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), and through 2013 by the American Taxpayer Relief Act of 2012 (ATRA, P.L. 112-24). The Consolidated Appropriations Act, 2016 (P.L. 114-113) permanently incorporated the sales tax deduction option into law.

Since the 2004 tax year, taxpayers have been allowed to choose between deducting sales or income taxes. There was also a temporary additional standard deduction for state and local sales and excise taxes paid on up to \$49,500 of the purchase price of a qualified new car, light truck, motor home or motorcycle. The deduction was available for purchases made between February 16, 2009, and January 1, 2010.

The 2017 tax revision (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act) made a number of changes to the deduction for state and local taxes paid. Beginning in tax year 2018, P.L. 115-97 restricted deductions for state and local taxes paid to \$10,000 for taxes not paid in the carrying on of a trade or business. Property taxes paid in the carrying on of a trade or business are not subject to the \$10,000 limit. (Business sales taxes paid are measured as business income and thus are not tax expenditures.) Deductions claimed for foreign real property taxes were eliminated. P.L. 115-97 also increased the value of the standard deduction, which will reduce the number of taxpayers claiming itemized deductions and thus who are eligible for the deduction for state and local taxes. Modifications to the deduction for state and local taxes paid included in P.L. 115-97 (including the increased value of the standard deduction) are scheduled to expire at the end of the 2025 tax year.

Assessment

Proponents argue that the deduction for state and local taxes is a way of promoting fiscal federalism by helping state and local governments to raise revenues from their own taxpayers. Itemizers receive an offset for their deductible state and local taxes in the form of lower federal income taxes. Deductibility thus helps to equalize total combined (federal, state, and local)

tax burdens across the country, as itemizers in high-tax state and local jurisdictions pay somewhat lower federal taxes as a result of their higher deductions.

Modern theories of the public sector discount the “don’t tax a tax” justification for state and local tax deductibility, emphasizing instead that taxes represent citizens’ decisions to consume goods and services collectively. From this perspective, state and local taxes are benefit taxes and should be treated the same as expenditures for private consumption. As such, these taxes should not be deductible against federal taxable income.

Deductibility can also be seen as an integral part of the federal system of intergovernmental assistance and policy. Public economic theory suggests that:

1. deductibility provides indirect financial assistance for the state and local sector and should result in expanded state and local budgets, and
2. deductibility will influence the choice of state and local tax instruments if deductibility is not provided uniformly.

In theory, there is an incentive for state and local governments to rely upon the taxes that are deductible from federal income, such as personal property taxes, because the tax “price” to the taxpayer is lower than the “price” on taxes that are not deductible. To the extent the federal tax treatment of state and local government taxes moves the jurisdiction away from the otherwise preferred tax structure, this tax expenditure generates an economically inefficient tax system. The limitation on nonbusiness deductions in tax years 2018 through 2025 may provide state and local governments with further incentive to adjust their tax systems, though the legal viability of structural alternatives depends on the structure of the mechanism utilized.

The deductibility of state and local taxes may also alter the behavior of individuals, as changes in their share of the tax burden may have consequences for locational choices of residence, employment, and consumer behavior. There is some evidence to suggest that large relative changes in state and local income tax rates induce household mobility, though such activity is typically confined to high-income households. Moreover, like the mortgage interest deduction, the value of the property tax deduction may be capitalized to some degree into higher prices for the type of housing bought by taxpayers more likely to itemize. Consequently, restricting the deduction for property taxes

may lower the price of housing purchased by middle- and upper-income taxpayers, at least in the short run.

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General Government

**ELIMINATE REQUIREMENT THAT FINANCIAL
INSTITUTIONS ALLOCATE INTEREST EXPENSE
ATTRIBUTABLE TO TAX-EXEMPT INTEREST**

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	—	0.4	0.4
2021	—	0.4	0.4
2022	—	0.4	0.4
2023	—	0.4	0.4
2024	—	0.4	0.4

Authorization

Section 265(b).

Description

Interest expenses are generally deductible for businesses, with limitation. An exception to this general rule is for the expenses that are allocable to any class of income (other than interest) that is wholly exempt from tax; the expenses are related to the production of income and are allocable to interest that is wholly exempt from tax; or the interest is on debt that is incurred or continued to purchase or carry an obligation that produces interest that is wholly exempt from tax. As a result, financial institutions cannot deduct any portion of their interest expense that is allocable to tax-exempt obligations acquired after August 7, 1986.

An exception applies to certain qualified tax-exempt obligations. Qualified small issuer bonds, those issued by an entity expecting to issue \$10 million or less (\$30 million or less for debt issued in 2009 or 2010) in tax-exempt obligations in a calendar year, are exempt from this requirement. In

addition, under a de minimis safe harbor, interest expense that is allocable to investments in tax-exempt obligations does not include investments in tax-exempt municipal bonds issued during 2009 and 2010, to the extent that these investments constitute less than two percent of the average adjusted bases of all the assets of the financial institution. The portion of any obligation not taken into account under this rule is treated as having been acquired on August 7, 1986, for purposes of the rules regarding financial institution preference items.

Impact

Eliminating the requirement to allocate certain interest expenses could increase the demand for small issuer tax-exempt obligations, which would reduce the interest costs to the issuing governments.

Rationale

The Tax Reform Act of 1986 (P.L. 99-514) generally required the allocation of interest expenses to offset tax-exempt interest.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) expanded the de minimis level for small issuers and allowed a two-percent safe harbor for financial institutions to stimulate demand for tax-exempt obligations.

Assessment

This tax expenditure subsidizes the provision of state and local public goods and services by small issuers. This may not be economically efficient, as this provision favors small projects at the expense of larger projects—regardless of the relative economic value.

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General Government

BUILD AMERICA BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	3.3	—	3.3
2021	3.3	—	3.3
2022	3.3	—	3.3
2023	3.3	—	3.3
2024	3.3	—	3.3

Note: Estimates include outlay effects associated with the refundable portion of BABs. These outlay effects are estimated to be \$3.3 billion for each fiscal year listed above. These outlays are to state and local governments and are attributed to individuals for purposes of this table.

Authorization

Sections 54A, 54AA, 1400U, and 6431.

Description

In the 111th Congress, the American Recovery and Reinvestment Act (ARRA; P.L. 111-5) created a new type of tax credit bond, the Build America Bond (BAB), which gave issuers the option of receiving a direct payment from the Treasury or allowing investors to receive the credit instead of tax-exempt interest payments. The legislation also provided for a version of BABs with a deeper subsidy called Recovery Zone Economic Development Bonds for economically distressed areas (see the entry under *General Government: Recovery Zone Economic Development Bonds*). This tax expenditure entry covers BABs.

BABs are not targeted in their designation, as are other tax credit bonds (TCBs; such as qualified zone academy bonds, qualified school construction

bonds, and clean renewable energy bonds). The volume of BABs was not limited, but they had to be issued before January 1, 2011, thus the tax expenditure represents the tax credits generated by the outstanding bonds. The purpose was constrained only by the requirement that “the interest on such obligation would (but for this section) be excludible from gross income under section 103.” Thus, BABs were issued for any purpose that would have been eligible for traditional tax-exempt bond financing other than private activity bonds. The 2017 tax revision (P.L. 115-97) repealed issuing authority for all tax credit bonds beginning on January 1, 2018.

The BAB credit amount is 35 percent of the interest rate established between the buyer and issuer of the bond. The issuer and investor agree on terms either as a result of a competitive bid process or through a negotiated sale. For example, if the negotiated taxable interest rate is 8 percent, on \$100,000 of bond principal, then the credit is \$2,800 (8 percent times \$100,000 times 35 percent). The issuer had the option of receiving a direct payment from the Treasury equal to the tax credit amount or allowing the investor to claim the tax credit. The issuers chose the direct payment option for all BABs issued because the net interest cost was less than traditional tax-exempt debt of like terms. The interest cost to the issuer choosing the direct payment is \$8,000 less the \$2,800, or \$5,200. If the tax-exempt rate is greater than 5.20 percent (requiring a payment of greater than \$5,200) then the direct payment BAB would have been a better option for the issuer. Note that the direct payment option means the bond proceeds must have been used for capital expenditures.

Pursuant to the Budget Control Act (P.L. 112-25), as amended, the credit rate for direct payment BABs and all other direct payment TCBs were subject to sequestration from FY2013 through FY2020. For FY2021 and FY2022, the sequestration reduced the direct payment BAB credit rate by 5.7 percent. Current law extends the 5.7 percent reduction to direct payment BABs for all fiscal years through FY2030. In other words, the 5.7 percent reduction lowers BAB direct payments from 35 percent to 33.005 percent from FY2021 through FY2030.

Impact

The impact of BABs on the municipal bond market has been significant, although it is unclear how much additional public infrastructure investment and economic stimulus the BAB program created. Until the authority to issue BABs expired on January 1, 2011, \$242.8 billion of BABs had been issued, roughly one-fourth (24.8 percent) of all municipal issuance over the same

period. A Treasury Department report on BABs estimated that through March 2010, the bonds had saved municipal issuers roughly \$12 billion in interest costs. The BAB debt likely displaced tax-exempt debt in many cases, though some portion may have been unplanned public investment or future projects that were expedited to take advantage of BAB financing.

Rationale

The American Recovery and Reinvestment Act (ARRA, P.L. 111-5) created BABs. These bonds offer a federal subsidy larger than that provided by tax-exempt bonds and were intended to spur more infrastructure spending and to aid state and local governments. Proponents also cited the possible stimulative effect of additional public infrastructure spending arising from this program during the economic downturn in 2009 and 2010.

Assessment

There are three principal stakeholders in the tax-preferred bond market: (1) state and local government issuers; (2) investors; and (3) the federal government. For issuers, BABs are best assessed against the most common alternative mechanism for financing public infrastructure: tax-exempt bonds. With direct-payment BABs, the federal government subsidizes the issuer directly, unlike with tax-exempt bonds which provide an indirect subsidy through lower interest rates. Either way, issuers receive an interest rate subsidy. In theory, if the demand for BABs exceeded that for traditional tax-exempt bonds issued for the same purpose, then interest costs for the issuer would have been further reduced. Also, if the credit rate were set such that the bonds were more attractive relative to other taxable instruments, issuers might have realized an additional interest cost savings.

When BABs are evaluated against tax-exempt bonds, the credit rate should equal the ratio of the investor's forgone market interest rate on tax-exempt bonds divided by one minus the investor's tax rate. Investors in higher tax marginal income tax brackets would need a higher rate to equate the return on BABs to that of tax-exempt bonds. Thus, high-income investors would prefer tax-exempt bonds to BABs. In contrast, non-taxable investors, international investors, and lower marginal tax rate investors would find BABs more attractive than tax-exempt bonds.

For the federal government, the BAB mechanism is a more economically efficient subsidy than tax-exempt bonds, particularly in cases where the issuer claims the direct payment (all BABs issued have been direct-payment BABs).

The direct payment to the issuer mechanism, which is modeled after the “taxable bond option,” was first considered in the late 1960s. Later, in 1976, the following was posited by the then-President of the Federal Reserve Bank in Boston, Frank E. Morris:

The taxable bond option is a tool to improve the efficiency of our financial markets and, at the same time, to reduce substantially the element of inequity in our income tax system which stems from tax exemption [on municipal bonds]. It will reduce the interest costs on municipal borrowings, but the benefits will accrue proportionally as much to cities with strong credit ratings as to those with serious financial problems.

The authority to issue BABs expired January 1, 2011. Many who supported extension of BABs, however, proposed a credit rate lower than the current 35 percent. Some observers were concerned that BABs would completely displace tax-exempt bonds, creating uncertainty in a market that has existed since inception of the federal income tax. P.L. 115-97 repealed all tax credit bond issuance authority from tax year 2018 forward.

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Interest

DEFERRAL OF INTEREST ON SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
2020	0.8	—	0.8
2021	0.8	—	0.8
2022	0.8	—	0.8
2023	0.8	—	0.8
2024	0.8	—	0.8

Authorization

Section 454(c)

Description

Owners of U.S. Treasury Series E, Series EE, and Series I savings bonds have the option of either including interest in taxable income as it accrues or excluding interest from taxable income until the bond is redeemed. All E bonds no longer earn interest after June 2010, because they have matured. Before September 1, 2004, EE bonds also could be exchanged for current income HH bonds with the accrued interest deferred until the HH bonds were redeemed. As of September 1, 2004, the U.S. Treasury ended the sale and exchange of HH savings bonds. Series EE bonds issued before May 1997 earn various rates for semiannual earnings periods, depending on the issue date. Series EE bonds issued from May 1997 through April 2005 continue to earn market-based interest rates set at 90 percent of the average 5-year Treasury yields for the preceding six months. Series EE bonds issued from May 2005 onwards earn a fixed rate of interest, depending on the rate set when the bond was issued. The revenue loss shown above represents the tax that would be due on the deferred interest if it were reported and taxed as it accrued. On

September 1, 1998, the Treasury began issuing Series I bonds, which guarantee the owner a real rate of return by indexing the yield for changes in the rate of inflation.

Impact

The deferral of tax on interest income on savings bonds provides two advantages. First, it delays payment of tax on the interest, delivering the equivalent of an interest-free loan of the amount of the tax. Second, if the taxpayer is in a lower-income tax bracket when the bonds are redeemed, the deferral reduces the rate of tax paid on the interest. This is particularly common when the bonds are purchased while the owner is working and redeemed after the owner retires.

The small denominations and low risk of savings bonds may make them an appealing instrument for certain taxpayers. There are currently annual cash purchase limits of \$5,000 per person for both EE bonds and I bonds with these limits applying separately to each series (for a total of \$10,000 per year). The tax deferral of interest on savings bonds primarily benefits middle-income taxpayers.

Rationale

Before 1951, a cash-basis taxpayer generally reported interest on U.S. Treasury original issue discount bonds in the year of redemption or maturity, whichever came first. In 1951, when Series E bonds were extended past their dates of original maturity, a provision was enacted to allow the taxpayer either to report the interest currently, or at the date of redemption, or upon final maturity. Senate Finance Committee records indicated that the provision was adopted to facilitate the extension of maturity dates.

On January 1, 1960, the Treasury permitted owners of E bonds to exchange these bonds for current income H bonds with the continued deferment of federal income taxes on accrued interest until the H bonds were redeemed. This action was designed to encourage the holding of U.S. bonds, and was later extended to EE bonds, HH bonds, and I bonds. On February 18, 2004, the U.S. Treasury announced that HH savings bonds would no longer be offered to the public after August 31, 2004. The Treasury's press release stated that "The Treasury is withdrawing the offering due to the high cost of exchanges in relation to the relatively small volume of transactions."

Assessment

The savings bond program was established to provide small savers with a convenient and safe debt instrument and to lower the cost of borrowing to the taxpayer. The option to defer taxes on interest increases sales of bonds. There is no empirical study that has determined whether or not the cost savings from increased bond sales more than offset the loss in tax revenue from the accrual.

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Appendix A: Forms of Tax Expenditures

Tax expenditures may take any of the following forms:

- special exclusions, exemptions, and deductions, which reduce income subject to tax and, thus, result in a lesser amount of tax;
- preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income;
- special credits, which are subtracted from taxes as ordinarily computed; and
- deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business).

The corporate income tax rate is 21 percent.

Any credits are deducted directly from tax liability. The flat statutory rate of the corporate income tax means there is no difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry

back or carry forward a net operating loss or credit. Most firms cannot carry back net operating losses. (The Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-36, temporarily allowed a five-year carryback for losses in 2019 and 2020.)

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except excluded income (i.e., exclusions). They then subtract certain deductions (deductions from gross income or “business” deductions) to arrive at adjusted gross income. The taxpayer then has the option of “itemizing” personal deductions or taking the standard deduction. (Prior to 2018, the taxpayer would then deduct personal exemptions (for themselves, and if applicable, their spouses and any dependents) to arrive at taxable income. The personal exemption has been suspended between 2018 and 2025 as a result of the 2017 tax revision commonly referred to as the Tax Cuts and Jobs Act [P.L. 115-97].) A graduated tax rate structure is then applied to this taxable income to yield tax liability, and any credits are subtracted to arrive at the net after-credit tax liability.

The graduated tax structure is currently applied at rates of 10, 12, 22, 24, 32, 35, and 37 percent, with brackets varying across types of tax returns. These rates were enacted in the 2017 tax revision (P.L. 115-97) and are temporary, expiring in 2026. At that time, the rates and brackets will return to pre-2018 values with rates (in percent) of 10, 15, 25, 28, 33, 35 and 39.6. For joint returns, in 2022, rates on taxable income are 10 percent on the first \$20,550, 12 percent for amounts from \$20,550 to \$83,550, 22 percent for amounts from \$83,550 to \$178,150, 24 percent for amounts from \$178,150 to \$340,100, 32 percent for incomes from \$340,100 to \$431,900, 35 percent for taxable incomes of \$431,900 to \$647,850, and 37 percent for amounts over \$647,850. These amounts are indexed for inflation using the chained consumer price index (C-CPI-U).

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer’s marginal tax rate. Thus, the exclusion of interest from state and local bonds saves \$37 in tax for every \$100 of interest for the taxpayer in the 37-percent bracket, whereas for the taxpayer in the 12-percent bracket the saving is \$12. Similarly, the increased standard deduction for persons over age 65 or an itemized deduction for charitable contributions

are worth almost twice as much in tax saving to a taxpayer in the 22-percent bracket as to one in the 12-percent bracket.

In general, the following deductions are itemized (i.e., allowed only if the standard deduction is not taken): medical expenses, specified state and local taxes, interest on nonbusiness debt such as home mortgage payments, casualty losses in disaster areas, and gambling losses. (Certain of these deductions are subject to floors or ceilings.) The 2017 tax revision eliminated or restricted itemized deductions including adding a cap of \$10,000 on state and local taxes, reducing the cap on mortgage interest to indebtedness up to \$750,000 (rather than \$1 million), eliminating deductions for home equity loans, eliminating casualty loss deductions in areas not declared a national disaster, and eliminating miscellaneous deductions subject to a floor (including certain unreimbursed business expenses of employees, expenses of investment income, union dues, costs of tax return preparation, and uniform costs). These restrictions expire at the end of 2025, absent legislative changes.

Whether or not a taxpayer minimizes their tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction. Higher-income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners often itemize because deductibility of mortgage interest and property taxes leads to a larger sum of itemized deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the reduced rates on dividends and capital gains) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater the tax relief from the preferential rate.

Credits

A tax credit (such as the dependent care credit) is subtracted directly from the tax liability that would accrue otherwise; thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can generally only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to offset. Most business tax credits (and a limited number of individual tax credits) can be carried backward and/or forward for fixed periods, so that a credit which cannot be used in the year in

which it first applies can be used to offset tax liabilities in other prescribed years.

The earned income credit, child credit, and the American opportunity tax credit (AOTC) are the major individual income tax credits which are refundable. That is, qualifying individuals will obtain in cash the amount of the refundable credit that exceeds their tax liability. In the case of the child credit and the AOTC, only part of the overall credit amount may be refundable. As a result, certain low-income families may not receive the full amount of these credits. P.L. 117-169, often referred to as the Inflation Reduction Act of 2022, made a limited number of clean energy credits refundable by allowing an election to receive a direct payment, and allowed other energy credits to be transferred to other taxpayers.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these things, the taxpayer's income is lower than it otherwise would be, and because of the current reduction in the tax base, current tax liability is reduced. The reduction in tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed.

Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in their taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (that is, the tax deferred), the value of the interest-free loan—per dollar of tax deferral—depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-free loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.

The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long-run estimates at the level of economic activity for the year in question.

Appendix B:

Tax Provisions Previously Classified as Tax Expenditures

This appendix gathers basic information concerning five federal tax provisions that have previously been treated as tax expenditures. All of these items were excluded from the Tax Expenditure Budgets prepared for fiscal years 2020-2024 by the Joint Committee on Taxation (JCT),⁸ but were included in some previous years' documents.

With respect to each tax provision discussed below, the following information is provided:

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

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

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

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

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

A selected bibliography.

The information presented for each tax expenditure is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory

⁸ U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024*, November 5, 2020 (JCX-23-20).

understanding of the nature, effect, and background of each provision. Useful starting points for further research are listed in the selected bibliography following each provision.

**EXCLUSION OF INVESTMENT INCOME ON LIFE
INSURANCE AND ANNUITY CONTRACTS**

Authorization

Sections 72, 101, and 7702.

Description

Life insurance companies invest premiums they collect, and returns on those investments help pay benefits. Amounts not paid as benefits may be paid as policy dividends or given back to policyholders as cash surrender values or loan values.

Policyholders are not generally taxed on this investment income, commonly called “inside build-up,” as it accumulates. Insurance companies also usually pay no taxes on this investment income. Death benefits for most policies are not taxed at all, and amounts paid as dividends or withdrawn as cash values are taxed only when they exceed total premiums paid for the policy, allowing tax-free investment income to pay part of the cost of the insurance protection. Investment income that accumulates within annuity policies is also free from tax, but annuities are taxed on their investment component when paid.

Life insurance policies must meet tests designed to limit the tax-free accumulation of income. If investment income accumulates faster than is needed to fund the promised benefits, that income will be attributed to the owner of the policy and taxed currently.

Impact

The interest exclusion on life insurance savings allows policyholders to pay for a portion of their personal insurance with tax-free interest income. Although the interest earned is not currently paid to the policyholder, it covers part of the cost of the insurance coverage and it may be received in cash if the

policy is terminated. The tax-free interest income benefit can be substantial, despite limitations imposed on the amount of income that can accumulate tax-free in a contract.

The tax deferral for interest credited to annuity contracts allows taxpayers to save for retirement in a tax-deferred environment without restrictions on the amount that can be invested for these purposes. Although the taxpayer cannot deduct the amounts invested in an annuity, as is the case for contributions to qualified pension plans or some IRAs, the tax deferral on the income credited to life insurance investments can benefit taxpayers significantly.

These provisions thus offer preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies and annuity contracts. Middle-income taxpayers, who make up the bulk of the life insurance market, may reap most of this provision's benefits. Many higher-income taxpayers, once their life insurance requirements are satisfied, generally obtain better after-tax yields from tax-exempt state and local obligations or tax-deferred capital gains. Some very wealthy individuals, however, can gain tax advantages through other forms of life insurance, such as closely held life insurance companies (CHLICs, or CICs) or private placement life insurance (PPLI), which may serve as an intergenerational wealth transfer tool.

Rationale

The exclusion of death benefits paid on life insurance dates back to the 1913 tax law (P.L. 63-16). While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests, which also were excluded from the tax base.

The nontaxable status of the life insurance inside build-up and the tax deferral on annuity investment income also dates from 1913. Floor discussions of the bill made it clear that inside build-up was not taxable, and that amounts received during the life of the insured would be taxed only when they exceeded the investment in the contract (premiums paid), although these points were not included in the law explicitly. These views were, in part, based on the general tax principle of constructive receipt. Policyholders, in this view, did not own the interest income because to receive that interest income they would have to give up the insurance protection or the annuity guarantees. Since the early-1980s, Congress has taken various steps to limit tax-free inside build-up in

certain cases and restricted the favorable treatment of inside build-up to ‘traditional’ life insurance policies from a broader category of ‘investment-oriented’ products.

The inside build-up in several kinds of insurance products was made taxable to the policy owners in the 1980s. For example, corporate-owned policies were included under the minimum tax in the Tax Reform Act of 1986 (P.L. 99-514); and the Deficit Reduction Act of 1984 (P.L. 98-369) and the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) imposed taxes on inside build-up and distributions for policies with an overly large investment component. On the other hand, during consideration of the Tax Reform Act of 1986, Congress rejected a comprehensive proposal included in President Reagan’s tax reform initiative that would have imposed current taxation on all inside build-up in life insurance policies. The President’s Advisory Panel on Federal Tax Reform, which issued its final report in November 2005, recommended elimination of the exemption on life insurance investment earnings. Instead, the Advisory Panel favored savings incentives which would treat various investment vehicles in a more neutral manner.

Assessment

The tax treatment of policy income combined with the tax treatment of life insurance company reserves (see “Special Treatment of Life Insurance Company Reserves,” above) makes investments in life insurance policies virtually tax-free. Cash value life insurance can operate as an investment vehicle that combines life insurance protection with a financial instrument that operates similarly to bank certificates of deposit and mutual fund investments. This exemption of inside build-up distorts investors’ decisions by encouraging them to choose life insurance over competing savings vehicles such as bank accounts, mutual funds, or bonds. The result could be overinvestment in life insurance and excessive levels of life insurance protection relative to what would occur if life insurance products competed on a level playing field with other investment opportunities.

A risk-averse and forward-looking family can use life insurance, in conjunction with investments in stocks and bonds, to hedge against the financial consequences of an unexpected loss of a wage earner. Many families, according to some economists, fail to buy enough life insurance to protect surviving family members from a sharp drop in income and living standards that the death of a wage-earner could cause. Such families, whose financial vulnerabilities are not offset by insurance benefits, may be described as

underinsured. Encouraging families to buy more life insurance could reduce those families' financial vulnerabilities. Whether the tax exemption on life insurance benefits, however, induces families to buy prudent levels of life insurance is unclear. Better financial education, for example, may provide a more direct route to helping families reduce financial vulnerabilities due to death or other serious disruptions.

The practical difficulties of taxing policy owners' inside build-up and the desire to avoid subjecting heirs to a tax on death benefits have discouraged many tax reform proposals covering life insurance. The value of inside build-up, however, could be computed actuarially. The insurer could be tasked with withholding taxes, which the policyholder could then claim as a credit. Taxing at the company level as a proxy for individual income taxation has been suggested as an alternative.

In the 1980s and 1990s, the inside build-up exclusion helped boost the number of corporate-owned life insurance (COLI) policies (also known as "employer-owned life insurance contracts"). Many firms, which had previously bought policies only for key personnel, bought life insurance on large numbers of lower-level employees. Several newspaper articles highlighted purchases of COLI policies bought without employees' knowledge or consent, which have been termed "dead peasant insurance" or "janitor insurance." Many policies, however, were structured so that a corporation would expect to neither gain nor lose from an employee's death.

The IRS argued that such COLI policies served as a tax shelter and successfully sued several major corporations. Those cases limited some of the tax benefits of COLI policies. The Pension Protection Act of 2006 (P.L. 109-280) limited tax benefits of COLI policies on key personnel and to benefits paid to survivors, and requires firms to obtain employees' written consent. Firms with COLI policies generally must report data on IRS Form 8925, *Report of Employer-Owned Life Insurance Contracts*.

The statutory definition of key personnel (26 U.S.C. §101(j)(2)(A)), however, is broadly defined, so that the effect of limiting tax benefits of COLI policies on key personnel may be less than stringent. Such key personnel include the top 35 percent of employees ranked by compensation. Those earning above an inflation-adjusted threshold (\$135,000 for 2022; see 26 U.S.C. §414(q)) also fall within that definition.

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Appendix—Medicare

EXCLUSION OF UNTAXED MEDICARE BENEFITS: HOSPITAL INSURANCE (PART A)

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31.

Description

Part A of Medicare provides hospital insurance (HI) for individuals who are age 65 and over, as well as certain disabled persons and people with kidney failure. HI benefits cover costs of in-patient hospital care, skilled nursing facility care, home health care, and hospice care. In 2022, according to the Congressional Budget Office, an estimated 64 million aged and disabled persons were enrolled in Part A. Mandatory outlays for Part A, before offsets for deductibles and copayments, were estimated to be \$388 billion in 2022. Other components of Medicare provide medical care insurance (Part B), Medicare Advantage plans (Part C), and a prescription drug benefit (Part D).

Medicare Part A is financed primarily by a payroll tax levied on the earnings of current workers. The tax rate is 2.90 percent, and there is no ceiling on the earnings subject to the tax. Self-employed individuals pay the full rate, while employees and employers each pay 1.45 percent. Since 2013, an additional 0.9 percent payroll tax has been levied on wages over \$200,000 for single workers and over \$250,000 for married couples. The revenue from the payroll tax is credited to a trust fund, from which payments are made to health care providers for current Medicare beneficiaries. Individuals contribute to the fund during their working years and obtain eligibility for themselves and their spouses for premium-free Part A benefits during their retirement years once 40 quarters of Medicare-covered employment are completed.

The employer's share of the payroll tax is excluded from an employee's gross income. Moreover, the expected lifetime value of Part A benefits under current law generally exceeds the amount of payroll tax contributions made by

current beneficiaries during their working years. These excess benefits are excluded from the gross income of Part A beneficiaries.

Impact

The value of the untaxed Part A benefit varies among individuals. All Medicare Part A beneficiaries arguably receive the same dollar value of in-kind insurance benefits per year if Part A is viewed as a community-rated insurance program, but the number of years Part A benefits are received depends on a beneficiary's longevity. The accumulated value of payroll tax contributions depends on an individual's work history.

Untaxed benefits tend to be larger for persons who started working before Medicare was established in 1965, for persons who had low taxable wages in their working years or who qualified as a spouse with little or no payroll contributions of their own, and for persons who live a long time. The value of the exclusion of Medicare insurance benefits from income also depends on a beneficiary's marginal income tax rate during retirement.

Rationale

The exclusion of Medicare Part A benefits from the federal income tax has never been established or recognized by statute. The tax code (26 U.S.C. §104(a)) excludes most compensation for injuries and sickness from the definition of gross income. The Internal Revenue Service in 1970 ruled (Rev. Rul. 70-341) that the benefits under Part A of Medicare were in the nature of disbursements intended to achieve the social welfare objectives of the federal government, and hence are excluded from gross income. The ruling also stated that Medicare Part A benefits had the same legal status as monthly Social Security payments to an individual, in determining an individual's gross income under section 61 of the Internal Revenue Code. An earlier IRS ruling (Rev. Rul. 70-217, 1970-1 C.B. 13) determined these payments to be excluded from gross income.

Under the Omnibus Budget Reconciliation Act of 1993 (OBRA93; P.L. 103-66), a portion of the Social Security payments received by taxpayers whose provisional income exceeded certain income thresholds was subject to taxation, and the revenue was deposited in the HI trust fund. A taxpayer's provisional income is his or her adjusted gross income, plus 50 percent of any Social Security benefit and the interest received from tax-exempt bonds. If a taxpayer's provisional income falls between income thresholds of \$25,000 (\$32,000 for a married couple filing jointly) and \$34,000 (\$44,000 for a

married couple), then the portion of Social Security benefits that are taxed is the lesser of 50 percent of the benefits or 50 percent of provisional income above the first threshold. If a taxpayer's provisional income is greater than the second threshold, then the portion of Social Security benefits subject to taxation is the lesser of 85 percent of the benefits or 85 percent of provisional income above the second threshold, plus the smaller of \$4,500 (\$6,000 for married couples) or 50 percent of benefits. (See the entry on the exclusion of untaxed Social Security and Railroad Retirement benefits for details.) The same rules apply to Railroad Retirement tier 1 benefits.

Congress modified the HI payroll tax in 1990 and 1993. Before 1991, the taxable earnings base for Medicare Part A was the same as the earnings base for Social Security. But the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) differentiated the two bases by raising the annual cap on employee earnings subject to the Medicare HI tax to \$125,000 in 1991 and indexing it for inflation in succeeding years. OBRA93 eliminated the cap on wages and self-employment income subject to the Medicare HI tax, as of January 1, 1994. More recently, the Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended) enacted an additional 0.9 percent payroll tax for high-wage earners.

Assessment

The exclusion of the value of Part A benefits lowers the tax burden of Part A beneficiaries. In aggregate, the Joint Committee on Taxation previously estimated the revenue loss at \$180.7 billion over the 2014-2018 budget window. Without that exclusion, some workers might postpone their retirements, which would increase labor force participation in the economy. More generally, pressures for health care cost containment in Part A might have been greater in the absence of the exclusion. The exclusion may also shift income from younger to older generations.

Curtailing this exclusion in an equitable manner, as a means of increasing federal revenue or encouraging stronger health care cost control, would be difficult. Medicare benefits receive the same tax treatment as most other health insurance benefits: they are untaxed. Moreover, changing longstanding practices that would reduce the value of social insurance benefits would complicate retirement planning for those near or in retirement.

For current and future retirees, the share of HI benefits they receive beyond their payroll tax contributions is likely to decrease over time, as the

contribution period will cover more of their work years. The absence of a cap on wages subject to the Medicare HI payroll tax means that today's high-wage earners contribute more during their working years to Medicare and consequently receive a smaller (and possibly negative) subsidy once they begin to receive Part A benefits. Also, income thresholds for the 0.9 percent payroll tax are not indexed for inflation and so will apply to more workers in future years.

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Appendix—Medicare

EXCLUSION OF MEDICARE BENEFITS: SUPPLEMENTARY MEDICAL INSURANCE (PART B)

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31 (citing to section 104(a)).

Description

Part B of Medicare provides coverage for physician services, outpatient hospital services, durable medical equipment, and other services. After a beneficiary satisfies an annual deductible, set at \$233 for 2022, the Part B program generally pays 80 percent of Medicare's fee schedule or other approved amounts for covered services. In 2022, according to CBO projections, 59 million aged and disabled Americans were enrolled in Part B. Mandatory outlays on Part B were estimated at \$475 billion in 2022.

Other components of Medicare provide hospital insurance (Part A), Medicare Advantage plans (Part C), and a prescription drug benefit (Part D). Part B and Part D (discussed in the next section) are part of Supplementary Medical Insurance (SMI). Those eligible for Medicare hospital insurance are generally eligible for SMI. Participation in SMI Parts B and D is voluntary, so that eligible persons may decline to enroll and avoid paying premiums.

Part B beneficiaries' premiums are set to cover 25 percent of estimated Part B program costs for aged enrollees, with the remainder financed by federal general revenues. The 2022 standard monthly premium is \$170.10, which is automatically deducted from Social Security benefit checks of Part B enrollees.

Since 2007, higher-income enrollees pay higher premiums. These premiums range from 35 percent to 80 percent of the value of Part B depending on income levels affecting about 5 percent of Medicare beneficiaries. The income thresholds, based on modified adjusted gross income (MAGI), were indexed to inflation. In 2010, however, income thresholds used to determine

which beneficiaries are subject to higher Part B premium rates were frozen at 2010 levels through 2019, thus increasing the expected number of enrollees paying higher premiums. For 2022, these levels were adjusted for inflation and the thresholds start at a MAGI of \$91,000 for an individual and at \$182,000 for couples filing jointly.

Impact

The tax expenditure associated with this exclusion depends on the marginal tax rates of enrollees and the amount of the subsidy, which is the difference between the value of the benefit and Part B premiums paid. Taxpayers who claim the itemized deduction for medical expenses under section 213 may include any Part B premiums they pay out of pocket or have deducted from their monthly Social Security benefits.

Most enrollees arguably receive the same amount of the subsidy. If one viewed enrollment in Part B as analogous to receipt of a community-rated health insurance plan, so that all enrollees were presumed to receive the same dollar value of in-kind benefits, then the imputed general-fund premium subsidy for SMI would be the same for most eligible individuals. However, in 2022 some enrollees are bifurcated depending on whether the “hold harmless” provision is binding for them. In years where the “hold harmless” provision is not activated, about 95 percent of enrollees pay the same monthly premium. In addition, the roughly 5 percent of Part B enrollees that pay higher premiums—who are generally in higher tax brackets with higher marginal tax rates—have greater tax savings from the exclusion, although income-related premiums offset those gains in part.

The exclusion of Part B benefits from gross income may shift resources from younger to older generations.

Rationale

The exclusion of Medicare Part B benefits has never been expressly stated in statute. Rather, it emerged from two related regulatory rulings by the Internal Revenue Service (IRS). In 1966, the IRS ruled (Rev. Rul. 66-216) that the premiums paid for coverage under Part B may be deducted as a qualified medical expense under section 213. The ruling did not address the tax treatment of the medical benefits received through Part B. The IRS did address that issue four years later when it held (Rev. Rul. 70-341) that Part B benefits could be excluded from taxable income under section 104(a), which excludes

“amounts received through accident and health insurance for personal injuries or sickness.”

Assessment

Medicare benefits are similar to most other health insurance benefits in that they are exempt from taxation. While the tax subsidy for Part B reduces the after-tax cost of medical insurance for retirees, the addition of an income-related premium has partially reduced the tax subsidy for higher-income beneficiaries. The lower after-tax cost of Part B medical insurance might encourage some to switch from employer-provided health insurance to publicly provided Part B coverage by retiring earlier than they otherwise would have, thus reducing labor force participation. In aggregate, the Joint Committee on Taxation previously estimated the revenue loss at \$128.1 billion over the 2014-2018 budget window.

Part B premiums were originally set to cover 50 percent of projected SMI program costs. But between 1975 and 1983, that share gradually shrank to less than 25 percent. From 1984 through 1997, premiums were set to cover 25 percent of program costs under a succession of laws. A provision of the Balanced Budget Act of 1997 (P.L. 105-33) and subsequent amending legislation permanently fixed the Part B monthly premium at 25 percent of projected program costs. The Medicare Modernization Act of 2003 (P.L. 108-173) introduced income-related premiums for Part B, which took effect in 2007.

The introduction of income-related premiums for Part B reduced the tax subsidy for high-income households. Attempts to recapture the subsidy from lower- and middle-income beneficiaries may impose an added tax burden on those who have little flexibility in their budgets to absorb higher taxes.

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Appendix—Medicare

EXCLUSION OF MEDICARE BENEFITS: SUPPLEMENTARY MEDICAL INSURANCE (PART D PRESCRIPTION DRUG BENEFIT)

Authorization

Rev. Rul. 70-341, 1970-2 C.B. 31 (citing to section 104(a)).

Description

Medicare Part D provides an outpatient prescription drug benefit, which went into effect on January 1, 2006. Other components of Medicare provide hospital insurance (Part A), medical services and durable medical equipment (Part B), and Medicare Advantage plans (Part C). The Part D drug benefit is offered through stand-alone private prescription drug plans (PDPs) or through Part C Medicare Advantage (MA) plans that include coverage for outpatient prescription drugs, which are often called MA-PD plans. A smaller number of beneficiaries receive Part D subsidies for drug coverage within employer-based plans.

Medicare beneficiaries obtain the Part D drug benefit by enrolling in one of those plans, which are open to anyone entitled to Medicare Part A and/or enrolled in Medicare Part B. Participation in Part B and Part D, which together comprise Supplementary Medical Insurance (SMI), is voluntary, with the exception of so-called “dual eligibles”—those eligible both for Medicare and Medicaid—and certain other low-income Medicare beneficiaries who are automatically enrolled in a PDP if they do not select one on their own.

In 2022, the standard benefit includes a \$480 deductible. Once that deductible is paid, a beneficiary then pays up to 25 percent of drug costs until out-of-pocket costs of \$7,050 are reached. Once a beneficiary’s out-of-pocket drug costs reach \$7,050, the catastrophic portion of the benefit then applies, and the program covers all drug expenses, except for nominal cost sharing. Most plans, however, feature four or five different cost-sharing tiers for

generic, preferred brand name drugs, other brand name drugs, and specialty drugs. The Part D standard plan originally had a coverage gap between the initial and catastrophic coverage. The Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended) contained provisions to phase out the gap over the period from 2011 through 2020, and the Bipartisan Budget Act of 2018 (P.L. 115-123) moved up the date to 2019.

In 2022, more than 51 million aged and disabled beneficiaries were enrolled in Part D drug plans. Monthly premiums vary among plans and regions. The base premium for 2022 is \$33.37 a month. Beneficiary premiums defray 25.5 percent of the Part D program costs, while general revenues and state contributions finance the rest. The value of Part D drug benefits, net of premiums, is excluded from enrollees' taxable income, just as Medicare Part A and Part B benefits are.

Higher-income Part D enrollees pay higher premiums, just as in Part B. In 2022, individuals whose modified adjusted gross income (MAGI) exceeds \$91,000 for single and \$182,000 for joint filers are subject to higher premium amounts, ranging from 35 percent to 80 percent higher depending on income category. Income thresholds were frozen by the ACA at 2010 levels from 2011 through 2017, thus increasing the expected number of enrollees paying higher premiums. Beneficiaries with incomes below 150 percent of the poverty line can receive low-income subsidies to help pay premiums, cost-sharing, and other out-of-pocket expenses.

According to CBO, mandatory outlays for Medicare Part D are estimated to total \$119 billion in 2022. Program costs reflect the number of enrollees, their health status and drug use, the number of recipients of low-income subsidies, drug prices negotiated between plan sponsors and drug suppliers, the administrative efficiency of plan sponsors, as well as the regional level of competition among plans.

Impact

The exclusion of Part D benefits from gross income reduces the after-tax cost of covered drugs to enrollees. As such, it promotes a central aim of Part D; namely, expanding access to affordable prescription drugs among the Medicare population.

The tax expenditure arising from the exclusion depends on the marginal tax rates of enrollees and the subsidies they receive. Both factors can vary considerably among individuals. The subsidy can be measured as the average

difference between the cost of providing benefits to enrollees and the total premiums they pay. The value of the exclusion was unambiguously greater for enrollees in the higher tax brackets before 2011 when premiums were not adjusted by income. Since 2011, higher-income enrollees have paid higher premiums, which somewhat offsets the exclusion's value. Enrollees who itemize deductions for medical expenses under section 213 may include their payments for Part D premiums.

Rationale

Part D was added to Medicare by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (P.L. 108-173), following years of sporadic debate in Congress over establishing such a benefit. It was intended to expand access to outpatient prescription drugs among the Medicare population, restrain their spending on drugs, and contain program costs through heavy reliance on private competition and enrollee choice. The Medicare Improvements for Patients and Providers Act of 2008 (P.L. 110-275), which became law on July 15, 2008, made some modifications to the Part D program. In 2010, the Patient Protection and Affordable Care Act (ACA; P.L. 111-148, as amended) made several significant changes to the design of the Part D drug benefit. ACA imposed income-related premiums similar to Part B. In addition, ACA included a phaseout of the coverage gap by 2020; and manufacturer discounts of 50 percent for brand-name drugs during the coverage gap, among other changes. The phaseout of the coverage gap was moved up to 2019 by the Bipartisan Budget Act of 2018 (P.L. 115-123). P.L. 117-169, commonly referred to as the Inflation Reduction Act, restructures the Part D standard benefit by (1) modifying enrollee cost sharing and the formula for setting premiums beginning in 2024; (2) reducing the Medicare reinsurance subsidy beginning in 2025; (3) establishing a new manufacturer discount program beginning in 2025; and negotiating prices for some covered drugs beginning in 2026.

The exclusion of Medicare Part D benefits has never been expressly stated in statute. Rather, it emerged from two related regulatory rulings by the Internal Revenue Service (IRS). In 1966, the IRS held in Rev. Rul. 66-216 that premiums paid for coverage under Part B could be deducted as a qualified medical expense under section 213. Four years later, the agency ruled (Rev. Rul. 70-341) that Part B benefits could be excluded from gross income under section 104(a), which excludes "amounts received through accident and health insurance for personal injuries and sickness."

Assessment

Medicare benefits receive the same tax treatment as other health insurance benefits; they are exempt from taxation. In the case of the drug benefit under Part D, this treatment has the effect of reducing the after-tax cost to enrollees of the drugs they use. Making drugs more affordable for beneficiaries is one of the primary objectives of the program. In aggregate, the Joint Committee on Taxation previously estimated the revenue loss at \$41.4 billion over the 2014-2018 budget window.

Some evidence suggests that Part D has made progress towards some of its main objectives. About 70 percent of Medicare beneficiaries were enrolled in a Part D plan and the share of those without drug coverage, including those in employer or other plans, has fallen to about 12 percent. Some evidence suggests that expanded drug coverage reduced hospitalization rates and non-drug medical spending for Medicare beneficiaries who previously had trouble affording drugs.

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EXCLUSION OF CASH PUBLIC ASSISTANCE BENEFITS

Authorization

Numerous IRS rulings, including Revenue Ruling 57-102, C.B. 1957-1, 26; Revenue Ruling 63-136, 1963-2 C.B. 19; and Revenue Ruling 75-271, 1975-2 C.B. 23.

Description

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. The Internal Revenue Service has consistently held, under a “general welfare exclusion,” that payments under governmental social benefit programs for the promotion of the general welfare are not includible in a recipient’s gross income. For a payment to qualify under the general welfare exclusion, the payment must (1) be made from a governmental fund, (2) be for the promotion of the general welfare (that is, based on individual or family need), and (3) not represent compensation for services. Congress has codified specific aspects of the general welfare exclusion: section 139 excludes disaster relief payments, and section 139E excludes Indian general welfare benefits paid by tribes.

The federal government provides public assistance benefits tax free to individuals either in the form of cash transfers or noncash transfers (in-kind benefits such as certain goods and services received free or for an income-scaled charge). Cash payments come from programs such as Temporary Assistance for Needy Families (TANF), which replaced Aid to Families with Dependent Children (AFDC) during FY1997; Supplemental Security Income (SSI) for the aged, blind, or disabled; and the refundable portion of the earned income tax credit and the child tax credit.

Traditionally, the tax benefits from in-kind payments have *not* been included in the tax expenditure budget because of the difficulty of determining

their value to recipients. (However, the Census Bureau publishes estimates of the value and distribution of major noncash welfare benefits.)

Impact

Exclusion of public assistance cash payments from taxation gives no benefit to the poorest recipients and has little impact on the income of many, in the absence of refundable tax credits. This is because the payments are relatively low and many recipients have little if any non-transfer cash income. If cash public assistance payments were made taxable, most recipients still would owe no tax due to insufficient income.

However, some recipients do benefit from the exclusion of public assistance cash payments. They include persons who receive relatively greater cash aid, including aged, blind, and disabled persons enrolled in SSI. Other beneficiaries of the exclusion include persons who have earnings for part of the year and public assistance for the rest of the year (and whose actual annual cash income would exceed the taxable threshold if public assistance were counted). Public assistance benefits are often based on monthly income, and thus families whose fortunes improve during the year generally keep benefits received earlier.

A 2019 CBO report estimated the annual cost of SSI (\$60 billion) and programs that benefit children including TANF (\$33 billion) and the earned income and child tax credits (\$89 billion) would be \$182 billion in 2022. Means-tested health care benefits including Medicaid (\$464 billion) and Medicare Part D Low-Income Subsidy (\$32 billion) were estimated to cost \$496 billion, while SNAP (\$64 billion), child nutrition (\$27 billion), and Pell Grants (\$7 billion) were estimated to total \$98 billion in 2022. Hence, according to CBO, federal spending on ten selected means-tested benefits totaled approximately \$848 billion in 2022.

Rationale

The exclusion of public assistance payments from income is not expressly stated in statute. The IRS rulings providing for the general welfare exclusion reflect a rationale that public assistance provided under government programs should not be taxed when made for the promotion of the general welfare. For federal programs, the reasoning might include that Congress did not intend to tax with one hand what it gives with the other. The exclusion also has the effect of harmonizing the tax treatment of public assistance with

assistance provided by private charitable entities, which is generally a non-taxable gift to the recipient under section 102.

Assessment

Several reasons have been advanced for treating means-tested cash payments as taxable income (eliminating the income tax exclusion). First, excluding these cash payments results in treating persons with the same level of cash income differently. Second, removing the exclusion would not harm the poorest because their total cash income still would be below the income tax thresholds.

Third, the general view of cash welfare has changed. For example, cash benefits to TANF families are not generally viewed as “gifts,” but as payments that impose obligations on parents to work or prepare for work through schooling or training, and many general assistance programs require work. Thus, it may no longer be appropriate in all cases to treat cash welfare transfers similar to gifts for tax purposes. (The SSI program imposes no work obligation, but offers a financial reward for work.)

Fourth, the exclusion of cash public assistance increases the work disincentives inherent in need-tested aid by increasing the marginal tax rate above the statutory tax rate. A recipient who goes to work replaces nontaxable cash with taxable income. The loss in need-tested benefits serves as an additional “tax”, which increases the marginal tax rate above the statutory tax rate.

Fifth, using the tax system to subsidize needy persons without direct spending masks the total cost of aid and is considered economically inefficient.

Sixth, taxing public assistance payments would help to integrate the tax and transfer system. In essence, part of the transfer system could be replaced through use of a negative income tax system.

There are several objections to eliminating the income tax exclusion for means-tested cash transfers. First, cash public assistance programs have the effect of providing guarantees of minimum cash income; these presumably represent target levels of disposable income. Making these benefits taxable might reduce disposable income below the targets.

Second, unless the income tax thresholds were set high enough, some persons deemed needy by their state might be harmed by the change (a

recipient may be subject to federal, state, or local income taxes based on different income thresholds). TANF and SSI minimum income guarantees differ by state, but the federal tax threshold is uniform for taxpayers with the same filing status and family size. If cash public assistance payments were made taxable, the impact would vary among the states.

Third, if cash public assistance payments were made taxable, it is argued that noncash public assistance should also be taxable (raising difficult measurement issues). Further, if noncash means-tested benefits were treated as income, it is argued that other noncash income (such as employer-paid health insurance) should also be taxable.

Fourth, the public might perceive the change (to taxing cash or noncash public assistance) as weakening the social safety net, and, thus, object.

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Appendix C:

Relationship Between Tax Expenditures and Limited Tax Benefits Subject to Line Item Veto

Description

The Line Item Veto Act (P.L. 104-130), enacted in 1996, gave the President the authority to cancel “limited tax benefits.” A limited tax benefit was defined as either a provision that loses revenue and that provides a credit, deduction, exclusion or preference to 100 or fewer beneficiaries, or a provision that provides temporary or permanent transition relief to 10 or fewer beneficiaries in any fiscal year. The act was found unconstitutional in 1998, but there have been subsequent proposals to provide veto authority for certain limited benefits.

Items falling under the revenue losing category did not qualify if the provision treated in the same manner all persons in the same industry, engaged in the same activity, owning the same type of property, or issuing the same type of investment instrument.

A transition provision did not qualify if it simply retained current law for binding contracts or was a technical correction to a previous law (that had no revenue effect).

When the beneficiary was a corporation, partnership, association, trust or estate, the stockholders, partners, association members or beneficiaries of the trust or estate were not counted as beneficiaries. The beneficiary was the taxpayer who is the legal, or statutory, recipient of the benefit.

The Joint Committee on Taxation was responsible for identifying limited tax benefits subject to the line item veto (or indicating that no such benefits exist in a piece of legislation); if no judgment was made, the President could identify such a provision.

The line item veto had taken effect on January 1, 1997. Prior to the law being struck down in 1998, President Clinton used the authority to cancel two tax provisions in the Taxpayer Relief Act of 1997 (P.L. 105-134).

Similarities to Tax Expenditures

Limited tax benefits resemble tax expenditures in some ways, in that they refer to a credit, deduction, exclusion or preference that confers some benefit. Indeed, during the debate about the inclusion of tax provisions in the line item veto legislation, the term “tax expenditures” was frequently invoked. The House initially proposed limiting these provisions to a fixed number of beneficiaries (originally 5, and eventually 100). The Senate bill did not at first include tax provisions, but then included provisions that provided more favorable treatment to a taxpayer or a targeted group of taxpayers.

Such provisions would most likely be considered as tax expenditures, at least conceptually, although they might not be included in the official lists of tax expenditures because of de minimis rules (that is, some provisions that are very small are not included in the tax expenditure budget although they would qualify on conceptual grounds), or they might not be separately identified. This is particularly true in the case of transition rules.

Differences from Tax Expenditures

Most current tax expenditures would probably not qualify as limited tax benefits even if they were newly introduced (the line item veto applied only to newly enacted provisions).

First, many if not most tax expenditures apply to a large number of taxpayers. Provisions benefitting individuals, in particular, would in many cases affect millions of individual taxpayers. Most of these tax expenditures that are large revenue losers are widely used and widely available (e.g., itemized deductions, fringe benefits, exclusions of income transfers).

Provisions that only affect corporations may be more likely to fall under a beneficiary limit; even among these, however, the provisions are generally available for all firms engaged in the same activity.

These observations are consistent with a draft analysis of the Joint Committee on Taxation during consideration of the legislation which included examples of provisions already in the law that might have been classified as limited tax benefits had the line item veto provisions been in effect. Some of

these provisions had at some time been included in the tax expenditure budget, although they were not currently included: the orphan drug tax credit, which is very small, and an international provision involving the allocation of interest, which has since been repealed. (The orphan drug tax credit is currently included in the tax expenditure budget.) Some provisions modifying current tax expenditures might also have been included. But, in general, tax expenditures, even those that would generally be seen as narrow provisions focusing on a certain limited activity, would probably not have been deemed limited tax benefits for purposes of the line item veto.

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